Securities Litigation REPORT

December-January 2006 Vol. 3 No. 1 © Legalworks

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LEGALWORKS

The State of Scienter: A Comparative Survey Ten Years After the Enactment of the Private Securities Litigation Reform Act

Robert W. Perrin, Brian T. Glennon & Julie R. F. Gerchik

[Latham & Watkins LLP partner Robert Perrin and associates Brian Glennon and Julie Gerchik are members of the firm's Securities Litigation and Professional Liability Practice Group and reside in the Los Angeles office. Contact: robert.perrin@lw.com or brian.glennon@lw.com.]

Ten years ago Congress enacted the Private Securities Litigation Reform Act (the "PSLRA") in an effort to counter meritless "strike suits." The legislation had at least two goals: (1) to require a heightened pleading standard for scienter in securities fraud cases brought under Section 10(b) and Rule 10b-5[1]; and (2) to harmonize the previously divergent holdings of the courts of appeal.[2] Prior to the enactment of the PSLRA, the various federal circuits employed widely differing approaches in evaluating the nature and content of the scienter allegations that a plaintiff was required to plead in order to survive a motion to dismiss. For example, the Second Circuit had long held that securities fraud plaintiffs must allege specific facts giving rise to a "strong inference" of scienter – a standard which was satisfied by (among other things) facts demonstrating that a defendant had a motive and the opportunity to commit fraud. At the time, the Second Circuit's standard was considered to be the most stringent in the land. By contrast, the Ninth Circuit allowed plaintiffs to plead scienter generally. Congress was unsatisfied with this discrepancy, as well as the perceived ability of plaintiffs to successfully prosecute strike suits notwithstanding the requirements of Federal Rule of Civil Procedure 9(b).[3] Thus, in 1995 – over President Clinton's veto – Congress amended the 1934 Securities Exchange Act to provide, in relevant part: "In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[4]

To the extent Congress required the courts to adopt a more stringent standard for pleading securities fraud actions nationwide, the PSLRA appears to have been a success. All circuits now apply a standard at least as stringent as that applied by the Second

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From the Editors...

Welcome to the last issue of 2005 and the first issue of 2006 – such is the odd beast that is a December/January double-issue! Of course, a straddling of such a two-month span does allow for a certain amount of reflection over the past year, as well as a speculative estimate of what the new year holds.

Our lead story, for example, performs that straddle well. In fact, authors Robert W. Perrin, Brian T. Glennon and Julie R. F. Gerchik of Latham & Watkins LLP don't just look over the past year in securities litigation – they start a decade back, to when the Private Securities Litigation Reform Act was first passed by Congress. Even now, the authors point out, while the PSLRA did do some of what its proponents had hoped (like tougher pleading standards), the Act has not resulted in uniform standards across all circuit courts. Ten years later, the state of scienter is still being debated.

Elsewhere in this issue, Joseph M. McLaughlin, a partner at Simpson Thacher & Bartlett LLP as well as a member of our board of editors, examines the liability issues surrounding the new offering registration reforms. Specifically, he analyzes how the new rule changes will affect liability (under Sections 11 and 12(a)(2) of the Securities Act of 1933) in regard to which purchasers of a registered offering have rights of action for misstatements, omissions or materially misleading statements.

Also, authors Frank Aquila and Lisa DiNoto, of Sullivan & Cromwell LLP, describe the environment for acquisitions of U.S. assets in the wake of the failure of China's CNOOC's bid for Unocal Corp. and several recent court decisions. The authors ask the question that may be on many deal-lawyers' minds when considering offers from foreign buyers – Where does our clients' loyalty lie? With shareholders, or with the United States' national interests? And can the two be reconciled? Fascinating reading here.

Finally, if you have any comments or suggestions – or story ideas! – for *Securities Litigation Report*, please do not hesitate to contact our Managing Editor, Gregg Wirth. He can be reached at gregg@gwirth.com.

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Securities Litigation Report

Legalworks
395 Hudson Street, 3rd Floor
New York, NY 10014

One year subscription,
10 issues, $395

Please address all editorial, subscription, and other correspondence to the publishers at west.legalworkspublications@thomson.com

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Circuit before the adoption of the PSLRA. To the extent Congress intended the statute to produce uniformity in pleading scienter across the circuits, however, the success of the PSLRA is far less clear. On one hand, every circuit to consider the issue has recognized that scienter may be established for pleading purposes by particularized factual allegations establishing a heightened degree of "recklessness" that exceeds a gross negligence standard. On the other hand, a survey of recent circuit court decisions reveals that there are still significant differences in how the various circuits analyze the pleading of scienter – differences primarily resulting from a disagreement over the extent to which Congress intended to codify the Second Circuit's pre-existing pleading standards. Perhaps the most notable area of disagreement among the circuits concerns the issue of whether a plaintiff may establish the required "strong inference" of scienter by alleging facts demonstrating that a defendant had a motive and the opportunity to commit fraud. To date, there are at least three different schools of thought on this particular issue: one which allows a plaintiff to establish the "strong inference" requirement by pleading motive and opportunity; another which holds that motive and opportunity allegations by themselves can never be enough to establish scienter; and a third which purports to apply a case-by-case approach in which it is theoretically possible that motive and opportunity allegations, if pled in sufficient detail, might establish scienter.

The Second and Third Circuits: Allegations of Motive and Opportunity Are Still Sufficient

Today, the Second and Third Circuits allow (as the Second Circuit historically allowed) scienter to be pled through particularized allegations establishing either (1) strong circumstantial evidence of conscious misbehavior or recklessness, or (2) facts showing that a defendant had both the motive and opportunity to commit securities fraud.[5] With respect to the recklessness standard, the Second and Third Circuits continue to apply a definition of "recklessness" very similar in substance to that employed by the Second Circuit prior to the enactment of the PSLRA.[6] The same is true regarding the "motive and opportunity" prong: Although these courts are quick to point out that a plaintiff cannot establish scienter merely by incanting the words "motive and opportunity," they recognize that the same factual allegations that established scienter in the Second Circuit pre-PSLRA generally will overcome an attack on the pleadings today. Accordingly, both circuits regularly cite to and draw upon pre-PSLRA cases from the Second Circuit in analyzing the sufficiency of the scienter allegations in contemporary securities fraud cases.[7]

This is because both the Second and Third Circuits have held that – with the exception of the new "with particularity" requirement – the PSLRA effectively raised the nationwide pleading standard to that "previously existing" in the Second Circuit, and no higher.[8] There is significant support for this proposition in the Congressional Record. After all, the PSLRA specifically incorporated the "strong inference" language previously employed by the Second Circuit to define the standard for pleading scienter in securities fraud cases. Moreover, the Senate Committee that reported the bill observed that it was not proposing "a new and untested pleading standard that would generate additional litigation," but instead, "a uniform standard modeled upon the pleading standard of the Second Circuit."[9] The Second and Third Circuits have interpreted this legislative history as revealing an intent merely to codify the pre-existing Second Circuit standard.

Even as the PSLRA thus did not alter the courts' use of the "motive and opportunity" test in the Second Circuit, the years following the PSLRA's enactment have seen the term "motive" become defined with much greater precision. To establish motive, a plaintiff must allege facts demonstrating a "concrete and personal benefit" that could be realized through the alleged fraud, and motives that generally are possessed by most corporate insiders are insufficient as a matter of law.[10] Thus, the desire to appear profitable,[11] keep stock prices high,[12] hide a poorly performing subsidiary,[13] maintain a high credit rating,[14] avoid personal liability[15] and maintain a seat on the board of directors,[16] have been considered and rejected as independent bases for satisfying the "motive" prong of the "motive and opportunity" test. Indeed, the stringency of the "motive and opportunity" test often depends upon the heightened "motive" requirement, as the "opportunity" prong usually is satisfied in issuer cases.[17]

The Ninth Circuit Standard: Allegations of Motive and Opportunity Are Not Enough

Although once viewed as having the most lenient standard in the nation, the Ninth Circuit now sits at the opposite end of the spectrum, at least insofar as pleading scienter is concerned. Indeed, in applying the PSLRA, the Ninth Circuit has rejected the "motive and opportunity" test altogether, even though that test is still accepted as a method of pleading scienter in the Second and Third Circuits. Instead, a plaintiff alleging securities fraud in the Ninth Circuit must plead, at a minimum, detailed facts constituting strong circumstantial evidence of "deliberate recklessness."[18] Pre-PSLRA, the Ninth Circuit had held that recklessness satisfied the scienter element in Section 10(b) cases, and historically had even adopted a definition of "recklessness" similar to that currently used by the other circuit courts.[19] After the PSLRA, the Ninth Circuit now defines "*deliberate* recklessness" as consisting of "facts that come closer to demonstrating *intent*, as opposed to mere motive and opportunity."[20] While factual allegations tending to show motive and opportunity to commit fraud may provide some "reasonable inference" of intent which may assist a plaintiff in meeting the "deliberate recklessness" pleading burden, the Ninth Circuit has concluded that such allegations standing alone are insufficient to satisfy the required "strong inference of scienter."[21]

Like the Second and Third Circuits, the Ninth Circuit also draws support for its view of the requisite pleading standard from the PSLRA's legislative history. According to the Ninth Circuit, the legislative history demonstrates Congress' intent to raise the pleading standard *above* that employed by the Second Circuit at the time.[22] By way of example, Congress refused to adopt the Specter Amendment, a provision which would have (among other things) specifically incorporated the Second Circuit's "motive and opportunity" test into the PSLRA.[23] Furthermore, the joint conference committee – consisting of managers from the House and Senate charged with reconciling the differences between the two bills – stated that it intended to "strengthen existing pleading requirements, [and] it [did] not intend to codify the Second Circuit's case law interpreting this pleading standard."[24] Moreover, in his veto message to Congress, President Clinton explained: "I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit – the highest pleading standards of any Federal circuit court. But the conferees make crystal clear . . . their intent to raise the standard even beyond that level."[25] Of course, Congress overrode the President's veto and enacted the PSLRA without further modification, but also without further clarifying whether the President's characterization was accurate.

The Emerging Middle Ground: Allegations of Motive and Opportunity *May* Be Sufficient

Between these two views, a third standard has emerged which appears to have gained traction with a majority of the remaining circuits. This analysis, originally articulated by the Sixth Circuit, neither adopts the "motive and opportunity" test which remains viable in the Second and Third Circuits, nor categorically rejects that test as the Ninth Circuit has done, but instead finds middle ground. For better or for worse, these courts have eschewed viewing scienter allegations under a uniform test, and instead determine the adequacy of scienter allegations by engaging in a more "fact-sensitive" inquiry that looks to the totality of the allegations to determine if the PSLRA's heightened scienter standards are met.[26]

In keeping with its sister circuits, the Sixth Circuit has acknowledged that a plaintiff may establish scienter by alleging recklessness, defined as "highly unreasonable conduct" representing "an extreme departure from the standards of ordinary care" which is akin to "conscious disregard."[27] Unlike the Second and Third Circuits, however, the Sixth Circuit has not adopted the "motive and opportunity" test as a co-equal method for pleading scienter.[28] Instead, the Sixth Circuit has held that "the bare pleading of motive and opportunity does not, standing alone, constitute the pleading of a strong inference of scienter."[29] Although the Sixth Circuit is similar to the Ninth Circuit in this respect, the Sixth Circuit differs from the Ninth Circuit in that it has left open the possibility that detailed allegations of motive and opportunity might be sufficient if they "simultaneously establish that the defendant acted recklessly or knowingly, or with the requisite state of mind."[30] Put another way, while simply alleging that a defendant has the motive and opportunity to commit fraud clearly is insufficient to plead a claim, the Sixth Circuit has suggested that facts demonstrating motive and opportunity might be pled in sufficient detail to create an inference of "recklessness" sufficient to plead scienter under the PSLRA.

