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- **Shadow Banking: The Growing Sector of Non-bank Credit Activity**
  The global financial crisis revealed a host of deficiencies in the existing regulatory regime. Regulators have spent the last three years working their way through a myriad of perceived issues, from increased capital requirements to regulation of trading of over-the-counter derivatives. Regulators are now turning to "shadow banking."

- **The Stock Issuer's Dilemma: How Duties to Shareholders Limit an Issuer's Options in Employee Disputes**
  When a dispute arises between a stock issuer and its former employee who owns restricted shares of the company’s stock, the company may be tempted to use its powers as issuer to gain leverage in the dispute.

- **Determining Full-Time Employees for Purposes of Employer Shared Responsibility Payments under the Affordable Care Act**
  In late August, the Department of the Treasury issued Notice 2012-58, which provides further guidance on methods employers are permitted (but not required) to use in determining which employees must be treated as full-time employees for purposes of calculating any assessable payment under the employer shared responsibility provisions in Section 4980H of the Internal Revenue Code (Section 4980H).

- **A U.S./Canadian Dialogue About the Current State of Poison Pills**
  Canada and the United States have both developed case law pertaining to poison pills, which are the most common defense for a board facing a hostile bid.

Departments:

- **Keeping Current: SEC's Proposed Rules on General Solicitation and Advertising in Private Offerings**
  Section 4(a)(2) of the Securities Act of 1933, as amended (Securities Act), provides an exemption from registration for transactions by an issuer "not involving any public offering."

- **Keeping Current: Federal Courts Expand Dodd-Frank Whistleblower Definition**
  September was a busy month in the world of whistleblower litigation. Within the same week, two different federal district courts issued decisions offering expansive interpretations of the anti-retaliation provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"), holding that a plaintiff need not prove that he or she is a "whistleblower" as that term is defined by the Act, in order to bring a successful retaliation claim under Dodd-Frank.

- **Delaware Insider: The Presumption Against Plaintiffs Who Fail to Inspect Books and Records**
  The right of a shareholder to inspect corporate books and records pursuant to 8 Del. C. § 220 is not new. Delaware courts have long advised shareholders to utilize the "tools at hand," meaning the right to inspect corporate books and records, to investigate possible wrongdoing before filing an action for breach of fiduciary duty or other wrongs.

- **Member Spotlight: Morris Dees’ ABA Medal Acceptance Speech**
  Morris Dees, co-founder of the Southern Poverty Law Center, received the ABA Medal at the House of Delegates meeting during the Association’s 2012 Annual Meeting in Chicago. Dees received the ABA’s highest honor for his efforts to ensure access to justice for society’s most vulnerable members.

**Inside Business Law**
At the recent ABA Annual Meeting in Chicago, the Pro Bono, Young Lawyer, and Nonprofit Organizations Committees presented a very useful program which addressed best practices in the formation of non-profit organizations, titled "One Foot in Front of the Other: Basics and Best Practices in Nonprofit Formation and Governance."
The global financial crisis revealed a host of deficiencies in the existing regulatory regime. Regulators have spent the last three years working their way through a myriad of perceived issues, from increased capital requirements to regulation of trading of over-the-counter derivatives. Regulators are now turning to “shadow banking.”

The concept of shadow banking has been discussed since the first responses to the financial crisis. However, it was not until a report published by the Financial Stability Board (FSB) in October 2011 that a comprehensive definition of shadow banking was articulated. The report broadly defines shadow banking as “The system of credit intermediation that involves entities and activities outside the regular banking system.”

This is an intentionally broad definition as the FSB wants regulatory authorities to cast their net wide when conducting market surveillance to ensure that all areas where shadow banking-related risks to the financial system might potentially arise are captured. This broad definition reveals that the size of the shadow banking sector grew from $27 trillion in 2002 to $60 trillion in 2007 (these figures cover Australia, Canada, Japan, Korea, UK, United States, and the euro area) to make up approximately 25–30 percent of the total global financial system.

**What are the Benefits of Shadow Banking?**

The size of the shadow banking sector suggests that it plays a useful role in the financial system. In particular, shadow banking activities can perform the following functions:

- Provide alternatives for investors to bank deposits.
- Channel resources towards specific needs more efficiently due to increased specialization.
- Constitute alternative funding for the real economy, which is particularly useful when traditional banking or market channels become temporarily impaired.
- Constitute a possible source of risk diversification away from the banking system.

To reflect these functions, some in the industry prefer the term “alternative” banking, rather than shadow banking.

**Why Does Shadow Banking Raise Concerns?**

Shocks in the financial sector have led to discussions from commentators and regulators about regulated and unregulated activities.

The FSB’s definition of shadow banking is very broad and encompasses a large range of activities, each with its issues. However, in a recent speech, Lord Turner (chairman of the Financial Services Authority and the co-chair of the FSB Task Force on Shadow Banking) explained that the regulators’ key concerns with shadow banking are essentially the same as those in the regulated banking sector:

- Maturity transformation is inherently risky activity — if all depositors want their money back simultaneously, they cannot have it.
- The volume of credit extended and money created can be subject to strong pro-cyclical self-reinforcing cycles — more credit lent drives up asset prices, higher asset prices mean lower losses on credit extended, meaning banks have more capital to support further borrowing. This works until a shock in confidence causes all these factors to work in the opposite direction.

Implementation of prudential regulations, lender of last resort liquidity insurance from central banks, and deposit insurance schemes have mitigated these issues in the regulated sector. However, there are no equivalent policies for the shadow banking sector.

**FSB Recommendations**

To deal with its concerns, the FSB has made eleven recommendations on which to base further work and has divided these recommendations into five workstreams — regulation of banks’ interaction with shadow banking entities, regulatory reform of money market funds, regulation of other shadow banking entities, regulation of securitizations, and regulation of securities lending and repos. Work has now begun on these five workstreams and a number of discussion papers have been published. It is expected that the recom-
mendations under each of the workstreams will be complete by the end of 2012, at which point the FSB will publish a final report to the G20.

Eight of the recommendations have been captured in these five workstreams. The remaining three recommendations are included in a sixth catch-all workstream and reflect recommendations on which implementation of existing initiatives will be monitored. This sixth workstream includes transparency and reporting, rigorous underwriting and reducing the role of credit rating agencies in facilitating shadow banking activities.

In parallel to the FSB’s work, the European Commission of the European Union (EU) has published a green paper (EU Green Paper) on the regulation of shadow banking in 2012, which deals broadly with the same areas. While no similar formal reports or white papers on broad regulatory changes to shadow banks have been published on the subject by United States regulators, some members of the Board of Governors of the Federal Reserve System have been very vocal on the subject of shadow banking, stressing the importance of implementing a regulatory response and suggesting certain near- and medium-term reforms.

This article summarizes the recommendations of the FSB together with any subsequent policy developments. We have structured the article to track the five workstreams identified by the FSB.

Regulation of Banks’ Interactions
The first four of the FSB’s recommendations make proposals for adjustments to bank regulatory capital rules so that the rules properly reflect the risks arising from a bank’s interaction with shadow banking entities. The sixth recommendation proposes that the shadow banking entities themselves be subject to regulatory capital and liquidity requirements. Both the FSB and the European Commission are giving further consideration to the issues covered by these recommendations. Some of these recommendations are inherent in the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in the United States in 2010. Primarily through the law’s ability to designate certain systemically important nonbank financial institutions for supervision by the Federal Reserve, including the imposition of capital and liquidity requirements.

Consolidation. Bank regulatory capital rules apply both on a stand-alone basis and on a consolidated basis. The FSB first recommends, in order to ensure that the rules work effectively on a consolidated basis, that the consolidation includes all shadow banking entities which are sponsored by the bank. This will prevent banks from moving risky assets into shadow banking entities for the purpose of avoiding the application of the regulatory capital rules to those assets.

Exposure Limitations. In its second recommendation, in order to limit interconnectedness to the shadow banking system, the FSB proposes placing limits on the size and nature of exposure banks will be permitted to have to shadow banking entities. If introduced, these limits would form part of the existing large exposure limits.

Adequate Risk-Weighting of Shadow Banking Exposures. The FSB’s third recommendation addresses the need for banks to assign risk weights to shadow banking exposures that reflect the true level of risk. The FSB is particularly concerned about banks being able to treat their investments in funds as equity exposures without regard to the assets or liabilities held within the funds. The FSB wishes to introduce a “rigorous look-through treatment.” A further area of concern is the treatment of undrawn short term liquidity facilities made available to shadow banking entities. Under Basel II, banks can apply a 20 percent credit conversion factor to these facilities, which the FSB considers may be too lenient given the risks of non-payment if the facilities are drawn down.

Restrict Bank Support of Shadow Banking Entities. In its fourth recommendation, the FSB focuses on scenarios in which a bank may give “implicit support” to shadow banking entities — that is, where it might be expected to support an entity even in the absence of a formal, legally enforceable commitment to do so, for example, for reputational reasons. The FSB notes that this issue has already been the subject of reform in 2009, but suggests that more detailed standards may be needed.

Regulatory Reform of Money Market Funds
The FSB’s fifth recommendation relates to regulatory reform of money market funds (MMFs). Although there is no globally accepted definition, MMFs are defined broadly as funds which invest in money market instruments (such as bonds) to preserve capital and provide daily liquidity. In order to achieve this, MMFs typically invest in a diversified portfolio of high-quality, low-duration fixed-income instruments. As such, MMFs have an important role to play both as an investment option for those looking for an efficient way to achieve diversified cash management and also as a buyer of short-term debt issued by a large number of businesses and governments.

During the financial crisis, a number of events in relation to MMFs highlighted their potential role in spreading or even amplifying a crisis. In particular, the International Organization of Securities Commissions (IOSCO) has noted:

- MMFs are susceptible to runs as there is an incentive for shareholders to redeem their shares before others do where there is a perception that the fund may suffer a loss. This is particularly an issue for MMFs that give a constant, rounded Net Asset Value (NAV), where the effect of rounding the NAV concentrates losses in remaining shareholders.
- When MMFs face redemption pressures, they may need to unwind their positions. Since MMFs are such an important supply of short-term funding, this can fuel a liquidity crisis.
- MMFs have relied historically on discretionary sponsor capital
support to preserve the stability of NAV. As the size of MMFs have grown, this has created substantial risks for sponsors.

- MMFs are important participants in the repo market. Problems with MMFs can therefore transfer into the repo markets, which are an important source of funding for banks.

Since the financial crisis, both the EU and the United States have introduced additional regulation for MMFs. In the EU, this took the form of guidelines issued by CESR/ESMA, which cover issues such as portfolio quality, portfolio maturity and the use of constant NAV. In the United States, amendments were made to the main regulation governing MMFs (Rule 2a-7 under the Investment Companies Act of 1940) to tighten up the requirements in relation to portfolio quality, portfolio maturity, portfolio liquidity, stress testing, and public disclosures.

However, the FSB has recommended that regulatory reform of MMFs be further enhanced and has instructed the IOSCO to consider possible policy options. Following a consultation process, IOSCO published its final report on October 9, 2012. The report sets out 15 recommendations intended to form the basis for common standards for the regulation and management of MMFs across jurisdictions. The general approach of IOSCO is that while MMFs are currently regulated as funds, their role in the market and their potential risks are more akin to banks. As such, regulation of MMFs should reflect banking rules, rather than investment fund rules. The key recommendations include:

- A requirement that stable NAV funds move to variable NAV where such a move is workable. Because variable NAV values assets on a marked-to-market basis, this provides price transparency and removes the first mover advantage by forcing redeeming shareholders to redeem at a NAV that reflects current losses, lessening the transfer of losses to remaining shareholders.

This should therefore reduce the risk of MMFs suffering runs.

- Where a move to variable NAV is not workable, stable NAV funds should be subject to additional requirements. This could include imposing NAV buffers (i.e., a fund-level capital reserve which would act as a backstop against losses) or a liquidation fee charged on investors seeking to withdraw.

- Restrictions on the type of assets MMFs may hold and the imposition of limits on the average weighted term to maturity and the weighted average life of the portfolio.

- MMFs should undertake appropriate efforts to identify patterns in investors’ cash needs, their sophistication, their risk aversion, as well as to assess the concentration of the investor base. This will allow MMFs to predict likely redemption profiles. However, IOSCO does not propose specific concentration limits for MMFs.

- Each jurisdiction should define a minimum level of liquid assets that MMFs should hold.

- MMFs should have in place tools to manage a run on the fund, such as temporary suspensions, gates, and/or redemptions-in-kind.

- Disclosure requirements, including a requirement for MMF documentation to explicitly state the possibility of principal loss and information regarding valuation and procedures in time of stress.

- Regulators should develop guidelines governing the use of the repo market by MMFs. Such guidelines should include areas such as settlement, counterparty risks, and collateral management, including the nature of the collateral received.

It is too soon to judge the market’s reaction to the final report. However, it is fair to say that when a number of the recommendations were raised as options in IOSCO’s prior consultation paper they were not widely welcomed by the industry. The overarching view in the market is that MMFs actually performed relatively well during the crisis and additional regulation (beyond that already brought in by the EU and the United States since the crisis) is unnecessary. In particular, a mandatory move to variable NAV funds was criticized by both MMF managers and investors who still see important uses for stable NAV funds (stable NAV funds are treated differently on investors’ balance sheets than variable NAV funds). It is not clear whether the opt-out where a conversion to variable NAV is not workable is sufficient to deal with these concerns. In addition, any move towards bank-like regulation for MMFs, either directly or through options such as capital buffers was criticized as making MMFs less attractive to investors and therefore running the risk of driving business into less regulated vehicles. However a number of the final recommendations do impose such bank-like requirement.

Regulation of Other Shadow Banking Entities

Recommendation 6 of the FSB’s report is to assess what other types of shadow banking entities should be captured by the regulatory regime and subject to appropriate regulatory capital and liquidity requirements to the extent the entity is a source of systemic risk. The need to regulate other types of shadow banking entities is also reflected in the EU Green Paper. Via the Dodd-Frank Act, the United States has extended its oversight of other shadow banking entities, but generally only if the entity is viewed as systemically important. The FSB and the EU identify other shadow banking entities that might need to be caught by regulation as entities such as finance companies, conduits/structured investment vehicles, mortgage insurance companies, and credit hedge funds. This is
on the basis that these entities could pose systemic risk and may provide opportunities for regulatory arbitrage.

The FSB is working to identify and categorize other shadow banking entities. The FSB has set up an Expert Group to coordinate creation of a global Legal Entity Identifier (LEI) and to prepare recommendations for an appropriate global LEI governance framework.

