

INSIGHTS

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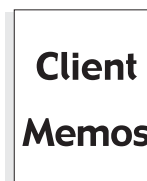
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SHAREHOLDER PROPOSALS

***Trinity Wall Street v. Wal-Mart Stores, Inc.:* Third Circuit Broadly Interprets Ordinary Business Exclusion under Rule 14a-8(i)(7)**

A Third Circuit decision affirms the exclusion of a shareholder proposal relating to the sale of firearms under the “ordinary business exclusion” in SEC Rule 14a-8(i)(7). While in line with SEC no-action precedent, it is the first time in decades that a circuit court has examined this exclusion.

By Keir Gumbs, Ciarra Chavarria, and Reid Hooper

On July 6, 2015, the U.S. Court of Appeals for the Third Circuit (Third Circuit) released its opinion in *Trinity Wall Street v. Wal-Mart Stores, Inc. (Trinity v. Wal-Mart)*.¹ In that decision, the court ruled that Wal-Mart Stores, Inc. (Wal-Mart) could rely on the so-called “ordinary business exclusion” to exclude from its proxy materials a shareholder proposal relating to the sale of firearms with high-capacity magazines that was submitted by Trinity Wall Street (Trinity). While this decision was in line with decades of no-action letters issued by the Securities and Exchange Commission (SEC), it is the first time that a federal circuit court has examined the application of the ordinary business exclusion in several decades. In addition, the decision could have significant implications for the SEC’s administration of the rule going forward—especially if the SEC decides to revisit the rules as suggested by the court.

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Background

In December 2013, Trinity, one of Manhattan’s oldest churches and a shareholder of Wal-Mart, submitted a shareholder proposal under Rule 14a-8 of the Securities and Exchange Act of 1934 for inclusion in Wal-Mart’s 2014 proxy materials in connection with Wal-Mart’s 2014 annual meeting.

Trinity’s proposal requested that Wal-Mart’s Board amend its Compensation, Nominating and Governance Committee charter to provide that the committee would:

overs[ee]...the formulation and implementation of...policies and standards that determine whether or not [Wal-Mart] should sell a product that: 1) especially endangers public safety and well-being; 2) has the substantial potential to impair the reputation of [Wal-Mart]; and/or 3) would reasonably be considered by many offensive to the family and community values integral to [Wal-Mart’s] promotion of its brand.

Based on this language, Wal-Mart submitted a no-action request to the SEC, seeking to exclude the proposal under Rule 14a-8(i)(7). Under this rule, a company may exclude a shareholder proposal from its proxy materials if the proposal “deals with a matter relating to the company’s ordinary business operations.”² This exclusion is based on the principle that shareholders should not manage (or micromanage) a company’s day-to-day operations. It bears noting that the SEC has developed an exception to this basis for exclusion, pursuant to which shareholder proposals that raise significant social policy issues may not be excluded.³ The line between ordinary business operations and social policy matters has been difficult to define, and the courts, and the SEC, have

struggled with the treatment of social policy issues for decades. It is often the case that seemingly similar proposals yield opposite responses by the SEC.

Wal-Mart's request for no-action relief was based on a large body of no-action letters issued by the SEC in which the SEC took the position that shareholder proposals relating to choices that companies, especially retailers, must make concerning the sale of products, such as pricing, advertisement, packaging, design, and product content, relate to ordinary business matters.⁴ In fact, as noted in the amicus brief submitted by the American Petroleum Institute, the Business Roundtable and the Chamber of Commerce, the SEC has issued more than 150 no-action letters in which the SEC has taken the position that shareholder proposals that seek to influence a retailer's selection of products and services to sell are excludable as relating to ordinary business matters.⁵

Wal-Mart's request also was predicated on the SEC's historical approach to shareholder proposals seeking board or committee action. Since 1983, the SEC has taken the position that a company may exclude from its proxy materials any shareholder proposal that seeks action by its board (such as preparing a report or forming a special committee) so long as "the subject matter of the special report or the committee involves a matter of ordinary business." Under that approach, the SEC ignores whether a proposal seeks board or committee action and focuses on whether the underlying subject matter of the proposal relates to ordinary business matters. In this regard, the SEC consistently has held that proposals that seek board or board committee review of a company's selection of goods to sell fall within the ordinary business exclusion.⁶

Based on these longstanding bodies of no-action letters, in March 2014, the SEC granted Wal-Mart no-action relief, concurring in Wal-Mart's view that the proposal related to Wal-Mart's ordinary business decisions, i.e., the sale of a particular product.⁷

The District Court Opinion

Two weeks after the SEC issued a no-action letter to Wal-Mart, Trinity filed suit against Wal-Mart in federal court seeking a preliminary and permanent injunction to prevent Wal-Mart from soliciting proxies for its annual meeting with proxy materials that omitted Trinity's shareholder proposal. At the initial hearing, the District Court denied Trinity's request for a preliminary injunction.⁸ However, months later when Wal-Mart moved to dismiss the case, the District Court, having had more time to consider the merits of the case, reversed its initial decision and concluded

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that Wal-Mart could not exclude Trinity’s proposal from its proxy materials in reliance on the ordinary business exclusion.⁹ In so ruling, the District Court found that Trinity’s proposal “focuse[d] on sufficiently significant social policy issues” that transcended the ordinary business matters to which the proposal related.

The District Court held that Wal-Mart could not exclude the proposal under Rule 14a-8(i)(7) because the proposal focused on board oversight of merchandising decisions as opposed to giving a directive to Wal-Mart’s management with respect to the products that Wal-Mart should sell. While the District Court acknowledged that the proposal “could (and almost certainly would) shape what products are sold by Wal-Mart,” it noted that the direct impact of the proposal would be felt at the Board level and that it would be up to the Board to determine what, if any, policies should be formulated and implemented as a result of the proposal.

The District Court’s decision could have had significant implications for the ordinary business exclusion.

The District Court also concluded that the proposal implicated a significant policy issue that transcended Wal-Mart’s ordinary business operations and for that reason could not be excluded under the ordinary business exclusion. The significant policy issue identified by the District Court’s was “the social and community effects of sales of high capacity firearms at the world’s largest retailer and the impact this could have on Wal-Mart’s reputation, particularly if such a product sold at Wal-Mart is misused and people are injured or killed as a result.”

The District Court’s decision could have had significant implications for the ordinary business exclusion. By focusing on the mechanism by which the proposal operated, and not just the underlying substance of the proposal, the District Court

opinion had the potential to create an exception to the ordinary business exclusion that would have allowed a shareholder to avoid exclusion by simply framing a proposal as a request for board or committee action on a topic. It also would have opened the door to shareholder proposals seeking to dictate the products sold by retailers.

The Third Circuit Opinion

On appeal, the Third Circuit overturned the District Court’s ruling and concluded that Wal-Mart could exclude Trinity’s proposal from its proxy materials in reliance on Rule 14a-8(i)(7).¹⁰ In coming to this conclusion, the Third Circuit focused on the proposal’s substance—the proposal’s attempt to influence the products that Wal-Mart sells, rather than its form—a request for corporate governance reform. The Third Circuit applied the SEC’s traditional approach to analyzing whether a proposal can be excluded under the ordinary business exclusion, focusing on whether the proposal implicated Wal-Mart’s ordinary business operations and whether the proposal raised a significant social policy issue.¹¹

Whether the Proposal Implicated Wal-Mart’s Ordinary Business Operations

In considering whether the proposal dealt with ordinary business matters, the Third Circuit focused on the ultimate subject matter of the proposal and then evaluated whether that subject matter was related to Wal-Mart’s ordinary business operations.

With respect to the ultimate subject matter of the proposal, the Third Circuit looked at the “ultimate consequence” resulting from the proposal rather than its immediate consequence, finding that the “subject matter” or “ultimate consequence” of the proposal related to “how Wal-Mart approaches merchandising decisions...”,¹² essentially, the sale of its products. In reaching this conclusion, the Third Circuit rejected the District Court’s approach, which would have treated a

proposal directing management as to certain products differently from a proposal that “merely” asks the board of directors to oversee the development and effectuation of a merchandising policy.

The Third Circuit concluded that the proposal did not transcend the company’s day-to-day business matters.

The Third Circuit also evaluated whether the subject matter of the proposal was related to Wal-Mart’s ordinary business operations. The Third Circuit concluded that the proposal related to Wal-Mart’s ordinary business operations on the basis that a retailer’s decisions regarding what products to sell is “the bread and butter of its business” and involves “operational judgments that are ordinary-course matters.”¹³ The Third Circuit, responding to Trinity’s argument that its proposal did not dictate which products should be sold or what policies should be implemented, clarified that a shareholder proposal need only relate to a company’s ordinary business, not dictate a particular outcome, to come within the exclusion.

Whether the Proposal Raised a Significant Social Policy Issue

Having determined that Trinity’s proposal related to Wal-Mart’s ordinary business operations, the Third Circuit considered whether the “proposal’s underlying subject matter transcends the day-to-day business matters of the company *and* raises policy issues so significant that it would be appropriate for a shareholder vote.”

Here, the Third Circuit concluded that Trinity’s proposal focused on significant policy issues, but concluded that such matters did not transcend the ordinary business matters to which the proposal related. In reaching this conclusion, the Third Circuit interpreted the concept of transcendence as being “disengaged from the essence” of the company’s business or “divorced from how

a company approaches the nitty-gritty of its core business.”¹⁴ Further, it noted that a proposal likely does not “transcend” day-to-day business matters if the subject matter of a proposal “targets day-to-day decision-making” or is “enmeshed with [the company’s] day-to-day business.”

The Third Circuit took the position that determining the appropriate product mix for retailers of multiple products such as Wal-Mart is “the meat of management’s responsibility” and an issue typically addressed by management rather than the board of directors.¹⁵ The court drew a contrast between such a decision when made by a retailer like Wal-Mart and the decision to stop selling a particular product by a company that is a manufacturer of a narrow line of products, which is more likely to transcend ordinary business matters. Because Wal-Mart is a major retailer and Trinity’s proposal addressed how Wal-Mart approaches its decisions regarding the sales of certain products, the Third Circuit concluded that the proposal did not transcend the company’s day-to-day business matters. To do so, the Third Circuit said, the proposal would have needed to “target something more than the choosing of one among tens of thousands of products [Wal-Mart] sells.”¹⁶ Consequently, the Third Circuit held that Wal-Mart could exclude the proposal from the company’s proxy materials under Rule 14a-8(i)(7).¹⁷

Implications of the Third Circuit Opinion

The *Wal-Mart* decision is as important for what the court did not do as it is for what it did. Had the District Court’s decision prevailed, the potential implications would have been far-reaching, as it would have potentially opened the door to many shareholder proposals that the SEC has long taken the view could be excluded in reliance on Rule 14a-8(i)(7). Such proposals could have been formulated as requests for board or committee action in order to avoid exclusion under Rule 14a-8(i)(7). Instead of endorsing this approach, however, the Third Circuit focused on the subject

of the proposal, adopting a position that is consistent with the SEC's longstanding approach to shareholder proposals that seek board or committee action. In addition, the court's decision gives judicial support to the distinction that the SEC consistently has drawn between retailers and manufacturers of controversial products.¹⁸

Conclusion

The *Wal-Mart* decision will have long-term implications for shareholder proposals. As noted above, the SEC's approach to retailers and manufacturers is now the law as opposed to just an agency interpretation, while its approach to proposals that seek board or committee action now also has stronger legal standing. This, however, is not likely the only lasting impact of the decision.

The Court suggested that the SEC issue fresh interpretive guidance.

Despite the fact that the Third Circuit's decision followed the well-established SEC staff precedent, the Third Circuit did not let the SEC off the hook. In the final paragraph of its opinion, the Third Circuit noted the difficulties of coming to a determination in a case like this where agencies like the SEC "have hard-to-define exclusions to their rules and exceptions to those exclusions."¹⁹ Noting that the last official guidance from the SEC on this topic was nearly twenty years ago, the Court suggested that the SEC "revis[e] its regulation of proxy contests and issue fresh interpretive guidance."²⁰ While there is no telling whether these recommended revisions might happen, given the prominence of the case and the timeliness of the issue, we expect the SEC to take note.

Notes

1. Trinity Wall St. v. Wal-Mart Stores, Inc., No. 14-4764 (3d Cir. July 6, 2015).
2. 17 C.F.R. § 240.14a-8(i)(7).

3. SEC Staff Legal Bulletin No. 14E, 2009 (Oct. 27, 2009). If "a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7)."

4. See e.g., Dominion Resources, Inc., SEC No-Action Letter (February 19, 2014) (proposal relating to the sale of renewable energy products and services, excludable as relating to ordinary business matters); DENTSPLY International Inc., SEC No-Action Letter (March 21, 2013) (phasing out mercury from products).

5. See Brief for the American Petroleum Institute, the Business Roundtable, and the Chamber of Commerce of the United States of America as Amici Curiae Supporting Appellants, Trinity Wall St. v. Wal-Mart Stores, Inc., No. 14-4764 (3d Cir. July 6, 2015).