Oddly enough, the Sixth Circuit also has turned to the legislative history of the PSLRA as a source of support for this fact-driven scienter test. The Sixth Circuit relies heavily on the fact that the PSLRA itself does not specifically endorse – nor for that matter prohibit – any particular test. Thus, even as the legislative history suggests that Congress intended for the PSLRA to produce a uniform (and more stringent) scienter pleading standard nationwide,[31] the Sixth Circuit attaches significance to the fact that Congress opted not to endorse any particular formulation. Instead, it appears that Congress decided to leave it to the courts to decide, rather than committing the courts to a single, rigid test for establishing the pleading requirements for scienter.[32]

The majority of other circuits appear to be following the Sixth Circuit's "middle ground" approach to varying degrees with respect to the role motive and opportunity plays in pleading scienter. These courts have employed a similar "totality of the allegations" test, and each has acknowledged that motive and opportunity are "relevant" or "important" to the analysis without going so far as definitively holding that such facts are sufficient (or insufficient) to give rise to a strong inference of the required state of mind.

For instance, the First Circuit has followed the Sixth Circuit both in holding that "merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough,"[33] but simultaneously rejecting arguments that motive and opportunity can *never* be enough to permit the drawing of a strong inference of scienter.[34] The Fourth Circuit also has held that while motive and opportunity might be relevant to a plaintiff's burden to plead facts giving rise to a "strong inference" of recklessness, the proper inquiry should not focus on the "type" of facts alleged, but whether all of the facts considered collectively satisfy the pleading requirements under the PSLRA.[35] The Tenth and Eleventh Circuits also employ a "totality of the pleadings" analysis, and both circuits have held that "formalistic" categories of allegations should not somehow frame or limit the discussion of scienter.[36] By the same token, these courts also have acknowledged that motive and opportunity are relevant to the scienter analysis, but a plaintiff must do more than simply recite the mantra of "motive and opportunity" to satisfy the PSLRA. Finally, the Eighth Circuit has adopted a similar test, but like the Second Circuit,[37] it has assigned enough weight to the importance of pleading motive that if a plaintiff fails to establish motive, the facts alleged in support of the defendant's recklessness must be "particularly strong."[38]

It additionally bears noting that their treatment of "motive and opportunity" allegations aside, the circuits employing the "totality of the allegations" standard have defined recklessness in a similar fashion as the Second and Third Circuits. Thus, there is a considerable degree of uniformity throughout the circuit courts in defining recklessness as constituting an "extreme departure" from ordinary standards of care. The Fifth and Eleventh Circuits have espoused a "severe" recklessness standard, defined as "limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."[39] The First, Fourth, Seventh, Eighth and Tenth Circuits have maintained that recklessness alone (as opposed to "severe" recklessness) will suffice, but have defined "recklessness" generally as "an act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[40] Thus, while there inevitably are differences in the stringency of application of these standards by different courts, the definitions associated with recklessness in the vast majority of the circuits are very much the same.

Conclusion

Congress' goals of both strengthening and harmonizing the scienter pleading standards by enacting the PSLRA remain only partially realized. Consistent with Congress' objectives, the circuit courts all have implemented pleading requirements that, at a minimum, are at least as strong as those endorsed by the Second Circuit prior to the enactment of the PSLRA. But while all of the circuits agree that a plaintiff may satisfy the "strong inference" requirement by alleging a heightened degree of recklessness, the courts continue to disagree on the application of the "motive and opportunity" test and the extent to which Congress intended to adopt this Second Circuit standard in enacting the PSLRA. In leaving the task of actually defining the threshold for establishing scienter in issuer cases to the courts, Congress may have hoped that the courts would settle on a uniform pleading standard, but this has not occurred. As a result, the courts of appeal have adopted at least three distinct standards for pleading scienter, and the legislative history of the PSLRA can be invoked in support of all three tests. Thus, similar to the period before the enactment of the PSLRA, whether a securities fraud complaint adequately pleads scienter potentially may hinge as much on the jurisdiction in which it is filed as it does on the particular types of facts it alleges.

Notes

1 *See* 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

2 *See* H.R. Conf. Rep. No. 104-369, at 41 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 740.

3 *See, e.g.*, Sherrie R. Savett, *Securities Class Actions Since the 1995 Reform Act: A Plaintiff's Perspective*, 1442 Practicing L. Inst. Corp. L. & Practice Course Handbook Series 13, 19-20 (2004).

4 15 U.S.C. § 78u-4(b)(2).

5 *See In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 148-49 (3d Cir. 2004); *Novak v. Kasaks*, 216 F.3d 300, 309-11 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

6 *See Novak*, 216 F.3d at 308 (defining recklessness as "at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it'") (quoting *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978)); *see also Alpharma*, 372 F.3d at 148 (defining "scienter" as including "at a minimum, highly unreasonable (conduct), involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it").

7 *See, e.g.*, *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (quoting *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)).

8 *See Novak*, 216 F.3d at 310.

9 *See* S.Rep. No. 104-98, at 15 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 694.

10 *See Novak*, 216 F.3d at 307.

11 *See Rombach v. Chang*, 355 F.3d 164, 177 (2d Cir. 2004).

12 *See Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995).

13 *See Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

14 *See San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 805, 815 (2d Cir. 1996).

15 *See Kalnit v. Eichler*, 264 F.3d 131, 140 (2d Cir. 2001)

16 *Id.*

17 Although the Seventh Circuit has indicated that allegations of recklessness will suffice to establish scienter at the pleadings stage (*see, e.g., Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 650 n.7 (7th Cir. 1997)), the court has not yet addressed the extent to which a plaintiff may rely upon motive

and opportunity to establish a strong inference of the required state of mind. The district courts in the Seventh Circuit, however, appear to be following the standard adopted by the Second and Third Circuits, which allows plaintiffs to plead scienter by alleging (among other things) facts demonstrating a motive and opportunity to commit fraud. *See, e.g.*, *Davis v. SPSS, Inc.*, 2005 U.S. Dist. LEXIS 9497, at *37 (N.D. Ill. May 10, 2005); *In re Motorola Sec. Litig.*, 2004 U.S. Dist. LEXIS 16857, at *87-88 (N.D. Ill. Aug. 25, 2004).

18 *Janas v. McCracken* (*In re Silicon Graphics Inc. Sec. Litig.*), 183 F.3d 970, 974 (9th Cir. 1999).

19 *Id.* at 976 ("Reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.") (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc)).

20 *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 389 (9th Cir. 2002) (quoting *Silicon Graphics*, 183 F.3d at 974) (emphasis added).

21 *Id.*

22 *See Silicon Graphics*, 183 F.3d at 977.

23 *See* 141 Cong. Rec. S9, 170 (daily ed. June 27, 1995); H.R. Conf. Rep. 104-369, at 41.

24 *See* H.R. Conf. Rep. 104-369, at 41; *see also* S. Rep. 104-98, at 15.

25 *Silicon Graphics*, 183 F.3d at 979 (quoting 141 Cong. Rec. H15, 214 (daily ed. Dec. 10, 1995)).

26 *See Helwig v. Vencor, Inc.*, 251 F.3d 540, 550 (6th Cir. 2001); *Hoffman v. Comshare, Inc.* (*In re Comshare, Inc. Sec. Litig.*), 183 F.3d 542, 549 (6th Cir. 1999).

27 *See Helwig*, 251 F.3d at 551.

28 Although there are some similarities between the Sixth Circuit's approach and the standard adopted by the Ninth Circuit, the Sixth Circuit has not gone so far as to require a securities fraud plaintiff to allege "deliberate recklessness."

29 *Comshare*, 183 F.3d at 551 (quoting *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979)).

30 *Id.*

31 *See* H.R. Conf. Rep. No. 104-369, at 41 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 740.

32 *See, e.g.*, 141 Cong. Rec. S9, 201 (daily ed. June 28, 1995) (statement of Sen. D'Amato).

33 *See Greebel v. FTP Software, Inc.* 194 F.3d 185, 197 (1st Cir. 1999).

34 *Id.*

35 *See Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003).

36 *City of Phila. v. Fleming Cos.*, 264 F.3d 1245, 1263 (10th Cir. 2001); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285-86 (11th Cir. 1999).

37 *See Kalnit*, 264 F.3d at 142.

38 *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001).

39 *Bryant*, 187 F.3d at 1282 n.18 (quoting *Broad v. Rockwell Int'l. Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc)); *see also Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001).

40 *Ottmann*, 353 F.3d at 343 (quoting *Phillips v. LCI Int'l Inc.*, 190 F.3d 609, 621 (4th Cir. 1999)).

Liability Considerations of Securities Offering Reform

Joseph M. McLaughlin

[Joseph M. McLaughlin is a partner at Simpson Thacher & Bartlett LLP. Contact: jmclaughlin@stblaw.com.]

Effective December 1, the Securities and Exchange Commission adopted a variety of new and amended rules constituting the most comprehensive reform of the registration, communication and offering processes for issuers of registered securities since the introduction of shelf registration in the early 1980s. Generally, the new rules streamline and simplify the requirements for the shelf registration process and certain other types of registered offerings, expand the written and electronic communications the issuer and offering participants can make before and during such offerings, and liberalize the means by which information may be provided to investors in registered offerings. This article examines how the new rules change, in certain respects, the liability framework under Sections 11 and 12(a)(2) of the Securities Act of 1933, under which purchasers of an issuer's securities in a registered offering have private rights of action for misstatements or omissions in a registration statement (§11) and materially misleading statements in prospectuses or oral communications soliciting a sale in a public offering (§12).

Liability Under Sections 12(a)(2) and 17 (a)(2)

The most significant development is the SEC's interpretation of the time at which the Section 12(a)(2) and 17(a)(2) liability of offering participants will be determined. Section 12(a)(2) allows a purchaser of a security in a public offering to bring a private action against a seller that "offers or sells a security ... by means of a prospectus or oral communication, which includes" a material misstatement or omission,[1] and 17(a)(2) is the general antifraud provision of the Securities Act, but has no private right of action. Section 12(a)(2) entitles the purchaser to rescission, or if they have already sold the security, to damages, subject to the defendant's right to prove that the misstatements or omissions did not cause the loss.[2]

The SEC noted that the final prospectus for an offering usually is not available until after an investor decides to and then agrees to purchase a security. In order to bolster investor protection concerning information about the issuer and the securities received at or before the time of contractual commitment to purchase, the SEC adopted new Rule 159, which codifies the SEC's interpretation that Section 12(a)(2) disclosure liability is determined at the time of the contract of sale, not the time when the final prospectus is available. Fixing the moment of "time of sale" has often proved elusive. Generally, that time is deemed to be when the purchaser either (i) enters into the contract (including acceptance by the seller of an offer) or (ii) completes the sale. For purposes of determining liability under Section 11 of the Securities Act, however, the relevant time remains when the registration statement became effective.