Both the FSB and the EU recommend a detailed assessment of current regulation. Such an assessment should identify potential gaps, develop possible policy recommendations, and propose additional prudential measures where necessary. The FSB also recommends that it assess the scale and risk of these entities and their role during the economic crisis. Both the FSB and the EU recognize that national supervisors may lack the powers necessary for collection of this data and will consider what steps, whether legislative or otherwise, are required to ensure it is possible. The FSB is to publish its report setting out policy recommendations in September 2012.

In the United States, the Dodd-Frank Act’s newly created Financial Stability Oversight Council (FSOC) has the authority to monitor potential threats to the financial system and to provide for more stringent regulation of nonbank financial companies that the FSOC determines pose a risk to the financial system (i.e., systemically important financial institutions or “SIFIs”). Specifically, identified SIFIs would be subject to regulation by the Federal Reserve and to stricter operating standards, including higher capital requirements, leverage limits, liquidity requirements, concentration limits, resolution plans, credit exposure requirements, short-term debt limits, enhanced public disclosure requirements, and overall risk management requirements. The FSOC also may make recommendations to apply more strict standards to a financial activity or practice that it determines poses a risk to the financial system.

**Regulation of Securitization**

The FSB’s Recommendation 7 addresses the incentives associated with securitizations — specifically, risk retention and transparency and standardization of securitization products. In June 2012, IOSCO published a consultation paper titled “Global Developments in Securitization Regulation” in response to the FSB’s recommendation. IOSCO’s observations and findings point to policy recommendations about the following primary issues for consultation with interested parties:

- **Risk Retention:** IOSCO proposes that it monitor industry experience and views on the impact of the differences it has identified in regulatory approach between jurisdictions (e.g., the U.S. and the EU). IOSCO foreshadows that should industry feedback and experience point to the envisaged impacts emerging it will consider developing appropriate regulatory responses and mechanisms to address those differences.

- **Disclosure (Stress Testing/Scenario Analysis):** IOSCO proposes that it consult with investors about their appetite for stress testing information and, if appropriate, provide guidance on the disclosure issuers should be expected to make about stress testing and scenario analysis of pooled assets. Increased transparency could also contribute to the broader objective of reducing investor’s reliance on credit rating agencies.

- **Standardization of Disclosure:** IOSCO proposes that it encourage industry to develop best practice disclosure templates and to encourage industry bodies to work with their counterparts in other jurisdictions to ensure consistent and harmonized approaches. IOSCO should consider developing principles to support harmonization in these approaches.

Separately, the European Commission in its EU Green Paper recognizes the need to examine whether existing regulatory provisions applying to securitizations concerning transparency, standardization, retention, and accounting requirements effectively address shadow banking concerns. The European Commission and the U.S. Securities and Exchange Commission are working jointly on comparing securitization rules in the EU and the United States with this aim in mind.

In its response to the EU Green Paper, the Association for Financial Markets in Europe (AFME) stresses the need for clarification over what is and what is not a securitization that partakes shadow banking:

- **AFME’s view is that not all forms of securitization by definition generate shadow banking concerns. AFME has stressed that the Commission focus its actions on shadow banking on “activities” that generate risk rather than entities of asset classes. In addition, a number of regulatory changes in respect of securitization have already been introduced (or are in the process of being introduced) in Capital Requirements Directive IV, CRA I, and CRA III. These developments should be taken into account by regulators when considering any additional regulatory needs in the securitization field in relation to shadow banking.**

- **Many traditional securitizations include “pass-throughs,” where the investor’s right to repayment is dependent on the securitized assets producing cash and the timing of that event. As such, they involve no maturity transformation and do not involve any leverage issues.**

- **AFME also draws attention to existing regulatory measures being undertaken in Europe, such as the Prime Collateralized Securities (PCS) initiative, which is aimed at ensuring that securitizations with**
the “PCS” label demonstrate a high level of quality, simplicity, and transparency.

- In the case of Asset-Backed Commercial Paper Conduits (ABCP), maturity transformation can clearly be undertaken. There may be a maturity mismatch between conduit assets and liabilities. However, this mismatch is absorbed through the existence of liquidity lines provided by banks in almost all cases. Therefore, maturity transformation risks that appear within ABCP conduits are not shadow banking risks, as such, they are being extensively covered by changes in banking regulations such as CRD IV and Basel III.

- Other types of structured vehicles, such as SIVs, are not strictly speaking securitizations since SIV liabilities were not directly backed by SIV assets. Their nature is more that of leveraged funds. While SIVs did engage in highly leveraged forms of maturity transformation (for example Collateralized Debt Obligations) AFME states that this is not the case for traditional real economy asset securitizations and as above, stresses that the focus for shadow banking regulation should be on “activities” that generate risk rather than entities or asset classes.

In the United States, the Dodd-Frank Act made substantial changes to the way in which asset-backed securities are created, rated, and sold. The Dodd-Frank Act generally requires securitizers to retain 5 percent of the credit risk of their offerings, imposes conflict of interest prohibitions, and expands disclosures of asset-backed securities in registered public offerings. However, proposed rules to implement this provision remain pending.

Regulation of Securities Lending and Repos

Recommendation 8 provides that the regulation of securities lending and repos should be assessed carefully and further enhanced from a prudential perspective. Securities lending and repurchase agreements (repos) are in the focus of the regulators because these activities can be used rapidly to increase leverage and are a key source of funds used by some shadow banking entities. Regulators also fear that there are regulatory gaps in existing regulations as well as inconsistencies between various jurisdictions.

The EU Green Paper indicates that special attention should be given to global leverage resulting from securities lending, collateral management, and repos transactions in order to ensure that supervisors have accurate information to assess this leverage, the tools to control it and to avoid its excessive procyclical effects. Moreover, bankruptcy laws and their impact on collateral should also be reviewed with regard to increasing international consistency along with the accounting practices of such transactions.

The FSB in its report has initially identified three main areas that should be considered in addressing the risks in the secured funding market:

- Regulating securities lending-related cash collateral reinvestment programs: Regulatory measures should be introduced to place limits on the maturity of investments into which cash collateral is invested or on the types of instruments that are used for these investments. Limits on the use of customer’s collateral to finance banks and securities dealers (re-hypothecation) should also be reviewed.

- Macro-prudential measures related to repos and securities lending: Introduction of macro-prudential requirements such as minimum margin or haircuts to mitigate procyclicality should be considered further in addressing systemic risks, drawing on the Committee on the Global Financial System report “The role of margin requirements and haircuts in procyclicality of March 2010.”

- Improving market infrastructure for secured funding markets: Strengthening market infrastructure for secured funding markets such as repo clearing, settlement and trade reporting arrangements should be considered.

In its subsequent Interim Report, published in April 2012, the FSB identified the following issues that should be especially considered from a financial stability perspective:

- Lack of transparency: Due to the usual bilateral nature of securities financing transactions market transparency may be lacking for its participants as well as policymakers.

- Procyclicality of system leverage/interconnectedness: Because leverage may be obtained in a way that is sensitive to the value of the collateral as well as to the financial institutions own perceived creditworthiness, the leverage and the level of risk-taking may potentially destabilize the entire financial system.

- Fire-sale of collateral assets: Collateral fire-sales may lead to market turmoil especially when the defaulting party’s asset pool is large and rather illiquid in comparison to the market.

- Cash collateral reinvestment: By reinvesting cash collateral received from securities lending transactions, any entity with portfolio holdings can effectively perform “bank-like” activities, such as credit and maturity transformations, thereby subjecting its portfolio to credit and liquidity risks.

In the United States, the Federal Reserve Bank of New York in late 2009 created the Task Force on Tri-Party Repo Infrastructure (Task Force) to address the...
systemic risk that had become evident during the financial crisis in the tri-party repo market. The Federal Reserve asked the Task Force, made up of market participants and relevant industry associations, to review and make recommendations regarding opportunities for improvement to the tri-party repo infrastructure. The Task Force’s recommendations, published in February 2012, included reducing demand and supply on intra-day credit, shortening the window for the daily unwind, increasing transparency, and speeding settlement finality.

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The Stock Issuer’s Dilemma: How Duties to Shareholders Limit an Issuer’s Options in Employee Disputes

By Stephen J. Siegel

When a dispute arises between a stock issuer and its former employee who owns restricted shares of the company’s stock, the company may be tempted to use its powers as issuer to gain leverage in the dispute. For example, the former employee may want to sell restricted stock while the issuer may not want to facilitate such a sale until the dispute is resolved. But the law sharply circumscribes an issuer’s ability to stop or delay share transfers in a dispute. In particular, an issuer’s authority to decline to register a stockholder’s share transfers are limited—even when the stockholder may have engaged in fraud. As a result, in disputes with former employees who own restricted stock, a corporation must observe substantial restraint in exercising its powers as stock issuer. Those restraints are the subject of this article.

Illustrating the Dilemma

Two hypotheticals demonstrate just how narrow is an issuer’s authority to use its stock registration powers to prevent or delay a former employee in transferring her restricted shares.

Scenario #1: James Holding Company acquired Bundy Tool and Die in a stock-for-stock merger. In the year after the merger, Bundy turned only a meager profit. The rosy forecasts of Bundy’s former owners faded fast as, one by one, they resigned from James. Fueled by the suspicions of James’ board of directors, you, as general counsel, begin an investigation. The preliminary results cast serious doubt on the accuracy of certain financial information Bundy’s former principals provided in the merger. The scent of fraud seems hard to ignore.

At just this moment, two recently departed Bundy vice presidents submit requests to sell some of the restricted James stock they received in the merger. Restricted stock is stock that the issuer has not registered with the United States Securities and Exchange Commission (SEC) under the Securities Act of 1933, 15 U.S.C. § 77a, et seq. (the 1933 Act). Section 5 of the 1933 Act, 15 U.S.C. § 77e, provides a general bar on sales of unregistered securities, while Section 4, 15 U.S.C. § 77d, states certain exceptions to Section 5’s registration requirement. For convenience, this article refers to securities registration under the 1933 Act as “public registration” and to the registration of stock transfers on the books of the issuer or its transfer agent as “transfer registration.”

To return to our illustration, the Bundy vice presidents have submitted sale paperwork that appears on its face to be in order. Included among these papers are attorney opinion letters stating that the proposed stock sales would not violate the securities laws. Surely, though, the former VPs ought not to be able to sell their stock and abscend with the bounty of a possible fraud.

You consider James’ possible courses of action. The company might refuse to honor the former VPs’ requests to register the sales of their shares, pending the completion of your investigation. But, this course is merely defensive; it would obtain no affirmative relief for James as the wronged party.

You settle on a more aggressive course that holds the promise of getting something back for James. If your investigation finds a fraud, James not only will refuse to register the former VPs’ share transfers, but also will sue Bundy’s former principals. The suit will claim that James paid too much for Bundy because of the sellers’ fraud and will also allege breaches of the merger agreement. Because the Bundy acquisition cannot be unwound, James will seek damages, not rescission. Bundy and its assets still have value to James—but at a lower price than that paid in the merger. Essentially, your damages suit will seek to re-value the Bundy acquisition. Pending its conclusion, the former VPs will not be allowed to sell their remaining shares.

Scenario #2: Jeremy Langdon had been brought into Dunedin Corp. to increase its share of the market for high-end powerboats. Historically, sales at Dunedin had grown slowly. Dunedin ran in the black, but its stock was thinly traded and overlooked. Jeremy had a track record of boosting sales at two previous luxury item compa-
nies. Dunedin hired Jeremy under a three-year employment contract that provided a base salary and generous commission and, upon commencing work, shares of restricted stock.

During his first year at Dunedin, Jeremy proved to be a phenomenal asset. Dunedin’s market share grew by over four percent. The company’s stock began to attract interest. Almost as quickly, however, Jeremy appeared to lose interest. In the first quarter of his second year, he missed a few key meetings and sales growth slowed a bit. During that quarter, Jeremy took advantage of the modest run-up in Dunedin’s stock price to sell half of his restricted shares in sales under SEC Rule 144, 17 C.F.R. § 230.144. Rule 144 allows sales of specified amounts of restricted shares beginning one year, or several years, after the shareholder received them from the issuer, as and when various conditions are met.

In the second quarter of Jeremy’s second year, Dunedin’s sales growth stalled entirely. At mid-year, Jeremy announced his resignation from Dunedin. About this time, his lawyer submitted a request to Dunedin to allow him to sell Jeremy’s remaining shares under Rule 144, along with an attorney opinion letter and other documents supporting the requested sale.

Jeremy received his stock under a contract that called for him to work for Dunedin for three years. At his resignation, however, Jeremy had worked for Dunedin for only half of that time. You instruct Dunedin’s transfer agent to decline to remove the restrictive legend from the remaining half of Jeremy’s restricted shares, preventing Jeremy from making further sales under Rule 144. You wait to hear from Jeremy’s lawyer and start to calculate the proper tribute to demand from Jeremy.

However intuitive these courses of action may seem they are more likely to add to a stock issuer’s problems than to solve them. As discussed more fully in the next section of this article, under Article 8 of the Uniform Commercial Code (UCC), when a holder of securities submits share transfer paperwork that is properly endorsed and conforms with certain formal other requirements, an issuer that seeks to prevent a stock sale generally must either enforce an express contract right to stop the transfer, or prosecute a claim to rescind its own prior sale of the securities to the stockholder. In all events, the issuer risks liability to the stockholder under the UCC for unreasonably delaying or refusing the requested transfer.

Thus, in the two hypotheticals discussed above, the refusals by James and Dunedin to register their former employees’ requested share transfers on their own books (i.e., transfer registration) would expose each company to a suit for (a) injunctive relief and (b) damages accruing from any subsequent decline in their stock’s price. Ironically, James’ and Dunedin’s efforts to gain leverage over their former employees-shareholders could have the reverse effect.

As shown in the final section of this article, an issuer’s options can be similarly circumscribed when a former employee asserts a contractual rather than a statutory right to sell his or her restricted stock. For example, an employment or merger agreement under which an employee obtained restricted stock may state conditions under which the issuer is obligated to facilitate requested securities sales. If the former employee invokes such a contractual right then the issuer can generally stop a requested sale by seeking to rescind its own stock sale to the former employee.

Yet, rescission — unwinding a business transaction — oftentimes is not an attractive or feasible option. Moreover, an issuer’s contractual duty to facilitate a former employee’s stock sales may be deemed an independent obligation that must be satisfied even if the former employee breached other terms of the same contract, although the law is not settled on that point.

Nevertheless, careful drafting of the contract and restrictive legend may enable the issuer to condition its obligation to facilitate share transfers on the former employee-shareholder’s compliance with his contractual and fiduciary duties to the issuer. On the other hand, absent well-crafted contract language, an issuer’s rights to delay or entirely avoid a contractual obligation to register a transfer may be limited. Indeed, in a dispute with a former employee, a company may find that its statutory or contract duties as issuer substantially tie its hands in dealing with the former employee’s stock sales.

