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# Ethics Issues Faced by Lawyers and Investment Bankers in Mergers and Acquisitions: A Problem Approach and Report of Panel Discussion

Barry S. Alberts Esq.

Samuel Thompson Jr.

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AUTHORS:* BARRY S. ALBERTS, ESQ.
SCHIFF, HARDIN & WAITE
CHICAGO, IL

SAMUEL THOMPSON, JR.
PROFESSOR AND DIRECTOR
CENTER FOR THE STUDY OF MERGERS & ACQUISITIONS
UNIVERSITY OF MIAMI SCHOOL OF LAW
CORAL GABLES, FL

PANELISTS: BARRY S. ALBERTS, ESQ.
SCHIFF, HARDIN & WAITE
CHICAGO, IL

ANTHONY V. ALFIERI
PROFESSOR AND DIRECTOR
CENTER FOR ETHICS AND PUBLIC SERVICE
UNIVERSITY OF MIAMI SCHOOL OF LAW
CORAL GABLES, FL

CHANCELLOR WILLIAM T. ALLEN
PROFESSOR OF LAW AND BUSINESS AND DIRECTOR,
CENTER FOR LAW AND BUSINESS
NEW YORK UNIVERSITY AND
WACHTELL, LIPTON, ROSEN & KATZ
(OF COUNSEL)
NEW YORK, NY



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PROFESSOR JOHN C. COFFEE
COLUMBIA UNIVERSITY SCHOOL OF LAW
NEW YORK, NY

ARTHUR FLEISCHER JR.
FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
NEW YORK, NY

JOSEPH H. FLOM
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
NEW YORK, NY

JAMES FREUND
SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
(OF COUNSEL)
NEW YORK, NY

THE HONORABLE ANDREW MOORE
WASSERSTEIN & PERELLA
NEW YORK, NY

ROBERT H. MUNDHEIM
SHEARMAN & STERLING (OF COUNSEL)
NEW YORK, NY

MODERATOR: LEWIS B. KADEN
DAVIS POLK & WARDWELL
NEW YORK, NY

## I. INTRODUCTION

This article explores ethical issues facing lawyers and investment bankers in mergers and acquisitions through the use of a hypothetical problem that raises issues in both private and public company transactions.[1] The hypothetical was the basis of a panel discussion on *Ethics Issues in M & A: A Problem Approach*, which was part of the Workshop on Emerging Issues in Mergers and Acquisitions. The panelists, who are set out above, are experts in legal ethics and experienced mergers and acquisition attorneys.

Although the panelists were not able to address all of the issues raised in the hypothetical, all of the identified issues are addressed in

1. The authors of this article drafted the problem. For a discussion of other ethical issues arising in mergers and acquisitions *see* Roberta S. Karmel, *The Role of Counsel in Corporate Acquisitions and Takeovers: Conflicts and Complications*, 39 HASTINGS L.J. 677 (1998); M. Breen Haire, *Comment: The Fiduciary Responsibilities of Investment Bankers in Charge of Control Transactions: In re Daisy Systems Corp.*, 74 N.Y.U. L. REV. 277 (1999); Miriam P. Hechler, *The Role of the Corporate Attorney Within the Takeover Context: Loyalties to Whom?*, 21 DEL. J. CORP. L. 943 (1996); Tariq Mundiya, *Liability of Investment Banks for Providing Financial Advice*, 27 SEC. REG L.J. 294 (1999); Marc I. Steinberg, *The Role of Counsel in Corporate Acquisitions and Takeovers: Conflicts and Complications, Attorney Conflicts of Interest in Corporate Acquisitions*, 39 HASTINGS L.J. 579 (1988).

this article and are supplemented by the salient comments made by the panelists during the discussion. Answers to many of the issues the panel uncovered are uncertain. Furthermore, many of the issues raised are not peculiar to mergers and acquisitions and could arise in other business contexts. For example, some issues present potential violations of common law fraud principles, fiduciary duty principles, or Rule 10b-5 under the Securities Exchange Act of 1934 ("34 Act") which prohibits, inter alia, fraud and misrepresentation in connection with the purchase of or sale of securities.

The principal focus of the discussion here in connection with the ethical duties of lawyers is the American Bar Association's Model Rules of Professional Conduct[2] and the American Law Institute's Restatement of The Law Governing Lawyers.[3]

The hypothetical is set out in Section II and each of the ethical issues is identified at the point it is raised in the hypothetical. In addition, the section of the article that addresses the issue is identified. Thus, there is a link between the issues presented in the hypothetical and the section of the article that addresses the issue.

## II. Hypothetical Problem: The Private and Public Acquisition Scene

### A. *Introduction*

Set forth below is a summary of the events surrounding a hypothetical acquisition by a public company, Consumers Choice, Inc., of a successful family-owned business, Technology, Inc. Shortly after acquiring Technology, Inc., Consumers Choice was approached by ALO.com, Inc., a public company, about the possibility of combining in a merger of equals. Before that transaction was consummated, Macro Ware Inc., a large publicly-held computer software company, made a hostile tender offer for ALO. Thus, the facts present a private transaction, a merger of equals between publicly-held companies and a hostile tender offer.

### B. *The Cast of Characters*

Consumers Choice is a leading manufacturer and merchandiser of a wide range of consumer goods. Through its domestic and international operations, Consumers Choice caters to mass retailers and wholesalers, home centers, and office super-stores that do business through more than

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2. Model Rules of Professional Conduct (3d Ed. 1996); *see also* American Ann. Model Rules of Professional Conduct Rule 1.9 (3d Ed. 1996) [hereinafter ABA Model Rules Ann.].

3. Restatement of the Law Governing Lawyers (1998).

twenty subsidiaries, affiliates and divisions. Consumers Choice has annual revenues of approximately $10 billion. Its stock trades on the New York Stock Exchange.

Technology is the leading producer and marketer of "high-end" anodized aluminum products for the automotive industry. Over the past four years, Technology has broadened its business through the acquisition of five cookware companies to include name-brand, luxury-line aluminum cookware, particularly, state-of-the-art aluminum pots and pans. The investment banking firm of Silk & Stockings assisted in these acquisitions by Technology.

Technology is owned by two brothers, Robert and William Bottomline. Robert owns seventy-five percent of Technology's stock and is its president. William owns twenty-five percent. William is not actively involved in Technology's business. The Bottomline brothers increasingly have been at odds over the strategic focus of Technology. In May 1999, William indicated that he would rather cash out than continue to have to suffer what he regarded to be Robert's mismanagement and control of the company. Robert was receptive; by the end of the month the brothers were discussing a sale to Robert of William's twenty-five percent interest (9,000 shares) for approximately $1,000 per share.

ALO.com, Inc., a NASDAQ traded company, is a leading marketer of consumer products over the Internet and sees the possibility of substantial synergies and new business opportunities arising from a combination with Consumers Choice. It has been following Consumers Choice for a significant period and thinks that the time is right to combine the two firms.

Macro Ware is a leading software company that is traded on the New York Stock Exchange. The CEO of Macro Ware, Bill King, has been following the developments of ALO for a significant time and has been considering making an offer for ALO. He is not interested at all in Consumers Choice, and thinks that the announced merger between ALO and Consumers Choice does not make sense.

### C. *The Consumers Choice-Technology Stock Purchase Agreement*

On June 1, 1999, Consumers Choice's CEO, Jenny Sharpeye, contacted Robert Bottomline to explore the possibility of Consumers Choice acquiring all of Technology's outstanding common stock. Three days later, Jenny met over lunch with Robert and Technology's outside corporate attorney, Patricia Black, to begin discussing the possibility in earnest. Robert and Consumers Choice entered into a confidentiality agreement, which, among other things, prohibited Robert from discussing the proposed transaction with anyone other than his lawyer, accountants and investment bankers. Consumers Choice did not ask Robert if he owned all of the stock of Technology, and Robert did not volunteer that there was another shareholder. As a result, Consumers Choice commenced due diligence and engaged the investment banking firm of Silk & Stockings (though not the same Silk & Stockings personnel who had previously assisted Technology in connection with its cookware company acquisitions) to assist it.