6. See, e.g., Rite Aid Corp., SEC No-Action Letter (Mar. 5, 1997) (proposal requesting that the board adopt a policy to stop selling cigarettes unless management can demonstrate that its stores are able to fully implement FDA regulations restricting youth access to tobacco excludable as relating to the sale of a particular product).

7. In its no-action letter to Wal-Mart, the SEC staff stated that "[p]roposals concerning the sale of particular products and services are generally excludable under the [ordinary business exclusion]." Wal-Mart Stores Inc., SEC No-Action Letter (Mar. 20, 2014).

8. *Trinity Wall St. v. Wal-Mart Stores, Inc.*, C.A. No. 14-405-LPS (D. Del. Nov. 26, 2014).

9. *Id.*

10. Trinity Wall St. v. Wal-Mart Stores, Inc., No. 14-4764 (3d Cir. July 6, 2015).

11. Securities Exchange Act Release No. 40018 ("Amendments to Rules on Shareholder Proposals"), May 21, 1998 (the "1998 Release"). This approach is described in the 1998 Release as follows:

The policy underlying the ordinary business exclusion rests on two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include the management of the workforce, such as the hiring, promotion, and termination of employees, decisions on production quality and quantity, and the retention of suppliers. However, proposals relating to such matters but focusing on sufficiently significant social policy issues (e.g., significant discrimination matters) generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.

The second consideration relates to the degree to which the proposal seeks to “micro-manage” the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment. This consideration may come into play in a number of circumstances, such as where the proposal involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies.

12. *Trinity Wall St. v. Wal-Mart Stores, Inc.*, No. 14-4764 at 42.

13. *Id.* at 45-46.

14. *Id.* at 50.

15. *Id.* at 51.

16. *Id.* at 59.

17. *Id.* at 60. It is worth noting that while the court’s decision was in line with SEC staff precedent, its analysis of whether the proposal “transcended” Wal-Mart’s ordinary business operations may have opened up the door to a reading of the exclusion that is broader than that of the SEC staff. In her concurring opinion, Judge Patty Schwartz opined that the majority’s analysis could potentially allow companies to exclude many proposals for actions over which shareholders should have a say. In Judge Schwartz’ view, the entire proposal should have been excludable based on the fact that two of the three components of Trinity’s proposal (reputational harm and brand impact) did not meet the criteria for the significant

social policy issue exception, and as a result, the Third Circuit need not have even reviewed the issue of whether it transcended the ordinary business operations. By performing such review and then concluding that the issue in this case did *not* transcend Wal-Mart’s ordinary business, Judge Schwartz opined, the majority “practically gives companies carte blanche to exclude any proposal raising social policy issues that are directly related to core business operations,” which, she continued “undermines the principle of fair corporate suffrage...” *See Trinity Wall St. v. Wal-Mart Stores, Inc.*, No. 14-4764 (*concurring opinion*).

18. *See, e.g.*, Philip Morris Companies Inc., SEC No-Action Letter (Mar. 14, 1990) (proposal seeking an amendment to the company’s charter to prohibit the company from engaging in the tobacco business); R.J. Reynolds Tobacco Holdings, Inc., SEC No-Action Letter (Mar. 7, 2002) (proposal regarding packaging of tobacco); Rite Aid Corporation, SEC No-Action Letter (Mar. 26, 2009) (proposal requesting that the board issue a report to shareholders on how the company is responding to rising regulatory, competitive and public pressures to halt sales of tobacco products); Walgreen Co., SEC No-Action Letter (Sept. 29, 1997) (proposal requesting that the company discontinue the sale of tobacco and tobacco-related products).

19. *Id.*

20. *Id.* at 60.

SECURITIES ENFORCEMENT

SEC Enforcement Midway Through 2015

While the number of SEC enforcement actions involving public company financial reporting continued to rise slowly in the first half of 2015, the most notable changes at the agency continued to be the sharpening of tools within the SEC's arsenal, including increased reliance on corporate whistleblowers and the use of streamlined administrative proceedings in litigated cases.

By Marc J. Fagel

Midway through the 2015 calendar year, the SEC enforcement program has often been finding itself garnering more public attention for the manner in which it sources, litigates, and resolves cases than for the cases themselves. The Division of Enforcement's increased reliance on administrative proceedings rather than federal court actions for contested enforcement actions, a topic of discussion throughout the current administration, became, if anything, even more contentious in recent months. Litigants filed a number of constitutional challenges to the SEC's administrative process, and while, as in the past, most were unsuccessful, one federal court stepped in and blocked an administrative proceeding in its tracks.

Similarly, the SEC's reliance on paid whistleblowers in the wake of Dodd-Frank has continued to pick up steam. Most notably, the SEC filed a

high profile action penalizing a public company for the use of employee confidentiality agreements which, in the eyes of the SEC, could have deterred potential whistleblowers from coming forward.

In terms of the SEC's enforcement case mix, after switching gears in 2013 and pledging to bring more attention to public company reporting, the number of financial reporting cases remains relatively small, though a few significant cases were filed in recent months.

Significant Developments

Use of Administrative Proceedings Continues to Stoke Controversy

The controversy over the SEC's growing use of administrative proceedings (APs) as an alternative to federal court actions continued unabated in the first half of 2015.¹ Several respondents in SEC APs have filed civil injunctive actions seeking to block the proceedings, raising a number of constitutional and fairness challenges. Most of these efforts have proved unsuccessful; some courts have found they lacked jurisdiction to interfere in an ongoing SEC AP, requiring that any constitutional questions be addressed within the confines of the AP itself,² while other courts have rejected the constitutional claims on the merits.³

However, bucking this trend, an Atlanta court in June enjoined an ongoing SEC AP. In *Hill v. SEC*, an individual alleged by the SEC to have engaged in insider trading filed a lawsuit in the Northern District of Georgia challenging as unconstitutional the SEC's decision to bring its case against him in an AP. The court held that the individual had shown a likelihood of success

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on the merits and temporarily enjoined the AP because the SEC administrative law judge (ALJ) hearing his case was an “inferior officer” improperly appointed in violation of the Appointments Clause of the Constitution.⁴ Although this decision constituted a defeat for the SEC, its long-term impact on the SEC’s use of APs is questionable, as the court in *Hill* rejected a number of more fundamental constitutional challenges to the SEC’s use of APs and acknowledged that its Appointments Clause holding “may seem unduly technical, as the ALJ’s appointment could easily be cured by having the SEC Commissioners issue an appointment or preside over the matter themselves.” The SEC has since filed a motion to stay the district court injunction pending an appeal.

Recent reports questioning the impartiality of SEC ALJs have further inflamed the controversy.

Recent reports questioning the impartiality of SEC ALJs have further inflamed the controversy. A May 6 *Wall Street Journal* article discussing the SEC’s high success rate in APs quoted a former SEC ALJ as saying that the SEC’s Chief ALJ had “questioned my loyalty to the SEC” after finding too often in favor of defendants.⁵ According to the former ALJ, the SEC ALJs were expected to put “the burden [] on the people who were accused to show that they didn’t do what the agency said they did.” The article noted that one current SEC ALJ had held defendants liable on at least some charges in every case that had come before him. Notably, an investment adviser who recently lost a litigated AP before that ALJ appealed his decision, arguing in part that the SEC’s administrative forum lacked impartiality. While the SEC did not grant the respondent’s request to depose the ALJ, the agency “invited” the ALJ to “submit an affidavit addressing whether he has had any communications or experienced any pressure similar to that”

alleged by the former ALJ in the *Wall Street Journal* article.⁶ On June 9, the ALJ responded in a single-sentence email, “I respectfully decline to submit the affidavit requested.”⁷

Perhaps in response to some of the public discussions surrounding the agency’s use of APs, the Division of Enforcement released written guidance in May addressing the factors considered in determining whether an action will be brought in an AP or in federal court. The four factors that the SEC stated that it considers are: (1) the availability of the desired claims, legal theories, and forms of relief in each forum; (2) whether any charged party is a registered entity or an individual associated with a registered entity; (3) the cost-, resource-, and time-effectiveness of litigation in each forum; and (4) the fair, consistent, and effective resolution of securities law issues and matters.⁸ While the guidance represents an important first step in introducing some degree of transparency into the forum selection process, it does not go very far in addressing many of the fairness and other key concerns associated with the SEC’s growing use of APs, and is therefore unlikely to dampen the continued controversy surrounding this issue.

Whistleblowers

The SEC’s whistleblower program continued to grow in prominence in the first half of the year. While no recent awards have approached the massive \$30 million award to a single claimant announced in late 2014, there have been many “firsts” in the realm of whistleblower claims—the first award to an officer where compliance personnel learned of a fraud and failed to act; the first award to a whistleblower alleged to have been retaliated against for making a complaint; and the first enforcement action against a company for language in its confidentiality agreements that could impede the whistleblowing process.

On March 2, the SEC announced the first whistleblower award to a company officer.⁹

Typically, officers and directors are ineligible to receive a whistleblower award where they obtain information about potential misconduct through the report of another employee. However, the whistleblower here was able to collect between \$475,000 and \$575,000 because of an exception to the rule that permits an officer who reports a wrongdoing to the SEC to recover where at least 120 days have passed since compliance personnel learned of the allegations and failed to take steps to address them.

The following month, a compliance officer received over \$1.4 million in connection with whistleblowing that resulted in an enforcement action against the compliance officer's company.¹⁰ The SEC announcement did not provide details on the nature of the enforcement action resulting from the tip. This is the second whistleblower award the SEC has made, since the 2011 launch of the whistleblower program, to an employee with either compliance or audit responsibilities.

The SEC announced its first award to a whistleblower who experienced retaliation.

Also in April, the SEC announced its first award to a whistleblower who experienced retaliation.¹¹ Upon learning that the whistleblower had reported potential misconduct to the SEC, the company was alleged to have retaliated against the whistleblower in various ways, such as removing the whistleblower from their position, changing the whistleblower's job function, and paring down the whistleblower's job responsibilities.

These recent awards bring the number of whistleblowers who have received awards to 17, with payouts exceeding \$50 million.

One of the more noteworthy SEC actions so far this year was an enforcement action filed in April against a company for its use of restrictive

language in its confidentiality agreements.¹² According to the SEC, in the midst of an internal investigation, the company required witnesses to sign agreements that they would not discuss the subject matter of their interview with anyone without prior authorization of the company's legal department. This "pre-notification requirement" was found by the Commission to be a violation of Rule 21F-17, promulgated under Dodd-Frank, which prohibits any actions to impede whistleblowers from communicating with the SEC about potential securities law violations. Notably, the SEC expressly noted that there were no instances in which the agreements had been invoked to prevent whistleblowers from coming forward; nonetheless, the company (which had already modified its agreements) agreed to settle the charges, without admitting or denying wrongdoing, by paying a \$130,000 penalty.¹³

Public reports suggest that the SEC has since broadened its review of company confidentiality agreements, sending letters to numerous entities seeking copies of employment contracts, non-disclosure agreements, and similar documents. The initiative has led many public companies and financial institutions to review their own agreements, while precipitating some industry concern that the SEC's actions represent an overly broad interpretation of the Dodd-Frank whistleblower provisions and constitute regulation through enforcement.¹⁴ While SEC Chair Mary Jo White has pushed back on such criticism by stating that the SEC's actions are not a wholesale attack on the use of confidentiality agreements,¹⁵ significant concern remains about the scope of the SEC's ongoing review of such documents.

Corporate Waivers

The issue of waivers for large financial institutions which would otherwise be subject to regulatory disqualifications based on settlements with the government grew increasingly heated in the first half of 2015. Under various federal

securities laws, companies charged by the SEC, the Department of Justice, or other regulators may be automatically precluded from availing themselves of certain exemptions from regulatory requirements. For example, under the “bad actor” rule, parties to SEC enforcement actions may be denied exemptions from registering private securities offerings; similarly, public companies could lose their “well-known seasoned issuer” (WKSI) designation, which permits them to bypass SEC approval for various capital-raising activities. Waivers of these regulatory bars, historically viewed as somewhat routine, have become tremendously divisive among the Commissioners.

In February, Commissioners Luis Aguilar and Kara Stein issued a joint statement expressing their disagreement with the SEC’s decision to grant Oppenheimer & Co. a waiver from the bad actor rule following the firm’s settlement of an SEC proceeding relating to improper sales of penny stocks.¹⁶ In their dissent, Commissioners Aguilar and Stein noted that the firm had faced repeated regulatory action since 2005 and the grant of a waiver based on its promise to hire an independent compliance consultant, which the SEC’s order did not require, was “a dangerous precedent.”

A few months later, Commissioner Stein wrote a sharply worded dissent in response to the agency’s grant of various regulatory waivers to multiple banks who settled with the Department of Justice in the wake of an investigation into the alleged manipulation of exchange rates in the global foreign currency spot market.¹⁷ She highlighted the number of waivers the banks had been granted over the past nine years, stating: “This type of recidivism and repeated criminal misconduct should lead to revocations of prior waivers, not the granting of a whole new set of waivers.”