Statutory Limits on Stopping Share Transfers

Issuers owe a duty under Section 8-401(a) of the UCC to register a requested securities transfer on the issuer’s books once certain statutory conditions are met. UCC § 8-401(a) provides:

If a certificated security in registered form is presented to an issuer with a request to register transfer or an instruction is presented to an issuer with a request to register transfer of an uncertificated security, the issuer shall register the transfer as requested if:

1. under the terms of the security the person seeking registration of transfer is eligible to have the security registered in its name;
2. the endorsement or instruction is made by the appropriate person or by an agent who has actual authority to act on behalf of the appropriate person;
3. reasonable assurance is given that the endorsement or instruction is genuine and authorized (Section 8-402);
4. any applicable law relating to the collection of taxes has been complied with;
5. the transfer does not violate any restriction on transfer imposed by the issuer in accordance with Section 8-204;
6. a demand that the issuer not register transfer has not become effective under Section 8-403, or the issuer has complied with Section 8-403(b).
but no legal process [e.g., an injunction] or indemnity bond is obtained as provided in Section 8-403(d); and
(7) the transfer is in fact rightful or is to a protected purchaser.

The provisions of Section 8-401(a) differ modestly as enacted by certain states. In sum, however, under UCC Sections 8-401(a) and 8-403, an issuer may not “unreasonably” delay or refuse a requested transfer registration if: (a) the shareholder’s request meets the specified formalities (such as endorsement by an appropriate person); (b) a third-party has neither obtained an injunction to prevent the transfer nor posted an indemnity bond that protects the issuer against liability for refusing the transfer; and (c) the transfer is “rightful.” Further, if an issuer is under a duty to register a transfer and fails or refuses to do so, or unreasonably delays in registering the transfer, then the issuer is liable, under Section 8-401(b) of the UCC, for a stockholder’s resulting damages.

Moreover, the option under UCC Section 8-403 to obtain an injunction or post an indemnity bond to stop a requested share transfer belongs to third-parties, not issuers. Thus, where a shareholder submits transfer papers that are proper in form, the principal statutory avenue available to an issuer that desires to delay or refuse a transfer registration is to claim, under Section 8-401(a)(7), that the proposed transfer is not “rightful.”

Yet, it is not difficult to make a facial showing that a proposed transfer of restricted stock is rightful. For example, issuers have argued that a share transfer requested by a former employee is not rightful because he or she engaged in misconduct that may expose the issuer to civil or criminal liability for securities fraud if it registered the transfer. As shown below, however, courts generally reject an issuer’s claims that a transfer is not “rightful” where a former employee presents an attorney opinion letter, or SEC no-action letter, to the effect that a proposed transfer of restricted stock would not violate the securities laws. This is true even though such attorney opinion letters may assume the truth of the seller’s representations, including that the seller does not possess material non-public information. Courts have reasoned that issuers face no exposure to criminal or civil fraud liability in registering the requested stock transfers because the issuer acts merely as a “conduit” for the shareholder’s sales.

A second, more promising ground that issuers have raised to contend that a requested share transfer is not rightful is that the agreed consideration for the restricted shares was not fully and timely paid. Rule 144 provides that restricted securities must be held for a period of one year, or longer, from the date when consideration for the shares was fully and timely paid.

Cases decided both prior to enactment of the UCC, and under its provisions, illustrate these principles. Indeed, several pre-UCC cases continue to resonate and be cited. Moreover, common law cases may continue to have precedential value in those jurisdictions that hold that Section 8-401 of the UCC did not displace all common law causes of action concerning refusals or delays in registering a requested share transfer.

The seminal common law case is Kanton v. United States Plastics, Inc., 248 F. Supp. 353 (D.N.J. 1965). The defendant issued had terminated the plaintiff’s employment. Thereafter, plaintiff sought to dispose of unregistered shares of the defendant’s stock, which plaintiff had bought from defendant’s president. Plaintiff submitted both an attorney opinion letter and an SEC no-action letter, each stating that he was free to transfer the stock without registering it under the 1933 Act. Notwithstanding the opinion letter and SEC no-action letter, at the president’s direction, the issuer ordered its transfer agent not to transfer the plaintiff’s stock. Plaintiff sued the issuer and its transfer agent in federal court in New Jersey, alleging that they had converted his stock.

The Kanton court held that the defendants could not refuse to register the transfer based on their asserted fear of criminal liability. The court held that neither the 1933 Act nor the Securities Exchange Act of 1934, 15 U.S.C. § 78a, et seq. (the 1934 Act), posed potential criminal liability for the issuer. Accordingly, the court rejected the issuer’s argument that transfer registration could make an issuer criminally liable under Section 24 of the 1933 Act, 15 U.S.C. § 77x, for a willful violation of the public registration requirements of Section 5 of that Act.

A second pre-UCC case also merits discussion. In Riskin v. Nat’l Computer Analysts, Inc., 308 N.Y.S.2d 985, 986–87 (N.Y. App. Div. 1970), aff’d as mod’d on other grounds, 336 N.Y.S.2d 419 (N.Y. App. Div. 1971), the court held that an SEC no-action letter relieved an issuer of any responsibility to ensure that its registration of a share transfer would not assist a criminal act. In Riskin, the plaintiff was a former employee of the defendant who sought to facilitate a share transfer by compelling the corporation to reissue certain shares without a restrictive legend. The legend prohibited transferring the shares without either (a) registering them under the 1933 Act or (b) obtaining an opinion of company counsel that public registration was not required. Plaintiff supplied the issuer and its transfer agent with an SEC no-action letter to the effect that the shares could be transferred without public registration. Nevertheless, the issuer’s counsel refused to provide an opinion letter and even sought, unsuccessfully, to convince the SEC to rescind its no-action letter. Although the SEC confirmed its no-action letter, the issuer argued that it was reasonable for it to satisfy itself that if it allowed the requested transfer it would not be participating in a criminal act.

The court disagreed and held that the SEC no-action letter protected the issuer from any penalty for a willful violation of Section 24 of the 1933 Act. Likewise, the court ruled that the issuer had no civil liability under Section 12 of the 1933 Act, 15 U.S.C. § 77l, for selling securities by means of a prospectus or oral communication that makes an untrue statement.
of material fact or a misleading omission. According to the court, if the issuer granted the former employee’s requested transfer then the issuer would have acted “merely as a conduit for the transfer of the shares without participating in any manner in the sale.” (Emphasis added.)

A Delaware Chancery Court opinion, *Bender v. Memory Metals, Inc.*, 514 A.2d 1109 (Del. Ch. 1986), is an influential decision under the UCC. It illustrates the difficulty of establishing that a registered stock transfer is not “rightful” under Section 8-401 of the UCC. The plaintiff had bought 100,000 shares of unregistered stock from the issuer’s chief executive officer. The shares bore a restrictive legend that prohibited transferring them unless (a) they were publicly registered under the 1933 Act or (b) the issuer received an acceptable opinion of counsel stating that the shares were exempt from public registration. Plaintiff sought to sell the shares under Rule 144 and asked for the issuer’s counsel to provide the necessary opinion letter. But, the issuer’s CEO denied that the plaintiff owned the shares and claimed that the plaintiff’s husband had failed to provide certain financial services to the issuer, which the CEO contended was consideration for the shares issued to plaintiff. The CEO sued the plaintiff, alleging breach of contract and fraud and seeking damages and a return of the shares.

The issuer then refused to issue the requested opinion letter, stating that the CEO’s pending claim precluded such a letter because Rule 144 required full consideration to be paid two years before the restricted shares could be sold. (The comparable holding period under Rule 144 is now one year.)

Plaintiff’s counsel responded by authorizing two successive opinion letters asserting that, regardless of the CEO’s claim, the plaintiff’s sale would be exempt from public registration. The issuer rejected each letter as not being “acceptable to the company,” claiming that if the CEO owned the shares, rather than the plaintiff, then the requested transfer registration could expose the issuer to civil and criminal liability under the 1933 Act.

Plaintiff responded by suing the issuer to compel it to provide her a clean share certificate with no restrictive legend. The court granted this relief, holding that the issuer had no reasonable fear of liability under the 1933 Act. Regardless of the stock ownership dispute, the court reasoned that the evidence the issuer possessed, including the opinion letter, established that plaintiff was not an “issuer,” “dealer,” or “underwriter” and, thus, the sale was exempt from public registration under the 1933 Act.

The court reasoned that an issuer may rely on an opinion of counsel because its author has greater familiarity with the facts and assumes the risk of liability for a negligent opinion. Therefore, even if the transfer violated the 1933 Act, the defendant issuer faced no possible criminal liability because the violation would not have been “willful.” The court also held that the issuer could not face civil liability under Section 12 of the 1933 Act where it had acted simply as a “conduit” for a stock transfer, citing *Riskin*. In particular, the issuer could not be held liable under Section 12 for mere negligence; instead, such liability required that the issuer have participated in the underlying violation knowingly and substantially. The court reasoned that an issuer who relies in good faith on a stockholder’s sworn statement and an opinion of counsel cannot violate the 1933 Act knowingly or willfully. Accordingly, the court rejected the issuer’s defense that the transfer was not “rightful” under Delaware UCC Section 8-401(e).

More recently, in *Netwolves Corp. v. Sullivan*, No. 00 Civ. 8943 & 9628, 2001 WL 492463, at *2–4, 9 (S.D.N.Y. May 9, 2001), the court ordered the issuer to instruct its corporate counsel to issue an opinion letter stating that five former employees of a subsidiary could lawfully transfer their restricted stock. The plaintiff’s counsel then asked the issuer to instruct its counsel to issue an opinion letter stating that they could not be transferred without either (a) public registration or (b) an opinion from the issuer’s counsel stating that the transfer was permissible.

A dispute arose between the issuer and the plaintiffs over the subsidiary’s financial performance. The plaintiffs wanted to sell their restricted shares and asked the issuer’s counsel to prepare the opinion letter. The issuer’s counsel refused. In justifying this refusal, the issuer did not rely on the subsidiary’s disappointing financial performance. Instead, the issuer refused to cause its counsel to issue the opinion letter because: (a) the issuer had filed suit to rescind the merger pursuant to which plaintiffs received their shares; and (b) the proposed sales allegedly violated certain quantity limitations in Rule 144. The court rejected both arguments and ordered the issuer to instruct its counsel to issue the letter. The court cited its contemporaneous dismissal, on jurisdictional grounds, of the issuer’s rescission claim. The court also held that any violation of the quantity limits in Rule 144 would not justify a refusal to issue the opinion letter but would warrant only a limitation on the volume of permitted sales. Finally, the court found that because the issuer was nearing insolvency, irreparable harm justified requiring the issuer to cause its counsel to issue an opinion letter allowing the plaintiffs to sell the permitted volume of shares.

UCC Section 8-401 and these cases establish that when a shareholder presents, in proper form, both (a) share transfer paperwork and (b) an opinion letter stating that the transfer would comply with applicable securities laws, the issuer typically has no statutory or common law right to prevent the proposed share transfer unless one of a few potential exceptions applies.

The first exception arises under UCC Sections 8-401(a)(6) and 8-403(d) where a third-party procures either an injunction preventing the transfer or an indemnity bond protecting the issuer against liability for refusing the transfer. A second exception may prevent a share transfer if the issuer sues to rescind the contract under which the shareholder acquired the restricted shares. If the issuer fails to win
its rescission claim, however, then it may be liable for any damages the delay causes the shareholder.

Third, an issuer that restates its financial statements may be entitled, and indeed required, to reacquire (or “clawback”) restricted securities, or the proceeds thereof, from a former executive officer or other highly compensated employee. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the 1934 Act, 15 U.S.C. § 78j-4, to require a clawback of certain “incentive based compensation” in the event of a financial restatement. It is an open question whether restricted securities, or the proceeds thereof, may constitute such incentive based compensation. Clawback provisions were also included in the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243(a), and the Emergency Economic Stabilization Act of 2008 (establishing “TARP”), as amended, 12 U.S.C. § 5221(b)(3)(B). But, the Sarbanes-Oxley clawback provision is not enforceable by a private right of action. See, e.g., Cohen v. Viray, 622 F.3d 188, 194 (2d Cir. 2010). Similarly, it may be doubted whether the clawback provisions in Dodd-Frank and TARP are enforceable by private rights of action.

There is a fourth circumstance that may allow an issuer to prevent a former employee from transferring shares: if the issuer holds and exercises a clear contractual right to stop the requested transfer. It is to that subject that we now turn.

**Contract Duties Relating To Transfer Registration**

An issuer’s duty to register a stock transfer may arise not only from the UCC, but also from the issuer’s contractual obligations. For example, an employment or merger agreement may (a) provide restricted stock to new employees or to sellers of an acquired entity and (b) state conditions under which the issuer is required to register a requested share transfer. The contract also may authorize the issuer to decline a requested transfer registration under specified circumstances. In either situation, case law demonstrates that: (a) courts are reluctant to recognize an issuer’s right to bar a shareholder from transferring restricted shares, even when the issuer and shareholder are engaged in a dispute; and (b) an issuer that wants to prevent a former employee from selling restricted stock, as a practical matter, must have a clear contractual right to prevent the transfer or a sound basis for rescinding its sale of the stock in question.

As an initial matter, contractual restrictions on a former employee’s rights to transfer shares must be express. For example, in Catherines v. CopyTele, Inc., 602 F. Supp. 1019, 1021–23, 1026–27 (E.D.N.Y. 1985), the defendant-issuer refused to allow the plaintiffs to sell their restricted shares although the Rule 144 holding period had passed. The issuer argued that it was an implied condition of plaintiffs’ share transfer rights that plaintiffs remain employed by the issuer. The court found no support for the alleged restriction on plaintiffs’ transfer rights and enjoined the defendant-issuer from interfering with plaintiffs’ sales of stock.

Even when an issuer has an express contractual right to prevent a former employee from transferring shares, the issuer may not exercise that right if it has breached the contract. In Steranko v. Inforex, Inc., 362 N.E.2d 222 (Mass. App. Ct. 1977), the plaintiff, a former company executive, had acquired 24,000 restricted shares under his employment agreement. Plaintiff had contracted not to sell his stock for five years and to allow the issuer to repurchase the shares at cost if he was discharged for cause. After plaintiff was demoted, he sought a judicial determination that he had been constructively discharged. He also refused to assign certain patent rights, as called for in his employment agreement. Citing that refusal, the issuer discharged the plaintiff for cause and sought to repurchase his restricted shares at cost. When the plaintiff refused to sell the shares back, the issuer sued, seeking their return.