*First Issue.* The first issue, which is addressed in Section III, is whether, and under what, conditions Silk & Stockings may switch sides and represent Consumers Choice in the acquisition of its former client Technology. This issue was presented recently in a U.K. court in connection with a transaction in which Mannesmann, a German company, was the target of a hostile bid by Vodafone, a U.K. company. Mannesmann alleged that Goldman Sachs, one of Vodafone's investment bankers for the transaction and a former investment banker for Mannesmann, had switched sides inappropriately.

Consumers Choice's proposed letter of intent contained some provisions that were completely unacceptable to Robert Bottomline. In particular, the letter of intent contemplated an escrow of a significant amount of the cash purchase price to be paid to the selling shareholder(s). This would be used among other things, to secure a proposed indemnity of Consumers Choice against losses arising from a pending lawsuit brought against Technology by an alleged joint venture partner, "PANS!," seeking over $20 million in damages for breach of contract and fraud.

"You should tell Consumers Choice that this is a deal breaker — either they accept the PANS! exposure, and with no price concession from us, or we walk," said Patricia Black. "What makes you so damned sure that they won't just say goodbye," asked Robert. "Trust me", Black said,

> there is no risk that they'll walk. Let me tell you something confidentially: when Consumers Choice's general counsel faxed me a revised draft of their proposed Letter of Intent, to my surprise included in the papers was a 2-page memo from Consumers Choice's president to its general counsel. At first, I just casually glanced at it, but then I realized that it contained their 'final' positions on the deal points. Paragraph 6 said something like: As you suggested, I called PANS!' president to explore your idea that we might work out a settlement of the suit through some kind of strategic alliance with PANS! if Consumers Choice were to acquire Technology. He said he'd drop the Technology suit "in a heartbeat" if a mutually agreeable long-term alliance could be worked out. I have no doubt that we

could achieve such an alliance. So, if necessary, we can live with the PANS! exposure. Of course, we'll try to get a price concession if we do give on this point.

*Second, Third and Fourth Issues.* This paragraph presents the second, third and fourth issues. The second issue, which is addressed in Section IV, concerns the nature of the "confidential" conversation running from the lawyer to the client. Is this communication protected by the attorney client privilege? The third issue, which is addressed in Section V, is whether it was ethical for Black to have read and used the misdirected communication. The fourth issue, which is addressed in Section VI, is whether it was ethical for the general counsel of Consumers Choice to have suggested that the president of Consumers Choice contact the president of PANS! directly without giving the attorney for PANS! prior notice.

During the negotiations, Robert Bottomline maintained that the PANS! litigation would become Consumers Choice's problem. Further, when Consumers Choice's CFO broached a purchase price concession, Patricia Black jumped in with the observation (though false) that "Consumers Choice is not the only bidder in the picture, you know." Consumers Choice yielded.

*Fifth Issue.* The fifth issue, which is addressed in Section VII, is whether Black breached an ethical obligation by "lying" in the course of the negotiations by implying that Consumers Choice was not the only bidder.

### D. *Robert Bottomline's Acquisition of William Bottomline's Stock*

On June 15, 1999, Robert Bottomline telephoned his brother and suggested that they finalize Robert's purchase of William's twenty-five percent stock position. He did not disclose his negotiations with Consumers Choice. Indeed, he was prohibited from doing so by the confidentiality agreement. Hence, in accordance with their previous discussions, William agreed to sell his 9,000 shares to Robert for $1,000 per share.

*Sixth Issue.* As a prelude to addressing the issue below concerning the propriety of attorney Black's conduct in facilitating Robert's acquisition of William's shares, the question first must be asked whether Robert has breached a fiduciary duty in agreeing to purchase William's shares without disclosing the potential sale of all of the stock to Consumers Choice. This issue is addressed in Section VIII. Robert telephoned Patricia Black to inform her of the deal and to request that she "contact Bill's lawyer and get the deal done as quickly as possible." Like Robert in his conversation with his brother, Patricia Black did not reveal to

William's attorney Robert's negotiations with Consumers Choice for the sale of all outstanding shares of Technology for $2,500 per share.

*Seventh Issue.* The seventh issue, which is addressed in Section IX, is whether attorney Black's silence has facilitated a breach of fiduciary duty owed by William in violation of substantive law or an ethical rule. Robert's acquisition of William's shares closed on June 30, 1999. On July 20, 1999, Consumers Choice and Robert Bottomline executed the letter of intent, which provided, among other things, that, subject to execution of a definitive stock purchase agreement, Consumers Choice would purchase all of Technology's shares for $2,500 per share. The parties anticipated a closing by September 1, 1999.

### E. *The Closing of the Consumers Choice-Technology Stock Purchase Agreement*

Robert and Consumer's Choice entered into a definitive stock purchase agreement and the sale of Robert's Technology stock pursuant to the Stock Purchase Agreement closed as scheduled for the agreed upon price of $2,500 per share. A few weeks before the closing, a small transaction occurred: Robert Bottomline purchased an old warehouse and its underlying land from Technology. The warehouse was located in one of the most depressed, industrial parts of town. One morning at a meeting of the firm's conflicts committee, a partner of Patricia Black's mentioned that a client of their firm, a major urban development company, would announce its plans to develop and build a multi-purpose shopping center/movie theater/hotel complex in the area of Technology's old warehouse before year-end. Of course, when the news is made public, the real estate values in the area will quadruple. Patricia Black was a member of this committee.

Black immediately told Robert Bottomline what she had heard at the firm, and Robert in turn immediately instructed Black to seek Consumers Choice's consent to Technology's sale of the warehouse and land to Robert at the then current fair market value.

*Eighth Issue.* The eighth issue, which is addressed in Section X, is whether it was a violation of an ethical rule for Patricia Black to tell Robert about the development. Accordingly, Black notified Consumers Choice of Robert's desire to undertake the proposed real estate transaction and, being that Consumers Choice had no interest in the property and was delighted to see that Technology would be converting depressed assets into cash, consented to the transaction.

*Ninth Issue.* The ninth issue, which is addressed in Section XI, is whether attorney Black was obligated to disclose to a non-client, Consumers Choice, the material information regarding the developer's plans.

The real estate transaction closed the day before Consumers Choice closed its purchase of all of the Technology stock from Robert. Patricia Black represented Technology and, for good order's sake, Robert was represented by separate real estate counsel — his fresh-out-of-law school nephew.

### F. *ALO's Approach to Consumers Choice*

Shortly after Consumers Choice closed the acquisition of Technology, the CEO of ALO, Steve Vision, contacted the CEO of Consumers Choice, Jenny Sharpeye, about a "merger-of-equals" between ALO and Consumers Choice. The market capitalization of the two companies is similar and Steve has proposed that the shareholders of each firm end up with fifty percent of the combined entity, with Steve and Jenny serving as Co-CEOs in all respects. The board of the combined entity would consist of an equal number of members appointed by each company. Thus, the proposed deal is a true merger-of-equals. The idea of the deal came from Wayne Silk, a senior partner of Silk & Stockings who has been an active advisor to Steve and ALO but not to Consumers Choice. Jenny's immediate reaction is that the deal makes very good sense and should be pursued but with the shareholders of Consumers Choice receiving fifty-five percent of the stock of the combined firm. This would give the shareholders of Consumer Choice a slight premium to compensate for the faster growth in earnings at Consumers Choice. Jenny also thinks the timing is right for doing this type of deal now. Assuming Steve is willing to go with the premium, Jenny wants to move as quickly as possible.