Meanwhile, it has been reported that one financial institution withdrew its request for a waiver it had sought following a settlement relating to tax

law violations after ostensibly being informed by the SEC staff that such a waiver would not be approved.¹⁸

Public Company Reporting and Accounting Actions

Financial Fraud and Internal Controls Cases

Two years after the Enforcement Division’s public roll-out of its Financial Fraud Task Force, the number of public company accounting fraud cases remains relatively low, but does appear to be climbing.

On May 12, the SEC announced fraud charges against ITT Educational Services Inc., as well as its CEO and CFO, alleging that they concealed from investors and auditors the poor performance of ITT’s student loan programs and resulting repayment obligations amounting to hundreds of millions of dollars.¹⁹ The defendants are litigating the matter in federal court.

In June, the SEC settled charges against Computer Sciences Corp. for allegedly concealing the impact of losses on a multi-billion dollar contract by inappropriately adjusting its accounting models.²⁰ The SEC also alleged that the company had engaged in earnings management by using “cookie jar” reserves and failing to appropriately record expenses. Without admitting or denying the allegations, the company agreed to pay a \$190 million penalty. Its former CEO agreed to a clawback of \$3.7 million in compensation, and the former CFO agreed to a clawback of \$369,100 in compensation and a \$175,000 penalty. Six other individuals were charged as well, with three settling and three opting to litigate.

In April, the SEC brought charges against the former controller of the Japanese subsidiary of a Chicago electronics manufacturer, alleging that he engaged in unauthorized equity trading using the company’s brokerage accounts that resulted

in losses of over \$110 million.²¹ In a scheme that spanned almost two decades, the individual is alleged to have concealed massive trading losses by taking out unauthorized and undisclosed loans, while using the proceeds to replenish account balances. The trader entered into a settlement agreement with the SEC in which he admitted wrongdoing and was permanently barred from serving as an officer or director of a publicly traded company. The SEC also instituted settled administrative proceedings against the company for its inadequate internal controls.

The SEC also filed a number of smaller accounting and disclosure cases. On February 5, the SEC settled charges against Chicago-based Broadwind Energy, its former CEO, and its CFO for several improper revenue recognition practices and inadequate disclosures, including the delayed recording of a \$58 million impairment resulting from reduced business from two key customers.²² During the delay, the company conducted a public offering of stock; after the impairment was recorded, the company's stock price fell by 29 percent. The company agreed to pay a \$1 million penalty, and the two executives paid a total of \$700,000 in disgorgement and penalties.

In March, the SEC filed a settled proceeding against the former VP of Finance of a specialty food distributor, alleging that he had improperly adjusted accounting entries for inventory amounts in order to increase reported profit margins to be consistent with historical margins.²³ The same month, the SEC filed a litigated action against a Chinese construction company and two of its officers, alleging that they failed to disclose the resignation of the company's CFO, and forged his signature in various filings.²⁴ And on April 1, the SEC filed a settled action against the CEO of a North Carolina telecommunications company for fraudulently inflating the company's revenues and earnings to command a higher purchase price in an acquisition.²⁵ The executive agreed to be barred from serving as a public company officer or director for 10 years.

Executive Perks and Compensation

In the early months of 2015, the SEC addressed several instances of alleged misappropriation and fraudulent concealment by corporate officers. One of the more attention-grabbing cases was the SEC's March action against the former CEO of technology firm Polycom Inc., alleging that he used nearly \$200,000 of corporate funds for undisclosed perks, including extensive travel, entertainment, meals and gifts.²⁶ In addition to the litigated case against the executive, the SEC brought a settled action against the company, alleging that it had failed to maintain sufficient internal controls over its expenses. Polycom agreed to pay \$750,000 to settle the charges, without admitting or denying the SEC's findings.

In February, the SEC brought a settled action against a biotechnology company and its CEO, alleging that the CEO issued millions of shares of the company's stock to accounts he secretly controlled, netting over \$600,000 for himself and his family, and falsely recorded the sales in the company's accounting records.²⁷

The SEC brought another of its periodic stand-alone clawback cases.

Finally, on the remedies front, the SEC brought another of its periodic stand-alone clawback cases, demanding the return of compensation from corporate executives even in the absence of charges of wrongdoing by the individuals. In February, the SEC announced a settlement with two former CFOs of Saba Software, a company charged in 2014 with accounting fraud. In the follow-up action, the two financial officers agreed to return bonuses and stock sale profits even though neither had been personally accused of misconduct by the SEC.²⁸ In related news, the SEC inched forward in its rulemaking under Dodd-Frank requiring the agency to craft regulations regarding clawbacks of incentive-based

compensation. Under the proposed rule, national securities exchanges and associations would be required to establish listing standards mandating companies adopt clawback policies.²⁹

Financial Crisis Cases

Some seven years after the 2008 mortgage crisis, the SEC has continued to roll out yet more actions against public companies for their reporting of crisis-related losses. In January, First National Community Bancorp Inc. and its former principal financial officer agreed to pay penalties totaling \$195,000 to settle claims that the holding company materially understated losses for its investment securities portfolio for certain annual and quarterly reports filed in 2010.³⁰ In a settled proceeding instituted in April, the SEC required the former CEO and CFO of a now-defunct financial holding company, both CPAs, to pay a total of \$60,000 in penalties for allegedly underreporting significant 2009 loan losses for three large loans.³¹ And in May, a global bank settled the SEC's charges that, in 2008 and 2009, it overstated the value of a derivatives portfolio by understating the "gap risk" posed by certain leveraged trades. The SEC charged that this leverage left the bank exposed to a higher degree than it had disclosed.³² As part of the settlement, the bank agreed to pay a penalty of \$55 million.

Auditor and Accountant Cases

The SEC took a number of actions involving auditors in recent months. For example, in February, the SEC charged an audit firm and its owner with failing to adhere to professional standards in the audit of a broker-dealer's financial statements that overstated the firm's net capital by over 350 percent.³³ According to the SEC, the financial statements overstated the firm's assets by inflating the size of its positions in some securities and understated the firm's liabilities by omitting negative balances in its account with a clearing broker.

Also in February, the SEC finally settled its long-running case against China-based affiliates of the "Big Four" accounting firms, based on their refusal to produce workpapers related to various Chinese issuers under SEC investigation. Notwithstanding Chinese law limiting the ability of the firms to provide the documents, an SEC administrative law judge issued a blistering ruling against the auditors in 2014, among other things ordering the firms suspended from practicing before the Commission for six months.³⁴ Recognizing the agency's recent progress in obtaining the documents, the SEC settled with the firms, which each agreed to pay \$500,000 and admit their refusal to turn over documents (without admitting or denying the SEC's findings).³⁵

The SEC initiated several proceedings to sanction accountants for violating prior disciplinary orders.

Finally, also during the course of a busy February, the SEC initiated several proceedings to sanction accountants for violating prior disciplinary orders. The SEC filed applications in the U.S. District Court for the Eastern District of New York against David Rivard, alleging that Rivard violated a prior order suspending him from practicing before the SEC as an accountant and seeking to hold him in contempt of a related monetary judgment.³⁶ Rivard had been suspended for his role in the 2014 Computer Associates accounting fraud case. The Commission also instituted administrative proceedings against a CPA for violating the Sarbanes-Oxley Act by working for an issuer as a contract CFO after the PCAOB barred her from practicing as an accountant or financial manager. In addition, the Commission charged the issuer and its CEO for their association with the barred CPA.³⁷

The Months Ahead

For officers and directors of public companies, as well as auditors and others with a stake

in the industry, the SEC's renewed attention to accounting and disclosure cases presented a cause for alarm. As the financial crisis cases of the past half-decade continue to wind down, enforcement resources can be seen being redirected towards public company investigations. Nonetheless, it is still an open question whether this area will once again become one of the busiest components of the enforcement docket as it has been in the past. Common sense suggests that, after a lengthy lull since the Enron era, institutional memories would dim and some of the abuses of the past would resurface. Even in the absence of a clear trend towards significant new financial reporting cases, corporate gatekeepers would benefit from a proactive review of their practices rather than waiting for an invigorated enforcement staff (or an eager whistleblower) to do it for them.

Notes

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2. *See, e.g.*, *Tilton v. SEC*, No. 15-CV-2472 (S.D.N.Y. June 30, 2015).
3. *See, e.g.*, *Duka v. SEC*, No. 15-CV-357 (S.D.N.Y. Apr. 15, 2015).
4. *See Hill v. SEC*, No. 1:15-CV-1801-LMM (N.D. Ga. June 8, 2015).
5. Jean Eaglesham, SEC Wins With In-House Judges, Wall St. J. (May 6, 2015), available at www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.
6. *In re Timbervest*, Order Concerning Additional Submission, Admin. Proc. File No. 3-15519 (June 4, 2015), available at www.sec.gov/litigation/opinions/2015/ia-4103.pdf.
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10. SEC Press Release, SEC Announces Million-Dollar Whistleblower Award to Compliance Officer (April 22, 2015), available at www.sec.gov/news/pressrelease/2015-73.html.
11. SEC Press Release, SEC Announces Award to Whistleblower in First Retaliation Case (April 28, 2015), available at www.sec.gov/news/pressrelease/2015-75.html.
12. SEC Press Release, SEC: Companies Cannot Stifle Whistleblowers in Confidentiality Agreements (April 1, 2015), available at www.sec.gov/news/pressrelease/2015-54.html.
13. For a more in-depth analysis, *see* Gibson Dunn, SEC Brings First Enforcement Action Challenging Employee Confidentiality Agreement Alleged to Impede Whistleblowers (Apr. 2, 2015), available at www.gibsondunn.com/publications/Pages/SEC--First-Enforcement-Action-Challenging-Employee-Confidentiality-Agreement-Alleged-to-Impede-Whistleblowers.aspx. *See also* Landefeld, "Whistleblowers, NDAs and SEC Enforcement Action," INSIGHTS, August 2015.
14. *See* Letter from the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (Apr. 9, 2015), available at www.centerforcapitalmarkets.com/wp-content/uploads/2015/04/2015-4-8-SEC-Whistleblower.pdf. *See also* Eugene Scalia, Op Ed: Blowing the Whistle on the SEC's Latest Power Move, Wall St. J. (Apr. 5, 2015), available at www.wsj.com/article_email/eugene-scalia-blowing-the-whistle-on-the-secs-latest-power-move-1428271250-1MyQjAxMTI1NTEz MjAxMzI0Wj.
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SECURITIES REGISTRATION

SEC Guidance on General Solicitation Provides New Opportunities

The SEC's recent guidance on general solicitation brings capital raising into the electronic age and provides new opportunities and challenges for issuers, angel investor networks, online investor platforms, and others.

By Stanley Keller

The Securities and Exchange Commission's Division of Corporation Finance recently provided helpful guidance on what activities do not involve "general solicitation or general advertising"¹ within the meaning of Rule 502(c) of Regulation D under the Securities Act of 1933 (Securities Act), either because those activities do not involve an "offer" or because there is a pre-existing, substantive relationship with the offerees. The absence of general solicitation is important in order to be able to rely on the exemption from registration under Rule 506(b) because compliance with the condition of Rule 502(c) that there be no general solicitation is an express requirement.² In addition, the absence of general solicitation avoids the need to comply with Rule 506(c), with its requirement to verify the status of all investors as accredited investors. Use of Rule 506(c) also forecloses the ability to sell to non-accredited investors. Moreover, although not an express requirement, the absence of general solicitation is significant for reliance on the statutory Section 4(a)(2) private offering exemption.³

The SEC guidance takes the form of several Compliance and Disclosure Interpretations (CDIs), namely CDIs §§256.23–256.33 (August 6, 2015),⁴ and a no action letter, *Citizen VC, Inc.* (August 6, 2015).⁵ This guidance is significant for practitioners advising clients on permissible fundraising activities, for operators of angel investor networks, for sponsors of both physical and electronic investor platforms and for funds engaged in continuous offerings. Importantly, the ability of certain third-parties to establish a pre-existing, substantive relationship and of issuers to rely on networks of investors to avoid general solicitation is expanded. At the same time, the SEC guidance will require reexamining some of the fundraising practices of online investor platforms that have become common. Overall, by adding clarity and expanding what is permissible, the SEC guidance helps bring the private investment world truly into the electronic age and should contribute to facilitating capital formation.

Background

The concept general solicitation first explicitly came into use with the adoption of Regulation D in 1982. It substituted for the prior requirement to identify the number and nature of offerees as a key basis for distinguishing a private offering from a public offering. However, the principles underlying the ban on general solicitation as elements of a private offering existed at least as far back as the U.S. Supreme Court's *Ralston Purina* decision⁶ and even can be traced to a 1935 SEC General Counsel Letter.⁷ Under these principles, the knowledge of the investor and its relationship with the issuer were key factors in establishing a private offering.⁸

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Regulation D does not define "general solicitation" but indicates in Rule 502(c) that it includes

“any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio” or “any seminar or meeting whose attendees have been invited by general solicitation.” This concept was later extended to internet activity.⁹

Shortly after the adoption of Regulation D, the SEC staff made clear that the existence of a pre-existing, substantive relationship negated that the investor was attracted through general solicitation¹⁰ and indicated ways that such a relationship could be established.¹¹ The SEC staff subsequently indicated how the internet could be used in certain circumstances to establish the requisite relationship.¹² The new SEC guidance is an extension of this prior guidance, and recognizes developments in use of the internet and current offering practices.