The SEC also confirmed that Sections 12(a)(2) and 17(a)(2) do not require that oral statements or a prospectus contain all the information required under line-item disclosure rules, or otherwise contain all material information. Rather, these provisions require only that whatever disclosures are made at or before the time of sale contain no material misstatements or omissions. As before, whether information has been "conveyed" to an investor at the time of the contract of sale is a fact-specific matter. In the adopting releases, the SEC confirmed its view that the standard is what information is reasonably available to the investor, not what that investor actually knew. Accordingly, information can be conveyed in numerous ways, including through a free writing prospectus, an EDGAR filing and even orally.

To be material, there must be a substantial likelihood that an allegedly misrepresented or omitted fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[3] For liability purposes under Section 12(a)(2) or 17(a)(2) as to an oral communication, prospectus or statement, the SEC has clarified that it will consider the total mix of information available to the investor at the time of sale. The SEC expressly stated that because liability under Section 12(a)(2) attaches to information "conveyed" at or before the time of sale -- and not (as for §11) at the time of effectiveness of the registration statement -- this means that under Section12(a)(2) information delivered to the investor only after the time of sale will be disregarded for purposes of evaluating the total mix of available information, unless a new contract of sale was entered into with the purchaser after the additional information was made available. Consequently, the practice among some offering participants of assuming that potential Section 12(a)(2) liability could be avoided or mitigated by curative disclosures included in a final prospectus, prospectus supplement, or Exchange Act filing that is filed or delivered subsequent to the time of sale has been rejected by the SEC. However, information contained in a prospectus or prospectus supplement that is part of a registration statement filed after the time of sale will be part of a registration statement for purposes of liability under Section 11 at the time of effectiveness.

The reforms regarding timing of Section 12(a)(2) liability pose challenges to offering participants who may need to provide late-breaking material developments to investors (particularly changes to price-related information). In the adopting release, the SEC confirmed that a seller may correct materially misleading information provided at the time of sale and avoid Section 12(a)(2) liability by making additional disclosure to the investor, and obtaining informed agreement from the investor to terminate the existing contract and enter into a new contract of sale. If such agreement is secured, the time of contract of sale for Rule 159 purposes will be the time of the new contract. The SEC emphasized that this termination and reformation approach comports with the anti-waiver of rights provisions of the securities laws only if the investor is clearly advised of its right to terminate the existing contract and, after adequate corrective disclosure is made, elects to enter into a new contract.

The focus on the time of the contract of sale also will affect the marketing of registered offerings. If a preliminary prospectus is distributed, or in the event of a shelf offering, a base prospectus is available at the time of contract of sale, the offering participants must make every effort to complete due diligence before pricing and must have great confidence that such a prospectus is not materially misleading.

Issuer is Seller

Liability under Section 12(a)(2) extends only to a narrow group: those who are identified by a particular plaintiff as having sold or solicited the purchase of the securities at issue to that particular plaintiff.[4] Conclusory allegations that a defendant solicited the sale of stock and was motivated by financial gain to do so are insufficient to state a Section 12(a)(2) claim.[5] Courts have reached divergent conclusions on whether signing a registration statement constitutes the direct and active solicitation of the immediate sale needed to allege a Section 12(a)(2) claim.[6] But in a firm commitment offering, in which the underwriters contractually agree to purchase all of the offering shares from the issuer, the law was fairly clear that purchasers had no Section 12(a)(2) claim against the issuer as *seller* because an underwriter actually sold the securities to the purchaser.[7] New Rule 159A provides that for purposes of Section 12(a)(2), regardless of the form of underwriting, the issuer in a primary offering is considered a "seller" to a purchaser in the initial distribution of the securities as to certain enumerated types of communication made by or on behalf of the issuer. The communications as to which the issuer will be considered a seller could be summarized as those over which the issuer has control: (i) the registration statement and any preliminary prospectus or prospectus supplement relating to the offering filed pursuant to Securities Act Rules 424 or Rule 497; (ii) any free writing prospectus relating to the offering prepared by or on behalf of or used or referred to by the issuer; (iii) the portion of any other free writing prospectus concerning the offering containing material information about the issuer or its securities provided by or on behalf of the issuer; or (iv) any other communication made by or on behalf of the issuer. The SEC has clarified that an underwriter or dealer participating in an offering is not acting "on behalf of the issuer" simply by virtue of that participation. Of course, depending on the extent of issuer involvement, an underwriter communication might be on behalf of the issuer to the extent the communication disseminates issuer information. Nothing in the new rules affect the rule that only purchasers in the offering and not aftermarket purchasers, have standing to assert a Section 12(a)(2) claim.

All issuers and offering participants are permitted to use free writing prospectuses after the filing of the registration statement, subject to enumerated conditions. Because a free writing prospectus expressly is defined as a written offer to sell or the solicitation of an offer to buy securities relating to a registered offering that is used after the registration statement concerning the offering is filed, a free writing prospectus containing material misstatements or omissions may give rise to liability under securities law provisions that reach oral offers and statutory prospectuses, such as Section 12(a)(2). Because a free writing prospectus ordinarily is not filed as part of the registration statement, however, it will not form the basis for Section 11 liability unless the issuer decides to incorporate the free writing prospectus in the registration statement. Written communications not constituting prospectuses should not be subject to disclosure liability applicable to prospectuses under Section 12(a)(2), but the new SEC rules will not affect the status of such communications for liability purposes under other provisions of the securities laws, such as Rule 10b-5.

Timing of Section 11 liability

Section 11 of the Securities Act provides a private remedy for purchasers of a security in a registered offering against the issuer, signing officers, directors, auditors and other experts, and underwriters if "any part of the registration statement [including the prospectus], when such part became effective," contained a material misstatement or omission.[8] Section 11 imposes virtually strict liability; defendants may be liable for innocent or negligent material misstatements or omissions, subject to an affirmative defense of negative causation in which a defendant may avoid liability by proving that the decline in the value of a security was not caused by any material omissions or misstatements in the registration statement, and as to defendants other than the issuer, due diligence and reliance defenses.

New Rule 430 codifies the principle that primary shelf-eligible and automatic shelf issuers may omit from a base prospectus in delayed offerings on Form S-3 or F-3 information that is unknown or not reasonably available to the issuer. Information omitted from the base prospectus may be disclosed in a prospectus supplement, but Rule 430B provides that information included in a prospectus supplement is deemed part of the related registration statement for purposes of Section 11 liability as follows: (i) for a prospectus supplement not filed in connection with a shelf registration takedown, information in the prospectus supplement is deemed part of the registration statement as of the date that the prospectus supplement is first used[9] (*i.e.*, the date the supplement is first available to the managing underwriter or syndicate members); (ii) if a prospectus supplement is filed in connection with a shelf registration takedown, information in the prospectus supplement is deemed part of the registration statement as of the earlier of the date it is first used or the time of the first contract of sale of securities in the offering to which the prospectus supplement relates.[10]

Rule 430B also establishes a new effective date for purposes of issuer shelf registration statement liability under Section 11, conforming it to the underwriters' liability date. Now, for issuers and underwriters the effective date is the date a prospectus supplement filed in connection with the shelf takedown is deemed part of the relevant registration statement, *i.e.*, the earlier of the date of first use of the prospectus supplement or the time of the first contract of sale of securities in the offering. The SEC declined to change the effective date for Section 11 liability purposes of signing officers, directors and experts. These individuals' Section 11 liability continues to be evaluated at the later of the effective date of the registration statement or the date of the most recent annual report containing audited financial statements on Form 10-K or 20-F. This incongruity in the dates at which participants' liability is determined in shelf takedowns will mean that the due diligence investigation of directors and signing officers usually will focus on the 10-K process, while the diligence efforts on behalf of issuers and underwriters will focus on the time of shelf takedown.

Accordingly, in a shelf takedown, Section 11 liability may attach to a registration statement that would be deemed to include the final prospectus supplement. This approach contrasts with liability under Section 12(a)(2) and Section 17(a)(2) which, under the SEC's interpretation, is determined based on the disclosure available to the investor at the time of the contract of sale, which may occur prior to the availability of the final prospectus supplement. This interpretation would require a seller seeking to have disclosures in the final prospectus taken into account for Section 12(a)(2) and 17(a)(2) purposes either to defer contract of sale until delivery of the final prospectus or obtain purchasers' informed agreement to enter into a new contract of sale after the final prospectus is available.

Notes

1 15 U.S.C. § 77l(a)(2).
2 15 U.S.C. § 77l(b).
3 *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).
4 *Pinter v. Dahl*, 486 U.S. 622, 647 (1988).
5 *In re CNL Hotels & Resorts, Inc.* 2005 WL 2291729, at *5 (M.D. Fla. Sept. 20, 2005).
6 Compare *In re Musicmaker.com Sec. Litig.*, 2001 WL 34062431, at *14 n.9 (C.D. Cal. 2001) ("merely signing the registration statement is not sufficient to make a person a seller under §12, and that therefore an allegation that defendant signed the registration statement is not sufficient for purposes of stating a claim under §12"); with *Kensington Cap. Mgt. v. Oakley, Inc.*, 1999 WL 816964, at *4 (C.D. Cal. 1999) (holding that by signing a registration statement, individual defendants had solicited the public to buy securities).
7 *Rosensweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003); *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp.2d 628, 659-60 (S.D.N.Y. 2004).
8 15 U.S.C. § 77k(a).
9 17 C.F.R. § 230.430C(a).
10 17 C.F.R. § 230.430B(f).

Institutional Shareholder Services Outlines Proxy Voting Policies

Patrick S. McGurn and ISS Staff

Patrick McGurn, executive vice president and special counsel at Institutional Shareholders Services, Inc. (ISS), recently spoke at the 27th Annual Institute on Proxy Statements, Annual Meetings & Critical Corporate Disclosures, sponsored by Legalworks.

At the conference, McGurn outlined his firm's proxy voting policies for the coming year. According to its website, "ISS serves more than 1,600 institutional and corporate clients worldwide with its core business — analyzing proxies and issuing informed research and objective vote recommendations for more than 33,000 companies across 115 markets worldwide."

McGurn's presentation and ISS – in more detailed text available on its website –outlined the firm's policies toward corporate boards as follows:

Overboarded Directors

Current Policy Position: ISS currently recommends WITHHOLDING from director nominees who are: 1) CEOs of publicly-traded companies who serve on more than three public boards (i.e. more than two public boards other than their own board) except at the company in which they serve as CEO; and 2) Non-CEOs who serve on more than six public company boards. ISS currently indicates in its analysis that it may consider recommending withholding votes in the future for overboarded CEOs at the company in which they presently serve as the CEO.

New Policy Position: ISS will continue to recommend WITHHOLDING from director nominees who are: 1) CEOs of publicly-traded companies who serve on more than three public boards (i.e. more than two public boards other than their own board); and 2) Non-CEOs who serve on more than six public company boards. However, ISS will recommend WITHHOLDING votes from overboarded CEO directors (defined as more than three boards) only at their outside directorships and not at the company in which they presently serve as CEO.

Rationale for Update: While CEOs benefit from their exposure to other company boards, the time demands of their full-time jobs limit the number of outside commitments they can manage without compromising their effectiveness as CEOs and as outside directors. Considering the increased oversight and regulatory demands facing board members, ISS believes that directors who are overextended may be jeopardizing their ability to serve as effective representatives of shareholders. However, ISS believes that the remedy for an overextended CEO is to decrease the number of outside boards and to focus on their role at their home company. As such, while ISS will not recommend WITHHOLDING votes at an overboarded CEO's home company, ISS will continue to encourage boards to limit the commitments of their CEO with respect to outside directorships.