Jenny called Fred Stockings, the senior partner from Silk & Stockings who often works on big deals for Consumers Choice and asked him to work on this deal with ALO. Jenny also called Stu Stone, the senior partner of Consumers Choice's outside law firm, Stone & Cold, who supervised the work on the Technology deal and asked for the assistance of Stone & Cold. Steve Vision had already contacted Keith Cold, another senior partner at Stone & Cold and asked Stone & Cold to represent ALO on the transaction. Thus, Steve Vision and Jenny Sharpeye have attempted to retain members of the same investment banking firm and the same law firm. Wayne Silk and Fred Stockings have proposed that their firm can represent both sides of this transaction as long as the parties agree. Silk & Stockings has previously represented both sides of a transaction, but only after erecting appropriate firewalls. Even with consent and firewalls, Stu Stone and Keith Cold think that they probably cannot represent both parties. However, they are being urged by their partners to at least explore the possibility. The partners argue that, as Wachtell Lipton has represented both parties in a public transaction, Stone & Cold should be able to do so also as long as there are appropriate consents. An article in the *New York Times* addressing dual representation by both law firms and investment bankers explains:

> Wachtell Lipton Rosen & Katz gave legal advice to both the Banc One Corporation and the First Chicago NBD Corporation in a $30 billion merger; Merrill Lynch & Company advised Italy's Credito Italiano and Unicredito in a $10 billion combination, and . . . Goldman advised the Norwest Corporation and Wells Fargo & Company on their $34 billion merger.[4]

As Steve and Jenny wish to conclude the deal quickly, they are willing to consent to the dual representation if it expedites the deal. They need to know quickly whether this dual representation by the investment bankers and the lawyers is feasible.

*Tenth Issue*. The tenth issue, which is addressed in Section XII, is whether Silk & Stockings and Stone & Cold can undertake this dual representation, and if so, under what conditions. To answer this question, both firms will have to consider issues such as what if the parties are unable to agree on the exchange ratio and what if a third party makes a competing offer for one of the merging firms?

Both Steve and Jenny have read the recent article in the *Wall Street Journal* about the $35 million dollar success fee that Time Warner Inc. will pay to the law firm of Cravath, Swaine & Moore if the merger with America Online Inc. goes through.[5] If the deal is not completed, Cravath will be paid a much smaller fee. As an inducement to expediting the deal, Steve and Jenny are each proposing to pay Stone & Cold a success fee if the deal closes and a fraction of the standard hourly rates if the deal does not close. They both think it is appropriate to have this type of incentive for lawyers, who can sometimes be deal breakers.

*Eleventh Issue*. The eleventh issue, which is examined in Section XIII, is whether and under what conditions Stone & Cold can agree to this success fee arrangement.

After due consideration, they proceed with the dual representation. In the course of tough negotiations over the exchange ratio, Steve suggests to Jenny that she should get a new employment contract complete with a significant increase in salary and other benefits that will put Jenny slightly ahead of Steve. Steve is not much concerned with salary,

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4. Laura M. Holson, *It Takes 2 to Merge but One Firm to Give Advice*, N.Y. TIMES, June 13, 1998, at D1.

5. *See Cravath, Swaine & Moore: Time Warner Counsel Gets Huge Fee if Merger Occurs*, WALL ST. J. INTERACTIVE EDITION, Jan. 21 2000.

because he owns thirty percent of ALO's stock. Shortly after this proposal, Jenny settles on a fifty-fifty split in the shareholdings.

*Twelfth Issue.* The twelfth issue, which is addressed in Section XIV, is whether the lawyers for Consumers Choice can merely accept this deal on salary even though there are grounds to believe that Jenny may have settled on the fifty-fifty split because she is being given the higher salary.

### G. *Macro Ware's Unsolicited Offer for ALO*

As indicated, Bill King, the CEO of Macro Ware, has long been interested in ALO, and thinks now is the time to make a bid for ALO prior to the completion of its deal with Consumers Choice. Bill has retained the law firm of Blue & Blood and the investment-banking firm of Quick & Easy to represent Macro Ware on the transaction.

In consultation with Blue & Blood and Quick & Easy, it is decided that Bill King will approach Steve Vision, ALO's CEO, with an offer that is forty percent higher than the trading price of ALO's shares on the date of the offer. ALO's shares are currently trading at $100 per share. It is also decided that Bill will not approach Steve until the FTC has issued its expected second request for information relating to the antitrust aspects of the Consumers Choice deal. It is expected that the second request, which will delay the potential FTC clearance of the transaction, will be issued within ten days. This time frame was selected believing it will be best to make the offer to Steve at the point when the antitrust clearance of the Consumers Choice transaction is in doubt. It is decided that if Steve does not react favorably to Bill's offer, then Macro Ware would make a tender offer for ALO.

During the period between the date of the decision to make the premium offer and the date of the offer, the shares of ALO went up from $100 to $110. This resulted in Macro Ware making an offer to ALO for $144 per share rather than $140 per share. As noted below, after a tender offer and proxy contest, Macro Ware succeeded in acquiring ALO for the $144 offer price.

The increase in ALO's share price was largely attributable to two massive insider trading schemes. The first originated with a summer associate in the Blue & Blood firm. The associate learned of the proposed offer by Macro Ware for ALO at a firm luncheon at which the head of the firm's mergers and acquisitions department told the summer associates that they should "watch the press closely within the next several days, because the firm's new client Macro Ware was going to upset the ALO-Consumers Choice transaction by making a premium offer for ALO." Blue & Blood does not have any special procedures in place to prevent insider trading, because it has always viewed its lawyers as beyond reproach and never in its 100-year history has it had an insider trading violation.

The second scheme originated with a broker at Quick & Easy who cracked a computer code and learned about Macro Ware's planned offer. Due to a previous injunction between Quick & Easy and the SEC resulting from an insider trading violation, Quick & Easy had erected what it thought was an air tight firewall between its M&A department and its brokerage operation.

It can be fairly established that if the insider trading had not taken place, it is likely that Macro Ware would have completed the transaction at $140 per share. Thus, the insider trading caused Macro Ware to pay an extra $4 per share, which aggregated to a total of $50 million.

*Thirteenth Issue.* The thirteenth issue, which is addressed in Section XV, involves the potential liability of Blue & Blood and Quick & Easy for the insider trading by their employees. This liability could run to the sellers of the securities purchased in the scheme as provided for "certain controlling persons" under Sections 20A and 20(a) of the 34 Act. In addition, if Blue & Blood or Quick & Easy are found to have controlling person liability under Section 21A of the 34 Act, the firm would could be fined the greater of $1,000,000 or three times the profits gained by the primary violator. Another issue is whether Macro Ware could recover from its advisors for the $50 million additional payment it was required to make to complete the transaction.

When Bill King presented the offer to Steve Vision, Steve immediately said, "No way. I did not build this company to turn it over to you." Steve immediately called the lawyers for ALO, Stone & Cold and the investment bankers, Silk & Stockings, and told them to make sure Bill King's offer does not succeed. He said, "I don't care what it takes, erect every barrier to a takeover by Macro Ware." Further, he reminded both firms that their success fees were tied to the Consumers Choice deal and not to any deal with Macro Ware. Despite these instructions, Silk & Stockings tried to negotiate a transaction fee if an ALO/Macro Ware deal occurred and a success fee if ALO were successful in defending itself, but Steve would not budge.

Stone & Cold and Silk & Stockings launched an extensive defense to Macro Ware's offer, and Macro Ware was required to launch a hostile tender offer with a proxy contest to remove ALO's poison pill. Silk & Stockings issued an opinion to the effect that the $144 per share offer was inadequately priced from a financial standpoint.