Guidance on General Solicitation

The SEC guidance confirms and amplifies prior SEC positions on what constitutes general solicitation. It begins by confirming that the use of an unrestricted website to offer and sell securities is general solicitation (CDI 256.23). It then identifies activities that are permissible.

Offers

The SEC guidance makes clear that if there is no “offer” of a security, there cannot be general solicitation (CDI 256.24). Thus, providing factual business information, even if widely disseminated (for example, on a website), is not an offer if it is not used to condition the market. In the SEC’s view, such information typically is limited to information about the issuer and its industry and generally does not include projections and, in the case of funds that continually offer interests, statements of past performances (CDI 256.25).¹³

Pre-Existing, Substantive Relationship

The SEC guidance reaffirms that there is no general solicitation if there is a pre-existing,

substantive relationship with the investors (CDI 256.26). However, it also confirms that this is only one way to avoid a general solicitation, and that a pre-existing, substantive relationship is not required for the exemption to be available.

A relationship is “pre-existing” if it is formed prior to the offering or, if formed by a third-party such as a broker-dealer, prior to that party’s participation in the offering (CDI 256.29). A relationship is “substantive” if sufficient information is obtained to evaluate the person’s status as an accredited or sophisticated investor (CDI 256.31). Self-certification alone is not sufficient for this purpose. The guidance then addresses how a pre-existing, substantive relationship can be formed.

Forming a Pre-Existing, Substantive Relationship

Earlier SEC guidance had made it clear that a registered broker-dealer can create a relationship with an investor and then use that relationship to make an offer as placement agent for an issuer without that offer being a general solicitation.¹⁴ This is the so-called “two call” rule that permits making an investor a customer with one call and then following up with a second call offering a specific investment opportunity. An issuer, however, ordinarily cannot create that relationship using the two-call approach, although it can have a pre-existing, substantive relationship with an investor through various other means, such as the person being an existing investor or having a business relationship as a customer or supplier.

The SEC guidance expands how a pre-existing, substantial relationship can be created in several ways. The SEC makes clear that registered investment advisers can form the requisite substantive relationship the same as registered broker-dealers (CDI 256.28).¹⁵ Significantly, under certain circumstances, other third parties also can form the requisite relationship with investors, including (as discussed below) operators of angel investor networks and investor platforms.

Most importantly, the SEC indicates that an issuer can rely on the relationship established by others, when that reliance is justified (CDI 256.27 and 256.32). Thus, an issuer can make offers to investors introduced by a broker-dealer or an investment adviser even if that introducing party is not acting as an agent of the issuer, as a placement agent would. In addition, depending upon the facts and circumstances, an issuer may be able to rely on investors within a network typically understood to be comprised of sophisticated investors to establish the pre-existing, substantive relationship. This network may be members of a formal angel investor organization or an informal network of persons experienced investing in private offerings. An issuer will need to take care to satisfy itself that it is entitled to rely on these arrangements and relationships in order to avoid general solicitation and establish a reasonable belief regarding the status of the investors as accredited or sophisticated. For example, it would likely be easier for an issuer to get comfortable with an established angel investor network that subscribes to a code of conduct regarding its membership¹⁶ than it would be with an informal network of acquaintances.¹⁷

The SEC guidance provides that no minimum waiting period is required if a sufficient substantive relationship is created.

Also of importance, the SEC makes clear that the quality of the substantive relationship is more important than any waiting period (CDI 256.30). It has been common, although not universal, under the two-call approach to require a waiting period of as much as 30 days from establishing the relationship before an investor is invited to invest in a specific offering. Although a waiting period still may be useful in some situations to establish that the relationship was created before an offering or participation in an offering commenced, the SEC guidance provides

that no minimum waiting period is required if a sufficient substantive relationship is created. Thus, an intermediary or platform operator may create a relationship with an investor by obtaining sufficient information about the investor and then immediately make an investment opportunity available (see the discussion of the *Citizen VC* letter below). As an exception to the requirement that the relationship be formed prior to the offering, the SEC, in recognition of its position in *Lamp Technologies*,¹⁸ will permit a private fund (i.e., one relying on the exclusion in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940) engaged in a continuing offering to create the relationship after the offering commenced so long as there is a reasonable waiting period before the actual investment (CDI 256.30).

Demo-Days, Pitch Events, and Venture Fairs

Much ink has been spent on trying to distinguish between demo-days and pitch events and figuring out where venture fairs fit. Demo-days are events where companies make presentations about their company to a group of interested persons, typically investors, but without discussing a specific financing. Pitch events are similar but with an express effort to raise money. Venture fairs are usually events sponsored by some credible organization, like a university, that can be either of the foregoing. The problem, of course, is that even demo-days are designed to raise money with discussions often taking place after the presentation—or as Captain Renault said to Rick in Casablanca: “I’m shocked, shocked to find that gambling is going on here.”

There may not be an offer at all if the presentation is appropriately structured.

The SEC guidance attempts to cut through this by providing a practical roadmap for dealing with these events, indicating that such an event does not necessarily involve a general solicitation

(CDI 256.33). First, the guidance provides that there may not be an offer at all if the presentation is appropriately structured to avoid there being an “offer” (as discussed above). Next, even if there is an offer, the event may not involve a general solicitation under a facts and circumstances analysis—for example, if the attendees are limited to persons with whom the issuer or the event organizer has a pre-existing, substantive relationship or who have been contacted through a network that the issuer or event organizer can rely upon to create that relationship. Finally, even if the invitations to the event are widely disseminated so that there is a general solicitation, the issuer may then be able to use Rule 506(c).

Some Practical Considerations

Relationship of Rule 506(b) and Rule 506(c)

It is ironic that at a time when general solicitation can be undertaken by using Rule 506(c), with its manageable additional verification requirement, we now have guidance that can help to avoid general solicitation and the need to use Rule 506(c), in some cases by following a more rigorous process to establish a pre-existing, substantive relationship than that which satisfies the verification requirement of Rule 506(c). However, in the securities world, things turn slowly and there has been resistance in many quarters to using Rule 506(c).¹⁹ Some of that resistance may be justified due to the natural reluctance to undertake verification steps and to the limitation on sales to nonaccredited investors, not only in the particular offering but in any other offering that might be integrated. Consequently, the SEC guidance is helpful by providing added flexibility. In fact, it may have the effect of slowing the acceptance of Rule 506(c) by expanding what safely can be done under Rule 506(b).

There are similarities between the steps necessary to form a pre-existing, substantive relationship and those necessary to establish (*i.e.*, have

a “reasonable belief”) or to verify accredited investor status. However, it is important to keep separate what is necessary to form the requisite substantive relationship to avoid general solicitation and what is necessary to establish or verify a purchaser’s accredited investor status. While self-certification might not be sufficient to create a substantive relationship to avoid general solicitation, it might, depending on the circumstances, be sufficient to establish a reasonable belief that an investor is accredited. If Rule 506(c) is being used, more will be necessary to verify the investor’s status as accredited, and there are specified safe harbors for natural persons that can be relied on, which also are likely sufficient to form the requisite substantive relationship. Thus, the SEC guidance on general solicitation should not change practice for dealing with accredited investor status, including under Rule 506(c).

The SEC guidance offers new opportunities for issuers to seek investors for Rule 506(b) offerings.

Significance for Issuers and Their Counsel

The SEC guidance, as a practical matter, offers new opportunities for issuers to seek investors for Rule 506(b) offerings, as well as for Rule 504 offerings that are not state-registered and Rule 505 offerings. As noted above, it also should help when the statutory Section 4(a)(2) exemption is relied on. In addition, issuers will benefit from the increase in liquidity for their securities from the potential expansion of resale opportunities using the “4(1 ½)” exemption. These new opportunities derive mostly from the expanded permissible activities of intermediaries and the ability to rely on networks of investors without triggering general solicitation. However, use of the new opportunities will require care on the part of issuers and their counsel because the determinations necessary to avoid general solicitation will be highly facts and circumstances dependent. This will create a

special challenge for counsel in giving no registration opinions when expanded offering activities are undertaken in reliance on the guidance.

In addition, issuers must realize that some of the activities that are permissible for third-parties may not be available to them. For example, while certain third-parties may establish the requisite relationship in contemplation of a securities offering, it would be extremely difficult for an issuer to do so because of the difficulty of separating its communications from the offering.

Significance for Angel Investor Networks

The SEC guidance validates many of the activities angel networks and angel investor groups have engaged in with some uncertainty. It thus provides clear ground rules under which they can operate and expand their activities. This in turn will help issuers with their capital raising. In particular, the guidance will allow reliance on the vetting activities of angel investor networks in admitting members. Because issuers will have to be satisfied that they can rely on these prequalification efforts, angel investor networks should continue their rigorous vetting processes.

The guidance will allow reliance on the vetting activities of angel investor networks in admitting members.

The guidance also provides a roadmap that angel investor networks and other event sponsors can use to conduct their group activities in a way that will satisfy securities law requirements, whether they are structured as demo-days or pitch events.

Significance for Private Funds

Private funds have been given guidance that confirms their ability to engage in continuous

private offerings using Rule 506(b) while avoiding general solicitation that would require use of Rule 506(c). Thus, a private fund can continue to establish the requisite substantive relationship even though its offering is ongoing, although in doing so it will have to continue to impose a waiting period. On the other hand, although private funds can continue to broadly provide information about themselves without there being an offer, this information may not include reference to past performance because of concern over the promotional aspects of such information.

Significance for Investor Platforms

The combination of the CDI guidance and the *Citizen VC* letter gives operators of investor platforms a clear path for conducting their activities, especially with respect to online platforms. Citizen VC, an online investor platform, asked the SEC to confirm that it could rely on Rule 506(b) in connection with its online offering activities. Those activities involve selling interests in special purpose vehicles it forms for investing in independent private companies to investors with whom Citizen VC created a relationship by first evaluating an investor's self-certification through an online questionnaire and then following up through various actions to obtain information sufficient to evaluate the investor's sophistication, financial circumstances and ability to understand the nature and risks of an investment. The SEC staff confirmed that these procedures were sufficient to establish a pre-existing, substantive relationship that avoided general solicitation and that the quality of that relationship was what was important. The SEC staff added that no specific waiting period or particular short form questionnaire can be relied upon solely to create such a relationship, but that whether there is sufficient information to evaluate a potential investor's financial circumstances and sophistication is dependent on the facts and circumstances.

The SEC guidance could lead to an increase in the platforms that make investment opportunities

available to investors, both for offerings by issuers and potentially for resales. The key benefit for investor platforms will be their ability to solicit potential investors widely to become participants in the platform and then, once the requisite substantive relationship has been established, to be able to offer them separate investment opportunities without its being a general solicitation.²⁰ It should not matter whether the subsequent opportunities are for investment directly in the particular companies or, as in *Citizen VC*, through investment in a special purpose vehicle formed by the platform sponsor to invest in particular companies. If the quality of the substantive relationship that is established is sufficient, no waiting period would be required before investment opportunities are provided to the investor.²¹

Self-certification and a waiting period alone is not necessarily enough to create the requisite relationship.

The *Citizen VC* letter identifies procedures that online investor platforms can follow to establish the requisite substantive relationship. It begins with an investor questionnaire to establish accredited investor status followed by several pro-active steps to create a direct relationship to evaluate the investor's financial position, sophistication and investment objectives. The request letter to the SEC provides a list of possible steps that generally include a follow up contact with the investor, giving the investor an opportunity to ask questions, some external verification and meaningful thresholds on each offering. These are not mandatory but rather provide an indication of what might be done to create the relationship.

An open question is whether the traditional approach of obtaining information, typically online, about accredited investor status without further actions and then waiting a reasonable period before making an offer will still be

acceptable. The CDI guidance and the *Citizen VC* letter put this practice, which has been followed by a number of online platforms, into question by indicating that self-certification and a waiting period alone is not necessarily enough to create the requisite relationship. A clear message from the SEC guidance is that online investor platforms will have to up their game if they are to widely solicit and enroll members without engaging in general solicitation. What actions, perhaps coupled with a waiting period if the actions are not as extensive as suggested in *Citizen VC*, will suffice is not clear. I expect that practice will evolve, ranging from use of procedures along the lines identified in the *Citizen VC* letter, with no specific waiting period, to a combination of certain actions and some waiting period that will be considered acceptable.

Conclusion

The SEC guidance on general solicitation provides welcome flexibility for conducting exempt securities offerings while avoiding general solicitation that would require use of Rule 506(c). This flexibility will benefit issuers raising capital, validate the activities of angel investor networks and create new opportunities for online investor platforms. It also might increase liquidity for investors of restricted securities if resale platforms develop. At the same time, practices followed before by some online investor platforms can be expected to be upgraded. The SEC staff is to be applauded for taking the sensible approach reflected in the guidance and recognizing existing practices and for bringing capital raising activities into the electronic age.