In response, plaintiff demanded that the issuer and its transfer agent issue certificates for most of his shares without a restrictive legend. But the transfer agent, on instructions from the issuer, declined to issue clean certificates. Plaintiff then brought another suit, seeking damages from the issuer, its president and the transfer agent for refusing to lift the restrictive legend. The three cases were then consolidated.

The trial court and appellate court each held that by demoting plaintiff the issuer had breached the employment agreement. The trial court further held that the stock restrictions in the issuer’s favor remained enforceable despite the issuer’s breach. But the appellate court disagreed. It held that the issuer’s breach rendered unenforceable the employment agreement’s restrictions on the former employee’s right to sell his stock, as well as the issuer’s contractual right of repurchase. Accordingly, the court ordered the restrictive legends removed from the plaintiff’s share certificates and held plaintiff was entitled to damages for the delay in allowing the stock sale. In sum, the Steranko court held that an issuer’s breach of contract deprived the issuer of the power to enforce express contractual restrictions on a former employee’s right to sell shares.

Yet, the converse is not necessarily true — courts have split on whether a restricted shareholder’s contractual right to register a share transfer is independent of the shareholder’s contractual obligations. In the Metzler Group, Inc. v. Kearns, No. 99 C 1543 (N.D. Ill. Sept. 15 and 24, 1999), the plaintiffs, a publicly-traded issuer and its recently-acquired subsidiary, sued the individuals who had sold the subsidiary to the issuer. (The author and Novack and Macey LLP represented a defendant in the The Metzler Group case.)

The issuer alleged that the sellers engaged in fraud in the inducement and that, after the merger, certain sellers breached the merger agreement and their fiduciary duties as officers of the subsidiary. The plaintiff companies did not request to rescind the merger agreement and instead sought money damages.

One of the sellers brought a counterclaim alleging that the issuer had breached a contractual obligation to lift the restrictive leg-
end on her stock. Under the merger agreement, a condition to this contractual right was that the shareholder have tendered an opinion letter satisfactory to the issuer stating that the proposed share transfer was exempt from public registration under the securities laws. The counterclaimant had submitted an attorney opinion letter, but the issuer still refused to allow the sale. Among the issuer’s numerous objections to registering the share transfer were that: (a) the opinion letter was not “satisfactory to the Company”; (b) the counterclaimant could not enforce the merger agreement because she had breached it; and (c) the proposed sale might leave the issuer and its subsidiary without recourse against the counterclaimant if they prevailed on their affirmative claims.

The court rejected each of these arguments. First, it dismissed the issuer’s objections to the attorney opinion letter as “frivolous.” Second, the court held that the general principle that a material contract breach by one party excuses the other party from continuing to perform had no application to plaintiff’s share transfer rights. The court reasoned that the issuer’s contractual obligation to lift the restrictive legend upon satisfaction of certain conditions was independent of the contractual provisions that the former officer allegedly had breached. Third, the court rejected the issuer’s attempt to preserve the former officer’s shares to satisfy a potential judgment in the issuer’s favor because the issuer had not sought to rescind the merger agreement nor shown any statutory or other ground for holding the stock as security against a future judgment.

Accordingly, on summary judgment, the court ordered the issuer to lift the restrictive legend and register the proposed open-market sales. Impliedly, had the issuer sought to rescind the merger agreement and reacquire the shares, the court would have held that that claim suspended the issuer’s contractual duty to perform the requested transfer registration. Absent a claim for rescission, however, the shareholder’s alleged breach of a contractual obligation did not suspend the issuer’s duty to register the share transfer. To similar effect is the decision in Diversified Earth Sciences, Inc. v. Hallisey, No. 73 Civ. 816, 1973 WL 401, at *3–4 (S.D.N.Y. June 12, 1973), which concluded that, “Diversified does not seek rescission in its complaint, only money damages. By implication, therefore, it does not contest the ownership of the shares sought to be transferred. Hence I find that Diversified has no reasonable justification for obstructing the transfer[.]”

A different result from The Metzler Group was reached in Mackinder v. Schawk, Inc., No. 00 Civ. 6098 (DAB), 2005 WL 1832385, at *16 (S.D.N.Y. Aug. 2, 2005). That court, on summary judgment, declined to hold that an issuer’s contractual duty to facilitate a transfer registration is severable from the shareholder’s contractual obligations. The plaintiff had sold her business to defendant in return for restricted stock. When a dispute arose concerning plaintiff’s post-merger performance as an officer of the acquired entity, the issuer refused to lift the restrictive legend from the shares to enable plaintiff to sell them. Plaintiff sued, seeking, among other things, an order requiring defendant to remove the restrictive legend. Although the holding period under Rule 144 had expired, the court denied plaintiff’s summary judgment motion on this claim, citing the following language in the restrictive legend:

The shares represented by this certificate may not be transferred in violation of such act and laws, the rules and regulations thereunder or the provisions of said stock purchase agreement. . . . The holder of this certificate, by the acceptance of this certificate, agrees to be bound by the provisions of such stock purchase agreement.

Based on the highlighted language, the court reasoned that:

It is clear from the language contained in the restrictive legend that the shares were subject to the Merger Agreement and the Employ-
requests to register transfers of restricted shares or remove restrictive legends. Issuers who want such leverage to be available in future disputes should draft their stock purchase, merger, and employment agreements to provide specifically that the issuer’s claims of material breach of contract, fraud, breach of fiduciary duty, or other wrongdoing against the employee entitle the issuer to delay or prevent transfer registration by any holder of the share certificate. Likewise, issuers should draft their restrictive stock legends to specify that the holder agrees to be bound by the associated stock purchase, merger and/or employment agreements as a whole, including, but not limited to, the restrictions on transfer they contain.

Absent such provisions, issuers should presume from the UCC and the decisions discussed above that a court will favor transferability in deciding a former employee’s request to sell restricted shares. In that regard, an issuer who wants to delay or prevent a requested share transfer, but lacks an express contractual right to do so, would likely need to rescind the transaction by which the shares were originally obtained to have a secure legal basis for preventing a subsequent stock transfer.

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In late August, the Department of the Treasury issued Notice 2012-58, which provides further guidance on methods employers are permitted (but not required) to use in determining which employees must be treated as full-time employees for purposes of calculating any assessable payment under the employer shared responsibility provisions in Section 4980H of the Internal Revenue Code (Section 4980H). These provisions generally apply to employers with at least 50 full-time equivalent employees (applicable large employers).

Notice 2012-58 is the latest in a series of releases from the United States Department of Labor, Health and Human Services, and the Treasury (the Departments) addressing certain provisions of the Affordable Care Act that are of special concern to employers due to their potential impact on plan design and cost. These provisions include the employer shared responsibility provisions in Section 4980H, as well as the automatic enrollment provisions of Section 18A of the Fair Labor Standard Act and the maximum 90-day waiting period a group health plan can impose on employees who are otherwise eligible for the employer’s group health plan coverage under Section 2708 of the Public Health Services Act (Section 2708). The regulatory process in developing guidance under these provisions has been characterized by coordination among the Departments and a give-and-take between the regulators and interested stakeholders, with the Departments issuing guidance describing proposals for dealing with some of the most challenging aspects of the new provisions, then refining those proposals in response to stakeholder feedback.

By way of background, beginning in 2014, an applicable large employer may be subject to the employer shared responsibility provisions of Section 4980H if at least one of its full-time employees receives a premium tax credit or cost-sharing reduction for coverage that he or she purchases on one of the new insurance exchanges. The amount of an employer’s exposure under Section 4980H depends on whether the employer offers its full-time employees the opportunity to enroll in a qualifying health plan. If the employer does not make a qualifying offer of coverage, the penalty is $2,000 per all full-time employees (excluding the first 30); if such an opportunity is offered, the penalty is $3,000 per full-time employee who receives a premium tax credit, capped at the penalty the employer would have paid if it had failed to offer coverage in the first instance. In general, in determining whether an employee is eligible for a premium tax credit or cost-sharing reduction, an employer will be considered to offer a “qualifying plan” if the actuarial value of the plan exceeds 60 percent and if the employee contribution to the cost of coverage is less than 9.5 percent of the employee’s household income.

For purposes of determining an employer’s potential Section 4980H liability, a “full-time” employee is an employee who, with respect to any month, works at least 30 hours per week, which may be different than the “full-time” standard plan sponsors are currently using to determine plan eligibility. Many of the proposals that have been put forth by the Treasury Department so far have been attempts to grapple with how employers will administer this monthly determination, particularly those employers with large numbers of workers whose hours fluctuate from week to week, much less month-to-month,
In all, the Treasury Department has issued five notices covering a variety of issues under Section 4980H, including Notice 2012-58. Notice 2012-58 builds on proposals set forth in guidance issued earlier this year by the Departments in Notice 2012-17 and Technical Release 2012-01. In that guidance, the Departments addressed the expected scope of proposed regulations to be issued under Section 4980H. They reiterated their intent to include an employer safe harbor that allows employers to determine the affordability of coverage offered to employees by reference to their W-2 wages rather than to their household income, as originally proposed in Notice 2011-73. They also confirmed their intent to permit employers to use a “look-back/stability period” safe harbor method, originally proposed in Notice 2011-36, to determine whether employees with less predictable work schedules are full-time employees for purposes of assessing a penalty under Section 4980H. Finally, this earlier guidance addressed the interaction of Section 4980H with the Section 2708 prohibition on waiting periods in excess of 90 days.

Notice 2012-58 expands the “look-back/stability period” safe harbor method for determining whether variable hour and seasonal employees are treated as full-time employees for purposes of the employer shared responsibility provisions of the Affordable Care Act. The Notice reflects comments received in response to the previous proposals by giving employers the option to use a look-back measurement period of up to 12 months to determine whether new and ongoing variable hour employees and seasonal employees are full-time employees. The guidance also provides for the optional use of certain periods intended to enable employers to administer the determinations made, explains how employees can transition from the determination method used for new employees to that used for ongoing employees, and provides useful examples of how these expanded methods can be applied. Simultaneously with the issuance of Notice 2012-58, the Department of the Treasury issued Notice 2012-59 and the Departments of Labor and Health and Human Services issued substantially identical administrative guidance expanding and refining the proposals previously put forward on the maximum 90-day waiting period permissible under Section 2708.

While the rules may appear complicated, they offer employers a common sense approach to determining whether a variable hour or seasonal employee should be treated as a full-time employee. In addition, the two Notices, read together, show how an employer can design its group health plan to take advantage of the safe harbor approach to determining the full-time status of newly-hired employees detailed under Notice 2012-58 with the 90-day maximum waiting period rules set forth in Notice 2012-59. In an effort to eliminate further uncertainty and enable employers to begin planning for 2014, the guidance permits employers to rely on Notices 2012-58 and 2012-59 at least through the end of 2014.

### Determining Full-Time Status

In general, the framework set forth in Notice 2012-58 builds off the safe harbor method first proposed in Notice 2011-36, under which an applicable large employer may use a measurement period of up to 12 months to determine whether an employee will be treated as full-time for each month during a corresponding stability period. The Notice introduces terms and concepts that will become familiar to employers establishing methods for determining full-time employee status. These include:

- **Variable Hour Employee.** A new employee is a variable hour employee if, based on the facts and circumstances at the date the employee begins providing services to the employer, it cannot be determined that the employee is reasonably expected to work on average at least 30 hours per week.

- **Seasonal Employee.** The Affordable Care Act does not define seasonal worker for purposes of determining when someone is a full-time employee. Notice 2012-58 states that through at least 2014, employers are permitted to use a reasonable, good faith interpretation of the term “seasonal employee” for this purpose.

- **Ongoing Employee.** An ongoing employee is an individual who has been employed by the employer for at least one complete standard measurement period.

- **Standard Measurement Period.** A standard measurement period is a time period of not less than three but not more than 12 consecutive calendar months, as chosen by an applicable large employer for determining the full-time status of an ongoing employee.

- **Initial Measurement Period.** The initial measurement period is a time period of not less than three but not more than 12 consecutive calendar months, as chosen by an applicable large employer for determining the full-time status of a new variable hour or seasonal employee.

- **Stability Period.** For ongoing employees, a stability period is a period of at least six consecutive calendar months that is no shorter in duration than the standard measurement period and that begins after the standard measurement period and any applicable administrative period. The stability period for new employees must be the same length as the stability period for ongoing employees (i.e., at least six consecutive calendar months that is no shorter in duration than the initial measurement period) and begins after the initial measurement period and any associated administrative period.

- **Administrative Period.** An administrative period is a period of not longer than 90 days following the end
of an initial or standard measurement period and before the associated stability period, during which an employer can complete standard duties associated with group health plan administration, such as making eligibility determinations and notifying and enrolling eligible employees. For new employees, the permissible 90 day period between the initial measurement period and the initial stability period is reduced by the number of days between the date of hire and the first day of the initial measurement period.

- **Permissible Employee Categories.**

  Permissible employee categories are those categories of employees for which employers may use measurement periods and stability periods that differ either in length or in their starting and ending dates. The categories are (1) collectively bargained employees and non-collectively bargained employers, (2) salaried and hourly employees, (3) employees of different entities, and (4) employees located in different states.

**Ongoing Employees**

Under the safe harbor method, employers can have a standard measurement period with a different start and duration for each permissible employee category, so long as the determination is made on a uniform and consistent basis for all employees in the same category. If an employee averages at least 30 hours per week (or 130 hours per month) during the applicable standard measurement period, then the employer must treat the employee as a full-time employee during the subsequent stability period, regardless of the employee’s number of hours worked during the stability period. If the employer determines that the employee did not average 30 hours per week during the standard measurement period, the employer can treat that employee as not a full-time employee during the stability period that follows, but is not longer than the standard measurement period.

In Notice 2012-58, the IRS has established a permissible administrative period of up to 90 days. This period neither reduces nor lengthens the standard measurement period or the stability period, but overlaps with the prior stability period to ensure continued coverage for ongoing employees who were eligible for coverage based on a determination of full-time status during a prior standard measurement period.

**New Employees**

The Notice modifies the prior proposal set forth in Technical Release 2012-1 by lengthening the maximum permissible initial measurement period for newly hired variable hour and seasonal employees from six to 12 months. If an employee is determined to be a full-time employee, he or she must be treated as a full-time employee for each month in a stability period that is the same length as the stability period for ongoing employees. If an employer is permitted to treat the employee as not a full-time employee during the stability period, the duration of the stability period cannot exceed the duration of the initial measurement period by more than one month and it must not exceed the remainder of the standard measurement period (plus any associated administrative period) in which the initial measurement period ends. The Notice also provides guidance on how to transition from the new employee rules to the ongoing employee rules.

For a new employee who is reasonably expected at his or her start date to work full-time, the Notice makes clear that no penalty under Section 4980H will be assessed with respect to the first three calendar months of employment, so long as coverage is offered at or before the conclusion of those three months.