After a long protracted fight, Macro Ware succeeded in acquiring ALO, leaving Consumers Choice out in the cold. Because of the doubts raised about the final outcome of the proxy contest, the shares of ALO traded at prices far below the $144 per share ultimately paid by Macro Ware. Thus, the ALO shareholders that sold during this period would have been much better off if Steve had not undertaken the defensive actions.

*Fourteenth Issue.* The fourteenth issue, which is addressed in Section XVI, concerns the appropriateness of the defensive tactics recommended by Stone & Cold and Quick & Easy in response to Steve's direction.

## III. First Issue: Switching Sides

Silk & Stockings has previously represented Technology and is now going to represent Consumers Choice in its acquisition of Technology. This move raises the question of whether a "switching of sides" by the investment bankers is an impermissible ethical conflict. Silk & Stockings had previously advised Technology in connection with Technology's purchase of five cookware companies, and presumably gained some — and perhaps a great deal — of confidential information about Technology's business and negotiation strategies. Whether such a prior relationship should preclude it from representing the adverse party, Consumers Choice, without Technology's informed consent even in the absence of specific evidence of actual misuse of Technology's confidential information, becomes a key issue.

Rule 1.9 of the ABA Model Rules provides: "A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation."[6] A common way to determine whether the matters are "substantially related" is to ask whether the attorney "could have obtained confidential information in the first representation that would have been relevant in the second."[7] If the matters are deemed to be "substantially related," the lawyer and, by imputation under Rule 1.10 all members of the lawyer's firm, are presumed irrebutably to have obtained such confidential information which then would be used on behalf of the current client against the interests of the former client.[8] *Analytical* provides, "It is irrelevant whether [the attorney] actually obtained such information and used it against his former client, or whether — if the lawyer is a firm rather than an individual practitioner — different people in the firm handled

6. Model Rules of Professional Conduct, *supra* note 2, Rule 1.9.
7. *See, e.g.*, Analytical, Inc. v. NPD Research, Inc., 708 F.2d 1263, 1266 (7th Cir. 1983).
8. Model Rules of Professional Conduct, *supra* note 2, Rule 1.10.

the two matters and scrupulously avoided discussing them."[9]

In Formal Ethics Opinion 99-415, the ABA's Standing Committee on Professional Responsibility clarified that the term "substantially related matter," which is not defined in the Model Rules, also contemplates a continuing duty of "loyalty" to a former client.[10] Thus, in addition to Rule 1.9's concern with protecting against the risk that a lawyer might misuse a former client's confidential information, Formal Opinion 99-415 makes it clear that the "substantial relationship test" also applies to prohibit an attorney from representing a client against a former client without the former client's consent where the adverse representation involves the work that the lawyer had done for the former client, regardless of whether the former client's confidences would be misused.[11] Given this analytical framework, it is apparent why the Model Rules generally do not allow screening devices (*i.e.*, so-called "firewalls") to be employed to overcome the ethical obstacles created by such "side switching."

In contrast, investment bankers are not subject to such irrebuttable presumptions, loyalty obligations or imputation rules.[12] Instead, they are generally limited in their use of a former client's confidential information only by contract and common law principles governing fiduciary relationships that prohibit the fiduciary from using such information to the extent that such use actually would harm the former client. It is helpful to consider the decision of the U.K.'s High Court of Justice in *Mannesmann AG v. Goldman Sachs International.*[13] In this case, Mannesmann AG, a German company, sought to enjoin Goldman Sachs from acting on behalf of Vodafone Airtouch plc., a U.K. company, in its hostile takeover offer for Mannesmann on the grounds that Goldman had previously represented Mannesmann.[14] In denying the injunction, the High Court said,: "The applicable principle of substantive law is accordingly that [Mannesmann AG] as owner of confidential information is entitled to prevent [Goldman Sachs] from exposing [Mannesmann AG] to any avoidable real *(as opposed to fanciful) risk that confidential information might be disclosed to third parties or otherwise misused.*"[15]

9. *Analytical*, 708 F.2d at 1266.

10. ABA Standing Comm. on Professional Responsibility, Formal Op. 415 (1999).

11. *Id.*

12. *See generally*, General Acquisition, Inc. v. Gen Corp., Inc., 766 F. Supp. 1460 (S.D. Ohio 1990); Wiener v. Lazard Freres & Co., 241 A.D.2d 114 (N.Y. App. Div. 1998).

13. High Court of Justice, Chancery Division, The Honorable Mr. Justice Lightman, Transcript of Judgment (Nov. 18, 1999).

14. *Id.*

15. *Id.* at 2 (emphasis added).

*Walton v. Morgan Stanley & Co.*[16] presents a somewhat analogous American situation. In *Walton*, the court held that an acquiring firm's investment banker who received confidential information from a potential target during the course of tender offer negotiations did not owe a fiduciary duty to the target, even where the investment banking firm had agreed to return the information.[17] Consequently, there was no prohibition against the investment banking firm trading on the basis of the information.

On the other hand, in his dissent, Judge Oakes concluded that the "acceptance of [the confidential] information by Morgan Stanley . . . along with its understood role as intermediary in a cooperative takeover, imposed a duty on the investment banker under well-established common law principles not to use that information for its own profit."[18] In this type of situation, the SEC seems to have adopted Judge Oakes view under Rule 10b-5.[19] Proposed Rule 10b5-2, which was announced on December 15, 1999, applies to any violation of Rule 10b-5 that is "based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust and confidence."[20]

Two of the enumerated duties of trust or confidence set out in Proposed Rule 10b5-2(b)(1) are

> (1) Whenever a person agrees to maintain information in confidence; [and] (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the person communicating the material nonpublic information has a reasonable expectation that the other person would maintain its confidentiality.[21]

It seems clear that if Proposed Rule 10b5-2 had been in effect when *Walton* was decided, in the situation in *Walton*, Morgan Stanley would have been in violation of that rule. It is possible that the Proposed Rule 10b-5 approach will have an impact in determining whether investment bankers generally owe the duties of trust and confidence to former clients.

However, the hypothetical suggests that there could be uncertainty as to whether Silk & Stockings has violated a fiduciary duty. Should the uncertainty be resolved by regarding Silk & Stockings as precluded (by

16. 623 F.2d 796 (2d Cir. 1980).
17. *Id.* at 799.
18. *Id.* at 801.
19. *See* 17 C.F.R. § 240.10b-5 (1999).
20. Proposed Rule 10b5-2(a), announced in SEC Release No. 34-42259 (Dec. 15, 1999) [hereinafter Insider Trading Release].
21. *Id.*

the kind of presumptions and imputations that govern side-switching by attorneys in adverse matters that are "substantially related") from advising Consumers Choice without Technology's informed consent even though there is no evidence of actual misuse of technology's confidential information? In this regard, *General Acquisition, Inc. v. GenCorp., Inc.* is instructive.[22] In this case, the court denied a motion to dismiss a breach of fiduciary duty claim under Ohio law against an investment bank that allegedly had been retained by a company to advise it on acquisitions and then disclosed confidential information regarding the company to a corporate raider that made a tender offer, with the assistance of the investment bank, for the company.[23] Also, in *Wiener v. Lazard Freres & Co.*, the court permitted a company that had retained an investment banker in connection with a financing to proceed with a breach of fiduciary duty claim against the banker for allegedly misusing the company's confidential information by passing the information to another party.[24]

It seems clear, however, that outside of the context of the situation covered by Proposed Rule 10b-5 (assuming this proposed rule is adopted), as noted above, the law does not prevent Silk & Stockings from switching sides as long as there is no breach of fiduciary duty or contractual provision. One way of addressing the issue that Silk & Stockings now faces would be for it to obtain from Technology a prior waiver that would permit Silk & Stockings to represent an adverse party in certain defined circumstances. Joe Flom indicates that his firm routinely gets this type of waiver from certain clients for which it undertakes specific tasks.

