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SEC APPROVES PROPOSED ANALYST RULES

By Amos J. Oelking III

On May 10, 2002, the SEC formally approved the rules previously proposed by the National Association of Securities Dealers and the New York Stock Exchange that seek to address concerns regarding the potential for conflicts of interest as a result of the relationships between firms' investment banking and research departments. (*Click here to link to the full text of SEC's Order.)* (*Click here to link to our E*Zine regarding the original proposal.)*

As discussed below, the new rules will take effect, depending on the provision, either 60, 120 or 180 days from the date of the SEC's formal approval. Significant provisions of the new rules are as follows:

Communications with Target Companies

- An analyst may share a draft research report with the subject company, provided that:
  - such review is only for the purpose of verifying facts;
  - the subject company is not provided with the sections of the draft report containing the research summary or proposed rating and price target;
  - a copy of the draft report is provided to the firm's compliance department prior to submitting the draft to the subject company;
  - if after submission to the subject company, the analyst intends to change the proposed rating or price target, the analyst must provide written justification to, and receive written approval from, the firm's compliance department; and
  - the subject company may not be notified of a rating or price target change until after the close of trading on the day prior to the announcement of the change.

Research Report "Quiet Periods"

- A firm acting as manager or co-manager of an offering is barred from issuing a research report on the issuing company

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Telecommunications & Utilities
Trusts, Esates & Personal Planning
Venture Capital & Emerging Companies

- within 40 days after an IPO; or
- within 10 days after a secondary offering, unless the company's securities are "actively traded" for purposes of Rule 139 under the Securities Act.

However, a firm may issue a research report concerning a significant event affecting the issuing company, provided the firm's compliance department approves the report before it is issued.

Promises of Favorable Research

- Analysts are now prohibited from offering favorable research ratings or price targets, or threatening to change ratings or price targets, as a means of attracting investment banking business from companies.

Analyst Compensation

- Firms may not tie analyst compensation to <u>specific</u> investment banking deals.
- If analyst compensation is tied to the firm's <u>general</u> investment banking revenues, this fact must be disclosed in the firm's research reports.

Firm Compensation and Other Research Report Disclosures

- A firm must disclose in its research reports if it:
  - managed or co-managed a public equity offering for the subject company during the past 12 months;
  - received any compensation for other investment banking services from the subject company during the past 12 months;
  - expects to receive compensation for investment banking services from the subject company during the next 3 months; or
  - owns 1% or more of the subject company's equity securities (as of the end of the month prior to issuance of the report).
- Research reports must also:
  - disclose whether the analyst or a member of his house-

hold owns securities of the subject company;

- clearly explain the meaning of all ratings terms;
- include the overall percentages of "buy," "hold," and "sell" ratings assigned by the firm;
- disclose the percentage of companies in each ratings category to which the firm has provided investment banking services within the previous twelve months;
- provide a chart indicating the historical daily closing prices of the target security and the points at which the firm initiated coverage and changed its ratings and price targets; and
- disclose any other material conflicts of interest that the analyst has reason to know of at the time the report is issued, including whether the analyst or a member of the analyst's household serves as an officer, director, or advisory board member of the subject company.

- The front page of research reports must contain these disclosures or, alternatively, refer the reader to the pages of the report where the disclosures can be found. Furthermore, the disclosures, and references to the disclosures, must be clear, comprehensive, and prominent.

Relationship with Investment Banking Departments

- Investment banking departments are not permitted to
    - supervise research analysts; or
    - discuss research reports with analysts prior to distribution unless the discussions are only for the purpose of verifying facts or identifying potential conflicts of interest and such communications are monitored by a member of the firm's compliance department.

Personal Trading by Analysts

- Analysts and members of their household are barred from investing in a company's securities prior to the company's IPO if the company is in a business sector covered by the analyst.

- Analysts are also barred from:
  - trading in a company's securities for 30 days before and 5 days after they issue a research report on the company; and
  - trading against their most recent recommendations.

Disclosures During TV and Other Public Appearances

- During television and radio interviews and other public appearances, an analyst must disclose whether
  - he or a member of his household has a position in the subject company's securities;
  - his firm owns one percent or more of the subject company's securities (as of the month-end prior to the public appearance);
  - the subject company is an investment banking client of his firm; and
  - any other material conflicts of interest exist at the time the report is issued, including whether the analyst or a member of the analyst's household serves as an officer, director, or advisory board member of the subject company.