Majority Threshold Voting for Director Elections

Current Policy Position: Generally recommend a vote FOR precatory resolutions calling for majority voting thresholds for director elections.

New Policy Position: ISS will generally recommend FOR reasonably crafted shareholders proposals calling for directors to be elected with an affirmative majority of votes cast and/or the elimination of the plurality standard for electing directors (including binding resolutions requesting that the board amend the company's bylaws), provided the proposal includes a carve-out for a plurality voting standard when there are more director nominees than board seats (e.g. contested elections).

ISS will consider recommending AGAINST a shareholder proposal if the company has adopted formal corporate governance principles that present a meaningful alternative to the majority voting standard and provide an adequate response to both new nominees as well as incumbent nominees who fail to receive a majority of votes cast.

Policies should address the specific circumstances of each company. At a minimum, a company's policy should articulate the following elements to adequately address each director nominee who fails to receive an affirmative of majority of votes cast in an election:

- Established guidelines disclosed annually in the proxy statement concerning the process to follow for nominees who receive majority withhold votes;
- The policy needs to outline a clear and reasonable timetable for all decision-making regarding the nominee's status;
- The policy needs to specify that the process of determining the nominee's status will be managed by independent directors and must exclude the nominee in question;
- An outline of a range of remedies that can be considered concerning the nominee needs to be in the policy (for example, acceptance of the resignation, maintaining the director but curing the underlying causes of the withheld votes, etc.);
- The final decision on the nominee's status should be promptly disclosed via an SEC filing. The policy needs to include the timeframe in which the decision will be disclosed and a full explanation of how the decision was reached.

In addition, the company should articulate to shareholders why this alternative to a full majority threshold voting standard is the best structure at this time for demonstrating accountability to shareholders. ISS will also evaluate the company's history of accountability to shareholders in its governance structure and in its actions. In particular, a classified board structure or a history of ignoring majority supported shareholder proposals will be considered at a company which receives a shareholder proposal requesting the elimination of plurality voting in favor of majority threshold for electing directors.

Rationale for Update: Shareholders have expressed strong support for precatory shareholders on majority threshold voting in 2005. Of the 60 shareholder proposals on this issue last season, 16 received a majority of the shares cast. The average level of support was 44%. ISS believes shareholders should have a greater voice in regard to the election of directors and believes majority threshold voting represents a viable alternative to the current plurality system in the U.S.

Performance Test for Directors

Current Policy Position: ISS does not apply a systematic performance overlay for vote recommendations with regard to director elections. Vote recommendations for director nominees are primarily based on an individual director's relationship to or interaction with the company, e.g. independence, attendance, etc.

New Policy Position: ISS will adopt a CASE-BY-CASE policy on all director nominees at companies that fail to meet a predetermined performance test for issuers within the Russell 3000 index. In applying our policy, ISS will take into consideration the circumstances surrounding these companies on a case-by-case basis.

<u>TEST</u>: The worst performers within each industry group (GICS) based on a weighted average TSR. The weightings are as follows:

- 20% weight on 1-year TSR
- 30% weight on 3-year TSR
- 50% weight on 5-year TSR

When evaluating whether to recommend WITHHOLD against the directors, ISS will look at the company's response to the ongoing performance issues, and consider several factors, including the following:

- Performance improvement in the current year
- Changes in management or board composition
- Recent transactions at the company
- Overall governance practices, particularly any recent changes
- Financial health of the company

Rationale for Update: A majority of ISS institutional investor clients who responded to the ISS 2005 Policy Jams Survey indicated that institutional investors support factoring in long-term financial performance when determining vote recommendations for or against directors in uncontested elections.

Independence Definition & Director Classification

Current Policy Position: ISS is further refining its definitions of independence to provide clarifications in the following areas:

- Definition of "interim" CEO;
- Definition of "Founder";
- Related Party Transactions.

ISS Classification of Directors – U.S. Policy 2006

- Inside Director (I)
- Employee of the company or one of its affiliates[1]
- Non-employee officer of the company if among the five most highly paid individuals (excluding interim CEO)
- Listed as a Section 16 officer[2]

- Current interim CEO
- Beneficial ownership of more than 50 percent of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a defined group).

Affiliated Outside Director (AO)

- Board attestation that an outside director is not independent
- Former CEO of the company
- Former CEO of an acquired company within the past five years
- Former interim CEO if the service was longer than 18 months. If the service was between twelve and eighteen months an assessment of the interim CEO's employment agreement will be made.[3]
- Former executive of the company, an affiliate or an acquired firm within the past five years
- Executive of a former parent or predecessor firm at the time the company was sold or split off from the parent/predecessor within the past five years
- Executive, former executive, general or limited partner of a joint venture or partnership with the company
- Relative[4] of a current employee of company or its affiliates
- Relative (*see endnote 4*) of former executive, including CEO, of company or its affiliate within the last five years
- Currently provides (or a relative provides) professional services directly to the company, to an affiliate of the company or an individual officer of the company or one of its affiliates.
- Employed by (or a relative is employed by) a significant customer or supplier[5]
- Has (or a relative has) any transactional relationship with the company or its affiliates excluding investments in the company through a private placement (*see endnote 5*)
- Any material financial tie or other related party transactional relationship to the company
- Party to a voting agreement to vote in line with management on proposals being brought to shareholder vote
- Has (or a relative has) an interlocking relationship as defined by the SEC involving members of the board of directors or its Compensation and Stock Option Committee[6]
- Founder[7] of the company but not currently an employee
- Is (or a relative is) a trustee, director or employee of a charitable or non-profit organization that receives grants or endowments from the company or its affiliates (*see endnote 1*)

Independent Outside Director (IO)

- No material[8] connection to the company other than a board seat

Cumulative Voting

Current Policy Position: ISS recommends AGAINST proposals to eliminate cumulative voting and FOR proposals to restore or provide for cumulative voting in the absence of sufficient good governance provisions and/or poor relative shareholder returns. Proposals to restore or provide for cumulative voting are evaluated on a CASE-BY-CASE basis relative to other governance provisions contained in the company's governing documents and the company's relative performance.

New Policy Position: ISS will generally maintain the current policy while adding an exception for companies that have majority threshold voting or proxy access provisions in place. ISS will generally recommend voting FOR proposals to restore or provide for cumulative voting unless there are compelling reasons to recommend AGAINST the proposal, such as the presence of a majority threshold voting standard, or a proxy access provision in the company's bylaws or governance documents, or a counterbalancing governance structure coupled with acceptable relative performance.

A counterbalancing governance structure coupled with acceptable relative performance should include all of the following:

- Annually elected board
- Two-thirds of the board composed of independent directors
- Nominating committee composed solely of independent directors
- Confidential voting; however, there may be a provision for suspending confidential voting during proxy contests
- Ability of shareholders to call special meetings or act by written consent with 90 day's notice
- Absence of superior voting rights for one or more classes of stock. For example, an unacceptable struc-

ture would consist of two classes of stock where Class A stock was entitled to one vote per share and Class B stock was entitled to ten votes per share. This provision does not prohibit tracking stock.

- Board does not have the right to change the size of the board beyond a stated range that has been approved by shareholders
- The company has not underperformed its peers and index on a one-year and three-year basis, unless there has been a change in the CEO position within the last three years
- No director received WITHHOLD votes of 35% or more of the votes cast in the previous election

ISS will generally recommend AGAINST proposals to eliminate cumulative voting.

Director Term Limits

Current Policy Position: ISS currently does not have a formal policy on director term limits due to the lack of empirical evidence regarding its impact on shareholder value. As such, ISS does not apply a narrow rule of thumb on director tenure and mandatory term limits.

New Policy Position: We will maintain our current policy for 2006. However, ISS will begin inserting cautionary language when the average director tenure on a board exceeds 15 years for the entire board.

Rationale for Update: While a formulaic term limit test should never become a substitute for thoughtful evaluation of individual director independence or performance, ISS does believe that boards with limited turn-over may lack new perspectives that can add value to the boardroom. On the one hand, long service on the board may assure continuity and familiarity with the company's business and industry. Nevertheless, despite these trade-offs, many institutional investors believe that directors who serve on a board concurrently for many years may become less independent from management and, as such, less willing to act as advocates for shareholders.

Obligation of Boards to Act on Shareholder Proposals Receiving Majority Support

Current Policy Position: ISS' current policy is two tiered. ISS will recommend to WITHHOLD votes from all director nominees at companies that have: 1) Ignored a shareholder proposal that was approved by a majority of the votes cast for two consecutive years; or 2) Ignored a shareholder proposal approved by a majority of the shares outstanding at the last annual or special meeting. If management puts the proposal on the ballot as a management proposal, then ISS will consider that it has responded to the majority-supported shareholder proposal.

New Policy Position: ISS is clarifying that, if management puts the proposal on the ballot with a recommendation other than FOR (that is, with an "AGAINST," "NONE" or "ABSTAIN" recommendation), ISS will not consider this as a response to the expressed desires of shareholders and will recommend WITHHOLD against all the directors if either of the above tests is met. Furthermore, if the test has not yet been met (e.g. the proposal received only one year of majority of votes cast), then ISS will consider this management proposal with the contrary recommendation the equivalent of a shareholder proposal when applying the test the following year.

Rationale: Boards are responsible for ensuring that the voices of the owners of the firm are heard. If the majority of shareholders have indicated they desire a particular governance change, the board should support the proposal in question.

Withholding Votes from Directors for Shareholder Rights Plan (i.e. Poison Pills)

Current Policy Position: ISS has a two-fold policy with regard to withholding votes from directors related to shareholder rights plans: 1) ISS will recommend to WITHHOLD votes from directors where the company has a dead-hand or modified dead-hand poison pill; and 2) ISS will recommend to WITHHOLD votes from directors if the board has adopted a poison pill without shareholder approval since the company's last annual meeting and there is no requirement to put the pill to shareholder vote within twelve months. ISS will not recommend WITHHOLD if a company that triggers this policy commits to put its pill to shareholder vote within twelve months of its adoption.

New Policy Position: ISS will generally maintain our current policy for 2006. ISS will continue to recommend WITHHOLDING votes from directors where the company has a dead-hand, slow-hand or modified dead-hand poison pill. In addition, ISS will recommend WITHOLD from director nominees at any company which has: 1) Adopted a pill beginning January 2005 without shareholder approval; and 2) Has not yet received a "Withhold" recommendation from ISS for this reason; and 3) Has not committed to putting it to a vote within twelve months of its adoption, either as part of its governance policies or as a specific public commitment.

Rationale for Update: ISS' policy stipulates that shareholders should have the ability to vote on any shareholder rights plan adopted by a board as to ensure that the features of the poison pill support the interests of shareholders and do not merely serve as a management entrenchment device. If the board, in the exercise of its fiduciary duties, determines that a pill is in the best interests of shareholders and adopts it without shareholder approval, the pill would still require a shareholder vote within twelve months after adoption. A pill adopted under this "fiduciary out" exception should expire or be ratified by shareholder vote within twelve months after adoption.

Notes

1 "Affiliate" includes a subsidiary, sibling company, or parent company. ISS uses 50% control ownership by the parent company as the standard for applying its affiliate designation.