Notes

1. The term "general solicitation" is used throughout to include "general advertising."
2. This condition also applies to exempt offerings under Rule 504 that are not state registered and under Rule 505. Although the guidance is focused on Rule 506 offerings, presumably it can be applied more broadly.

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3. The guidance is limited to Regulation D but it should be relevant to assessing the availability of an exemption under Section 4(a)(2) of the Securities Act. Since the so-called “4(1 1/2)” exemption for resales is based upon the Section 4(a)(2) exemption, the guidance also should be relevant to the exemption for private resales.
 4. Avail. at <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.
 5. Avail. at <http://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm>.
 6. *SEC v. Ralston Purina Co.*, 345 U.S. 119 (1953).
 7. Letter of General Counsel Discussing the Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), SEC Release 33-285 (Jan. 24, 1935).
 8. See SEC Release No. 33-4552 (1962) (relevance of “requisite association with and knowledge of the issuer”).
 9. See SEC Release No. 33-7185 (1995) and SEC Release No. 33-7856 (2000).
 10. See, e.g., *Mineral Lands Research & Marketing Corp.* (Mar. 21, 1985); *Bateman Eichler Hill Richards, Inc.* (Dec. 3, 1985); *E.F. Hutton & Co.* (Dec. 3, 1985); and *H.B. Shaine & Co.* (Mar. 31, 1987).
 11. *E.F. Hutton & Co.* and *Bateman Eichler* indicated that broker-dealers could establish a relationship with a customer through the account-opening process.
 12. See *IPONET* (July 26, 1996) and *Lamp Technologies, Inc.* (May 29, 1997); but see *AgriStar Global Networks, Ltd.* (Feb. 9, 2004). See also, *Michigan Growth Capital Symposium* (May 4, 1995) (venture fair did not involve general solicitation) and *Woodtrails-Seattle, Ltd.* (Aug 9, 1982) (no general solicitation for offers to existing investors).
 13. The limitation on use of projections and other forward-looking information should be read as applying in the context of determining if

there has been a general solicitation and should not be read to restrict otherwise permissible activities, such as information provided in reliance on Rule 168.

14. See note 11, *supra*.
15. Broker-dealers have had little difficulty establishing the requisite relationship because of the information they need to obtain to satisfy their duties as regulated persons. The same is true of investment advisers. Therefore, issuers can most easily rely on relationships established with investors introduced by these regulated entities.
16. See, e.g., Angel Capital Association *Member Code of Conduct*, available at <http://www.angelcapitalassociation.org/data/Document/ACAIndividualCodeofConduct.pdf>.
17. The SEC staff cautions in CDI 256.27 that “the greater the number of persons without financial experience, sophistication or any prior personal or business relationship with the issuer that are contacted by an issuer or person acting on its behalf through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation.”
18. See note 12, *supra*.
19. The SEC notes in several places in the CDIs that if the issuer cannot avoid general solicitation, Rule 506(c) may be available.
20. It is important to remember that the investors will have to qualify as accredited or sophisticated investors when actual investments are made in reliance on Rule 506(b).
21. If an investor platform does more than provide a matching service but provides investment advice, it may have to register as an investment adviser under the Investment Advisers Act of 1940. If the investor platform also effects transactions, it may have to register as a broker-dealer, and depending on the nature of its activities even as an exchange, under the Exchange Act. See *AngelList LLC* (Mar. 28, 2013) for circumstances when broker-dealer registration was not required for an investor platform.

IN THE COURTS

Doling Out Personal Liability: Delaware Court of Chancery Awards \$148 Million in Damages For Fraud in Management-Led Buyout

By Peter L. Welsh and Jesse M. Boodoo

In the eyes of many commentators and practitioners, the Delaware Court of Chancery is currently engaged in a two-front effort to “separate the wheat from the chaff” in mergers and acquisitions (M&A) litigation.¹ On one front, the Court is in the midst of a long-awaited effort to deter the meritless and routine merger objection lawsuits that have vexed so many in recent years.² More and more, the Court is apt to dismiss weak claims³, impose more exacting scrutiny on therapeutic settlements⁴, and reduce post-settlement fee awards for plaintiffs’ counsel. On the other front, the Court is simultaneously crediting meritorious and non-routine merger lawsuits and, in particular, imposing substantial (and sometimes enormous) damages and fee awards in those cases where plaintiffs succeed in rooting out clear misconduct.⁵ These cases include then-Chancellor Strine’s 2011 award of \$1.263 billion in damages and more than \$300 million in attorneys’ fees in *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*⁶, and Vice Chancellor Laster’s 2014 award of \$75.8 million in damages and more than \$25 million in attorneys’ fees in *In re RurallMetro Corporation Stockholders Litigation*.⁷

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The Chancery Court’s recent post-trial decision in *In re Dole Food Co., Inc. Stockholder Litigation* falls firmly within the latter trend.⁸ In the third-largest damages award on record from the Court of Chancery, Vice Chancellor Laster awarded \$148 million in damages to the former minority stockholders of Dole Food Company, Inc. (Dole) following a takeover by David H. Murdock, the company’s former Chairman, CEO, and controlling shareholder.⁹ The decision and award—which imposed personal liability against Murdock and C. Michael Carter, the company’s former President, COO, and General Counsel—serve as an important reminder of the risks attendant to management-led buyouts, and the Court of Chancery’s recent willingness to impose massive damages awards in those uncommon merger cases where real conflict issues exist.

The Facts

Murdock’s Company

In 1985, Murdock acquired a 14 percent stake in Dole and became the company’s Chairman and CEO.¹⁰ Eighteen years later, in 2003, Murdock took Dole private in a leveraged buyout and became the sole owner of the company.¹¹ After the company became overburdened by debt during the financial crisis, Murdock decided, albeit reluctantly, to sell some of Dole’s equity to the public.¹² The IPO occurred in 2009 and covered 41 percent of Dole’s equity.¹³ Murdock—who had previously given up the role of CEO—remained on as Chairman of the Board.¹⁴

Murdock disliked operating Dole as a public company. The Court characterized Murdock as “an old-school, my-way-or-the-highway controller, fixated on his authority and the power and

privileges that came with it.”¹⁵ Murdock—who was 91-years-old at the time of trial—kept a tight rein on the company, brooking no dissent and intimidating outside directors.¹⁶ After seeing him testify, the Court appeared bothered by Murdock’s dictatorial approach to the company, and regarded him as a particularly egregious example of a domineering controlling shareholder: “By dint of his prodigious wealth and power, [Murdock] has grown accustomed to deference and fallen into the habit of characterizing events however he wants.”¹⁷

Not long after Dole became public, Murdock, with the assistance of Deutsche Bank, began considering the possibility of taking it private again. Eventually, Murdock settled on a two-step plan of “separat[ing] Dole’s higher-margin businesses (predominantly Packaged Foods) from its lower margin businesses (predominantly Fresh Fruit), realiz[ing] the value of the higher-margin businesses, and then pursu[ing] a transaction involving the remainder of the Company.”¹⁸ Murdock did not tell the Board about his plan.

In September 2012, Murdock realized the first step of his plan when Dole agreed to sell its Packaged Foods division and the Asian operations of its Fresh Fruit division (collectively about half of Dole’s business) to ITOCHU Corporation of Japan.¹⁹ As part of the ITOCHU transaction, Murdock reassumed the role of CEO, and Carter, who was already General Counsel, joined the board and became President and COO.²⁰ As a practical matter, Carter was thereafter responsible for the day-to-day management of Dole. The Court concluded that Carter’s real “job was to carry out Murdock’s plans, and he did so effectively, even ruthlessly.”²¹ While Carter “nominally worked for Dole... he really worked for Murdock.”²²

Carter Fraudulently Drives Down Dole’s Stock Price

With the ITOCHU transaction behind them, Murdock and Carter turned their attention to buying the rest of the company. Their first step, the

Court found, was to “prime[] the market for the freeze-out by driving down Dole’s stock price.”²³ Post-ITOCHU transaction, Carter and the rest of the Dole management conservatively estimated that they could “right-size” the remaining business and achieve at least \$50 million (and maybe substantially more) in annual cost savings.²⁴ With a view toward a future freezout, however, Carter announced something very different to the public. In a press release, he said that the company would achieve only \$20 million in savings.²⁵ Dole’s stock price immediately dropped 13 percent, reflecting the market’s anticipation of greater cost savings.²⁶ The Court rejected Carter’s contention that he “honestly believed... that \$30 million of the \$50 million in savings was not achievable,” finding that Carter and Murdock made inconsistent representations to Murdock’s lenders in connection with the merger, and that “Carter’s reduced estimate was false” and intended to undermine Dole’s stock price as a measure of value.²⁷

Murdock Makes His Proposal

In June 2013, Murdock delivered his initial proposal to the Dole Board. Murdock offered \$12.00 per share for the 60 percent of Dole stock he did not already own.²⁸ He also told the Board that he was “a buyer, not a seller,” effectively precluding a higher price from a third party interested in buying the entire company.²⁹ Seeking to avail himself of the procedural protections established by *In re MFW Shareholders Litigation*³⁰, Murdock conditioned his proposal on: (1) approval by a committee of disinterested and independent directors; and (2) the affirmative vote of a majority of the unaffiliated shares.³¹ Unbeknownst to the Board, Murdock, with Carter’s assistance, prepared to launch a hostile tender offer if the company did not respond favorably to his proposal.³²

Carter Undermines and Misleads the Committee

The Board proceeded to form a special committee consisting of four outside directors.³³

According to the Court, Carter immediately set out to undermine the committee's independence and authority. First, Carter successfully insisted that the committee's authority be limited to considering Murdock's proposal, without the ability to consider alternatives.³⁴ Second, Carter demanded that he, and not the committee, negotiate confidentiality agreements with any third-party.³⁵ The committee agreed to this as well, and "[a]s a result, Carter always knew whenever the Committee provided confidential information to an interested party" and "Murdock knew as well."³⁶ Third, Carter objected to the committee's choice of financial advisor, Lazard, and demanded that the committee instead hire Bank of America Merrill Lynch, a bank with longstanding connections to Dole and Carter.³⁷ The committee still hired Lazard but, at Carter's insistence, limited the scope of the engagement to consideration of Murdock's proposal.³⁸

To be able to negotiate at arm's-length with Murdock, the committee needed reliable financial projections from Dole management. Carter took charge of preparing the projections. To do so, he prepared high-case and low-case EBITDA projections, and then asked his division heads to "reverse engineer" the supporting budgets to match his forecasts.³⁹ This was in contrast to Dole's ordinary course practice of preparing budgets and projections using a bottom-up process.⁴⁰ The Court found that Carter's projections were improbably and misleadingly low in two respects. First, the projections omitted \$30 million of the \$50 million in expected post-ITOCHU cost savings.⁴¹ Second, the projections omitted an expected \$15 million per year in incremental revenue attributable to the anticipated purchase of new fruit farms.⁴² The committee immediately recognized that "management had taken a meat cleaver to the projections in a way that it would be very difficult, if not inappropriate, for a committee to weigh the[] projections as the basis for determining the adequacy of a price."⁴³

The Committee and Murdock Agree on Price

In August 2013, Murdock and the committee agreed on a price of \$13.50 per share, which fell at the top of the range of Lazard's DCF analysis (which had valued Dole at between \$11.40 and \$14.08).⁴⁴ The committee and Lazard, however, were unaware that they "lacked material information about planned cost savings and farm purchases."⁴⁵ Murdock and the committee then began negotiations over definitive deal terms. Carter and his management team secretly advised Murdock on how to negotiate against the committee, and "took steps to conceal their involvement by minimizing their written communications."⁴⁶ Carter also took steps to conceal his manipulation of the financial projections and Murdock's plans to potentially go hostile.⁴⁷

Ultimately, the committee approved the transaction at \$13.50 per share, believing it to be a good outcome.⁴⁸ Dole held a special meeting of its stockholders in October 2013. A narrow majority of 50.9 percent of the disinterested shares voted in favor, and the transaction closed in November 2013.⁴⁹ After the merger, Dole performed as Murdock and Carter secretly expected it would, and not as Murdock and Carter told the committee it would. Dole achieved approximately \$64.5 million in cost savings from "right sizing" of the company, and generated approximately \$23 million in incremental EBITDA from the purchase of new fruit farms.⁵⁰

The Litigation

Following the public announcement of the merger, separate groups of plaintiffs filed actions seeking statutory appraisal of their shares and alleging breaches of fiduciary duty. The actions were consolidated before Vice Chancellor Travis Laster. The plaintiffs brought fiduciary duty claims against Murdock, Carter and a third Board member, David A. DeLorenzo, and sought to impose secondary liability on Deutsche Bank and DFC Holdings, LLC (Murdock's acquisition

vehicle for the merger) on aiding and abetting theories.⁵¹ The defendants moved for summary judgment, arguing that because they followed the procedures of *In re MFW Shareholders Litigation*, the business judgment rule was the operative standard of review.⁵² The Court denied their motion, and conducted a nine-day trial during February and March of 2015.