Effective Dates of New Rules

- The new rules will become effective as follows:
  - Firm 1% ownership disclosure requirements: November 6, 2002
  - Compliance department oversight and approval procedures: September 9, 2002.
  - Disclosure of ratings distributions charts: September 9, 2002.
  - Disclosure of historical trading price charts: September 9, 2002.
  - All other provisions: July 9, 2002.

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The SEC has also begun a formal inquiry into the practices of research analysts. The inquiry, which is being conducted jointly with the NASD, the NYSE, the New York State Attorney General, and the North American Securities Administrators Association, will seek to identify violations of federal and state law and assess the need for additional rules governing research analysts.

Prior to the SEC inquiry, Eliot Spitzer, the New York State Attorney General, had independently launched an investigation of the activities of research analysts. Spitzer accused Merrill Lynch of misleading investors after discovering evidence that showed that some of its analysts had publicly recommended, but privately disparaged, the securities of certain investment banking clients. On May 21, 2002, Merrill Lynch agreed to a settlement whereby it would pay a $100 million fine and revise its analyst compensation policies. The new policies would entirely separate analyst compensation from investment banking revenues, a stricter standard than that established by the SEC's new rules. As described above, the SEC's rules permit analyst compensation to be tied to general investment banking revenues so long as that fact is properly disclosed, but forbid compensation to be tied to a specific transaction. Salomon Smith Barney and Goldman Sachs have indicated that they will revise their compensation policies along the lines of the Merrill settlement, but the SEC has not indicated whether it will make similar revisions to its new rules.

SEC PROPOSES MD&A DISCLOSURE OF THE APPLICATION OF CRITICAL ACCOUNTING POLICIES

By Amos J. Oelking III

On May 10, 2002, the SEC proposed a disclosure requirement for the "Management's Discussion and Analysis" (MD&A) section of annual reports, registration statements and other filings regarding the application of critical accounting policies. (*Click here to link to the full text of the proposed rules.) (Click here to link to our E*Zine regarding the SEC's previous announcement that it would propose such rules.)*

The proposal would require disclosure in a separately-captioned section of MD&A regarding

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PROFESSIONAL LIABILITY
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PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
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VENTURE CAPITAL & EMERGING COMPANIES

- the critical estimates made in applying the company's accounting policies; and
- the initial adoption of material accounting policies.

This formal rule proposal was widely anticipated after the SEC in December 2001 encouraged companies to include in their MD&A disclosure regarding critical accounting policies and, in February 2002, announced that it was considering formal rulemaking in this area.

Critical Accounting Estimates

Under the SEC's proposal, an accounting estimate would be a "critical accounting estimate" if:

- the company is required to make assumptions about matters that are "highly uncertain" at the time the estimate is made; and
- alternative estimates that the company could reasonably have used, or changes in the estimate that are likely to occur, would have a material impact on the company's financial statements.

Required disclosures regarding such estimates would include:

- a description of the estimate, including the methodology used, assumptions made, and probable future changes in the estimate;
- an explanation of the estimate's significance to the company's financial statements;
- a quantitative "pro forma" analysis of changes in individual line items and overall financial statement presentation assuming changes in the estimate or the underlying assumptions;
- a quantitative and qualitative discussion of any material changes to the estimate in the past three years; and
- a statement as to whether senior management has discussed the estimate and related MD&A disclosures with the company's audit committee.

Moreover, in the event of a newly identified critical accounting estimate or a material change in a prior estimate, the SEC's proposal would require updated disclosures to be included in the company's next quarterly report on Form 10-Q.

The SEC is also considering whether to require independent auditor examination of these proposed MD&A disclosures. The SEC noted that current auditing standards require auditors to evaluate the reasonableness of accounting estimates made by management.

Adoption of Material Accounting Policies

The proposed rules would also require MD&A disclosure regarding accounting policies adopted during the previous year that had a material impact on the company's financial statements. The required disclosures with respect to such newly-adopted policies would include:

- a description of the policy and its application;
- a description of the events which resulted in the adoption of the policy;
- a qualitative discussion of the impact of the policy on the company's financial statements;
- if alternative policies were available, an explanation of the company's choice of policy and a description of the alternatives; and
- if material, a qualitative discussion of the financial statement impact such alternatives would have had.

Comments on the proposal should be delivered to the SEC no later than July 19, 2002.