2 " Executives" (officers subject to Section 16 of the Securities and Exchange Act of 1934) include the chief executive, operating, financial, legal, technology, and accounting officers of a company (including the president, treasurer, secretary, controller, or any vice president in charge of a principal business unit, division or policy function).

3 ISS will look at the terms of the interim CEO's employment contract to determine if it contains severance pay, long-term health and pension benefits or other such standard provisions typically contained in contracts of permanent, non-temporary CEOs. ISS will also consider if a formal search process was underway for a full-time CEO at the time.

4 "Relative" follows the NYSE definition of "immediate family members" which covers: spouses, parents, children, siblings, in-laws, and anyone sharing the director's home.

5 If the company makes or receives annual payments exceeding the greater of $200,000 or five percent of the recipient's gross revenues. (The recipient is the party receiving the financial proceeds from the transaction).

6 Interlocks include: (a) executive officers serving as directors on each other's compensation or similar committees (or, in the absence of such a committee, on the board) or (b) executive officers sitting on each other's boards and at least one serves on the other's compensation or similar committee committees (or, in the absence of such a committee, on the board).

7 The operating involvement of the Founder with the company will be considered. Little to no operating involvement may cause ISS to deem the Founder as an independent outsider.

8 For purposes of ISS' director independence classification, "material" will be defined as a standard of relationship (financial, personal or otherwise) that a reasonable person might conclude could potentially influence one's objectivity in the boardroom in a manner that would have a meaningful impact on an individual's ability to satisfy requisite fiduciary standards on behalf of shareholders.

Is Financial Statement Insurance a Viable Alternative to the Not-so-Independent Audit?

Joshua Ronen

[Joshua Ronen is a professor at the Stern School of Business at New York University. Contact: jronen@stern.nyu.edu.]

The cascade of recent audit failures has given rise to the Sarbanes-Oxley Act and to an ever-growing commentary on "corporate governance." A major theme of both the statute and the commentary is the role of "gatekeepers" and, in particular, of auditors. For example, in his book, Take on the Street, former SEC Chairman Arthur Levitt complains:

> More and more, it became clear that the auditors didn't want to do anything to rock the boat with clients, potentially jeopardizing their chief source of income. Consulting contracts were turning accounting firms into extensions of management—even cheerleaders at times. Some firms even paid their auditors on how many non-audit services they sold to their clients.[1]

The crisis of confidence created by the accounting scandals is clearly exacerbated by the failure of auditors to enforce accurate reporting of companies' true performance. Many of the companies that failed spectacularly had clean audit opinions prior to their collapse. This damaged auditors' reputations and compromised their role as independent experts. That's a problem, because independence from management—both real and perceived—is crucial to ensuring the auditor's opinion is relevant and reliable. The issue of auditor independence (or its absence) has occupied a major place in the debate over the failure of corporate governance.

This article discusses the circumstances that can diminish or even negate auditor independence, and offers a possible solution to the problem.

The Sarbanes-Oxley Act and the Impact of Regulation

Sarbanes-Oxley seeks to address the problem of lax accounting gatekeepers by increasing regulation and penalties, empowering audit committees, and curtailing the auditor's involvement with the client. Among the major reforms Sarbanes-Oxley introduced in the area of accounting and auditing are provisions that address specific deficiencies identified by Congress in reviewing the problems at Enron, WorldCom, and others, such as:

- Preventing officers from improperly influencing the auditing process;
- Changing the oversight of auditing firms; and
- Entrusting a higher level of financial review to independent audit committees.

A primary instrument for accomplishing these objectives was the establishment of the Public Company Accounting Oversight Board (PCAOB), which has regulatory authority over private audit firms. The PCAOB is empowered to "protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" for investors in publicly traded companies."[2] The PCAOB is responsible for registering[3] and inspecting public accounting firms and for establishing or adopting auditing, quality control, ethics, independence, and other standards pertinent to the conduct of audits. The PCAOB also is authorized to conduct investigations of auditing firms and disciplinary actions over auditors. Even with the existing system of peer review, Sarbanes-Oxley subjects firms with a record of regularly auditing more than 100 issuers to annual inspection by the PCAOB. Failure to meet the stipulated standards for quality control systems can subject a firm to sanctions.

Can this additional layer of regulatory oversight accomplish what the SEC, endowed with great authority, has failed to do over all these years? There is no reason to expect it would. All regulatory mechanisms impose penalties after the wrongdoing is detected. Ex-post mechanisms are nowhere near as effective as systems that provide incentives for ethical conduct.

Consider how regulation functions. Regulatory mechanisms prohibit certain acts while mandating others. The means of enforcement are penalties imposed when regulators discover that prohibited acts were committed or mandated actions were not taken. There is rarely, if ever, a reward for doing the right thing. Sarbanes-Oxley, for example, prohibits accounting firms from providing some non-audit services,[4] requires that audit committee members be independent,[5] and directs auditors to disclose to the issuer's audit committee "all alternative treatments that have been discussed with management officials of the issuer . . . ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the [audit] firm."[6] How well can the PCAOB implement these stipulations?

It is doubtful that these lofty regulatory goals can be accomplished effectively. Successful implementation requires a willingness to enforce the regulations. However, the objectives of the regulators are not necessarily congruent with the interests of the investing public. Regulators' incentives are determined and formulated within a barter system wherein political favors or threats are exchanged. The incentives generated in such a market are shaped by groups with interests that likely diverge from those of investors. Witness, for example, the SEC's backtracking on the requirement that lawyers resign and blow the whistle on securities law violations (influenced by the lawyers' lobby) and on the barring of tax shelter planning by auditors (targeted by the accountants' lobby). Moreover, with the exception of those with a high measure of integrity—a rare commodity in these days—regulators seek entrenchment in bureaucratic power and the preservation of their ability to exchange political favors so as to facilitate post-regulatory career marketability. This quest requires the goodwill and cooperation of interest groups with goals that are not aligned with those of investors.

Even if the individuals within a regulatory structure are diligent, enforcement is costly and requires budget authorization. But the availability of the requisite funds depends on political priorities that may lie outside the domain of corporate governance reforms. Competing demands for money can arise unexpectedly, such as when wars or tax cuts are imminent. Also, political agendas can shift over time and, in periods of complacency, corporate governance reforms may be accorded low priority.

Consider also the incentives of the would-be wrongdoers. Regulatory penalties are effective only if agents expect their misdeeds to be detected. If the probability of detection is perceived to be small, the errant will not be deterred. Rational wrongdoers would reasonably expect regulatory hesitancy and backtracking and hence are quite likely to perceive a small probability that regulators will detect their transgressions.

Suppose that to offset small probabilities of detection, draconian penalties are imposed when the wrongdoing is discovered. Can corporations then staff their boards of directors and audit committees with able members who might face such heightened risks?

Even if ultimately detected and penalized, the rendering of justice typically will come too late to properly rectify the wrongs, compensate investors for their losses, or restore their confidence. Punishments that loom in the distant horizon cannot function as effective deterrents.

Beyond all these impediments, there is the question of feasibility. Are the Sarbanes-Oxley mandates workable in principle? Consider for example the requirement that audit committee members be independent. Is that possible?

Can Directors or Audit Committee Members *Really* Be Independent?

Independence is an unobservable state of mind. While independence may be legislated, it cannot be made to happen easily. Even a cursory analysis of directors' (including audit committee members) incentives and motivations suggests that they are subject to an agency problem: Directors and audit committee members wish to be re-appointed to their board positions. The pay is good,[7] and good relations with the CEO also bestow valuable benefits, including social connections, prestige, and increased likelihood of becoming a member on other companies' boards.

The first impediment to director independence is the nominating process. Board elections are by slate, and dissidents face substantial impediments when they attempt to put forward a competing slate. Hence, the management-proposed slate of directors is the only one that typically ends up being offered. As a result, the CEO and his or her team dominate the nominating process, and directors wishing to be re-nominated feel compelled to acquiesce to the CEO's wishes in a host of matters.

Also militating against genuine independence for directors and audit committee members is the directors' pay structure. If well paid, the directors would have little incentive, if any, to oppose the CEO's pay or policies; there would be de facto dependence on management. Alternatively, if not well paid, the directors would have little interest, if any, in bringing an independent perspective to bear on real policy issues: They are not paid enough to make it worth their effort, nor would the directors want to risk relations with the management they need to work with. And while heightened personal liability concerns may somewhat "curb their enthusiasm" for cooperation with mendacious management, the small perceived probability of detection and enforcement over time would limit whatever deterrent effect enhanced liabilities may offer.

Moreover, directors typically have only nominal equity interests in the company. But even if directors owned a significant share of the equity, as long as they are not restricted from disposing of their equity interest, they would still have incentives to overlook attempts by management to inflate earnings or engage in other questionable accounting measures; this will only help them sell their stock at higher prices! Even if directors hold restricted stock with lock-up provisions that bar them from selling before a certain date, they would have the perverse incentive to encourage (and certainly not discourage) management to "cook the books" so as to inflate the price immediately prior to the expiration of the lock-up.[8]

Can Auditors Be Independent?

One of the causes suspected of contributing to the current state of financial disarray is the failure of the auditing profession to fulfill its role as independent gatekeepers. Currently, the incentives driving auditors' behavior may not elicit unbiased reports. Auditors are paid by the companies they audit and thus depend on CEOs and CFOs, who effectively decide on their employment and compensation. This creates an inherent conflict of interest.

The perception of auditors' conflict of interest (lack of independence) started with a host of high-profile, highly publicized corporate failures and near failures, such as Enron and WorldCom. Among the (probably false) premises for the culpability of the auditor was the belief that the problem could have been avoided if the auditing firm had not also provided lucrative consulting services to the audit client. In other words, many argued that had auditors not been enticed by the lure of large fees, they would have done the right thing. Unfortunately, the prohibition against an auditor providing consulting services results in the auditor acquiring less knowledge of the client's systems and operations even when, because of great changes in record-keeping technology and increased sophistication of the client's operations, more knowledge is critical.

While providing multiple services can generate economies of scale and scope, it allegedly creates two potential sources of conflict of interest. First, there is the potential to pressure individual auditors to bias their judgments and opinions in exchange for more (or continued) non-audit work. The second is that auditors often evaluate systems that were put in place by their own non-audit colleagues (consider, for example, the off-balance sheet special-purpose entities marketed by Arthur Andersen to Enron and other clients). In spite of these concerns, however, the empirical evidence does not reveal a systematic pattern of these conflicts creating obvious biases. Even so, regulators' concerns about threats to auditors' independence grew dramatically in the late 1990s, along with the growth in the share of the non-audit services relative to the auditors' total revenue and profits.

In fact, one does not need to resort to identifying non-audit services as the villain responsible for the conflict of interest and the lower quality of the audit. An indefinite stream of future audit fees to be received for being continually engaged as auditor supplies all the necessary incentives for complying with management's wishes or, at the very least, the grounds for being perceived as dependent on management. This conflict of interest has been intensified by changes in the business and audit environment over the few last decades. To see why this happened, we need to consider the audit process. It comprises two components: the validation of data (GAAS) and the validation of measures of financial statement items (GAAP). GAAS is designed to verify the appropriateness, completeness, accuracy, and timelines of the accounting data. GAAP involves the reasonableness of the values presented in the financial statements (for example, the quantification of inventory at cost or market, or the net realizable values of accounts receivable after write-offs and allowances for uncollectible debts).