The Decision

On August 27, 2015, the Court issued its 108-page post-trial opinion. Despite the volume and complexity of the factual background, the Court largely regarded the case as an easy one. Because Murdock “mimick[ed] *MFW*’s form” but “did not adhere to its substance”—including by withholding information from and actively misleading the special committee—the Court applied the entire fairness standard of review.⁵³ The entire fairness standard required that the defendants establish “to the court’s satisfaction that the transaction was the product of both fair dealing and fair price.”⁵⁴

With respect to fair dealing, the Court found that no “overly granular analysis” was necessary because “Carter engaged in fraud” and “intentionally tried to mislead the Committee for Murdock’s benefit.”⁵⁵ “[R]ather than making a merger proposal when Dole’s stock was trading at high levels following the announcement of the ITOCHU Transaction... Carter first primed the market by pushing down the stock.”⁵⁶ And when the special committee asked Carter for management’s forecasts, “Carter constructed a set of protections that contained falsely low numbers.”⁵⁷ “By providing the Committee with false information, Carter ensured that the process could not be fair.”⁵⁸ The Court also found that Carter created an unfair process in several other respects, including by interfering with the committee’s work, secretly assisting Murdock with his negotiations against the company and hostile takeover plans, and providing information to Deutsche Bank that was not provided to the committee.⁵⁹

With respect to fair price, the Court concluded that “without accounting for Carter’s fraud, the \$13.50 per share price fell within a range of fairness” but “[a]fter accounting for Carter’s fraud, the \$13.50 per share price... may have fallen within the lower end of a range of fairness” and “may have dropped below it.”⁶⁰ Relying on Lazard’s analyses and testimony from the plaintiffs’ expert, the Court found that the \$30 million in hidden cost savings would justify an increase of \$1.87 per share, and that the hidden projected revenue attributable to new fruit farms would justify an increase of \$0.87 per share, for a total of \$2.74 per share.⁶¹ Adding \$2.74 per share to Lazard’s DCF range generated a new range of \$14.14 to \$16.82, greater than the \$13.50 deal price.⁶²

Murdock and Carter Are Personally Liable

Concluding that the merger was not entirely fair, the Court turned to the liability of the fiduciary defendants.⁶³ Murdock, the Court concluded, was liable both as Dole’s controlling shareholder and as a Dole director. Dole’s exculpatory charter provision could not apply to Murdock in his capacity as a controlling shareholder⁶⁴, and would not apply to Murdock in his capacity as a director because he “breached his duty of loyalty by orchestrating an unfair, self-interested transaction.”⁶⁵ Under the holding of *In re Emerging Communications, Inc.*⁶⁶, Murdock’s acquisition vehicle, DFC Holdings, LLC, was liable as an aider and abettor to the same extent as Murdock.⁶⁷

Carter, the Court concluded, was liable both as a Dole director and as a Dole officer.⁶⁸ Dole’s exculpatory charter could not apply to Carter in his capacity as an officer⁶⁹, and would not apply to Carter in his capacity as a director because “he breached his ‘duty of loyalty to the corporation [and] its stockholders’ and his acts and omissions were ‘not in good faith.’”⁷⁰ “Carter demonstrated that his primary loyalty was to Murdock, not to Dole or to its unaffiliated stockholders.”⁷¹

Deutsche Bank and DeLorenzo escaped liability. DeLorenzo, though closely connected to Murdock and Carter, “did not personally participate in or know about the specific misconduct in which Murdock and Carter engaged.”⁷² And Deutsche Bank, though it “acted improperly by favoring Murdock and treating him as the bank’s real client in transactions before the Merger, even when [it] was officially representing Dole,” did not “knowingly participate”⁷³ in any breach of fiduciary duty.⁷⁴

Plaintiffs Are Entitled to a “Fairer” Price

Turning to the calculation of damages, the Court noted, at the outset, that its willingness to award damages did not depend upon a conclusion that the deal price was unfair. “In a plenary breach of fiduciary duty action, ‘the court can, and has in the past, awarded damages designed to eliminate the possibility of profit flowing to defendants from the breach of the fiduciary relationship.’”⁷⁵ “[O]n the facts presented, the stockholders are not limited to an arguably fair price. They are entitled to a fairer price.”⁷⁶

Although finding that Murdock’s and Carter’s wrongdoing could support an award more than twice as large, the Court imposed damages of \$2.74 per share which, based on Lazard’s work and the testimony at trial, reflected a fair and realistic expected incremental value for the hidden cost savings (\$1.87 per share) and hidden fruit farm revenue (\$0.87 per share) at the time of the merger.⁷⁷ The resulting damages award totaled \$148,190,590.18, independent of pre- and post-judgment interest, and the massive attorneys’ fees award that is sure to come.⁷⁸

The Takeaways from the Decision

Fact-bound decisions typically present few generalizable lessons, particularly when based on findings of fraud. Nevertheless, though largely limited to its facts, the Court’s decision in *Dole* provides several important and timely

reminders for M&A practitioners in the Court of Chancery.

The Court’s powers to fashion damages awards are broad and equitable in nature. In several recent decisions, the Court has found transactions not entirely fair but declined to award damages in light of its conclusion that the transaction price was fair or that the damages sought by the plaintiffs were speculative.⁷⁹ Perhaps emboldened by those decisions, the defendants in *Dole* wagered that they could prove that the \$13.50 deal price was within the range of fairness, and that the plaintiffs’ damages model amounted to hindsight 20/20 second-guessing based on Dole’s post-merger performance.⁸⁰ Ultimately, the Court was unpersuaded, finding that because the defendants committed fraud, neither an arguably fair deal price nor uncertainties in awarding damages could save the defendants from liability.

[A]ssuming for the sake of argument that the \$13.50 price still fell within a range of fairness, the stockholders are not limited to a fair price. They are entitled to a fairer price designed to eliminate the ability of the defendants to profit from their breaches of the duty of loyalty.⁸¹

Dole therefore serves as an important example of the Court’s broad power to fashion damages awards, and willingness to use that power, especially as of late, to impose massive awards in cases where real fiduciary misconduct is found.

MFW is not a cure-all. Murdock structured his buyout pursuant to the procedures of *In re MFW Shareholders Litigation*, conditioning his proposal on: (1) approval by a committee of disinterested and independent directors; and (2) the affirmative vote of a majority of the unaffiliated shares.⁸² But Murdock wanted only to use *MFW* as a fig-leaf. Working through Carter, Murdock intentionally and systematically undermined the informed deliberation of the committee. *Dole* breaks no new ground in applying

entire fairness under the circumstances. Under the Delaware Supreme Court's opinion in *Kahn v. M&F Worldwide Corp.*, the protections of *MFV* have always required that the merger be "conditioned *ab initio* upon both the approval of an *independent, adequately-empowered* Special Committee that fulfills its duty of care" and "the *uncoerced, informed vote* of a majority of the minority stockholders."⁸³ Nevertheless, *Dole* provides a forceful reminder that controlling stockholders seeking the advantages of *MFV* must comply equally with procedural and substantive requirements of the rule.

Management-led buyouts present significant risks. Management-led buyouts invariably present heightened risks of buyers engaging in coercion, misuse of confidential information, and manipulation of outside advisors and committees. On a basic level, management-led buyouts pit managers' personal interests against their fiduciary duties to shareholders. As demonstrated by Carter's behavior, members of company management maintain special access to information about the company's future prospects, and retain the ability to affect the company's stock price by controlling the flow of information and the timing of strategic decisions.⁸⁴ Carter proved unable to restrain himself from using those advantages to benefit himself and Murdock. Carter's behavior—and the severe consequences that flowed from it—cautions advisors to remember, in the context of management-led buyouts, the critical importance of managing conflicts and ensuring the full disclosure of "all material information known to the fiduciary except that information that relates only to its consideration of the price at which it will buy or sell and how it would finance a purchase or invest the proceeds of a sale."⁸⁵

Trials matter. The decision in *Dole* leaves little doubt that the Court was disturbed by the conduct of Murdock and Carter, and that the Court's unfavorable impression was driven in large part by its observations of the two as testifying witnesses at trial. The Court's opinion repeatedly criticizes

Murdock and Carter for their "evasive" and "not credible" trial testimony and, both implicitly and explicitly, relies on their evasiveness as supporting its larger findings of improper domination, manipulation, and fraud. In a greater sense, the decision in *Dole* also reflects the Chancery Court's role as a crucible for ultra-complex fact disputes. The parties in *Dole* introduced over 1,800 exhibits, lodged twenty-nine depositions, examined thirteen live witnesses, and filed 668 pages of post-trial briefing.⁸⁶ The comprehensive 108-page opinion in *Dole* demonstrates the Chancery Court's continuing status as a forum that is willing and able to truly test evidence and resolve intra-corporate disputes accurately, efficiently and on a large scale.

Notes

1. See Kirkland & Ellis LLP, *The Evolving Face of Deal Litigation*, March 18, 2014.
2. See J. Travis Laster, *Response: A Milder Prescription for the Peppercorn Settlement Problem in Merger Litigation*, 93 TEX. L. REV. See Also 129, 130 (2015) ("I agree wholeheartedly with the ... diagnosis of the underlying problem of excessive M&A litigation and the[] identification of routine disclosure-only settlements as a contributing cause."); Donald F. Parsons Jr. and Jason S. Tyler, *Docket Dividends: Growth in Shareholder Litigation Leads to Refinements in Chancery Procedures*, 70 WASH. & LEE. L. REV. 473, 496 & n.102 (2013) ("[T]he costs of expected, perhaps inevitable, deal litigation against directors should not be shoe-horned into a transaction intended to maximize shareholder value.");
3. See Paul J. Collins, *The Chancery Court as "Gatekeeper" in M&A Litigation*, Delaware Business Court Insider (August 21, 2013); Fried Frank, *Key Delaware Trend in 2014: Increasing Deference to Directors' Decisions—But Not "Anything Goes"* (January 15, 2015).
4. See *Acevedo v. Aeroflex Holding Corp.*, C.A. No. 7930-VCL, July 8, 2015 (TRANSCRIPT) (denying approval of therapeutic settlement, and noting that the long-time trend of settling M&A litigation for a "peppercorn and a fee" has the effect of "undercut[ting] the credibility of the litigation process" and "undercut[ting] Delaware's credibility as an honest broker in the legal realm"). See also Practical Law Corporate & Securities, *Delaware Court of Chancery Signals Stricter Approach to Approving Settlements in M&A Deals*, July 22, 2015 (discussing bench rulings and orders following *Aeroflex* in which the Court "has rejected settlements of fiduciary duty claims brought in various M&A deals that would have granted the defendants global releases, and has indicated

- its unwillingness to continue approving settlements and attorney fees in return for releases that extend beyond the grounds for the underlying claims”).
5. See Parsons and Tyler, *supra* note 2, at 494-95 (“Recent precedents like *Southern Peru* make clear that there is enormous upside potential to zealous advocacy of shareholders’ rights—assuming, of course, that the plaintiffs’ claim is meritorious and the harm caused by the defendants’ misconduct is extreme, as occurred in Southern Peru.”).
 6. *In re Southern Peru Copper Corp. S’Holder Deriv. Litig.*, 30 A.3d 60 (2011); *Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (2012).
 7. *In re RurallMetro Corp. S’Holders Litig.*, 102 A.3d 205 (2014).
 8. 2015 WL 5052214 (Del. Ch. Aug. 27, 2015).
 9. The \$148 million damages award is surpassed only by then-Chancellor Strine’s award of \$1.263 billion in damages in *In re Southern Peru Copper*, see *supra* note 6, and Vice Chancellor Laster’s award of \$171 million in damages in *In re El Paso Pipeline Partners, L.P. Deriv. Litig.*, 2015 WL 1815846 (April 20, 2015).
 10. *4. Dole is one of the world’s largest producers and marketers of fresh fruits and vegetables. *Id.*
 11. *Id.*
 12. *Id.* Murdock also entered into a forward sale covering an additional block of stock. *Id.* at *4 n.5.
 13. *Id.* at *4
 14. *Id.*
 15. *Id.*
 16. *Id.* at *5.
 17. *Id.* at *5, n.6. See also *id.* at *5 (“Murdock testified that he was ‘the boss’ at Dole, and ‘[t]he boss does what he wants to do.’”).
 18. *Id.* at *6. Deutsche Bank, though already privately advising Murdock on take-private transactions, later agreed to serve as an advisor to Dole’s board on possible spin-offs of select businesses. The Court criticized Deutsche Bank for “act[ing] improperly by favoring Murdock and treating him as the bank’s real client in transactions before the Merger, even when Deutsche Bank was officially representing Dole,” but ultimately concluded that Deutsche Bank had not knowingly participated in any breach of fiduciary duty. *Id.* at *1.
 19. *Id.* at *9-10.
 20. *Id.*
 21. *Id.* at *10.
 22. *Id.* at *17.
 23. *Id.* at *2.
 24. *Id.* at *11.
 25. *Id.*
 26. *Id.*
 27. *Id.* at *1, 11, 20, 27.
 28. *Id.* at *15.
 29. *Id.*
 30. 67 A.3d 496 (Del. Ch.2013), *aff’d sub nom.*, *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).
 31. 2015 WL 50522214, at *1.
 32. *Id.* at *17.
 33. *Id.* at *15-16.
 34. *Id.* at *16-17.
 35. *Id.*
 36. *Id.*
 37. *Id.*
 38. *Id.*
 39. *Id.* at *18.
 40. *Id.*
 41. *Id.*
 42. *Id.* at *18-19.
 43. *Id.*
 44. *Id.* at *22-23.
 45. *Id.*
 46. *Id.* at *23.
 47. *Id.* at *17, 23.
 48. *Id.* at *24.
 49. *Id.*
 50. *Id.* at *25.
 51. *Id.* at *2.
 52. *Id.* at *3.
 53. *Id.* at *1, 25-26.
 54. *Id.* at *26 (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995)).
 55. *Id.* at *26, 31. “The concept of entire fairness ‘certainly incorporates the principle that a cash-out merger must be free of fraud or misrepresentation.’” *Id.* at *26 (quoting *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104 (Del. 1985)).
 56. *Id.*
 57. *Id.* at *30.
 58. *Id.* at *31. Before trial, the Court found triable questions of fact regarding the committee’s independence. *Id.* at *1. In particular, the Court found that Murdock’s “retributive threats” against outside directors—including berating outside directors and forcing at least one disagreeable outside director off the board—could have “influence[d] the thinking and actions” of the committee members. *Id.* at *28, n.15. Based on the evidence at trial, the Court concluded that the committee “carried out its task with integrity” and undertook “heroic” efforts to negotiate against Murdock. *Id.* at *1, 31. “But even the most motivated, skilled, and well-advised special committee cannot achieve a fair result if those in control of the corporation deliberately undermine its efforts.” *Id.* at *29.