Application of these rules is best explained by the many examples provided throughout the Notice.

**90 Day Maximum Waiting Period**

Section 2708 of the Public Health Services Act, as incorporated into the Code and ERISA, prohibits any group health plan from imposing a waiting period longer than 90 days. A waiting period is the period of time that must pass before coverage for an employee or dependent who has otherwise met the plan’s substantive eligibility conditions (such as being in an eligible job classification or achieving job-related licensure requirements specified in the plan’s terms) can become effective.

Notice 2012-59 provides temporary guidance on what the Departments will consider to be compliance with Section 2708, at least through the end of 2014. Under this guidance, eligibility conditions that are based solely on the lapse of a time period are permissible for no more than 90 days; other conditions for eligibility are generally permissible, so long as they are not designed to avoid having to comply with the 90-day waiting period limitation. The waiting period limitation will be considered satisfied if the employee can elect coverage that begins within a permissible 90-day period, even if the employee takes additional time to elect coverage.

In providing guidance on the application of the 90-day waiting period limitation to employees who work less predictable schedules, Notice 2012-59 builds on the safe harbor method set forth in Notice 2012-58 for newly hired variable hour and seasonal employees. Under the Notice, if a group health plan conditions eligibility on an employee regularly working a specified number of hours per period (or working full time), and it cannot be determined that a newly hired employee is reasonably expected to regularly work that number of hours per period (or work full time), the plan may take a reasonable period of time to determine whether the employee meets the plan’s eligibility condition. The reasonable period may include a measurement period that is consistent with the timeframe permitted for these determinations under Section 4980H (i.e., no more than 12 months), whether or not the employer is an applicable large employer subject to Section 4980H. For employees who satisfy the hours of service or full-time status requirement, coverage must
be made effective no later than 13 months from the employee’s start date (plus if the employee’s start date is not the first day of a calendar month, the time remaining until the first day of the next calendar month).

More to Come
Notice 2012-58 indicates that upcoming proposed regulations under Section 4980H will reflect the proposals and issues described in the Notice and certain other issues on which comments are specifically requested. Given the short comment deadline of September 30, 2012, employers might expect to see proposed regulations prior to the end of this year.

In addition, representatives of the Internal Revenue Service have recently confirmed that the proposed regulations will address a number of other important questions raised by the application of Section 4980H. We would expect these to include:

- What does it mean for an employer to “offer” coverage to employees? In Notice 2011-21, the IRS stated that it expected proposed regulations to make clear that an employer “offering coverage to all, or substantially all, of its full-time employees would not be subject to the 4980H(a) assessable payment provision” (emphasis added). This implies that an employer could avoid exposure for the more costly $2,000 assessment even if some of its full-time employees are not eligible for coverage under the employer’s group health plan. For example, notwithstanding that an employer excludes certain full-time employees based on their geographic location, the nature of the work or their status as seasonal employees, will the employer be deemed to be offering coverage to its full-time employees thereby avoiding the assessment under Section 4980H(a)?

- Whether an employer that offers coverage to “substantially all” its full-time employees might still have exposure under 4980H(a) for a failure to offer coverage if it does not offer family or other dependent coverage?

- How does an employer determine whether its health plan is affordable (i.e., whether the employee contribution exceeds 9.5 percent of household income)? It is expected that proposed regulations will confirm that affordability will be based on the wages paid to an employee by the employer and reported on the employee’s Form W-2. While such employee could still receive a premium tax credit or cost-sharing reduction from an exchange if the cost of the employer’s coverage exceeds 9.5 percent of his or her household’s adjusted gross income, the employer will not be assessed a penalty under Section 4980H if the employee’s contribution toward the cost of employer coverage does not exceed 9.5 percent of the employee’s income reported on Form W-2.

- Will employers that offer their employees a “defined contribution” health plan, such as a health reimbursement arrangement (or HRA) be considered to “offer” coverage for purposes of Section 4980H and, if so, can such a plan design continue to exist post-2014 when other provisions of the Affordable Care Act that prohibit the imposition of a lifetime or annual limit on benefits are in full effect? Moreover, how would the 60 percent minimum value and the 9.5 percent affordability standards apply to this type of plan design? Could an employer “integrate” an HRA or other similar funding arrangement with a plan purchased on the individual market (whether on the new exchanges or otherwise) and rely on the individual market policy to meet any applicable Affordable Care Act provisions?

Consistent with the past guidance issued, the Departments have signaled a keen awareness of the importance of providing timely guidance on these and other issues under Section 4980H on which employer can rely at least through 2014. Given the lead time necessary for employers to review and, if desired, make changes to plan design and eligibility for coverage effective on or after January 1, 2014, we believe that the Departments are working hard to provide the guidance needed in the not too distant future.

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Canada and the United States have both developed case law pertaining to poison pills, which are the most common defense for a board facing a hostile bid. Comparing the two countries’ jurisprudence suggests that a poison pill defense is significantly more effective in the United States. The following fictitious case study reveals how the two countries differ on the extent to which a target company board can rely on a poison pill to deter a hostile bid.

Easytarget Inc. is an American semiconductor chip maker incorporated in Delaware. Its shares of common stock are trading on NASDAQ at $26 per share. Easytarget’s board of directors recently reconfirmed its long-standing strategic plan to consolidate numerous smaller players in the industry, enabling it to challenge certain dominant competitors. Easytarget is widely held, except for one institutional shareholder that holds 12 percent of its outstanding stock.

DynamicGiant, a dominant player in the semiconductor industry, has announced its intention to launch a bid to acquire all of the shares of common stock of Easytarget at a price of $34 per share, conditional upon a minimum tender of 50 percent of the outstanding common stock. The consensus of Easytarget’s board is that DynamicGiant’s bid does not reflect an adequate premium for the control of Easytarget and fails to compensate its shareholders for the value of Easytarget’s growth prospects. Easytarget’s board seeks advice on whether and to what extent Delaware law and U.S. federal securities laws permit the poison pill to prevent DynamicGiant from consummating its bid.

The board has indicated that Easytarget’s annual shareholders meeting will be held within the next four months. Three board members of Easytarget are Canadian residents, and are asking if, and how, our answers would differ if Easytarget were instead subject to Canadian corporate and securities laws.

Delaware Yankee: When the Delaware Supreme Court upheld the poison pill in 1985, it left open the question of when the directors’ fiduciary duties would require them to eliminate the poison pill and permit a hostile bid to proceed. There has never been any question in Delaware that this is a legitimate use of the poison pill. At least partly for that reason, however, we don’t see any such hostile bids, as we did back at the time the poison pill was first developed.

Canadian’s response: In Canada, the two-tier, front-end loaded bid has not been used, simply because regulations adopted by provincial securities commissions require that the per share consideration in a second step transaction is at least equal in amount and form to the consideration received by tendering shareholders.

Delaware Yankee: In Delaware it became clear soon after 1985 that boards could deploy the poison pill to permit them to develop alternative transactions — restructurings, and not just white knight competitive bids — that might result in greater value to stockholders than the hostile bid. So at the very least, Easytarget’s board can maintain the poison pill for a considerable time — there’s no set limit — while searching for potentially superior transactions. Within reason, the timetable and content of that search is up to the board’s business judgment. Once the process concludes, however, and the board presents its preferred transaction to the stockholders, it
is the stockholders who will have the final say, either by tendering shares or voting on a proposed transaction; the poison pill falls by the wayside.

**Canadian’s response:** Canada’s approach is a lot friendlier to the unfriendly bidder. Canadian securities commissions have used their public interest jurisdiction to regulate poison pills based upon guidelines they adopted in 1986 (referred to as National Policy 62-202) dealing with defensive measures in face of a takeover bid. According to that policy, “public interest lies in allowing shareholders of a target company to exercise one of the fundamental rights of share ownership — the ability to dispose of shares as one wishes.” Nevertheless, Canadian regulators have through numerous poison pill cases confirmed that a poison pill plays a legitimate function by giving management of target companies more time than the minimum prescribed by law (currently 35 days from the launch of the bid) to explore alternatives that would maximize shareholder value. But unlike Delaware’s approach, that value maximization process has been narrowly interpreted by case law to be limited to finding alternative superior bids. Any other transactions not offered to shareholders, such as the sale of assets and issuance of additional shares, would, in most instances, be perceived by the regulators as additional defensive measures subject to careful scrutiny by the regulators. In deciding whether to prohibit continued use of the poison pill, securities commissions consider the likelihood that the target company will be able to find a better bid, and they usually limit the search for alternative bids to at most 60 days after the initial bid was commenced. To conclude, considering that the bid made by DynamicGiant does not appear to be structurally coercive, the board of directors of Easytarget can adopt a poison pill in order to obtain 10 to 30 days in addition to the minimum 35-day period required by law to conduct an auction or other value maximization process for the shareholders.

**Delaware Yankee:** Delaware’s corporate law affords boards much more discretion and avoids the regulatory approach you describe. From *Household* on, the Delaware courts have emphasized that directors’ responses to takeover bids are part of their statutory managerial responsibilities. Thus, poison pills may be used for any legitimate corporate purpose, and not just to protect a process for developing alternative transactions in the face of a hostile bid. In our view, the latter approach — limiting the use of the pill to protecting efforts to sell the company — effectively takes away from the board the decision about whether and when to put the company up for sale.

The hard question is what limits the board’s discretion in maintaining a poison pill. Practitioners have always speculated that Delaware courts would endorse the so-called “just say no” approach, in which the board can maintain a poison pill simply to continue its existing strategy and block a hostile bid indefinitely. That issue was what was addressed in the well-known decision by Chancellor Chandler in the *Airgas* case last year, in which the Court of Chancery declined to compel the elimination of the poison pill in the face of an all-shares, all-cash tender offer accompanied by an undertaking to complete a second-step merger promptly and on the same terms. The board’s concern that the court legitimated has been described as “substantive coercion”: The risk that despite board advice to the contrary, stockholders might choose to tender into an inadequate bid due to ignorance or mistaken belief about the value of the stock.

This is not a position that the Delaware court found easy to reach: At a minimum, it required substantial proof of the basis for the expressed concern, and in the *Airgas* case itself, the court took considerable comfort from the fact that three of the directors who voted to maintain the pill had been nominated by and elected with the aid of the hostile bidder. So no one should think that directors can “just say no,” without more; even under Delaware’s relatively director-centric approach, courts can and do demand specific evidentiary support for the proposition that the board’s maintenance of the pill is justified.

**Canadian’s response:** Most of the early Canadian cases dealing with poison pills involved situations where the target board had initiated a search for competing offers in response to a hostile bid. Therefore, and as in Delaware, where multiple bids had emerged from that process, the case law naturally held that “there comes a time when the pill must go” to enable the shareholders to decide for themselves, and that poison pills should not permit the management of the target to interfere between competing bids.

In the last decade, however, boards have increasingly decided not to initiate a sale process when facing a hostile bid. Instead, they have continued to focus on continuing the company’s existing business plan. Unfortunately, Canadian securities commissions have made no useful distinction between these two scenarios. When the Canadian regulators have set aside poison pills over the years, they have acted under the assumption that target company shareholders are able and have a “right” to decide in ALL circumstances, with the benefit of the board’s advice, whether or not to sell their shares into a bid. We question, however, whether invoking this assumption is consistent with good policy, in light of substantial new circumstances that emerged over the last decade in the capital markets, such as: More rigorous corporate governance practices that arguably reduce the risk of management entrenchment; the recent challenging environment for potential white knights to obtain acquisition financing; powerful consolidation of certain industries; and a withdrawal from the M&A market by private equity firms leading to a less efficient M&A market in certain industries. A wise poison pill policy should also take account of the specifics facts of each case, including whether the shareholder base is widely disaggregated, the identity of the target’s shareholders and their possible conflicting interests, the identity of the bidders, and current economic conditions and industry-specific challenges or conditions.

These contextual considerations are not well suited to a doctrinaire regulatory
approach; they are much more readily addressed by informed, independent directors familiar with the target company and its plans and position in the industry. It is therefore troubling, in my view, that securities regulators have generally declined to defer to any extent to the business judgment of a board of directors of a target company before terminating a poison pill, despite the fact that the issuance of securities, pursuant to a pill or otherwise, is specifically within the board’s corporate power to manage and direct the business and affairs of a corporation pursuant to corporate law. The difficult question is instead how much deference to accord to target board decisions to maintain the poison pill.

In light of the policy premise adopted by Canadian securities regulations — i.e., that shareholders are entitled to decide for themselves whether to sell their shares — the Canadian answer to that question of how much to defer to board decision making is essentially not at all. That position, however, fails to address why there should be any difference between the ability to sell shares and the ability to sell a company as a whole, where both actions involve a change of corporate control and payment of a premium for that change. As a matter of corporate law, the board of directors usually has the power to decide whether to approve a fundamental transaction such as a merger or sale of all assets, and shareholders only vote if the board first approves the transaction. For these types of transaction, the board of directors is established by law as the appropriate party to negotiate with a third party on behalf of the corporation or its stakeholders — and justifiably so, considering their knowledge of the business, their independence, and their fiduciary duties. Why should a transaction structured as a takeover bid be dramatically different than any other sale of control of a corporation? In terms of the ability to negotiate with a hostile bidder, the board of directors is certainly better equipped than a diverse and unorganized group of shareholders. To the extent that the shareholders are not satisfied with the board’s consideration of a change of control transaction, they have numerous options including selling their shares in the market, replacing the board at the shareholders meeting, and making claims against the directors for breach of fiduciary or other legal obligations.

And yet Canadian regulators have continued to reject the more flexible, case-specific approach employed by the Delaware courts. Canadian regulators have not yet considered, let alone embraced, the concept of substantive coercion. Thus, even if the board of Easytarget reasonably expects that the current business plan will deliver greater returns than the hostile bid from DynamicGiant yet believes that shareholders will reject its advice, it cannot prevent the bid from proceeding in Canada. **Delaware Yankee:*** That might be an unfortunate result, although Canadians looking at the Delaware system shouldn’t conclude that directors have the power to “just say no” forever. Whether in Delaware or Canada, it’s important to recognize that the stockholders’ power to elect directors is a major check on use of the poison pill. Specifically, bidders can seek to replace incumbent boards with directors who are presumably friendlier to their bids, and less likely to deploy or maintain a poison pill to foreclose those bids. Thus, for example, unless Easytarget’s board is staggered, the stockholders can replace the incumbent directors just four months from now at the annual meeting. Then, if directors nominated by DynamicGiant conclude, in the exercise of their fiduciary duties, that the DynamicGiant bid is in the best interests of Easytarget’s stockholders and the corporation, they will eliminate the poison pill and the bid will go forward. This accountability mechanism needs to be taken into account in evaluating the need for and scope of any form of judicial or regulatory accountability in regard to maintenance of the poison pill.