## IV. Second Issue: Counsel's Confidential Communication to the Client

How realistic is it for attorney Patricia Black to suppose that her "confidential" communications with Robert Bottomline concerning the misdirected fax will remain confidential after the stock purchase? Could Consumers Choice, as the controlling shareholder of Technology after the acquisition, waive Rule 1.6 which provides that a "lawyer shall not reveal information relating to representation of a client unless the client consents . . .?" In general, a successor may waive the corporation's privilege.[25] However, at least one case has held that communications

22. *General Acquisition*, 766 F. Supp. at 1498.

23. *See id.* at 1488.

24. *See Weiner v. Lazard Freres & Co.*, 672 N.Y.S.2d. 8 (N.Y. App. Div. 1998). *See generally* Mundiya, *supra* note 1, at 307-10.

25. *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 347 (1985).

between counsel for an acquired corporation and the selling shareholder remain protected against a successor's waiver of the attorney-client privilege to the extent communications concerned the acquisition itself.[26]

In the context of the hypothetical, the communication was between attorney Patricia Black and Robert Bottomline in his capacity as the selling shareholder; Black was, therefore, not acting as counsel to Technology. Presumably, Technology has no rights to confidentiality that can be waived by Consumers Choice as the controlling shareholder after the acquisition; the rights arguably are those of Robert.

However, the fact that the communication is going from the lawyer to the client raises a more fundamental question, as it involves factual information, not legal advice. Is this the type of communication that is protected by the attorney-client privilege?

The privilege against compelled disclosure ordinarily does not cover purely factual material not related to the provision of legal services or advice. Here, Patricia Black's comments seem to go to negotiating strategy, advice that could come from anyone, whether a lawyer or not. So, in asking whether this type of communication is (or ought to be) privileged against disclosure, it might be appropriate to consider questions such as: when is the lawyer in a deal acting as "a lawyer," and when is he or she acting as the client's business-negotiation agent or counselor? Can the roles be so compartmentalized? And, what are the evidentiary, ethical and substantive consequences that follow from how one looks at the lawyer's role(s) in the deal?

## V. THIRD ISSUE: READING THE OTHER SIDES MISDIRECTED COMMUNICATION

Was it ethical for attorney Patricia Black to read and use the opposing party's misdirected privileged communication? What was counsel to do? Not read the fax, even though it came to her through no wrongdoing on her or her client's part? Wouldn't she be obligated to represent her client vigorously and with everything at her command? The approach taken by the ABA's Standing Committee on Ethics and Professional Responsibility is that a lawyer who has received an opponent's confidential information mistakenly should not examine it, but instead should request the opponent's instructions.[27] The assumption is that the opponent made a mistake, and did not voluntarily waive his right to confidentiality. Accordingly, as discussed below, since as an "inadvertent waiver" may be regarded as a legal oxymoron (a "waiver" is the

26. *See* Tekni-plex, Inc. v. Meyner and Landis, 89 N.Y.2d 123, 138 (N.Y. 1996).

27. *See* ABA Standing Comm. on Ethics and Professional Responsibility, Formal Op. 368 (1992).

*intentional* relinquishment of a known right),[28] the receiving lawyer and his or her client ought not to take advantage of the error.

Would the situation change if Patricia Black did not realize that the document was privileged and confidential until after she reviewed it? Must she back out of negotiations or the representation of her client completely because she has been poisoned by confidential information? If so, does this give an unscrupulous counsel a mechanism for disqualifying an unwanted lawyer for the other side?

In any case, there are jurisdictions that hold to Wigmore's view that, inadvertent or not, once confidentiality has been lost, there is no privilege or other entitlement to confidentiality.[29] Thus, if one is in a Wigmore jurisdiction, wouldn't it be malpractice *not* to use the information innocently received, regardless of what the ABA would have counsel do?

Finally, does it make a difference if the misdirected fax went to Robert Bottomline and not to Patricia Black, and Robert brought it to the attention of Black? How could Black possibly prevent Robert from using the information in the negotiations? Art Fleischer contends that the lawyer is obligated to inform the other side of the misdirected communication. Black has an ethical obligation to return the document and not disclose the information to the client. Barry Alberts asked, "What interest is being protected in this instance?" Lou Kaden asked if Black read it inadvertently and returned it, was Black required not to tell her client about it? Jack Coffee asked, "What if the other side continues with their negotiating position even though the document has been returned?" He went on to ask: "Does the lawyer now have an obligation to tell the client about the document?" He expressed the view that "the negligence of the one side should not disable the effectiveness of the lawyer for the other side." He concluded that "one side's negligence [should not cause] the other side [to] lose the effective advocacy of its lawyer who knows that there has been a misrepresentation made to his client."

Anthony Alfieri stated that the "Model Rules allow you to slow the conveyance of information to the client." Further, he knows of "nothing in the current rules that would allow the lawyer to not disclose the information to the client."

Barry Alberts said that the discussion assumed that the information was privileged, and stated that an argument could be made that the information is not within the privilege. Art Fleischer countered that this is an

28. *See, e.g.*, Mendenhall v. Barbara Greene Co., 531 F. Supp. 951, 954-55 (N.D. Ill. 1982).

29. *See* 8 JOHN WIGMORE, EVIDENCE § 2325 at 633 (McNaughton Rev. 1961); International Digital Systems Corp. v. Digital Equipment Corp., 120 F.R.D. 445, 456 (D. Mass. 1988).

issue of secrecy or confidentiality. Barry Alberts responded that if the "information is not privileged and comes to the lawyer through the negligence of the other side, might it not be malpractice for the lawyer not to use it?" In a final comment on this issue, Art Fleischer said that the lawyer should not explicitly reveal the document to the client but the lawyer should be able to use the information in advising the client. Is this thought a presumptuous decision on the part of the lawyer? What if the client, for example, would refuse to allow the use of the document if he knew about it?

## VI. Fourth Issue: Communicating With Another Party Without Going Through the Party's Lawyer

Rule 4.2 provides: "[i]n representing a client a lawyer shall not communicate about the subject matter of the representation with a person the lawyer knows to be represented in the matter, unless the lawyer has the consent of the other lawyer or is authorized by law to do so."[30] Presumably, lawyers may not ethically "cause" a client or client's agent to do indirectly what the lawyer could not do directly.[31] Therefore, the issue is whether Consumers Choice's general counsel has violated Rule 4.2 in having Consumers Choice contact PANS! without the consent of counsel for PANS!.

Read literally, Rule 4.2 does not apply, because the "subject matter" of counsel's representation of Consumers Choice is not the same "matter" as the PANS! suit against Technology.[32] Yet, a persuasive argument can be mustered that the spirit of the ethical rule has been violated. Indeed, the argument can be made that the matter involves all issues material to the acquisition, which includes the PANS! litigation. If this argument is followed, the situation is not just within the spirit of the rule but also within the literal terms of the rule.

This raises the question of how broadly or narrowly the ethical prohibition on ex-parte contacts with opposing parties (or, as here, soon-to-be opposing parties) should be read in the M & A context. In this regard, Joel Greenberg, a member of the ABA's Negotiated Acquisitions Task Force, has raised a question regarding New York's version of Rule 4.2, which provides: "During the course of the representation of a client a lawyer shall not: (1) communicate or cause another to communicate on the subject of the representation with a party the lawyer knows to be represented by a lawyer in that matter unless the lawyer has the prior consent of the lawyer representing such other party or is authorized by

30. Model Rules of Professional Conduct, *supra* note 2, Rule 4.2.

31. *See, e.g.*, Miano v. AC&BR Advertising, Inc., 148 F.R.D. 68 (S.D.N.Y. 1993).