59. *Id.* at *32.
60. *Id.* at *34, 37.
61. *Id.* at *35-36.
62. *Id.* at *36.
63. *Id.* at *38 (“A ruling that a transaction is not entirely fair does not automatically result in liability for the defendants.”).
64. *Id.* at *39 (“As this court held in [*In re Emerging Commc’ns, Inc.*, 2004 WL 1305745 (Del. Ch. May 3, 2004)], a provision like the Exculpatory Clause ‘does not apply to [a defendant] in his capacity as [a] controlling stockholder.’”).
65. *Id.*
66. 2004 WL 1305745 (Del. Ch. May 3, 2004).
67. 2015 WL 5052214, at *39.
68. *Id.*
69. *Id.* at *40. “Under 8 Del. C. § 102(b)(7), a corporation may adopt a provision in its certificate of incorporation exculpating its directors from monetary liability for an adjudicated breach of their duty of care. Although legislatively possible, there currently is no statutory provision authorizing comparable exculpation of corporate officers.” *Gantler v. Stephens*, 965 A.2d 695, 709 n. 7 (Del. 2009).
70. 2015 WL 5052214, at *39-40.
71. *Id.*
72. *Id.* at *41.
73. A claim of aiding and abetting breach of fiduciary duty under Delaware law has four elements: (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary’s duty, (iii) knowing participation in the breach, and (iv) damages proximately caused by the breach. *See Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001). Drawing on prior precedent, the Court in *In re Dole Food Co.* provided the following list of “illustrative factors” relevant to whether a secondary actor knowingly participated in the breach: (i) “[t]he nature of the tortious act that the secondary actor participated in or encouraged, including its severity, the clarity of the violation, the extent of the consequences, and the secondary actor’s knowledge of these aspects”; (ii) “[t]he amount, kind, and duration of assistance given, including how directly involved the secondary actor was in the primary actor’s conduct”; (iii) “[t]he nature of the relationship between the secondary and primary actors”; and (iv) “[t]he secondary actor’s state of mind.” 2015 WL 5052214, at *42.
74. *Id.* at *41-44. The Court rejected the plaintiffs’ argument that Deutsche Bank “knowingly participated” in a breach of fiduciary duty because it received confidential Dole information through Carter. “In my view, a fiduciary sharing of information with an affiliated stockholder and its advisors, standing alone, is not inherently a breach of duty. It depends on what the provider and recipients do with the information, including whether they use the information to the detriment of the corporation and its stockholders or to benefit themselves improperly.” *Id.* at *43.
75. *Id.* at *45 (quoting *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1154 (Del. Ch. 2006)).
76. *Id.* The Court’s holding in this regard departs in some sense from recent decisions finding transactions not entirely fair, but awarding no damages because the prices were fair, *see, e.g., In re Nine Sys. Corporation Shareholders Litig.*, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014); *Ross Holding & Mgmt. Co. v. Advance Realty Grp.*, 2014 WL 4374261, at *1 (Del. Ch. Sept. 4, 2014), though these cases are likely distinguishable insofar as they presented more speculative damages theories or did not involve findings of fraud.
77. *Id.* at *45-46.
78. *Id.* at *1. The appraisal proceeding was mooted by the damages award. *Id.* at *47.
79. *See supra* note 76; Wilson Sonsini Goodrich & Rosati, *The Delaware Court of Chancery Finds Two Transactions Were Not Entirely Fair, but Awards No Damages Where the Prices of the Transactions Were Fair* (September 15, 2014).
80. 2015 WL 5052214, at *36.
81. *Id.* at *1. “[O]nce a breach of duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer.” *Id.* at *44 (quoting *Thorpe v. CERBCO, Inc.*, 1993 WL 443406, at *12 (Del. Ch. Oct. 29, 1993)).
82. *Id.* at *1.
83. *M&F Worldwide Corp.*, 88 A.3d at 644 (emphasis added).
84. *See* Robert F. Bruner and Lynn Sharp Paine, *Management Buyouts and Managerial Ethics*, 30(2) CALIFORNIA MANAGEMENT REVIEW 89, 91-92 (Winter 1988).
85. *Kahn v. Tremont Corp.*, 1996 WL 145452, at *16 (Del. Ch. Mar. 21 1996).
86. 2015 WL 5052214, at *3.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Akin, Gump, Strauss, Hauer & Feld LLP Washington, DC (202-887-4000)

SDNY Judge Berman Enjoins SEC Administrative Proceeding as “Likely Unconstitutional” (August 14, 2015)

A discussion of a federal district court decision finding that the SEC’s procedure in hiring administrative law judges was “likely unconstitutional” and preliminarily enjoining an administrative proceeding against a former Standard & Poor’s Rating Services executive.

Baker & Hostetler LLP Denver, CO (303-861-0600)

District Court Follows Supreme Court’s Lead in *Halliburton* (July 31, 2015)

A discussion of a federal district court decision, on remand from the Supreme Court’s *Halliburton* decision, determining that it was *Halliburton*’s—not the plaintiff’s—burden not only to rebut the *Basic* presumption of reliance but also to disprove price impact altogether.

Cahill Gordon & Reindel LLP New York, NY (212-701-3000)

FCPA Developments: BNY Mellon Agrees to Pay \$14.8 Million in SEC Settlement (August 25, 2015)

A discussion of a settled SEC enforcement action against BNY Mellon involving charges of violating of the Foreign Corrupt Practices Act (FCPA) for providing internships

to family members of foreign officials affiliated with a Middle Eastern sovereign wealth fund.

Cybersecurity Developments and the Growing Role of Senior Executives and Directors (August 31, 2015)

A discussion of the need for senior executives and directors to be proactive in their oversight and monitoring of the implementation and continued refinement of their company’s cybersecurity controls and processes.

Chapman and Cutler LLP Chicago, IL (312-845-3000)

SEC Seeks Comments on FINRA Proposed Rule Changes Addressing External Personal Accounts of Associated Persons (August 14, 2015)

A discussion of a FINRA proposed rule change addressing external personal accounts opened or established by associated persons of FINRA member firms.

Dechert LLP Philadelphia, PA (215-994-4000)

SEC Issues Settled Enforcement Action Against Investment Adviser, Its President and Senior Officers for Compliance Program Violations (August 2015)

A discussion of a SEC cease and desist order against Pekin Singer Strauss Asset Management Inc., a registered investment adviser, and its

former president and current co-CEO involving a number of compliance violations, including failing to conduct timely annual compliance reviews and failing to implement and enforce significant components of its compliance policies and procedures and code of ethics, among other things.

The 15(c) Process Continues to be a Focus of the SEC Enforcement Staff (August 2015)

A discussion of two recent SEC Enforcement Division administrative settlements, *In the Matter of Commonwealth Capital Management, et. al.* and *In the Matter of Komitzer Capital Management, et al.*, in which the staff alleged deficiencies in the process that certain mutual funds used to renew the annual advisory contract with their investment advisers, as required by Section 15(c) of the Investment Company Act of 1940.

Drinker Biddle & Reath LLP Philadelphia, PA (215-988-2700)

Federal Court Rejects Invalid Theory of FCPA “Accomplice” Liability (August 21, 2015)

A discussion of a federal district court decision, *United States v. Hoskins* (D. Conn. Aug. 13, 2015), holding that a foreign national cannot be subject to criminal liability under the FCPA when the defendant is not an agent of a domestic concern and did not commit the alleged acts while physically present in the United States.

Gibson, Dunn & Crutcher LLP Los Angeles, CA (213-329-7870)

M&A Report: 2015 Mid-Year Activism Update (August 10, 2015)

A discussion of shareholder activism activity involving publicly traded domestic companies during the first half of 2015.

King & Spalding LLP Atlanta, GA (404-572-4600)

Know Your Limits: Section 162(m) and Excess Equity Grants (July 2015)

A discussion of the uptick in stockholder derivative litigation related to equity compensation granted to named executive officers that exceed the plan share limits and the practices that companies should follow to avoid compromising the qualification of equity compensation as “performance-based” for purposes of Section 162(m) of the Internal Revenue Code.

SEC Brings Heightened Scrutiny to the Real Estate Fund Industry (August 19, 2015)

A discussion of the expansion of the SEC’s focus on private equity funds to ancillary asset classes, including private equity real estate funds. The areas of most concern to the SEC are fees, expense allocations, valuations and co-investment allocation.

Latham & Watkins LLP Los Angeles, CA (202-637-2200)

How to Navigate the SEC’s Proposed Mandate on Clawbacks (August 4, 2015)

A discussion of the need for companies to start planning for the broad clawback policies and clawback-related disclosures that will be required of all U.S. public companies under the clawback rules recently proposed by the SEC.

FINRA’s New Research Rules (August 27, 2015)

A discussion of two FINRA regulatory notices announcing the effective dates for new equity and debt research rules, Rules 2241 and 2242, recently approved by the SEC.

Morgan Lewis & Bockius LLP
Washington, DC (202-739-3000)

New SEC and PCAOB Proposals Related to Audit Committee Disclosure and Audit Quality (July 2015)

A discussion of a SEC concept release relating to audit committee reporting requirements and two PCAOB releases, which together evidence a coordinated approach to addressing investor requests for additional information about how audit committees oversee independent auditors and evaluate their performance and about the quality of audits.

Morris, Nichols, Arsht & Tunnell LLP
Wilmington, DE (302-658-9200)

2015 Amendments to Delaware’s Alternative Entity Statute (August 2015)

A discussion 2015 amendments to three of Delaware’s four “alternative entity” statutes—the Delaware Limited Liability Company Act, the Delaware Revised Uniform Limited Partnership Act and the Delaware Revised Uniform Partnership Act.

Orrick, Herrington & Sutcliffe LLP
San Francisco, CA (415-773-5700)

SEC Guidance Supports Its Position That Internal Whistleblowers Are Protected under the Dodd-Frank Act (August 6, 2015)

A discussion of interpretive guidance issued by the SEC elaborating its view that the anti-retaliation provisions of the Dodd-Frank Act apply equally to tipsters who claim retaliation after reporting internally, as well as those who are retaliated against after reporting information to the SEC.

Shearman & Sterling LLP
New York, NY (212-848-4000)

Court Upholds Partial Invalidation of SEC Conflict Minerals Rule (August 19, 2015)

A discussion of a decision by the U.S. Court of Appeals for the District of Columbia, in *National Association of Manufacturers v. Securities and Exchange Commission*, upholding its earlier ruling that requiring companies to describe their products as having “not been found to be ‘DRC conflict free’” is unconstitutional, thereby invalidating part of the SEC’s conflict minerals rule.

Sullivan & Cromwell LLP
New York, NY (212-588-4000)

Proxy Access Bylaw Developments and Trends (August 18, 2015)

A discussion of developments in the area of proxy access, including an analysis of company responses to shareholder proxy access proposals received during 2015 and key proxy access terms and the emergence of market trends.

Venable LLP
Baltimore, MD (410-244-7400)

ISS Releases 2016 Policy Survey (August 6, 2015)

A discussion of the annual Institutional Shareholder Services (ISS) Policy Survey, which seeks comment on a wide range of corporate governance matters and generally is a good indicator of the areas for which ISS is considering a policy change for voting recommendations. Among the issues addressed are proxy access, director compensation, unilateral board amendments to organizational documents, pre-IPO bylaws and non-GAAP measures.