LOUISIANA LEGISLATURE TO CONSIDER SECURITIES TRANSFER TAX

By Amos J. Oelking III

During its recently-convened 2002 regular session, the Louisiana Legislature will consider imposing a 1-1/2% tax on the sale or transfer of stock, bonds, derivatives and other securities. As proposed, the tax would be payable by the seller or transferor and would be based on the security's "face value."

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Transfers of securities issued by the U.S. government, the State of Louisiana, or a political subdivision of the state would be exempt from the tax. The proposal, House Bill No. 65 authored by Rep. Arthur Morrell (D - New Orleans), has been referred to the legislature's Ways and Means Committee. Prior attempts to impose such a tax in Louisiana have been unsuccessful.

Currently, New York is the only state that imposes a tax on securities transfers. However, New York law also provides for a credit against 100% of the transfer tax due, effectively phasing out the tax. The transfer taxes once imposed by the U.S. government and the States of Florida, Texas, South Carolina, Pennsylvania, and Massachusetts have been repealed, most recently in Florida in 1987.

DELAWARE COURT REJECTS "VOTE-BUYING" CLAIM ARISING OUT OF COMPAQ-HEWLETT PACKARD PROXY BATTLE

By Richard B. Montgomery IV

On April 30, 2002, the Delaware Chancery Court denied Walter Hewlett's request to invalidate the approval of Hewlett Packard's stockholders of the proposed merger between HP and Compaq Computer Corporation. Walter Hewlett, the son of the co-founder of HP, alleged in his lawsuit that (1) HP's management induced and/or coerced Deutsche Bank to vote in favor of the merger (the "vote-buying claim") and (2) while soliciting proxies in favor of the merger, HP's management knowingly made numerous false and misleading public statements regarding the integration of HP and Compaq (the "disclosure claim"). Although the Chancery Court held that Mr. Hewlett failed to meet the burden of proving his vote-buying and disclosure claims at trial, in deciding HP's motion to dismiss, the Chancery Court presented an illuminating discussion regarding the legal standard for a vote-buying claim under Delaware law.

Background

Mr. Hewlett's lawsuit arose out of a fiercely contested proxy contest over a merger agreement between HP and Compaq. The contest was waged between HP's management, which supported the merger, and various members of the Hewlett and Packard families, who were in opposition.

"Vote-Buying" Claim

Mr. Hewlett alleged that, in an extremely close vote, the outcome was

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decided in management's favor after management had "bought the vote" of Deutsche Bank with respect to a significant block of shares over which it had voting control. In particular, Mr. Hewlett alleged that Deutsche Bank switched its vote as a result of HP's naming of Deutsche Bank as a co-arranger of a significant credit facility four days before the stockholders' meeting, combined with coercive communications from HP's management to Deutsche Bank implying that Deutsche Bank's future business dealings with HP would be jeopardized if the votes were not switched.

In analyzing the vote-buying claim, the Chancery Court primarily focused on the possible deleterious effects of the alleged vote-buying on HP's stockholders. The Chancery Court stated that although stockholders are generally free to cast their votes in any manner they please, including selling them to the highest bidder, a corporation's management could not use corporate assets to buy votes in a proxy contest concerning an extraordinary transaction that would significantly transform the corporation. In discussing the legal standard of a vote-buying claim, the Chancery Court concluded that:

- a contractually binding obligation between parties to an agreement to vote shares in a particular manner is not a pre-requisite to a vote-buying claim;
- as a threshold matter, the plaintiff must plead facts from which it is reasonable to infer that in exchange for "consideration personal to the stockholder," a stockholder has agreed to vote, or has voted, his shares as directed by another;
- the plaintiff does not have to show that a majority of all outstanding shares was obligated to vote in favor of the transaction as a result of the vote-buying; and
- if voiding the votes cast in accordance with a fraudulent vote-buying agreement with corporate management is sufficient to change the result of a vote, the defrauded or disenfranchised stockholders can bring a vote-buying claim.

The Chancery Court had allowed Mr. Hewlett's vote-buying claim to survive a motion to dismiss because it concluded that that Mr. Hewlett had alleged facts sufficient to sustain the claim if they were proven at trial. At trial, however, the Chancery Court held that Mr. Hewlett failed to prove the existence of a vote-buying arrangement. Although the circumstantial evidence presented by Mr. Hewlett at trial created an inference of that such an arrangement

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existed, the court's decision indicates that plaintiffs will need to produce more direct and conclusive evidence to prevail.