32. *See* Model Rules of Professional Conduct, *supra* note 2, Rule 4.2.

law to do so. . . .[33] This provision goes on to state that notwithstanding this prohibition "a lawyer may cause a client to communicate with a represented party, . . . provided the lawyer gives reasonable advance notice to the represented party's counsel that such communications will be taking place."[34] Thus, the New York rule directly prohibits a lawyer from "causing" the client or any other person to contact another represented party without prior notice to such party's counsel.

In criticizing this provision, which he points out is a liberalization of the prior rule that required advance consent of the other lawyer rather than mere notice, Joel Greenberg argues:

> "Unless the word 'cause' is given a very narrow meaning (i.e., to exclude concepts of recommending or encouraging) . . . [the] rule — which seems to me to clearly derive from a litigation context — is totally impractical in the M & A transactional world in which all of us practice. It would characterize as an ethical violation a suggestion to your client or its investment banker that he or she discuss an economic term of a transaction with the other principal unless you remember to give the other lawyer reasonable advance notice.[35]

## VII. Fifth Issue: "Lying" in Negotiations

Patricia Black has falsely claimed that "Consumers Choice is not the only bidder in the picture . . . ." Is this statement a violation of Rule 4.1(a) of the ABA Model Rules, which provides that "[i]n the course of representing a client, a lawyer shall not knowingly make a false statement of material fact or law to a third person?"[36] Is Patricia's statement simply the kind of negotiation bluster that no one reasonably would rely upon, or might it properly be deemed to be a violation of Rule 4.1? The issue, of course, raises "truth-in-negotiation" issues generally, spotlighting the line(s) between the kind of dissimulation that is permissible, indeed *expected*, in the world of negotiation and deal making, and the kind of impermissible misrepresentation that is unethical. In this connection, Rule 8.49(c) of the Model Rules provides that it is "professional misconduct for a lawyer to: . . . (c) engage in conduct involving dishonesty, fraud deceit or misrepresentation . . ."[37]

Apart from ethical considerations, is it possible that the statement could give rise to a violation under Rule 10b-5 or principles of common law fraud? Is the materiality standard in Rule 4.1 the same as the mate-

33. N.Y. Ethics Rule § 1200.35(a) (1990).

34. *Id.* at § 1200.35(b).

35. E-mail message from Joel Greenberg, to ABA Negotiated Acquisitions Committee (July 20, 1999).

36. Model Rules of Professional Conduct, *supra* note 2, Rule 4.1(a).

37. *Id.*, Rule 8.49(c).

riality standard under Rule 10b-5?[38] Under Rule 10b-5, a misrepresentation or an omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available.[39] In this context, it is at least arguable that Patricia Black's false statement was a material misrepresentation under this standard. It should be noted that this is not an issue of whether Patricia might be a secondary participant and, therefore, not liable under the Supreme Court's holding in *Central Bank of Denver v. First Interstate Bank of Denver*[40] that there is no private civil aiding and abetting liability, because as explained by Professor Prentice "[in]" *Central Bank*, the majority accepted the universal rule that Section 10(b) and Rule 10b-5 impose an obligation upon persons not to defraud investors through affirmative misrepresentations."[41]

Assuming Consumers Choice went forward with the purchase of Robert Bottomline is shares, it is possible that Consumers Choice would have a cause of action against Patricia Black under Rule 10b-5. In setting out the elements of a claim under Rule 10b-5, the court in *Scattergood v. Perelman* said:

> the plaintiff must allege that the defendant (1) with scienter - an intent to deceive, manipulate, or defraud, *Ernst & Ernst*. . ., (2) made misleading statements or omissions, *Santa Fe Industries* . . ., (3) of material fact, *TSC Industries* . . ., (4) upon which plaintiff—a purchaser or seller of the security, *Blue Chip Stamps* . . ., (5) relied in entering the transaction, *Basic, Inc.* . . ., and (6) which caused economic loss to the plaintiff. *In re Phillips Petroleum* . . . .[42]

While it is by no means certain that Patricia Black's false statement gives rise to liability under Rule 10b-5, it is also not clear that she is free of such liability.

Chancellor Allen argues that a lawyer cannot make a "flatly false statement in the context of negotiations." He maintains, therefore, that while the lawyer could not say that Consumer Choice is not the only bidder when it is, the attorney could say "you aren't the only fish in the sea." This "would not be flatly false because there could be other potential bidders." Lou Kaden then asked whether this statement would not falsely connote that there is another bidder. On the other hand, Barry

38. *See id.* at Rule 4.1; *see also* 17 C.F.R. § 240.10b-5 (1999).

39. *See* Basic, Inc. v. Levinson, 468 U.S. 224, 231-32 (1988) (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)).

40. 511 U.S. 164 (1994).

41. Robert A. Prentice, *Locating that "Indistinct" and "Virtual Nonexistent" Line Between Primary and Secondary Liability Under Section* 10(b), 75 N.C. L. REV. 691, 718 (1997).

42. 945 F.2d 618, 622 (3rd Cir. 1991).

Alberts asked whether any lawyer would rely on such a statement. Art Fleischer said that the response depends on the person who is making the statement.

Analyzing the issue from another perspective, Bob Mundheim asked what would happen if the investment banker makes the statement that there are other bidders, although there are not. Jim Freund responded that he would "in confidence tell the investment banker to get back to the other investment banker and advise him that he was talking about possible bidders, not real bidders." Justice Moore asked: "What if the investment banker refuses?" Jim Freund's response was that he would then go to the client.

In referring to his chapter on *Lying in Negotiations*,[43] Jim Freund says that sometimes it is difficult to draw the line between mere puffing and a misrepresentation of fact.[44] He states that a helpful test is whether the nature of the statement is likely to be relied on and "the element of "justifiable reliance becomes more critical."[45] He adds that the "more specific the statement the more likely it is going to be treated as a factual representation for which the negotiator may be held liable."[46] He further elaborates that the less specific, such as there are "other fish in the sea" should not be a problem, but a statement that there are other bidders when there are not is a specific statement, that if given by a lawyer, is an ethical violation.[47] He makes the point as follows in his book:

> So, what guidelines can we derive [about lying in negotiations]? One of the commentators has suggested a helpful test: that liability for misrepresentation should depend on whether the deception causes some unfairness in the bargaining situation. Thus, the issue is not whether there's intent to deceive or mislead, but rather, whether or not the nature of the statement makes it likely that the negotiator will succeed in doing so. In this formulation, the element of justifiable reliance becomes critical. And the more specific the statement, the more likely it will be treated as a factual representation for which the negotiator may be held liable; the less specific — this case is a 'real winner' or this transaction 'a real steal'— the greater likelihood of it being considered mere opinion or puffing.[48]

Art Fleischer says the issue is "whether the statement is made with the expectation that it will be relied on, and if so there is a problem."

43. JAMES C. FREUND, THE ACQUISITION MATING DANCE AND OTHER ESSAYS ON NEGOTIATING: LYING IN NEGOTIATIONS (1987).

44. *Id.* at 159.

45. *Id.* at 168.

46. *Id.*

47. *Id.* at 165-68.

48. *Id.* at 168.

Barry Alberts concluded, by asking whether a lawyer can ever be "fully candid in a negotiation without engaging in malpractice?"