While the recent spate of "audit failures" is not unusual when viewed over, let us say, the last fifty years—in this period "audit failures" happened all the time—the failures become more noticeable in a weak economy and in an environment of stock price declines, and particularly where the failures are so visibly enormous. Indeed, the visibility, frequency, and magnitude of audit failures have increased substantially over the last few decades. Reasons for this possibly include a more aggressive plaintiff's bar coupled with increased demands on the auditor in light of more sophisticated and complex business contracts and transactions. Also noteworthy is the fact that an overwhelming number of visible audit failures were associated with the largest and best audit firms. What are the likely causes of this astonishing phenomenon?

One likely explanation lies in the movement from an industrial economy to an information economy. In the industrial economy of fifty years ago, the primary focus of the auditor was the validation of data, through extensive counting of inventory and confirming accounts receivable and payable with external parties. In addition, other than long-term assets (for example, plant and equipment), and long-term debt (such as bonds), the rest of the balance sheet had, by the time the auditor completed the necessary fieldwork, generally completed its cycle. Most of the inventory turned over, most of the receivables were collected, and most of the payables were settled. Auditors could look back and further validate their assessment of the data and valuations as of the statement date.

At least two major changes have had a significant impact on the auditor: the computer and the change in the nature of assets and liabilities. While the computer has substantially expanded the amount and quality of data available, auditors also became dependent on the data processing systems. In addition, the movement from tangible to intangible assets with very long lives, and from liabilities whose principal and terms are known and specified to liabilities whose principal and terms are legally related to and dependent on other factors (such as found in derivatives), has substantially reduced the auditor's ability to validate the values presented in the financial statements.

To put it more plainly, current financial statements are a blend of largely verifiable, but uninformative, depictions of past transactions, and largely unverifiable, but possibly informative, projections of future outcomes. Under existing GAAP, many of these projections show up in the balance sheets as assets, and even as revenues. Consider the "interest only strip," shown as an asset in the balance sheets of specialty finance companies under Financial Accounting Standard 140. This asset is simply the present value of a future stream of unrealized income recorded as current income. Its valuation is highly subjective and acutely sensitive to changes in assumptions. It is extremely difficult, even for a well-intentioned auditor, to dispute and reject the projection of a manager wishing to improve the appearance of his or her financial statements. Similarly, for one of its ventures, "Enron assigned the partnership a value of $124.8 million based on its projections of the [venture's] revenue and earnings potential."[9] Such largely unverifiable intangibles make financial statements difficult to audit. They constitute private information that cannot be perfectly verified after the fact. We can only observe whether a manager's forecasts were accurate; we cannot know whether the manager truly believed the forecasts were accurate when made. Under these circumstances, in equilibrium and on average, managers' presentations will not be truthful, in the sense that, at any point in time, a subset of companies will intentionally misinform.[10] Even detailed standards have not prevented unverifiable intangibles from creeping into the financial statements.

This changed environment puts the auditor in a very difficult position, especially within the extremely competitive market for audit services. Price competition puts the auditor at the mercy of the client. In an uncertain environment marked by the difficulty of verifying valuations that are necessarily soft and subjective, the auditor, who is paid by the potentially prevaricating client, is naturally tempted to adopt the client's position. Thus, while some audit failures were precipitated by incompetence and corruption, the conditions that created audit uncertainty likely contributed to the audit failures brought about by auditor malfeasance.

A major flaw, and one that has persisted over time, is that the auditor is effectively retained by the management of the client in the case of public companies, creating a circumstance wherein the auditor is beholden to the client and its management. Theoretically, auditors are the agents of the shareholders. But in practice, it is management that engages the auditor and ultimately pays for audit services and hence determines auditing and consulting fee structures to elicit actions, including opinions and assurances that it desires from the auditor. Even in the current litigation environment, the anticipation of potential gains from acquiescing to management's wishes more than offsets the threat of legal liability against auditors from shareholder class action suits. Furthermore, a large portion of shareholder recoveries in omissions and misrepresentation-related class action suits come from the corporation's own resources. And, on average, auditors pass costs related to legal settlements on to their corporate clients.

It is tempting to suggest that an increase in the liability exposure of the auditors can deter malpractice, but that theory falls short on three grounds. One, it fails to address the misallocation of risk and resources. Imposing higher litigation penalties on the auditor after the fact does not enhance the ability of society to distinguish, in advance, between firms with intrinsically high returns from the Enrons and WorldComs of the world that have intrinsically low or negative returns but misrepresent themselves as high-return firms. Two, increasing exposure to liability and instituting high penalties may drive auditors out of the business of auditing altogether. And finally, the penalties and costs of litigation would be passed on to clients in the form of higher audit fees, thus blunting the positive incentive effects that the threat of litigation may otherwise have had.

Financial Statement Insurance

Despite Congress' intentions, the Sarbanes-Oxley Act does not untie the auditor/management knot. Without realignment of the auditor's incentives and the establishment of a corporate governance framework, matters will not change.

To address the problem, I propose a financial statement insurance ("FSI") scheme. FSI is a market mechanism that can bring about significant changes in the structure and incentives of the auditing profession so as to align auditors' and managers' incentives with those of shareholders and ensure better quality audits, better quality financial statements, and, derivatively, fewer if any omissions and misrepresentations in the financial statements and smaller shareholder losses resulting from omissions and misrepresentations that do occur. At the same time, securities prices would reflect financial statement quality more accurately, contributing to a more complete market and enhancing allocative efficiency. Also, audit firms would compete along the dimension of quality rather than price, thus enhancing the profession's reputation for independence and competence.

The FSI process begins with companies that choose to do so soliciting from insurance carriers in year T-1 offers of insurance coverage for their shareholders against losses caused by omissions and misrepresentations in financial statements that occur during the covered year (year T). The carriers would engage an underwriting reviewer (that could be either an independent organization or the external auditor), which would assess the risk of omissions and misrepresentations by examining the soliciting companies' internal controls, management incentive structures, competitive environment, history of past omissions and misrepresentations and earnings surprises, and the market's responses to such surprises. Detailed underwriting review reports would be the basis for the carriers' decisions on whether to offer coverage, the maximum amount of such coverage, and the associated required premium (or they may offer a schedule of coverage amounts and premiums).

Based on the insurance offers received, a company would disclose in its proxy management's recommendation for buying FSI coverage at a given amount and premium (including zero coverage, or no insurance). After the vote, the shareholders' approved coverage and premium (including possibly zero coverage) would be publicized, becoming common knowledge. Companies that opt for zero coverage and companies that chose not to solicit FSI coverage would revert to the existing regime under which they would hire an external auditor that opines on their statements. Companies whose shareholders approve insurance coverage would select an external auditor from a list of firms approved by their chosen insurance carrier. The selected auditor would be hired and paid by the carrier. Audit firms also would be rated by an independent organization (likely the same as the one that conducted the underwriting review). The selected external auditor would coordinate the audit plan with the underwriting reviewer to adapt it to the findings of the review.

Eventually, the insurance coverage would become effective only if the auditor issues an unqualified opinion on year T's financial statements (sometime in year T+1). If the opinion is not unqualified there would be no coverage, or perhaps the policy terms would be renegotiated. In either case (no coverage or renegotiated coverage and premium) the renegotiated terms would be publicized. For companies with effective coverage, shareholders' claims for recovery for losses caused by omissions and misrepresentations that occurred during the covered year would be settled through an expedited process. A judiciary body, agreed upon in advance by both the insured and the insurer, would submit the claims upon the detection of omissions and misrepresentations, hire the necessary experts to estimate the damages, and agree on a settlement on behalf of the shareholders within the policy limits with the carrier. (The insurer may hire its own experts to analyze the damages.)

To see the benefits of this mechanism, consider the incentives of each of the parties.

Insurers -- Once having underwritten an FSI policy, the insurer's objective would be to minimize the cost of claims. But this is tantamount to minimizing shareholder losses that could be claimed. This means the insurer's incentives would be aligned with those of shareholders. Insurance industry competition will work to reduce the inclination of any carrier to dispute valid claims. To minimize claim losses, the insurer would incentivize, with a proper combination of rewards, its hired auditor to apply such intensity and quality of audit as would ensure zero or minimal omissions and misrepresentations. That is, audit quality would be optimized for any given coverage and premium. It can be shown that audit quality (effort) would be higher than in the existing regime.

In addition to the premium, the fee paid by the insurer would be reimbursed by the insured and separately publicized. The premium charged would be tailored to the risk assessed by the underwriting reviewer and would credibly signal (accurately) the financial statement quality (risk of omissions and misrepresentations). The insurer will neither charge too high a premium (lest it lose market share in a competitive insurance industry) nor too low a premium (lest it bankrupt itself).

The market -- Because the publicized coverage and premium become credible signals on the quality of financial statements, being based on a detailed assessment of the risk of omissions and misrepresentations, investors will pay a higher (lower) price for the securities associated with a lower (higher) premium for a given coverage. As a result, prices, in addition to reflecting expected cash flows, will reflect the information on financial statement quality embedded in the publicized coverage and premium. The markets would become more complete and security prices would become better signals for resource allocation.

The insureds -- Anticipating the effect of publicized coverage and premium on the price of their issued securities, and hence on their cost of capital, managers of companies with high quality financial statements will wish to buy insurance. Managers of companies with poor quality financial statements, knowing that with either no insurance or a higher (than their better peers) premium-to-coverage ratio, they will be recognized as poor-quality-financial-statements companies (incurring a higher cost of capital), will understand that their only option is to improve the quality of their statements so as to merit a smaller premium-to-coverage ratio. Thus, the FSI arrangement would drive companies to race to top-quality financial statements. With more transparent and truthful financial reports, investors would have more ability to distinguish between companies with low potential returns and those with high potential returns, resulting in improved resource allocation.

Auditors -- Being hired by the insurers, auditors will no longer be subject to the conflicts of interest that afflict their relations with clients under the existing arrangement. Their independence, both real and perceived, would be assured. They would be freed from client pressure to go along with dubious accounting or disclosures; they would be rewarded for better quality rather than for being willing to "fail to detect" material omissions and misrepresentations. Because they will be rewarded for better quality, they will compete on the dimension of quality rather than price or acquiescence to clients' wishes. The competition over quality would realign the profession, making it possible for smaller firms to compete effectively, not needing to have "deep pockets" to be demanded by the insurers. Also, auditors' legal liability would decrease on the average, since reduced conflicts of interest will make it more difficult for plaintiffs to prove scienter in fraud cases.

Furthermore, the debate now raging over principles versus rules would have a more clear-cut resolution. When the incentives of auditors and managers are not aligned with those of shareholders, principles can be abused in that clients can use the absence of rules to pressure auditors into accounting treatments or disclosures the managers prefer. With FSI, and the aligned incentives that FSI engenders, a regime of "principles" would become feasible and desirable: no constraining bright line rules would impede the reflection in the financial reports of a "fair view" of the company.

Conclusion

Several causes have been advanced in the media for an accounting meltdown: irrational exuberance, infectious greed, the stock market bubble, moral turpitude of executives, unethical accountants, non-audit services, and related ills. I have argued that the inherent conflict of interest in the auditor-client relationship combined with the unobservability of financial statement quality, together, are likely culprits. Bubbles and exuberance merely magnify the payoffs so that executives are more tempted to "cook the books" and the auditors' conflict of interest is aggravated.