DUTY OF CORPORATE DIRECTORS TO PREVENT FRAUD BY OFFICERS AND EMPLOYEES OF THEIR CORPORATION

By Richard P. Wolfe and Scott Chenevert

Most derivative shareholder lawsuits against corporate directors challenge the propriety of a specific affirmative act by one or more directors. If the defendant directors are able to show they exercised due care in good faith and had no conflict of interest with respect to their challenged action, the courts are precluded by the "business judgment rule" from reviewing the merits of their decision.

The "business judgment rule" only applies, however, where the plaintiff shareholder challenges a specific business decision by one or more directors. What about the case where the plaintiff does not challenge a specific business decision, but rather alleges that the corporation suffered damage because the directors failed to take appropriate action to prevent faithless officers or employees from acting improperly? What standard do the courts use in evaluating such a claim?

In 1996, the Delaware Court of Chancery addressed the issue of director liability for board inaction in *In re Caremark Int'l Inc. Derivative Litigation*. In *Caremark*, shareholders brought a derivative action alleging that the directors breached their fiduciary duty of care in connection with alleged criminal activities by some of the corporation's employees. Specifically, the plaintiffs alleged that the board failed to actively monitor the corporation's performance, and that such failure constituted a breach of their duty of care.

The problem the Chancellor faced in *Caremark* was what legal standard to apply in determining whether directors were liable for damage allegedly resulting from their failure to consider whether to act. He elected to set a high threshold for director liability in such a case. In rejecting the plaintiffs' claim, the Chancellor held that "only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability."

In February 2001, the U.S. Court of Appeals for the Sixth Circuit applied the *Caremark* decision in *McCall v. Scott*. *McCall* involved a derivative action brought by stockholders of Columbia/HCA Healthcare Corporation against current and former directors of that corporation. The claims arose out of investigations into widespread and systematic Medicare and Medicaid fraud by the company. The plaintiffs alleged, among other things, that the defendant-directors breached their fiduciary duty of care by intentionally or recklessly failing to stop illegal conduct by officers and employees.

In order to pursue a derivative action under Delaware law, which is the jurisdiction of incorporation of Columbia/HCA, plaintiffs must either make a pre-suit demand for action to the board of directors or they must allege with particularity that demand would be futile. The district court dismissed all of plaintiffs' claims on the grounds that they failed to make a demand, and they failed to establish that such a demand would have been futile. In reversing in part with respect to the claim of breach of the duty of care, the Court of Appeals held that the particularized facts alleged by the plaintiffs, when taken together, were sufficient to present a substantial likelihood of liability on the part of at least five directors, which created a reasonable doubt as to the futility of demand by the plaintiffs.

The district court had interpreted the plaintiffs' complaint as one alleging a breach by the directors only of their duty of care. The directors responded to that claim by arguing that a provision in Columbia/HCA's charter shielded them from liability in damages for a breach of their duty of care. The charter provision at issue was adopted by Columbia/HCA pursuant to Delaware Code Section 102(b)(7), which allows a corporation to amend its certificate of incorporation to protect its directors against claims for damages based on any alleged breach of their duty of care as a result of gross negligence. Specifically excepted from protection under this provision, as required by law, was liability arising out of any act or omission by the directors not in good faith.

In rejecting the defendants' argument, the Court of Appeals disregarded how the plaintiffs styled their claim, *i.e.*, as a breach of the duty of care, and instead construed it as alleging that the defendant directors breached their duty of good faith. The court cited *Caremark* for the holding that unconsidered inaction can be the basis for director liability. Under Delaware law, a director breaches his duty of good faith through unconsidered inaction where he consciously disregards his duties to the corporation to exercise oversight, as required by *Caremark*, and such disregard causes injury to the stockholders.

Noting that the plaintiffs accused the defendant directors of a conscious

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disregard of clear signs of wrongdoing on the part of company employees, and not just "sustained inattention" to their management duties, the Court of Appeals held that if proven, this conduct could not have been undertaken in good faith. Accordingly, the charter provision relied on by the defendants would not shield them from liability. The *McCall* decision is a wake-up call to directors and corporate lawyers who have relied on exculpation provisions in charters of Delaware corporations to protect directors from damage claims in derivative shareholder suits based on failure of the directors to exercise their duty of oversight.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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