## VIII. SIXTH ISSUE: PURCHASING A SHAREHOLDER'S SHARES AT A TIME WHEN THERE IS A POTENTIAL BUYER FOR ALL THE SHARES

William Bottomline has agreed to sell his shares to his brother, Robert, at a time when Robert is in negotiations to sell all of the Technology shares to Consumers Choice. Before addressing the ethical and legal issues attorney Patricia Black faces in facilitating Robert's acquisition of William's shares, the first issue to be addressed is whether Robert has breached a fiduciary duty to William or a Rule 10b-5 duty to affirmatively disclose to William material information about the Consumers Choice negotiations prior to purchasing William's minority stock position.[49] As noted, William has entered into a confidentiality agreement with Consumers Choice prohibiting the disclosure of the negotiations.

Turning first to the state law fiduciary duty issue, it is helpful to focus on Section 5.16(a) of the ALI's Principles of Corporate Governance: Analysis and Recommendations.[50] This section provides that although a controlling shareholder generally can dispose of his or her shares at a premium, such a shareholder violates the duty of fair dealing if the shareholder "does not make disclosure concerning the transaction . . . to other shareholders with whom the controlling shareholder deals in connection with the transaction."[51] Thus, without disclosure, Robert would apparently violate his fiduciary duty to William.

Next, we look at Rule 10b-5. In *Jordan v. Duff & Phelps, Inc.*, the court found a potential violation of Rule 10b-5 where a corporation that was in merger negotiations purchased its stock from an employee without disclosing the merger negotiations.[52] The court concluded that "[c]lose corporations buying their stock, like knowledgeable insiders of closely-held firms buying from outsiders, have a fiduciary duty to disclose material facts."[53] Although it looks bad for Robert, William had virtually agreed to sell his stock for $1,000 per share to Robert prior to the point at which Consumers Choice first contacted Robert on June 1, 1999. Thus, this situation might raise the "possession-use" dichotomy,

49. *See, e.g.*, Guy v. Duff & Phelps, Inc., 672 F. Supp. 1086, 1090-91 (N.D. Ill. 1987).
50. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.16 (1992).
51. *Id.*
52. 815 F.2d 429 (7th Cir. 1987).
53. *Id.* at 435.

which is discussed below and remains unsettled in Rule 10b-5 civil litigation. Robert might argue that his deal with Consumers Choice had nothing to do with his deal with William, that, although he certainly had knowledge of the potential sale to Consumers Choice he did not in any way use this information in his negotiations with his brother. If he did not use the information then, as the law currently stands, he may not have violated Rule 10b-5. This is because some courts have held that mere possession of inside information is not sufficient to establish a violation of Rule 10b-5; there must be a "use" of the information.[54] Similarly, he might argue that his purchase of William's shares is not "in connection with the [Consumers Choice] transaction," and, therefore, Section 5.16 of the Principles of Governance is not applicable.[55] If he were to prevail in these arguments, he would not be in violation of either his fiduciary duty or Rule 10b-5.

This possession-use distinction would be eliminated if Proposed Rule 10b5-1, which was proposed in December 1999, is adopted. Proposed Rule 10b-5(a) provides that "manipulative and deceptive devices" prohibited by Rule 10b-5 include "the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information." Proposed Rule 10b5-1(b) states that the "on the basis of" material nonpublic information element of Proposed Rule 10b5-1(a) is satisfied when a person trades while merely "aware" of material nonpublic information.[56]

Proposed Rule 10b5-1(c) would provide several affirmative defenses to the rule regarding trading "on the basis of" material nonpublic information.[57] Robert would have an affirmative defense if he could demonstrate "that before becoming aware of the information, [he]: (A) had entered into a binding contract to purchase . . . the security in the amount, at the price, and on the date which [he] purchased . . . the security." Robert could not demonstrate this affirmative defense, and therefore, under the standard in Proposed Rule 10b5-1, he would likely have

54. *See, e.g.*, U. S. v. Smith, 155 F.3d 1051, 1066-69 (9th Cir. 1998) (mere possession of inside information is insufficient to establish violation of insider trading prohibitions); SEC v. Adler, 137 F.3d 1325, 1337-39 (11th Cir. 1998) (10b-5 entails a "use" requirement). *But see* U. S. v. Teicher, 987 F.2d 112, 119 (2d Cir. 1993) (suggesting that proof of "knowing possession" is information sufficient to sustain insider trading prosecution without proof that investor actually "used" such in formulating trade).

55. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 32.

56. *Id.*

57. *Id.*

Rule 10b-5 liability, notwithstanding the confidentiality agreement, which probably would not shield him. Art Fleischer expressed the view that this situation would constitute a "Rule 10b-5 violation because Robert is in possession of insider information."

## IX. Seventh Issue: Facilitating the Client's Breach of Fiduciary Duty in Purchasing Other Shareholder's Shares

Patricia Black represents Robert Bottomline in the purchase of William Bottomline's stock and she faces questions of whether, by her silence, she participated in a client's breach of fiduciary duty or violation of Rule 10b-5. Further, she may have violated Rule 1.2 (d) and Rule 4.1(b) of the ABA Model Rules.[58]

With respect to Patricia Black's potential liability under Rule 10b-5, in *Central Bank of Denver v. First Interstate Bank*,[59] the Supreme Court held that there is no aiding and abetting liability in a private civil action under Rule 10b-5. Therefore, Patricia Black does not have any risk of aiding and abetting liability in a suit by William Bottomline. However, under Section 20(l) of the 34 Act the SEC has the authority to seek injunctive relief and certain monetary penalties against "any person that knowingly provides substantial assistance to another person [i.e., aids or abets] in violation of a provision of the [34 Act] or of any rule or regulation issued [thereunder] . . ."[60] Thus, Patricia Black may be exposing herself to a potential SEC enforcement action for aiding and abetting a violation by Robert of Rule 10b-5.

In addition, in *Central Bank*, the Court acknowledged that a secondary actor like Patricia Black can be held liable as a primary actor if she "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies."[61] Thus, Black could be subject to liability under Rule 10b-5 if in the course of representing Robert she makes a material omission.

Prior to the decision in *Central Bank* to the effect that there is no aiding and abetting liability under Rule 10b-5, the court in *SEC v. National Student Marketing Corp.*[62] found that the lawyers for a target firm had aiding and abetting liability under Rule 10b-5. In *National Student Marketing*, the lawyers for a target permitted a merger to close even though the "comfort letter" of the acquiror's accountants, which

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58. *See* Model Rules of Professional Conduct, *supra* note 2, Rule 1.2(d) & Rule 4.1(b).
59. 511 U.S. 164 (1994).
60. Securities Exchange Act of 1934 § 20(e).
61. Central Bank of Denver, 511 U.S. at 191.
62. 457 F. Supp. 682, 715 (D.D.C. 1978).

was a condition to closing, indicated that the acquiror's financials were materially defective.[63] The court stated the SEC's position as follows:

> The Commission contends that the [target's] attorneys should have refused to issue the opinions in view of the adjustments revealed by the unsigned comfort letter, and after receipt of the signed version, they should have withdrawn their opinion with regard to the merger and demanded resolicitation of the [target's] shareholders. If the [target's] directors refused, the attorneys should have withdrawn from the representation and informed the shareholders or the Commission . . . .[64]

Also, the SEC charged the law firm of the target's attorneys with "vicarious liability for the actions of [the attorneys] with respect to [their] activities on behalf of the firm."[65]

Although the court refused to issue an injunction, the court found that the target's attorneys "had a duty to the [target's] shareholders to delay the closing of the merger pending disclosure and resolicitation with corrected financials, and that the breach of that duty constituted a breach of the antifraud provisions through aiding and abetting the merger transaction."[66]

It is possible that under a similar set of circumstances arising today a court could find that the target's attorneys were primary violators of Rule 10b-5 because the line between a primary violation and a secondary violation is difficult to discern.[67] Further, as pointed out by Professor Prentice,

> the Supreme Court has held that a duty to disclose will exist if there is a fiduciary or other similar relation of trust and confidence between' plaintiff and defendant. Therefore, at the very least, accountants and other collateral defendants owe a duty to blow the whistle to warn third parties of their client's fraud when they owe a fiduciary duty to those third parties.[68]

Under a fact pattern similar to that in *National Student Marketing,* it is possible that the target's attorneys would be found to be primary violators of Rule 10b-5.