Financial Statement Insurance provides a market-based solution that acts as an effective check on the issuance of overly-biased financial statements. First, by transferring the auditor hiring decision to the insurer, this scheme eliminates the auditors' inherent conflict of interest. Second, publicizing the insurance coverage and the premium will credibly signal the quality of the insured's financial statements and direct investments toward better projects. At the same time, the ability to signal the quality of financial statements will motivate companies to improve that quality. Thus, along with the consequent improvement in audit quality, FSI will result in fewer misrepresentations, and accordingly, in fewer lawsuits and stakeholder losses.

Notes

1 Paula Dwyer and Arthur Levitt, Take on the Street: How to Fight for Your Financial Future, Vintage Books (2003), at 116.

2 Section 101(a) of the Sarbanes-Oxley Act.

3 As of September 16, 2005, 1,540 firms were registered with the PCOAB. *See* <www.pcaobus.org/Registration/Registered_Firms.pdf>.

4 Section 201(a) of the Sarbanes-Oxley Act.

5 Section 301 of the Sarbanes-Oxley Act.

6 Section 204 of the Sarbanes-Oxley Act.

7 Pearl, Meyer and Partners, a compensation consulting firm, reports average director compensation in the 200 largest U.S. corporations in 2004 to be $176,673, *see* <www.pearlmeyer.com/registered/DirectorsData2004.pdf>.

8 Randomizing the date at which the lock-up provisions expire would only exacerbate matters. Incentives to inflate the stock price would operate with unabated strength until such time that the lock-up provisions expire at a random date.

9 Rebecca Smith, "Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand," Wall Street Journal, Jan. 17, 2002, at A.1.

10 *See* J. Ronen and V. Yaari, "Incentives for Voluntary Disclosure," Journal of Financial Markets 5:349–390 (December, 2002), *available at* <http://pages.stern.nyu.edu/~jronen/IncentivesVDPDF3-2001.pdf>.

Selling the Corporate Bastion: CNOOC's Failed Bid for Unocal Raises the Question—Shareholder Interest or National Interest?

Frank Aquila & Lisa DiNoto

[Frank Aquila is a partner and Lisa DiNoto is an associate in the Mergers & Acquisitions Group of Sullivan & Cromwell LLP. The views and opinions expressed in this article are those of the authors and do not necessarily represent those of Sullivan & Cromwell LLP. Contact: aquilaf@sullcrom.com.]

In 1985, the Delaware Supreme Court outlined the basis for evaluating whether takeover defenses breach a board's fiduciary duties when it approved of the measures taken by Unocal Corp.'s board of directors in the face of a hostile takeover bid.[1] Twenty years after the Unocal decision, we again have occasion to consider whether Unocal's directors fulfilled their duties in the context of a potential business combination in which they approved the sale of the company to Chevron Corp. – the second highest bidder.

The Chevron transaction, which has produced the fourth largest energy company in the world in terms of oil and gas production, was recommended by the Unocal board even after it was approached by CNOOC Ltd. (CNOOC), a subsidiary of China's third-largest oil producer, the China National Offshore Oil Corp., with a competing all-cash offer that nominally topped Chevron's bid by more than $1 billion. In the end, CNOOC withdrew from the contest in the face of strong U.S. political opposition that created "an unacceptable risk to [its] ability to secure [the] transaction;"[2] and, on Aug. 10, Unocal's shareholders heeded the board's advice and approved the Chevron transaction. With this final hurdle to the Chevron deal cleared, we can now look back and ask whether the directors of Unocal, namesake of the standard of review applied to actions preventing corporate takeovers, satisfied their fiduciary duties once again when their actions were aimed at selling the company rather than preventing such a sale. Given that the issues at play in the fight for Unocal are becoming increasingly commonplace, answering this question is more of a practical necessity rather than a mere academic exercise.

There is wide speculation about the consequences of CNOOC's failed bid. Predictions range from the rather unlikely narrow commercial retaliation against the United States to the rather alarming conception of a powerful and aggressive U.S. opponent. Some things, however, are clear: this will not be the last bid by a Chinese entity for a U.S. company; and the bid's failure will neither derail China's quest for oil nor slow the progress of China's broader economic expansion overseas. Fast-paced economic growth has changed China in little more than a decade from a net exporter of oil to the world's second-largest importer, behind only the United States. CNOOC, in fact, is one of three state-owned oil companies specifically created to acquire much needed offshore oil reserves for the country. China's thirst for oil is obvious; its companies' optimistic predictions about oil prices, willingness to pursue deals with states shunned by other countries, and ability to borrow heavily from the Chinese government only render more certain the fact that the country will continue to pursue oil overseas – and that it will do so with similarly generous offers.

The oil industry is just one setting among many for China's broad efforts to establish itself economically on the global stage with an increasingly wide range of acquisitions, joint ventures and other commercial alliances. Given this well-established trend, every board of directors would be well advised to fully understand the nature of its responsibilities in any situation similar to the one that Unocal faced this year. Such situations extend beyond China and beyond the realm of mergers and acquisitions – the "rules of the road" here apply to the consideration of any deal, including even the most routine commercial transaction, with a company whose home country might incite political opposition.

Fiduciary Duties 101

Any survey of a director's responsibilities must start with the board's general fiduciary duties. Corporate fiduciary duties set forth the obligations owed to the corporation and its shareholders by those entrusted with its control, setting a standard that allows the corporate form to function despite a division, by definition, between control and ownership. As stated over 250 years ago in *Charitable Corp. v. Sutton*,[3] accepting "a trust of this sort" requires a fiduciary "to execute it with fidelity and reasonable diligence."[4]

In general, a director, in the role of corporate fiduciary, must act "(1) in good faith; (2) with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner reasonably believed to be in the best interests of the corporation."[5] Most agree that this should operate principally for the benefit of the corporation's shareholders.

Traditional fiduciary analysis sets forth two duties owed by the corporate managers to the corporation and its shareholders: loyalty and care.

Loyalty to Whom?

The duty of loyalty addresses conflicts of interest and generally "requires directors to exercise their powers in the interests of the corporation and not in the directors' own interest or in the interest of another person … or organization."[6] As a rule, "the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[7] Such obligations most commonly address readily quantifiable conflicts of interest such as diversion of corporate assets or opportunities, executive compensation, insider information and entrenchment. But the duty of loyalty also demands that a fiduciary set the interests of the corporation ahead of less quantifiable interests, such as beliefs, political leanings and national ties, held personally or by other parties not among the constituencies of the corporation.

Claims that a deal with CNOOC affected serious interests other than those of the shareholders were not in short supply. Coming at a time of mounting unease in Washington as to both U.S. energy security and Chinese influence over the U.S. economy, the CNOOC bid prompted harsh political opposition from some members of Congress – many of whom focused on CNOOC's being 70% owned by, and, in the words of one Senator,[8] "essentially an arm of," the Chinese government. Some argued that such an entity's acquisition of Unocal's oil assets and technology would present a national security risk. Others questioned whether the offer qualified as a free market transaction, with much of its financing coming from the Chinese government. Still others protested a perceived absence of reciprocity, arguing that the Chinese government would never allow a U.S. corporation to purchase analogous assets in China.

In considering whether such concerns should have been among those considered by Unocal's board, we might point out that whether rejecting CNOOC bid was in the nation's best interest is, in itself, hardly clear-cut. CNOOC was said to have given repeated assurances that oil produced in the United States would continue to be sold in the United States and that they would be willing to sell any assets that the U.S. government considered strategic. Moreover, whether Unocal even held the sort of "dual-use" technologies that could give China a military advantage at the expense of the United States is highly doubtful. Industry analysts have generally indicated that any such technologies held by Unocal are readily available to China from many other sources. As for arguments related to reciprocity, convincing counterarguments point out that blocking the CNOOC transaction would be far more harmful to the United States, given that our government has consistently tried to convince other countries to welcome U.S. investment. The hypocrisy suggested by American action to block the CNOOC bid would only bolster the arguments of countries seeking to restrict investment by U.S. companies. Lastly, arguments against CNOOC on the grounds of financing, while perhaps the most merit-worthy, should not be overstated. As many have pointed out, Chevron (or any large acquiror) is able to obtain financing internationally at the most favorable market rates, which remain low today by historic standards, rendering any advantage gained by CNOOC based on available financing of questionable and marginal significance. In short, the arguments against CNOOC's acquisition of Unocal do not hold much water. Much of the bid's opposition seems to boil down to nothing more than political grandstanding.

But far more importantly, even if Congress' claims were unquestionably well-founded, the board's duty of loyalty still requires that decisions be made in the interests of the corporation, not the interests of any particular country. Such national concerns must be set aside by the board in favor of the welfare of a corporation whose shareholders, as a group, as in the case of Unocal or any other sizeable entity, have no single connection to any one country or any one country's interests – be they a demand for reciprocity, national security, or any other.

It might be suggested that certain cases or state statutes allowing for consideration of non-shareholder constituencies might offer the flexibility to consider valid claims of national interest. Courts have long acknowledged that directors in certain situations, such as considering the desirability of a change of control or choosing between competing offers, might be able to consider factors other than the price offered to shareholders. In *Unocal Corp. v. Mesa Petroleum Co.*, discussed in greater detail below, the Delaware Supreme Court listed the impact upon "'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)" as factors that a board reasonably may consider in evaluating "the nature of the takeover bid and its effect on the corporate enterprise."[9] Statutes enacted in a majority of states (but not in Delaware) further grant directors some "leeway to consider non-shareholder constituencies by explicitly permitting directors responding to contests for control to consider the interests of employees, suppliers, creditors, consumers, and, in some jurisdictions, the long-term and short-term interests of the corporation and its shareholders and/or the local and national economies and society as a whole."[10] Yet such statutes and case law are generally interpreted in a way that still gives priority to shareholder welfare. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[11] discussed in further detail below, the Delaware Supreme Court placed limits upon the board's ability to consider other constituencies' interests, which it seemed to have endorsed in *Unocal*. According to the Court, "[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."[12] The *Revlon* Court was even more explicit in the context of selling the corporate enterprise, concluding that "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder."[13] Moreover, other-constituency statutes generally grant priority to shareholders in not allowing a decision that conflicts with shareholder interests. For example, a federal court construing the relevant Nevada statute in *Hilton Hotels Corp. v. ITT Corp.*[14] stated that nothing in the statute "suggests that the interests of third parties are as important as the right of shareholder franchise,"[15] reasoning that "[w]hile the two interests are not exclusive, neither are they equal."[16] Similarly, a federal court construing Missouri law in *Flake v. Hoskins*[17] stated that, while Missouri's statute allowed the consideration of other constituencies' interests, "in all business actions, a corporate board of directors owes a fiduciary duty to shareholders and must generally operate for their benefit," and "[a]ny consideration of other constituencies must therefore have at least a reasonable relationship to the general interests of shareholders."[18] Moreover, even other constituency statutes generally focus their attentions on the interests of only those constituencies that can be considered a part of, or directly linked to, the corporation, such as employees, customers, suppliers, creditors and the communities in which offices or other corporate establishments are located. No court or statute would endorse board decisions that were based upon neither the welfare of the corporation's shareholders nor the composition and welfare of these other constituencies.

And a decision based upon the national security of the United States would have been just that. Given that Unocal produces oil and gas in nine countries outside of the United States[19] and that 70% of its oil and gas reserves are located in Asia, much of Unocal's "other" constituencies, like those of most any sizeable, publicly-traded corporation, are not necessarily aligned with any particular national identity. They, like the shareholders as a whole, are global groups; and making a decision based on the interests of a single country would have ignored this fact.