INSIDE THE SEC

SEC Adopts Pay Ratio Rule

By Laura D. Richman, Michael L. Hermsen, Robert F. Gray, Jr., and Ryan J. Liebl

The Securities and Exchange Commission has adopted a pay ratio disclosure rule, requiring public companies to compare the compensation of their chief executive officer to the median compensation of their other employees.¹ The new pay ratio disclosure rule is contained in new paragraph (u) of Item 402 of Regulation S-K. It requires public companies to disclose:

- The median of the annual total compensation of all employees other than the chief executive officer;
- The annual total compensation of the chief executive officer; and
- The ratio of these amounts.

The SEC has provided a transition period so that the initial pay ratio disclosure will be required with respect to compensation for a company's first full fiscal year that begins on or after January 1, 2017. Therefore, calendar year-end companies will first be required to include pay ratio disclosure in 2018.

The Pay Ratio Disclosure Rule

For the purposes of the pay ratio rule, the term "employee" means an individual employed by the company or its consolidated subsidiaries as of any date (determined by the company) within the last three months of the company's last

completed fiscal year. In addition to full-time employees and employees based in the United States, the term includes:

- Employees based outside of the United States;
- Part-time employees;
- Temporary employees; and
- Seasonal employees.

Independent contractors and leased workers are not considered employees for the purposes of the pay ratio disclosure rule if they are employed by, and have their compensation determined by, an unaffiliated third party. Individuals who become employees as a result of a business combination or acquisition can be omitted from the company's identification of the median employee for the fiscal year in which the transaction became effective, provided that certain information is otherwise disclosed.

The SEC has provided two limited exemptions that permit companies to exclude certain employees located in non-US jurisdictions from the pay ratio calculation. First, the final rule provides an exemption for employees in a foreign jurisdiction in which data privacy laws or regulations are such that, despite the company's reasonable efforts to obtain and process the information necessary to comply with the pay ratio disclosure rule, the company is unable to do so without violating those data privacy laws or regulations. However, this exemption requires that, at a minimum, the company must use or seek an exemption or relief from such laws or regulations. Second, the rule provides a *de minimis* exemption for non-US employees representing 5 percent or less of a company's total employees. Any employees excluded under the privacy law exemption will count towards the 5 percent limit. If any employees in a foreign jurisdiction are excluded from the

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pay ratio calculation, all employees in that jurisdiction (other than the chief executive officer) must be excluded from the calculation.

Generally, the pay ratio disclosure will be provided in filings that require executive compensation disclosure pursuant to Item 402 of Regulation S-K, such as proxy and information statements, annual reports on Form 10-K and registration statements under the Securities Act of 1933 and the Securities Exchange Act of 1934. Smaller reporting companies, emerging growth companies, foreign private issuers, MJDS filers (i.e., registrants filing under the US Canadian Multijurisdictional Disclosure System) and registered investment companies will not be subject to the pay ratio disclosure requirement.

The pay ratio disclosure rule gives companies flexibility to select a method for identifying a median that is appropriate to the size and structure of their businesses and compensation programs. Companies may identify the median employee based on any consistently used compensation measure, such as compensation amounts reported in its tax and/or payroll records. Companies will be permitted to identify the median based on total compensation regarding their full employee population. Alternatively, they may do so by using a statistical sample or another reasonable method.

Once the median employee has been identified pursuant to one of the methods described above, the total compensation for the median employee will have to be calculated for the last completed fiscal year, consistent with the requirements for calculating the chief executive officer's total compensation for the same fiscal year for purposes of the summary compensation table.

The final rule permits a company to choose any date during the last three months of the fiscal year for the purpose of identifying the median employee. In addition, the final rule permits companies to identify the median employee

only once every three years, as long as there has been no change in the employee population or employee compensation arrangements that would significantly change the pay ratio disclosure. If, during those three years, the median employee's compensation changes, or the median employee has left the company, the company may substitute another employee with substantially similar compensation as its median employee.

The new rule permits a company to annualize the compensation for all permanent employees, whether full-time or part-time, who were employed on the calculation date, but who did not work for the company for the full fiscal year. The rule does not permit annualization for temporary or seasonal employees. In addition, the pay ratio disclosure rule does not permit the use of full-time-equivalent adjustments for the required pay ratio disclosure. However, a company is permitted to derive and disclose an additional ratio using full-time equivalent adjustments.

In determining the median employee, a company is permitted to use a cost-of-living adjustment for employees living in jurisdictions other than the jurisdiction in which the chief executive officer resides. If a company uses a cost-of-living adjustment, and the median employee resides in a different jurisdiction than the chief executive officer, the company must use the same cost-of-living adjustment in calculating the median employee's annual total compensation. In that event, the pay ratio disclosure must be provided two ways—including the cost-of-living adjustment and excluding the cost-of-living adjustment.

The rule requires a brief, non-technical overview of the methodology used to identify the median employee and any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or elements of total compensation. If a company uses a consistently applied compensation measure to determine the median employee,

it will have to disclose the measure used. If statistical sampling is used, the size of the sample and the estimated whole population should be disclosed, as well as material assumptions used in determining sample size.

Practical Considerations

Timing

Public companies will not be required to include pay ratio disclosures in their proxy statements for the next two proxy seasons—pay ratio disclosure will not be required until the 2018 proxy season at the earliest. Meanwhile, there may be litigation or legislative responses challenging the SEC's pay ratio rule. These responses may echo points raised by the two dissenting SEC commissioners at, and subsequent to, the meeting at which the final pay ratio disclosure rule was approved. However, public companies should assume that they will have to comply with this final rule and begin preparations in the near future to be able to provide the pay ratio disclosure on a timely basis.

Preparation

Companies should recognize that it may take a significant amount of time to determine the methodology they will use to calculate and report their pay ratio disclosure, to coordinate their reporting systems in various jurisdictions and to determine the ability to obtain and time involved to gather necessary information. Companies should evaluate their payroll and other compensation recordkeeping systems for planning purposes, develop strategies for compliance and consider how they will update their disclosure controls and procedures for pay ratio disclosure. Employees who have the responsibility to assemble the information to make the disclosure should be sure they understand what compensation programs the company has, including on a worldwide basis if the company has employees outside of the United States. This also should include an

understanding of how the company contracts with and makes payments to independent contractors in different jurisdictions if those workers are to be included for purposes of determining the median employee. In addition, it should be determined whether the gathered information needs to be adjusted to reflect differences in internal compensation reporting systems in various jurisdictions.

Filed, Not Furnished

Pay ratio disclosure will be “filed” as opposed to “furnished.” As a result, it will be subject to securities law liabilities and the certifications required of the chief executive officer and the chief financial officer. Therefore, companies affected by the rule should use this period before the compliance date to make sure that they are in a position to provide pay ratio disclosure with confidence that the information they include in their SEC filings will be accurate and in compliance with the rule.

Independent Contractors

In order to not be considered an employee for purposes of the pay ratio disclosure rules, an independent contractor must be employed by, and have his or her compensation determined by, unaffiliated third parties. Companies with a significant number of independent contractors will need to determine whether each individual is an employee for purposes of the new rules. Sooner rather than later companies should begin determining whether an independent contractor is employed by an unaffiliated party and whether more information is needed to make this determination.

Statistical Sampling or All-Employee Data

A company also should determine whether it would prefer to disclose its pay ratio using statistical sampling or by gathering complete pay data for all employees, if it has existing systems in place

that make it more convenient. To the extent a company plans to use statistical sampling, it may find it useful to try various sampling methods to determine which is the most appropriate, given the company's specific facts and circumstances. It is important to use a sampling measure that can be justified and supported with a methodology that can be repeated.

Non-U.S. Privacy Law Exemption

If a company with employees outside the United States determines that there is a foreign data privacy law that would be violated by complying with the SEC's pay ratio disclosure rule, it will need to take the steps necessary to use, or seek an exemption to or other relief from such foreign law. If the company is unable to qualify for an exemption, or receive a waiver, it will need to obtain an opinion of counsel from the foreign jurisdiction in order to rely on the exemption for pay ratio disclosure provided by the final rule. Because these measures are likely to be time-consuming, companies with an employee population outside of the United States should begin reviewing the applicable data privacy laws and regulations to ascertain whether there are any conflicts with the SEC rule and, if so, to determine the process they will need to follow to satisfy the SEC's foreign data privacy law exemption.

***De Minimis* Foreign Employee Exemption**

Companies with employees in multiple jurisdictions outside of the United States should identify the jurisdictions in which 5 percent or less of their total employee population is located to determine which jurisdictions, if any, they plan to exclude using the *de minimis* foreign employee exemption. Because all employees in a foreign jurisdiction must be excluded if any are excluded, and because employees excluded due to the privacy exemption count toward the 5 percent threshold for the *de minimis* exemption, companies in this situation may want to balance the relative difficulties of gathering the information

with respect to employees in such jurisdictions to determine how best to apply the exemption, if at all.

Cost-of-Living Adjustment

Companies should explore whether they want to apply cost-of-living adjustments to identify their median employee and to determine such employee's annual compensation. Presumably, a company only will present a pay ratio with a cost-of-living adjustment if it shows a lower ratio, which may be helpful in supporting a company's say-on-pay proposal. However, in order to use a cost-of-living adjustment for the pay ratio, the company also must give non-adjusted numbers. It is likely that people who view pay ratio disclosure as a means to achieve pay equity, and journalists who seek a more dramatic story, will focus on the unadjusted number even when the adjusted ratio is presented. Therefore, part of the assessment may be whether it is worth the time and effort to calculate pay ratio on both a cost-of-living adjusted and a non-adjusted basis.

Privacy Issues

While gathering the necessary data for the pay ratio disclosure, companies should review all applicable privacy laws and regulations, even when the privacy exemption does not apply. For example, while the company must identify a specific employee as its median employee, it must be careful when preparing its narrative disclosure not to violate any privacy laws and provide information that will identify the individual whose compensation data is being presented.

A privacy quandary can arise where a company uses a cost-of-living adjustment that results in the median employee being from a jurisdiction where the company has a very small number of employees. When a company uses a cost-of-living adjustment, the pay ratio rule requires the company to disclose the median employee's jurisdiction if that employee

resides in a jurisdiction other than the chief executive officer's jurisdiction. Yet, companies are not supposed to provide information that could identify the specific individual who is the median employee. If this situation arises, a company should consider carefully the pay ratio disclosure before it is made.

Early Adoption

To date, a small number of companies have provided some pay ratio disclosure in their proxy statements. Companies that are considering being early adopters of pay ratio disclosure or that would like to get a sense of how some companies have addressed this disclosure may want to review these examples. However, such disclosures are contained in proxy statements that were prepared before the final pay ratio disclosure rules were adopted. Therefore, they should be reviewed more for background and style and not as precedents for compliance with the new requirements.

Additional Narrative Explanations

Companies should consider whether, in addition to required disclosures, they want to provide additional narrative explanations. The narrative portion of the pay ratio disclosure may be sensitive. Therefore, it may be worthwhile to spend time drafting and reviewing possible disclosure even though pay ratio disclosure will not be required before the 2018 proxy season.

Selecting a Benchmark Date

The final rule gives companies the flexibility to select a date within the last three months of the fiscal year as of which the median employee will be determined. Companies might find it productive to assess fluctuations in the number and nature of their employee population during the last three months of 2015 and 2016 to determine if there is a specific timing that makes the most sense for their company.

Disclosure Controls and Procedures

Companies will need to update their disclosure controls and procedures to take into account the pay ratio disclosure rule. For example, the final rule permits companies to identify the median employee only once every three years, but only if there has not been a change in employee population or employee compensation arrangements that would significantly change the pay ratio disclosure. To retain the flexibility of relying on the identification of the median employee in a previous year, companies should develop a procedure to assess whether or not any such change has occurred. Similarly, it would be useful to have a procedure to provide prompt notice to the disclosure team if the median employee's compensation has changed to reflect a promotion or if that individual is no longer employed by the company.

Alerting the Compensation Committee

Even though the SEC has provided a relatively long lead time for compliance with pay ratio disclosure, it is important to update compensation committees on the final rule so that committee members can reflect on what impact, if any, the rule might have on their companies.

Employee Morale Implications

Companies also should consider the practical impact of pay ratio disclosure on its employee population. While employees as a group may share a general interest in the ratio of the chief executive officer's pay to the median employee, many employees may react to the pay ratio disclosure more personally, wanting to know why their compensation is in the bottom half or why their compensation is only in the middle of the compensation spectrum. Therefore, in addition to planning for public pay ratio disclosure, companies may want to begin planning on how they will handle internal employee communications on this subject.

Conclusion

The SEC has complied with its Dodd-Frank mandate by adopting a final pay ratio disclosure rule. Although there may be challenges to the rule, public companies should be operating under the assumption that pay ratio disclosure is becoming part of the SEC reporting landscape. The SEC has provided a relatively long transition period before pay ratio disclosure will be

required. However, there is a lot that companies should begin doing in the meantime to prepare. Public companies should be using this time wisely so that they will be in a position to comply with this new rule by the time they are required to do so.

Note

1. Available at <http://www.sec.gov/rules/final/2015/33-9877.pdf>.



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