Of course, if the board were staggered (in which case it wouldn’t be called Easytarget, would it?) the electoral check on use of the poison pill takes much longer: Two successive annual elections are need-
should withdraw from the field and repeal their policy guidelines on poison pills. The securities commissions have advised that they are reviewing the rules on poison pills and that they intend to publish a paper soon addressing the matter. I suggest that they should let the balance of powers between board and shareholders under corporate statutes proceed without regulatory interference. Ironically, back in 1986 when adopting the policy on defensive measures, Canadian securities commissions were concerned that boards of directors would unduly interfere with takeover bids. Now, we suggest that the real concern is whether securities commissions should be empowered to interfere with the board’s and shareholders’ separation of powers and deny the ability of the board of directors to manage the affairs of a corporation.

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Section 4(a)(2) of the Securities Act of 1933, as amended (Securities Act), provides an exemption from registration for transactions by an issuer “not involving any public offering.” For decades, judicial and administrative interpretations of the private offering exemption in the Securities Act placed restrictions on the nature of the offerees and the manner of offering, but there were no bright line tests. Eventually the Securities and Exchange Commission (SEC) adopted Regulation D, Rule 506, a safe harbor under Section 4(a) (2) with a bright line test that eliminated restrictions on the nature and number of offerees (but not purchasers) except that, as a condition of the safe harbor, offering by means of “general solicitation and general advertising” (collectively, “general solicitation”) was prohibited. These terms have never been specifically defined in federal securities law or regulation.

General solicitation is not specifically defined in Regulation D or elsewhere in the federal securities laws. However, Rule 502(c) of Regulation D provides some examples of general solicitation, such as advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation. In addition, the SEC staff has issued interpretive letters, and the SEC has issued interpretive releases and made decisions in enforcement actions providing some further guidance. For example, the SEC has stated that other uses of publicly available media, such as publicly accessible websites, also constitute general solicitation. See Use of Electronic Media for Delivery Purposes, SEC Release No. 33-7233 (Oct. 6, 1995); Use of Electronic Media, SEC Release No. 33-7856 (Apr. 28, 2000).

The prohibition of general solicitation is vague, and if an issuer conducting a private offering were to use such means and be deemed to be making an unregistered public offering, severe consequences could ensue, including regulatory enforcement and right to rescission by investors. This has made use of Rule 506 difficult, particularly for small businesses. The issue was finally addressed when, in an effort to facilitate capital formation and stimulate job growth, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which instructed the SEC to adopt rules to permit general solicitation in certain private offerings.

**JOBS Act and New Rules**

On April 5, 2012, the JOBS Act became effective. The JOBS Act mandated, among other things, that the SEC amend Rule 506 of Regulation D and Rule 144A under the Securities Act to permit general solicitation in connection with certain “private” offerings of securities. The JOBS Act also mandated that the amendments to Rule 506 require issuers to take reasonable steps to verify that purchasers of the securities are accredited investors, using methods determined by the SEC. The SEC proposed such amendments on August 29, 2012 (Proposing Release). 

Specifically, if adopted, the proposed amendments would:

- Permit general solicitation in securities offerings under new Rule 506(c) of Regulation D provided that all purchasers are “accredited investors” as defined in Rule 501(a) of Regulation D. The definition of “accredited investor” includes any investor that comes within certain enumerated categories or whom the issuer “reasonably believes” comes within any of such categories. The categories include, among other persons, individuals that meet net worth or income tests and various types of entities that meet asset and other tests.

- Provide that issuers must take “reasonable steps” to verify the accredited status of investors as a condition of the exemption in Rule 506(c) offerings in which general solicitation is used. The verification
requirement would be in addition to the requirement that purchasers be accredited investors: it is a condition to the Rule 506(c) safe harbor even if all the purchasers in fact meet the standards of one or more of the enumerated categories in the Rule 501 definition of accredited investor, or the issuer reasonably believes that they meet them, unless the issuer has actual knowledge that an investor meets such requirements.

- Preserve an issuer’s option to conduct a private offering under renamed Rule 506(b) without engaging in general solicitation and without subjecting itself to the new requirement to take reasonable steps to verify that the purchasers are accredited.

- Amend Form D to provide boxes to check if the issuer is relying on Rule 506(b) or Rule 506(c).

- Permit general solicitation in offerings under Rule 144A provided that securities are purchased only by Qualified Institutional Buyers (QIBs) (as defined in that rule).

- Notwithstanding some limited guidance from the SEC on the subject of general solicitation, its definition and the scope of permitted general solicitation activities remain unclear (see the second paragraph of this article).

**Proposed Amendments to Rule 506 and Form D**

The Proposing Release would create a new Rule 506(c) safe harbor from registration of offers and sales of securities under the Securities Act in which general solicitation is used. Rule 506(c) would permit issuers to conduct exempt securities offerings by means of general solicitation under the following conditions:

- Each purchaser of the securities must actually meet the requirements to be an accredited investor in one of the enumerated categories in Rule 501 of Regulation D or the issuer must reasonably believe that the purchaser of the securities meets such requirements;

- The issuer must take reasonable steps to verify that the purchasers of the securities are “accredited investors” as defined in Rule 501 of Regulation D; and

- All terms and conditions of Rule 501 and Rules 502(a) and 502(d) of Regulation D must be satisfied. Rule 501 sets forth qualification and numerical thresholds to be an “accredited investor,” as well as certain definitions applicable to Regulation D offerings. Rule 502(a) sets forth rules regarding integration of securities sales within a given offering. Rule 502(d) sets forth limitations on resales of securities issued in a Regulation D offering.

**Verification of Accredited Investor Status**

Proposed Rule 506(c) would mandate a “facts and circumstances”-based verification process in lieu of rigid rules or non-exclusive guidelines. The issuer would be required to “take reasonable steps to verify that purchasers” in a 506(c) offering are accredited investors. This verification requirement would be in addition to the requirement that the purchasers actually meet the accredited investor requirements or that the issuer reasonably believes that they meet such requirements. Under this standard, issuers would be required to consider the particular conditions surrounding the offering to verify each purchaser’s accredited investor status. Despite providing necessary flexibility, a facts-and-circumstances-based verification test without rigid rules or non-exclusive guidelines could make it difficult for an issuer to know whether it has met the verification requirement. Accordingly, the Proposing Release sets forth the following examples of relevant factors to assist an issuer in conducting the verification:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be.
- The amount and type of information that the issuer has about the purchaser.
- The manner in which the purchaser was solicited to participate in the offering.
- The terms of the offering, particularly a minimum investment amount.

**Nature of the Purchaser:** The Proposing Release states that an issuer may be required to verify a purchaser’s accredited investor status in different ways, based on the type of investor claiming to meet the standard. For example, if a purchaser claims to be an accredited investor as a result of its status as a registered broker-dealer, the issuer may rely on the information on FINRA’s BrokerCheck website. However, for individual investors, the SEC has conceded that privacy concerns may inhibit the issuer’s ability to obtain sufficient information about income or net worth to verify that the accredited investor threshold is met. The SEC has attempted to address the verification of individuals by means of the other factors, discussed below.

**Amount and Type of Information About the Purchaser:** In order to address the potential inaccessibility of information, the Proposing Release sets forth a sliding scale verification process regarding the amount and type of information obtained, whereby the more information an issuer has that indicates that a prospective purchaser is an accredited investor, the less rigorous a verification process it will need to undertake. Indeed, if the issuer has actual knowledge that a purchaser is an accredited investor, then the issuer would not be required to take any verification steps. Other types of information that an issuer could review or rely upon which might, under the circumstances, in and of themselves constitute reasonable verification steps include, but are not limited to:
(a) publicly available government filings that indicate sufficient income or net worth; (b) third party information that provides reasonably reliable evidence of the purchaser’s accredited investor status, such as Forms W-2 or industry publications regarding average annual compensation; or (c) verification by a third party such as a broker-dealer, attorney, or accountant, provided that the issuer has a reasonable basis to rely on such third-party verification. In light of the lack of additional guidance from the SEC, and absent the type of documentation described above, issuers could be confronted with difficult judgments as to whether additional verification may be required under the “reasonable steps” standard.

Manner of Solicitation. The Proposing Release also proposes a sliding scale verification process regarding the breadth of solicitation, whereby the more widely disseminated an offering is, the more rigorous the verification process would be. For instance, the Proposing Release notes that for a solicitation conducted through a publicly available website, a requirement that a purchaser check the box in a questionnaire or sign a form would not be sufficient to satisfy the verification requirement. Similarly, under this sliding scale approach, issuers could be confronted with significant questions regarding the level and type of verification sufficient to satisfy the requirement.

Terms of the Offering. Importantly, the Proposing Release states that if a minimum investment amount is sufficiently high that only accredited investors could reasonably be expected to meet it, and if the purchase is made through a direct cash investment that is not financed by the issuer or any third party, such evidence could be “taken into consideration” in verifying accredited investor status. The Proposing Release is silent on whether this information alone would be sufficient to satisfy the requirement, or whether the issuer has to verify that the investment was not financed by a third party.

Verification and Reasonable Belief. The Proposing Release confirms that the Rule 506(c) verification requirement does not supplant the “reasonable belief” standard that is part of the Rule 501 definition of accredited investor in Regulation D. In addition, the verification requirement is a condition of the safe harbor even if the purchaser actually meets the accredited status requirements. Thus the Rule 506(c) safe harbor would be available provided that the issuer has a reasonable belief that the purchaser meets one or more of the enumerated categories for an accredited investor under Rule 501, and it has taken reasonable steps to verify that belief, even if the purchaser does not in fact meet such accredited investor requirements. Conversely, if the purchaser actually meets the Rule 501 enumerated requirements for an accredited investor but the issuer has not taken reasonable steps to verify accredited status, the Rule 506(c) safe harbor would not be available (unless the issuer has actual knowledge that the purchaser meets one or more of the Rule 501 enumerated categories). (One hopes that this anomaly will be corrected in the final rule.) It is important to note that if an issuer has actual knowledge that a purchaser does not meet the accredited investor standard, or has knowledge obtained in the verification process that calls into question information upon which the issuer relied for its reasonable belief that the purchaser is an accredited investor, then the issuer cannot have a reasonable belief that the purchaser is an accredited investor.

Offerings Not Conducted by General Solicitation

The Proposing Release states that the SEC is preserving the existing ability of issuers to conduct Rule 506 offerings without the use of general solicitation and without verifying purchasers’ accredited status under the current renamed Rule 506(b) and that the reasonable belief standard of Rule 501 would be retained. Given the lack of clear guidance as to what constitutes a general solicitation, issuers that seek to avail themselves of the renamed Rule 506(b) safe harbor could unwittingly conduct a general solicitation, thus inadvertently subjecting themselves to the higher standards of Rule 506(c). Thus, if the proposed Rule is adopted, if an issuer has any reasonable question of whether it or persons acting on its behalf have engaged in a general solicitation, it should consider taking reasonable steps to verify the accredited status of the purchasers and check the Rule 506(c) box on Form D. See “Proposed Amendments to Form D” below. The risk of the issuer’s unwittingly conducting a general solicitation is not something that arose as a result of the Proposing Release. Although the risk of an inadvertent general solicitation essentially is eliminated if the issuer meets all the requirements of Rule 506(c), it is not eliminated if the issuer relies solely on Rule 506(b).

Proposed Amendments to Form D

The Proposing Release would also amend Form D, introducing a box that the issuer must check if it intends to rely on Rule 506(c) as well as retaining a box for the renamed Rule 506(b). It is not clear whether an issuer can check both Rule 506(b) and 506(c) boxes if it is in doubt as to whether its offering activities amount to general solicitation.

It is foreseeable that the SEC may treat a checked Rule 506(c) box as one of its risk factors in determining whether to conduct a risk-based examination of an issuer, an adviser managing a private fund or a broker-dealer acting as a placement agent.

Rule 506(c) Offerings by Private Funds

The Proposing Release confirms that Rule 506(c) offerings will not be deemed public offerings under the federal securities laws as a result of the JOBS Act amendments. Thus, privately offered funds, such as hedge funds, venture capital funds, and private equity funds that rely on the exceptions from the definition of “investment company” under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, as amended, will not lose their exceptions if they offer and sell fund securities pursuant to Rule 506(c). The effect of the JOBS Act on advisers to private
funds relying on certain exemptions from registering with the Commodity Futures Trading Commission (the CFTC) appears to be less clear. For example, both CFTC Regulations 4.13(a)(3) and 4.7 generally require the operators of private funds relying on such exemptions to offer and sell fund interests without marketing to the public in the United States. Therefore, operators of private funds relying on such exemptions still may be subject to restrictions on marketing unless and until the CFTC or its staff clarifies the effect of the JOBS Act on these exemptions.

**Recordkeeping**
The SEC stated in the Proposing Release that it will be important for issuers to retain adequate records that document steps taken to verify that a purchaser was an accredited investor. In addition, broker-dealers and investment advisers that assist issuers in Rule 506(c) offerings as placement agents or fund managers probably are subject to existing record keeping requirements with respect to their verification activities.

**Proposed Amendments to Rule 144A**
As mandated by Section 201(b) of the JOBS Act, the Proposing Release also proposes to amend Rule 144A(d)(1) under the Securities Act to provide that securities could be offered pursuant to Rule 144A to persons other than QIBs, including by means of general solicitation, so long as the securities are purchased only by persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs (as defined in Rule 144A). If adopted, this rule amendment would have the effect of permitting general solicitations in Rule 144A offerings.

**Offshore Offerings**
Finally, the Proposing Release provides assurances that concurrent offshore offerings that are conducted in compliance with Regulation S would not be integrated with domestic unregistered Rule 506 or Rule 144A offerings.

**Request for Comments**
The written comment period for the draft Proposing Release ended on October 5, 2012. After consideration of comments to the Proposed Exemption, the SEC is expected to issue a final rule.

David Mishel, Kay A. Gordon, Nicholas S. Hodge, Remsen M. Kinne IV, and Yusef Alexandrine all practice at K&L Gates LLP.
September was a busy month in the world of whistleblower litigation. Within the same week, two different federal district courts issued decisions offering expansive interpretations of the anti-retaliation provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act"), holding that a plaintiff need not prove that he or she is a "whistleblower" as that term is defined by the Act, in order to bring a successful retaliation claim under Dodd-Frank. (Yes, you did read that correctly.) Put more simply, an employee who does not fit the Dodd-Frank definition of a "whistleblower" may now be able to assert a successful claim that he or she has been retaliated against for being a Dodd-Frank whistleblower. There is little question that these decisions have thus expanded the universe of employees who can potentially bring Dodd-Frank retaliation claims, and are likely to embolden the plaintiffs’ bar and spawn more lawsuits.