And so a board's duty of loyalty, under any approach, does not allow it to make decisions based solely on the interests of any one particular nation. This is not to say that valid national interests are not important factors in contemplating a potential transaction – but only that the board of directors, vested with a duty of loyalty to a corporation owned by shareholders around the globe, is not the proper party to engage in such considerations. National interest-based considerations are more properly made by the government entity that is legally entrusted with this role. And, as discussed below, the effect of the considerations and procedures of such a government entity on the welfare of the corporation's shareholders is absolutely among those factors properly considered by the board.

Proving That You Care

The duty of care addresses the attentiveness and prudence that a person must exercise in a given role. Usually defined in a state's corporate statute, a director "is held to the standard of that degree of care that an ordinarily prudent director would use under the circumstances."[20]

The Business Judgment Rule: A Policy of Deference

A director's satisfaction of the duty of care is usually evaluated under the business judgment rule, a standard of review consistent with a "hands off" judicial policy that recognizes that directors are best positioned to make corporate decisions and allows them to exercise their roles as they see fit. It acts as "a corollary common law precept" to "[o]ne of the fundamental principles" of a corporate law: "that the business affairs of a corporation are managed by or under the direction of its board of directors."[21] As explained by the Alabama Supreme Court in *Godbold v. Branch Bank*,[22] "[directors] do not in our judgment undertake, that they possess such a perfect knowledge of the matters and subjects which may come under their cognizance, that they cannot err, or be mistaken.... To exact such extreme accuracy of knowledge from this or any other class of agents, to whom of necessity a large discretion in the choice of means must be entrusted, would be manifestly wrong... . The inevitable tendency of such a rule would be hostile to the end proposed by it, as no man of ordinary prudence would accept a trust surrounded by such perils."[23] The business judgment rule thus sets forth a rebuttable presumption that directors are honest and well-meaning, and that their decisions are informed and rationally undertaken. In other words, the business judgment rule presumes that directors have not breached the duty of care and offers protection against liability for decisions that turn out badly despite having been considered diligently and made in good faith.

What Changes in the Takeover Context

There are certain situations, however, in which directors' inherent conflicts of interest necessitate higher standards of review. Measures taken by directors faced with takeover-related decisions have long been recognized among this group, as their natural desire for self-preservation may cloud any attempt to evaluate the desirability of the proposed deal.

Unocal Part One: Setting the Standards for Defense

Over time, courts have developed a particular set of fiduciary obligations that directors and other controlling parties owe to the corporation in the context of corporate takeovers. Defensive measures undertaken in the face of a hostile takeover attempt, for example, are generally subject to enhanced scrutiny through the application of a modified business judgment rule. This approach was first articulated in the well known case between Unocal and Mesa Petroleum Company,[24] in which the Delaware Supreme Court saw the difficulty of directors' making objective decisions when facing a threat to control and thereby "of necessity confronted with a conflict of interest."[25] Because this inherent conflict of interest renders any defensive measure suspect, the court required "judicial examination at the threshold before the protections of the business judgment rule [were] conferred."[26] In defending the "corporate bastion" against takeovers, directors must satisfy a two-prong proportionality test requiring them to demonstrate: 1) that the threatened takeover posed a danger to corporate policy and effectiveness; and 2) if the existence of such a threat is established, that the defensive measures implemented in response were proportionate to the threat in size.[27] It was this standard that the Unocal board satisfied two decades ago.

When the Guardians Become Auctioneers

Later, in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*,[28] the same Court held that the standard set forth in *Unocal* does not apply once the sale of the target becomes inevitable. In these situations, the director's fiduciary duties change from preserving the corporate entity "to the maximization of the company's value at a sale for the stockholders' benefit."[29] It is this standard that the Unocal board must satisfy in its dealings with CNOOC and Chevron.

Revlon duties require directors to choose the bidder offering shareholders the most value in return for their stock in the company. When every bidder presents all-cash offers with certain financing, a direct comparison can be made between bid values and Revlon duties generally require the board to sell the company in an impartial auction that maximizes shareholders' monetary return. In such situations, all other factors being equal, a board would not be able to justify going with a lower bid.

Would the Unocal board have been obligated to accept CNOOC's offer over Chevron's if both offers had been all cash? Was the discretion involved in valuing the stock portion of Chevron's bid the factor that allowed Unocal's board to choose Chevron over Unocal? Not at all. The uncertainty involved in valuing a stock offer is hardly the only factor that might widen the gap between a deal's nominal value and its net present value to shareholders – and it is this latter value that must be maximized when choosing a bidder. Directors are not only permitted, but obliged, to consider any factors that have a material effect on an offer's net present value. These might include a deal's tax implications, price protections, representations and warranties, closing conditions and other provisions within the terms of the proposed agreement, or the potential for a deal to be delayed or prohibited by the government based on antitrust issues. Ideally, directors will choose an approach that considers all such value-affecting factors in a comprehensive way.

Defending the "National Bastion"

A relevant and appropriate factor for a board of directors to consider is the likelihood that a deal will be delayed or blocked by the Committee on Foreign Investment in the United States (CFIUS). [For more on CFUIS, see the February 2005 issue of *The M&A Lawyer*, (vol. 8, no. 8)] Ever since the expansion of its mandate under the Exon-Florio Amendment in 1988 and the President's corresponding delegation of authority, CFIUS has been charged with the investigation of international efforts to purchase U.S. businesses. The Committee's initial review of a deal lasts 30 days and, if not approved thereafter, is followed by a 45-day investigation to determine whether the deal poses a threat to national security. With CFIUS' recommendation, the president then has 15 days to approve or prohibit the transaction. In sum, this process can last up to 90 days.

Any deal that Unocal's board negotiated with CNOOC would have required CFIUS' review. It is difficult to know with any certainty what the outcome of this review would have been. As already discussed, arguments that the contemplated Unocal-CNOOC transaction posed a threat to national security were largely debunked. Moreover, despite strong talk by some members of Congress, in the 17 years since Exon-Florio became law, more than 1,500 notices have been filed with CFIUS, but only 25 have required investigation – 12 of which have been forwarded to the president for review. Of these, the President has ordered divestiture of only one – the 1990 takeover of Mamco Manufacturing Inc., a Seattle aerospace-parts maker, by China National Aero Technology Import & Export Co.

Still, even setting aside the possibility that a deal ultimately would be blocked, the fact that it would be delayed by CFIUS' review process must in itself be considered in translating the nominal value of CNOOC's bid into a comparable net present value. Institutional Shareholder Services (ISS) laid out this consideration in valuing, and ultimately deciding not to recommend, CNOOC's Unocal bid. As of the date of its evaluation, the blended nominal values of the Chevron and CNOOC bids were approximately $64.00 and $67.00 per share, respectively. "When faced with a competitive bid situation, ISS applies a 'bird in the hand' theory in which [they] compare the value of competing bids after adjusting for the relative certainty of such bids."[30] ISS considered the time-value of money lost in connection with the longer period of time likely required before the CNOOC bid, as compared to the Chevron bid, could close. ISS also considered, more broadly, the increased uncertainty of the CNOOC bid due to U.S. and Hong Kong regulatory issues and U.S. political opposition. While not explicitly considered by ISS, directors might also consider the possibility that changes, such as a material adverse event, were more likely to occur and threaten the deal given the longer time period between signing and close. ISS agreed with the board's recommendation to shareholders, concluding that "the putative CNOOC bid – while nominally higher than Chevron's offer – [was] not … sufficient to compensate Unocal shareholders for the higher risk of the CNOOC transaction, [and] that the Chevron merger agreement … [warranted] shareholder support."[31]

Such considerations will be important to remember when evaluating potential transactions such as CNOOC's bid for Unocal. In working to transform China into a more significant world player, and into a better position to tap the world's natural resources in particular, some analysts say that it is ready to pay a higher price for energy assets—what some have called a "China premium"[32]—to raise the chances of a deal's success. To the extent that China and other foreign bidders keep in view the United States' demonstrated sensitivity to foreign acquisitions in certain situations, premiums of this sort are likely to increase the nominal value of their bids. The broad array of factors affecting such transactions will at times create a decisive rift between these nominal values and the corresponding net present values properly considered. So while the broad guidance of Revlon still applies, requiring the board to make the decision that maximizes shareholder return, the board must carefully determine what each bid really puts on the table before attempting to chose the highest among them. This approach, which allows the board to use its discretion in determining a bid's true value, is generally consistent with the legal theory underlying the business judgment rule.

The Bottom Line

Given the increasingly global nature of transactions and the increasing role of China as a global economic player, directors must more than ever understand their proper roles and responsibilities as they consider transactions with Chinese companies. This is not a matter of suggesting the dominance of one consideration over another – because the question is not shareholder interests or national security, but to what extent boards of directors should be taking into account the latter when determining the former. A takeover's national security implications are properly left to the government entity legally charged with considering them. Rather than attempting to make that decision on its own, boards of directors need to consider this factor in the same way that they evaluate financing, tax implications, antitrust implications or any other risk factor – in the context of determining the real value. When that process is properly undertaken, shareholders can be confident that the board of directors has fulfilled its fiduciary duties and that its decisions are in the best interest of the corporation and its shareholders.

Notes

1 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
2 Associated Press, *China's CNOOC drops bid for Unocal: Chinese oil firm cites 'political environment' in the U.S.* (Aug. 2, 2005), http://www.msnbc.msn.com/id/8795682/.
3 2 Atk. 400 (1742).
4 *Id.* at 406.
5 Former Model Bus. Corp. Act § 8.30(a).
6 Committee on Corporate Laws, *Corporate Director's Guidebook*, 49 Bus. Law. 1243 (1994 ed.).
7 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).
8 151 Cong. Rec. 59436 (daily ed. July 29, 2005) (statement of Sen. Evan Bayh [D-Ind.]).
9 *Id.* at 955.
10 Business Judgment Rule [CG] (1998 & supplemented 9/02) - Dennis J. Block, Nancy E. Barton and Stephen A. Radin, Chapter III, A (part 3/3) (6).
11 506 A.2d 173 (Del. 1986).
12 *Id.* at 182 (citing *Unocal*, 493 A.2d at 955).
13 *Id.*
14 978 F. Supp. 1342 (D. Nev. 1997).
15 *Id.* at 1351.
16 *Id.*
17 55 F. Supp. 2d 1196 (D. Kan. 1999).
18 *Id.* at 1214.
19 Azerbaijan, Bangladesh, Brazil, Congo, Indonesia, Myanmar, The Netherlands, Thailand and Vietnam.
20 *Francis v. United Jersey Bank*, 432 A.2d 814, 824 (N.J. 1981).
21 *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000).
22 11 Ala. 191 (1847).
23 *Id.* at 199.
24 *Ibid.*
25 *Id.* at 955 (quoting *Bennett v. Propp*, 187 A.2d 405, 409 (1962) (stock repurchase)).
26 *Id.* at 954.
27 *Id.*
28 506 A.2d 173 (Del. 1986).
29 *Id.* at 182.
30 Institutional Shareholder Services, Proxy Analysis for Unocal Corp.'s August 10, 2005 Special Meeting.
31 *Id at 11.*
32 International Herald Tribune, *Chinese oil concerns are tired of getting the giants' scraps*, 10 Alexander's Gas and Oil Connections 15 (2005), http://www.gasandoil.com/goc/company/cns53390.htm.

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