**Dodd-Frank Basics**

Dodd-Frank, passed in 2010 in the wake of the 2008 financial meltdown, created a number of incentives designed to encourage corporate insiders to "blow the whistle" and report suspected financial misdeeds and violations of the securities law to government authorities. For example, the Act increased the financial rewards or "bounties" potentially available for employees who make such reports. Employees who follow the procedures established by the Act and prove that they provided the authorities with "original information" that then led to a successful enforcement action, may qualify as a "whistleblower" and be entitled to a substantial monetary reward or "bounty." Dodd-Frank defines "whistleblower" as "any individual who provides information relating to a violation of the securities laws to the Commission in a manner established, by rule or regulation, by the Commission."

In addition to these reporting and anti-fraud mechanisms, Dodd-Frank also includes an anti-retaliation provision, prohibiting employers from taking action against anyone who (1) provides information to the Securities and Exchange Commission (SEC); (2) initiates, testifies in, or assists in an investigation or judicial or administrative action; or (3) makes disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (SOX), or any other SEC law, rule, or regulation. The law provides that "no employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against a whistleblower in the terms and conditions of employment," because he or she has engaged in "whistleblowing activity." Given this language, one would think that a person would need to be a whistleblower in order to bring a claim of retaliation for engaging in whistleblowing activity — or does one?

The judges in the following two cases recently answered this question in the negative.

**Kramer v. Trans-Lux Corporation**

The plaintiff in *Kramer v. Trans-Lux Corp.*, No. 3:11cv1424, 2012 U.S. Dist. LEXIS 136939, at *3 (D. Conn. Sept. 25, 2012), had been Trans-Lux’s human resources vice president for 18 years when he became concerned that senior executives were violating the law in their oversight of the company’s pension plan. For one, Kramer, the plaintiff, believed that the chief financial officer (CFO) should not have been on the pension committee due to a conflict of interest, and that the pension committee was understaffed. Later, when the plan was amended, Kramer claimed that the CFO had failed to submit the amendments to the board of directors and to the SEC, as required by law. On the two occasions that Kramer expressed his concerns to the CFO, she dismissed them outright.

In March 2011, Kramer again expressed his concerns to the CFO and another executive, but was again rebuffed. Undaunted, Kramer reported his concerns directly to the audit committee and later to the SEC. Soon thereafter, the company launched an investigation of Kramer, reassigned two of his direct reports to other managers, and stripped him of his responsibilities, culmi-
Kramer alleged that the company terminated him in violation of Dodd-Frank’s anti-retaliation provision. Trans-Lux moved to dismiss, arguing that Kramer did not qualify as a “whistleblower” as the term was defined in the Act, which states that a whistleblower must provide “information relating to a violation of the securities laws to the SEC, in the manner established by the commission.” In response, Kramer’s lawyers argued that the court could apply the looser definition of a whistleblower contained in SOX, which defines whistleblower to include anyone who discloses information about a possible violation to his superiors.

In rejecting the company’s argument, Judge Underhill held that a narrow definition of a whistleblower would “dramatically narrow the available protections available to potential whistleblowers” and thus would be “inconsistent with the goal of the Dodd-Frank Act, which was to improve the accountability and transparency of the financial system and create new incentives and protections for whistleblowers.” Judge Underhill also looked to the SEC Rules defining a whistleblower under SOX, which requires only that the individual have a “reasonable belief” of a possible violation of the securities law, and then provide that information to the SEC. Using this definition, Kramer qualified as a whistleblower, as he had reported — both internally and to the SEC — his belief that Trans-Lux had violated SEC rules by failing to report the amendment to the pension plan. Thus, Kramer’s claim lives to see another day.

**Ott v. Fred Alger Management, Inc.**
The plaintiff in **Ott v. Fred Alger Mgmt., Inc., No. 11 Civ. 4418, 2012 U.S. Dist. LEXIS 143339, at *2 (S.D.N.Y. Sept. 27, 2012)**, was a portfolio manager for an investment fund who had concerns about aspects of her employer’s trading policy. Ms. Ott raised these concerns internally, and then contacted the SEC on more than one occasion to inquire about making a complaint; she was ultimately fired a few months later. Among her various claims, Ott alleged that the defendant terminated her in violation of Dodd-Frank.

The defendant argued that Ott did not qualify as a whistleblower under the Act because she made her first report to the SEC before Dodd-Frank was enacted. Thus, her second report after the statute was passed did not provide the SEC with any “original information,” such that would qualify her for a bounty under Dodd-Frank.

Judge Preska of New York’s Southern District rejected this reading of Dodd-Frank, finding that Ott did not have to prove she was entitled to a bounty under the law in order to assert a retaliation claim: “anti-retaliation protections apply whether or not you satisfy the requirements, procedures and conditions to qualify for an award [under Dodd-Frank].” Like Judge Underhill in **Kramer**, Judge Preska took the broader view of Dodd-Frank’s anti-retaliation protections and held that Ott should have her day in court.

**Implications**
To date, only two other courts have analyzed the conflicting whistleblower provisions in the context of Dodd-Frank retaliation claims. See **Nollner v. Southern Baptist Convention, Inc., No. 3:12-cv-00040, 2012 U.S. Dist. LEXIS 46484 (M.D. Tenn. Apr. 3, 2012); Egan v. TradingScreen, Inc., No. 10 Civ. 8202, 2011 U.S. Dist. LEXIS 103416 (S.D.N.Y. Sept. 12, 2011)**. As mentioned previously, Dodd-Frank defines whistleblower as “any individual who provides . . . information relating to a violation of the securities laws to the Commission in a manner established, by rule or regulation, by the Commission.” In contrast, Dodd-Frank’s anti-retaliation provision more broadly provides that a whistleblower is anyone who (1) provides information to the SEC; (2) initiates, testifies in, or assists in an investigation or judicial or administrative action; or (3) makes disclosures that are required or protected under SOX, or any other SEC law, rule, or regulation.

Like the **Kramer** and **Ott** courts, both courts held that the broader definition of whistleblower contained in the Act governs retaliation claims. However, both of the plaintiffs in those cases failed to meet even the broad definition of whistleblower and the courts dismissed their claims. Thus, the **Kramer** and **Ott** decisions mark the first time plaintiffs have survived motions to dismiss Dodd-Frank whistleblower complaints.

These decisions could well result in a steep increase in Dodd-Frank retaliation lawsuits, especially since Dodd-Frank carries a longer statute of limitations than SOX and provides for higher back-pay awards, sweetening the potential payoff for plaintiffs, and offering an even greater incentive for employees and plaintiffs’ attorneys to pursue such claims. Employers in the coming months may see plaintiffs styling their retaliation claims similar to that of the plaintiffs in **Kramer** or **Ott**, using those complaints as templates to sur vive a potential motion to dismiss. Thus, it is more important than ever for employers to be diligent in monitoring how they handle employee complaints, and in making sure that there are always legitimate reasons for the discipline of any employee, and especially anyone who has “blown the whistle.” You do not want to create the next Kramer or Ott.

**Barbara Hoey** is a shareholder in Littler Mendelson’s New York office and a member of the Whistleblower Practice Group. **Jeanne Barber** is an associate in Littler Mendelson’s Boston office. She litigates a wide range of employment disputes, including retaliation claims and wage and hour collective actions.
Additional Resources
For other materials related to this topic, please refer to the following.

Business Law Today
SEC Issues First Whistleblower Award
By Christian Bartholomew and Sarah S. Nilson
September 2012
The right of a shareholder to inspect corporate books and records pursuant to 8 Del. C. § 220 is not new. Delaware courts have long advised shareholders to utilize the “tools at hand,” meaning the right to inspect corporate books and records, to investigate possible wrongdoing before filing an action for breach of fiduciary duty or other wrongs. However, in a series of recent decisions, the inspection of books and records has taken on a new-found importance because of the Court of Chancery’s adoption of the “fast-filer presumption,” which comes close to converting the right to inspect into an obligation to inspect before bringing a particular species of derivative claims. In cases where plaintiffs allege breach of fiduciary duties against the board of directors for either (1) knowingly violating positive law, or (2) failing to establish a proper reporting mechanism for conducting oversight (otherwise known as Caremark claims), the Court of Chancery normally expects plaintiffs to inspect books and records before filing. Because a Caremark claim must link the board of directors to the wrongdoing, it is often impossible to plead demand futility without internal corporate documents. If a plaintiff’s Caremark claim cannot survive a motion to dismiss because the complaint fails to plead demand futility with particularity and the plaintiff opted not to inspect books and records before filing, the Court of Chancery will apply a rebuttable presumption that the fast-filing plaintiff failed to adequately represent the corporation, which may lead the court to dismiss a shareholder’s claim with prejudice as to that plaintiff.

Suggested Solutions to Failure to Investigate
The roots of the Court of Chancery’s recently applied presumption against fast-filing derivative plaintiffs dates back to a dispute over whether a shareholder who has already filed a derivative claim may thereafter bring an action seeking the inspection of books and records. In King v. VeriFone Holdings, Inc., 994 A.2d 354 (Del. Ch. 2010), a stockholder brought a demand to inspect the books and records of a corporation after already filing a derivative action asserting a Caremark claim in California. The stockholder purported to seek books and records to investigate mismanagement so as to amend the derivative complaint. Finding the timing of such a request improper, the Court of Chancery held:

[S]tockholders who seek books and records in order to determine whether to bring a derivative suit should do so before filing the derivative suit. Once a plaintiff has chosen to file a derivative suit, it has chosen its course and may not reverse course and burden the corporation (and its other stockholders) with yet another lawsuit to obtain information it cannot get in discovery in the derivative suit.

In reaching this conclusion, the court discussed the problem of fast-filing plaintiffs racing to the courthouse after the announcement of a corporate trauma in an effort to obtain lead-plaintiff status by winning the “filing Olympics.” According to the court, “[t]he only reason King rushed to file his complaint in the derivative action and has since sought supplementary discovery through the § 220 process is so that he and his counsel could win the race to become lead plaintiff and lead counsel.” Further explaining that allowing plaintiffs to file a derivative action and then investigate rewards behavior that costs the corporation and the
judicial system resources, the court stated: “The derivative suit’s central purpose is compromised when counsel prematurely file thinly-substantiated complaints that cannot meet the heightened Rule 23.1 particularized pleading standard only in order to beat their competitors in the plaintiffs’ bar, and then attempt to compensate for those inadequate pleadings through an after-the-fact process that needlessly saps corporate funds through drawn-out discovery practice and simultaneous lawsuits in separate forums.”

Rejecting the Court of Chancery’s bright-line test barring a books and records inspection after filing a derivative action, the Delaware Supreme Court reversed and reaffirmed the “long-standing Delaware precedent which recognizes that it is a proper purpose under Section 220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, where the earlier-filed plenary complaint was dismissed on demand futility-related grounds without prejudice and with leave to amend.” King v. VertiFone Holdings, Inc., 12 A.3d 1140, 1150 (Del. 2011).

Although it reversed, the Delaware Supreme Court further instructed that the reversal should not be read as an endorsement of the file first and investigate later character of the plaintiff’s actions. The court suggested three non-exclusive solutions to the problem of derivative actions filed without proper investigation. First, the court hearing the derivative action could deny the plaintiff “lead plaintiff” status. Second, the court could dismiss the derivative complaint both with prejudice and without leave to amend as to the named plaintiff. Third, the court could allow the plaintiff leave to amend once so long as the plaintiff paid the attorneys’ fees incurred by the defendants on the first motion to dismiss.

Presumption Punishes Plaintiffs Who Fail to Inspect
Following the Supreme Court’s suggestions in King to find other remedies to the fast-filer problem, the Court of Chancery applied what it termed the “fast-filer presumption” in two recent cases. In Louisiana Municipal Police Employees’ Retirement System v. Pyott (“Allergan”), 46 A.3d 313 (Del. Ch. 2012) (appeal pending), a Delaware corporation specializing in pharmaceuticals, entered into a settlement agreement with the U.S. government following a three-year investigation into its off-label marketing of Botox. As part of the settlement, Allergan agreed to pay $375 million in criminal fines for misbranding and $225 million in civil fines to resolve False Claims Act actions that also dealt with off-label marketing. Following the public announcement of the settlement, various shareholder plaintiffs filed derivative actions in both California and Delaware. One of the shareholder plaintiffs in one of the Delaware actions sought to inspect books and records pursuant to Section 220. The rest did not.

After the California court dismissed the consolidated cases before it, the defendant directors moved to dismiss the Delaware action based on collateral estoppel. Rejecting the defendants’ request in part because the California plaintiffs did not properly investigate the claims, the court stated:

[A] court in a plenary derivative action such as this one has discretion to address a rush to the courthouse by determining that the plaintiff in the original derivative action did not provide adequate representation for the corporation and declining on that basis to give preclusive effect to a Rule 23.1 dismissal of the fast-filer’s complaint. In this case, to give preclusive effect to the California Judgment would favor the lawyers who filed hastily, penalize the diligent counsel who used Section 220, and confer a case-dispositive advantage on the defendants at the potential expense of the corporation.

Accordingly, the court denied the motion to dismiss based on the presumption that the fast-filing California plaintiffs had not adequately represented the company because they failed to seek books and records before filing. However, the Allergan court did not explain what test governed the fast-filer presumption or how it could be rebutted.

Test for Fast-Filer Presumption
In South v. Baker, 2012 WL 4372538 (Del. Ch. Sept. 25, 2012), the Court of Chancery expanded on the Allergan decision to articulate the test governing the fast-filer presumption. Following the public announcement of lower silver production projections by Hecla Mining Company and the announcement of numerous safety violations by the U.S. Mine Safety and Health Administration after several accidents in Hecla’s mines, plaintiffs filed two actions alleging securities law violations in Idaho. The securities cases alleged that Hecla’s disclosures relating to its safety procedures had been materially misleading. In Delaware, shareholders of Hecla brought a derivative action alleging Caremark claims against the directors of the company for the damages the company had and would suffer as a result of the securities lawsuits.

The plaintiffs in the Delaware action failed to inspect Hecla’s books and records before bringing their action, and the directors moved to dismiss. As is often the case with Caremark claims that are not investigated before filing, the court found the plaintiffs were unable to allege particularized facts supporting demand futility by showing that a majority of the board faced a substantial risk of liability. Explaining the disloyalty to the company normally evidenced by fast-filing of a Caremark claim, the court stated:

When a stockholder rushes to file a Caremark claim without first conducting an adequate investigation to determine whether or not there is a connection between the corporate trauma and director action or conscious inaction, the stockholder acts contrary to the interests of the corporation but consistent with the interests of the plaintiffs’ firm that files the suit. This recurring scenario supports
a presumption that the plaintiff has acted disloyally and is not an adequate fiduciary for the corporation.

The court further explained that the fast-filing plaintiff is normally serving the interests of the law firm filing the action so that the firm may win the race to the courthouse to increase the chance that the law firm will represent the lead plaintiff. Because the plaintiffs in South filed shortly after the public announcements and the filing of the securities actions and failed to conduct a books and records inspection pursuant to Section 220, their actions triggered the fast-filer presumption.

However, the court also concluded that the presumption that the fast-filing plaintiff acted disloyally was not an adequate representative of the corporation could be rebutted. Delaware Rule of Evidence 301 provides that “a presumption imposes on the party against whom it is directed the burden of proving that the nonexistence of the presumed fact is more probable than its existence.” Pursuant to DRE 301, the court found that the party opposing the presumption could rebut it in two ways. First, the party could prove that despite the fast-filer’s failure to inspect books and records under Section 220, the shareholder had “conducted a meaningful and thorough investigation.” Second, the person attempting to rebut the presumption could prove that the act of filing quickly benefitted the company, and not just the law firm.

The plaintiffs in South were unable to rebut the fast-filer presumption. Plaintiffs’ counsel admitted to spending only “several hours” investigating the claims. Furthermore, the plaintiffs were unable to offer any reason why they could not have utilized Section 220 to investigate and then bring their Caremark claims if the inspection of books and records generated sufficient evidence. Finally, plaintiffs’ counsel admitted that he filed the action quickly due to the fear that other plaintiffs might move faster and gain control of the action against the directors. Accordingly, consistent with the Supreme Court’s suggestion in King, the court dismissed the plaintiffs’ claims with prejudice as to the named plaintiffs.

**Litigating Under the Fast-Filer Presumption**

Although the fast-filer presumption remains in its infancy, a number of lessons can be drawn for both plaintiff and defense counsel. Perhaps most obviously, a plaintiff shareholder who wishes to bring a Caremark claim should almost always seek to inspect books and records to investigate the board’s knowledge of the wrongdoing or failure to establish proper oversight to prevent the wrongdoing. If the plaintiff fails to investigate, defense counsel bringing a motion to dismiss should highlight the failure by the plaintiff to investigate as well as the timing of the filing vis-à-vis the announcement of the corporate trauma prompting the filing. The fast-filer presumption also creates situations in which both plaintiff and defense counsel will have to be prepared to rebut the presumption, depending on the procedural posture of the case. If the case is being brought by a fast-filer plaintiff and the fast-filer presumption is triggered, the plaintiff will need to prove that this is one of the rare situations in which a meaningful pre-suit investigation was possible without a books and records inspection or that somehow the speed of the filing benefitted the company. If on the other hand the case is being brought by a second derivative plaintiff after the fast-filer’s action has already been dismissed, and if the Delaware Supreme Court finds on the Allergan appeal that a second derivative plaintiff is in privity with the first and should ordinarily be collaterally estopped from litigating after a first derivative action is dismissed, counsel for the directors in the second derivative action will have to rebut the presumption that the original fast-filing plaintiffs inadequately represented the company in order to preclude the second derivative action. In other words, the directors who obtained the dismissal of the first derivative action will be in the somewhat awkward situation of defending the efforts and investigation of the fast-filing original derivative plaintiff in order to rebut the fast-filer presumption in the subsequent derivative action. Although the standard announced in South v. Baker only requires the party opposing the presumption to prove “that the nonexistence of the presumed fact is more probable than its existence,” given the difficulty of alleging demand futility on a Caremark claim without access to corporate documents, in practice this presumption will likely prove to be difficult to rebut.

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Morris Dees ABA Medal Acceptance Speech

ABA President Wm. T. (Bill) Robinson III: Thank you very much, Madame Chair. As my final responsibility as President of this great Association, it is my special privilege this morning to present the ABA Medal.

Morris Dees Jr. is a selfless public servant, passionate trial lawyer, and courageous social justice and civil rights leader. Today, the American Bar Association confers upon Mr. Dees its highest honor, the American Bar Association Medal.

The medal, first awarded 82 years ago, honors those who have given conspicuous service to the cause of American jurisprudence.

Mr. Dees is worthy of this medal because of his steadfast fight against racism and injustice, which has positively transformed the lives of countless Americans.

Born in 1936, the son of an Alabama cotton farmer, Mr. Dees began his life in a rented farmhouse near Montgomery without plumbing. An entrepreneur at heart, he successfully operated a livestock business as a teenager, which allowed him to save enough money to take his father’s advice and enter college. Later, he graduated from the University of Alabama School of Law.

But his path to the law was not a straight line. Several times he was diverted by other business interests including direct mail and publishing.

In 1967, Mr. Dees embarked on the path toward becoming a full-time civil rights lawyer. He sold his publishing business and used the proceeds as seed funding to create the Southern Poverty Law Center in 1971.

The center soon became known for fighting the unequal implementation of the death penalty and for championing the rights of the underdog. In an early but influential case, Smith v. YMCA, Mr. Dees showed that the city of Montgomery had entered into a private agreement with the YMCA to avoid having to integrate the city’s recreational facilities. The city had simply closed all its parks and pools and secretly agreed that the YMCA — which is a private entity and not subject to the Civil Rights Act — would take over. Mr. Dees brought this secret agreement to light and obtained a court order forcing the YMCA to comply with the Civil Rights Law and integrate its facilities.

With his skills in the courtroom, Mr. Dees also prevented a great injustice through his representation of the “Tarboro Three” in North Carolina in 1973. The three black defendants had been accused of raping a white woman and had been convicted and sentenced to death. Mr. Dees obtained a reversal by showing that numerous errors had occurred in the first trial. He ultimately obtained a plea bargain that resulted in the release of the young men.

Mr. Dees has pioneered the use of civil lawsuits to secure judgments against racist and hate groups. In the 1980s, Mr. Dees used the law to hold the Ku Klux Klan accountable for the actions of its members. Ultimately, he won a $7 million judgment for the mother of a black lynching victim in Alabama. The payment of the judgment bankrupted the United Klans of America.

In the 1990s, Mr. Dees used similar tactics to obtain massive monetary judgments against several other hate groups. As a result of his ardent advocacy, Mr. Dees has suffered property loss and endured many threats to his personal safety.

His contributions to the law, to human-kind and to the evolution of our nation are beyond measure.

The presentation of the ABA Medal today to Morris Seligman Dees Jr. represents our profound admiration for his personal courage and incomparable leadership as one of the greatest civil rights lawyers of our time.

We are indeed indebted to Mr. Dees as — how should I put it — an exemplar of
what our profession means to this country. His service, his dedicated service; . . . and we are extremely pleased and privileged today to present him with the ABA Medal, Mr. Dees.

MORRIS DEES’ ACCEPTANCE SPEECH

Mr. Dees: Thank you so much for that warm welcome from this wonderful organization.

I am sure that you can imagine how lonely the existence of a civil rights lawyer in the Deep South was back in the 1960s and 70s. And to be recognized by the organization that I consider to be the glue that holds our legal system together, the American Bar Association, to be embraced by you . . . erases all the loneliness and tough fights that I’ve been through with the help of so many people.

I want to thank my family, especially my wife Susan Starr.

My children are scattered all over America doing various wonderful things . . . and I want to thank them because, during all the times we’ve had issues that threatened us — when the Ku Klux Klan burned our building in 1983 and the social isolation — they always stuck by me.

When Bill called about this award, I stopped and thought, you know, I didn’t get this thing by myself.

You’re giving this award to the Southern Poverty Law Center, the 43 lawyers who work there now and several hundred who have come and gone over the years, many who are doing wonderful things in this country. I want to especially thank co-founder Joe Levin and Center President Richard Cohen. None of our lawyers have ever backed down or quit; or any of our staff has ever backed down or quit because of the trials and tribulations we’ve had to face.

And after I got that call from Bill, I started thinking — you know, I have to send a thank-you note to people who made all this possible. I came up with 157 lawyers in this country. Some of you sitting here got a note thanking you for your pro bono help on cases we’ve done around the country. I can assure you their help has been appreciated, and has added enormous inspiration and money and talent to our helping those with few champions.

And I want to thank the 350,000 contributors to the Southern Poverty Law Center. Many of you are here too. Without your help, we couldn’t fund our work nor afford the 200 Center staffers.

But the people I want to thank the most are the people who have made my life more meaningful over these last 52 years as a trial lawyer. And those are the judges, and the juries, and the clients that we represented.

And as I look back over those, I think about the 65 or so people we represented in capital cases; death penalty cases. Most of them were guilty; a few were innocent; but none deserved to die.

And I think about representing Sergeant Roy Patterson, a decorated Vietnam Veteran — a black man — in Cordele, Georgia. He shot two Georgia law enforcement officers who were beating him up in a small police station. He took one of their guns away and shot them in self-defense.

And I will never forget the courage of that jury back in 1975 that decided that he didn’t deserve to die. He finally walked out of prison a free man after 13 years of appeals.

And I think about the family that drove the compound of the Aryan Nations in Coeur D’Alene, Idaho. They were beating him up in a small police station. He took one of their guns away and shot them in self-defense.

And I will never forget the courage of that jury back in 1975 that decided that he didn’t deserve to die. He finally walked out of prison a free man after 13 years of appeals.

And I think about the family that drove the compound of the Aryan Nations in Coeur D’Alene, Idaho, and were beaten by the Aryan Nations’ security guards who thought they were Jews coming to attack.

This innocent family didn’t even know they were driving past a neo-Nazi compound. And I think about that jury who was certainly afraid of what might happen to them if they ruled for the prosecution, and the judge who gave them the backbone to render a verdict that allowed us to bankrupt the Aryan Nations and take their property.

And a sweet ending to that case was when a wealthy man bought that hate-filled mountaintop compound in bankruptcy and donated it and a million dollars to a local college. They tore down the buildings and turned it into a Peace Park.

And I think about the African-American members of the small rural Macedonia Baptist Church in Clarendon, South Carolina, that was burned by the Ku Klux Klan. Watching that minister, pride in his face, as that jury returned a $36 million verdict — another courageous jury surely concerned about their own lives and their own safety.

This verdict bankrupted the Carolina Knights of the Ku Klux Klan and provided enough money to help pay off the mortgage after the church was rebuilt.

And I think about Mulugeta Seraw, who was beaten to death in Portland, Oregon, by a group of skinheads from California and also the courageous jury that returned a verdict that bankrupted that organization. I applaud that courageous African-American judge who made sure the Aryan Nations — as unpopular as they were — received a fair trial.

And I think about those Vietnamese fishermen, those new American immigrants we represented in Galveston Bay, Texas, in the early 1980s.

They came to this country after the Vietnam War and settled in the Galveston area, and some decided to become fishermen. The Klan didn’t like it; they burned crosses, they threatened the immigrants with death, and they also burned two boats.

And a very courageous federal judge gave the Klan a fair trial before entering a very strong and serious injunction enjoining the Klan and some violence-prone American fishermen from interfering with the Vietnamese fishermen.

And as I stood with them on the dock at the blessing of the fleet a few days after that order came in, when they went out to fish — I have to tell you, as I stood there and watched those fishermen and their relatives — those new Americans finding a place at America’s table — I not only felt proud to be their attorney, I felt proud seeing the majesty of our American justice system at work.

And finally, I think about the client who taught me lessons probably more important, more significant, and more meaningful than I learned at the little Baptist Church I grew up in that cotton farming...
community in Montgomery County, Alabama.

I represented Beulah Mae Donald, whose son Michael was lynched by Klan members. It was the United Klans of America whose members burned the church in Birmingham that killed four little girls as they attended Sunday school. And then they decided to lynch a black man — any black man — to terrorize blacks from serving on juries in Mobile, Alabama.

One of the young Klansmen who had taken part in the lynching turned evidence in our civil trial against his Klan leaders. And while he was telling the jury what happened he broke down and started crying.

Mrs. Donald was sitting a few feet from him, next to the jury box, in that Mobile courtroom. I thought the judge was going to stop and grant him a recess so he could regain his composure. But the young Klansman cleared his throat and looked over at Mrs. Donald and asked, “Can you forgive me for what I did to Michael?”

And she looked at him in front of that jury, rocked back in her chair — and if I live to be a hundred; if I tried a thousand more cases; I don’t think I’d ever be more moved when she said softly to him, “Son, I’ve already forgiven you.”

There wasn’t a dry eye at our counsel table or in the jury box, and I saw that old judge brush back a tear. This mother who had lost one of the most precious things in her life had the understanding, the love, and the mercy — something that we hear so much about, but honestly know so little of — that she could forgive that man.

And I thought the words that came out of her mouth were a higher justice than the $7 million verdict that jury rendered later that night.

I think today about those five Sikhs and others wounded, I think about the continued hate and racism and injustice and anger that is dividing our country.

I give thanks to the American Bar Association for your commitment to the rule of law.

And I know that . . . the words the Reverend Dr. Martin Luther King Jr. chose from the Prophet Amos and used in his famous speeches . . . that “you will not be satisfied until justice rolls down like waters and righteousness like a mighty stream.”

Thank you so much.
Nonprofit Formation and Governance

- At the recent ABA Annual Meeting in Chicago, the Pro Bono, Young Lawyer, and Nonprofit Organizations Committees presented a very useful program which addressed best practices in the formation of nonprofit organizations, titled “One Foot in Front of the Other: Basics and Best Practices in Nonprofit Formation and Governance.”

- The program focused on basic concepts and best practices relating to nonprofit formation and governance, including identifying the organization’s purpose and mission, choosing an appropriate legal entity, preparing governing documents, understanding tax exemption issues, navigating federal and state requirements, and strategic approaches to board composition and governance. An audio version of the program is also available.

Developing and Financing Stadiums and Other Sports Facilities

- At the recent ABA Annual Meeting, the Project Finance, Business Financing, Commercial Finance, and International Business Committees delivered an interesting presentation which addressed developing and financing stadiums and other sports facilities. Topics covered include recent sports venue transactions, factors to consider whether to pursue a new venue, sources of financing and public-private partnerships, and venue financing options and structure. An audio presentation is also available.

Details of a Corporate Secretary

- Agreeing to act as a corporate secretary entails various responsibilities in connection with recordkeeping. At the recent ABA Annual Meeting, a distinguished panel of presenters addressed this topic and key principles and practices that every corporate secretary should know. The materials for this program include pointers on the proper incorporation and organization of a company, appropriately taking and documenting corporate action, common problems in issuing stock and stock options, as well as information concerning significant corporate actions and ratification. The presentation also is accompanied by an audio version.
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