Although in *National Student Marketing* the action was against the target's lawyers, in the hypothetical Patricia Black is representing the

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63. *See id.* at 709.

64. *Id.* at 701. Significantly, the court did not embrace the SEC's position that the lawyers might have had a duty to "blow the whistle" outside the corporate family context, i.e., to the Commission.

65. *Id.* at 701.

66. *Id.* at 714.

67. *See, e.g.,* Prentice, *supra* note 41, at 699.

68. *Id.* at 766.

acquiring person, Robert Bottomline, and we assume that competent counsel represents William Bottomline. Thus, the issue here is similar to the issue raised in *National Student Marketing* where the SEC brought an action against the counsel for the acquiror and his law firm in the matter. The SEC argued that the acquiror's attorney owed a duty to the target's shareholders to disclose the materially false financials; however, the district court did not so hold, and, because of the settlement of the case, this issue was never decided.[69] The SEC position is inconsistent with the current state of the law, which Professor Prentice describes as follow:

> Lawyers are even less likely to owe fiduciary duties to third parties .... According to most courts, attorneys do not typically owe duties of disclosure to nonclients and will rarely be liable to third parties for their legal work unless '[they] prepared a signed "opinion" letter designed for the use of a third party.' A common view is that expressed by the Fourth Circuit in *Schatz v. Rosenberg* that '[t]he better rule –that attorneys have no duty to "blow the whistle" on their clients – allows clients to repose complete trust in their lawyers.'[70]

In *Schatz v. Rosenberg*, the seller of a target firm brought a Rule 10b-5 action against the law firm of the buyer claiming that the financial statements of the buyer were fraudulent; that the lawyer knew of the fraud; and the lawyer failed to disclose the fraud to the seller.[71] The Fourth Circuit found that even if the law firm had violated a state bar ethical rule, such a violation did not create a duty to disclose under Rule 10b-5, and therefore, there could be no liability.[72] In describing this decision, Professor Phillips says:

> According to the Court of Appeals, the law firm simply 'papered the deal' and acted as a mere 'scrivener' in putting into writing the terms to which the parties agreed in preparing the closing documents .... Therefore, despite the lawyers' actual knowledge of the fraud, they could remain silent and participate in the closing of the transaction without liability under either the federal securities laws or Maryland State law.[73]

Additionally, Professor Phillips observes that the "law is clear; a lawyer has no right to disclose client fraud or crime unless it involves serious bodily injury, and lawyers are not liable for fraud under the federal securities laws, or otherwise, if they fail to disclose their knowledge

69. JAMES D. COX, ROBERT W. HILLMAN AND DONALD C. LANGEVOORT, SECURITIES REGULATION, CASES AND MATERIALS 1048 (2d Ed. 1997).

70. Prentice, *supra* note 41, at 767-68.

71. *See generally* 943 F.2d 485 (4th Cir. 1991).

72. 943 F.2d at 498.

73. Richard M. Phillips, *Client Fraud and the Securities Lawyer's Duty of Confidentiality*, 49 WASH. & LEE L. REV. 823, 825-26 (1992).

of a client's fraud."[74]

On the other hand, in *In Re Rospatch Securities Litigation*,[75] the court refused to grant the motion for summary judgment by a public company's law firm that was charged as a primary violator under Rule 10b-5 for preparing misleading disclosure documents. The law firm asserted that it did not have a duty to the purchasers of the company's stock.[76] The court held that the law firm's "direct participation in preparation of documents constitutes 'direct contacts' under the law of the Sixth Circuit. Accordingly, [the law firm] had a duty to disclose material omissions in those documents."[77] The court pointed out that the law firm's services "were more than the 'daily grist of the mill.' . . . [The firm's] lawyers had detailed knowledge of [the company's] business and legal affairs," as distinguished from the facts in *Schatz*, which was a pure "tattling" case.[78] However, the court pointed out that "*Schatz* has been criticized on ethical grounds," and that Professor Hazard, one of the foremost experts on legal ethics, concluded that "*Schatz* gives lawyers a 'license to steal.'"[79]

Thus, under the current state of the law concerning Rule 10b-5, and depending on the circuit, Patricia Black could have personal liability if she represents Robert Bottomline in the transaction, and full disclosure of the potential sale to Consumers Choice is not made.

Turning to the impact of the ABA Model Rules, Rule 1.2(d) provides that a "lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent."[80] The Annotations to the Model Rules further provide that "a lawyer may not knowingly assist a client in criminal or fraudulent conduct."[81] However, Rule 1.2(d) further provides that a "lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of law."[82]

Rule 4.1(b) provides that a lawyer shall not "knowingly fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client *unless disclo-*

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74. *Id.* at 826. Also note that in *National Student Marketing*, the target's shareholders were relying on the opinion of the target's lawyers, and therefore, this case and these facts would not appear to fall within the scope of the narrow view expressed in *Schatz v. Rosenberg*.

75. [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,939 (W.D. Mich. 1992).

76. *Id.* at 93,978.

77. *Id.*

78. *Id.* at 93,979.

79. *Id.*

80. MODEL RULES OF PROFESSIONAL CONDUCT, *supra* note 2, Rule 1.2(d).

81. *Id.*

82. *Id.*

*sure is prohibited by rule 1.6.*" (Emphasis added.)[83] The exceptions to this rule, which relate to disclosures that are necessary to prevent the client from committing certain criminal acts involving "imminent death" or "substantial bodily harm," and disclosures to establish a claim or defense in a controversy with the client, are not applicable here. However, the formulation of Rule 1.6 in many states permits the lawyer to make a disclosure in a broader set of circumstances.[84] For example, Professor Phillips reports that the "Virginia Code of Professional Responsibility permits a lawyer to disregard the duty of confidentiality if it is 'clearly established that the client is using the lawyer to perpetuate a fraud or other crime.'"[85] He argues that there is a "need for revision of Model Rule 1.6 and state codes of professional responsibility which inhibit the lawyer's right to take action to disclose client fraud involving the use of legal services."[86]

Indeed, the subject of lawyer facilitation of client fraud through silence and, in particular, the lawyer's discretion or obligation ethically to blow the whistle on client fraud, continues to be an evolving, controversial topic in the field of legal ethics. For example, Section 117B of the ALI, Law Governing Lawyers, which permits disclosure to "prevent, rectify, or mitigate substantial financial loss provides:

> (1) A lawyer may use or disclose confidential client information when and to the extent that the lawyer reasonably believes such use or disclosure is necessary to prevent a crime or fraud, and (a) the crime or fraud threatens substantial financial loss to a person; (b) the loss has not yet occurred; (c) the lawyer's client intends to commit the crime or fraud either directly or through a third person; and (d) the client has employed or is employing the lawyer's services in committing the crime or fraud.[87]

Subsection (2) provides that if a loss described in Subsection (1) above has already occurred, "a lawyer may use or disclose confidential client information when and to the extent that the lawyer reasonably believes such use or disclosure is necessary to rectify or mitigate the loss."[88] However Subsection (3) requires the lawyer, "if feasible," to remonstrate with the client before warning the victim or taking other action to prevent the harm.[89]

83. *Id.* at Rule 4.1. Rule 1.6(a) prohibits a lawyer from revealing "information relating to representation of a client unless the client consents." *Id.* at Rule 1.6(a).

84. Phillips, *supra* note 73, at 827-28.

85. *Id.*

86. *Id.* at 830.

87. ALI, Law Governing Lawyers, Section 117B.

88. *Id.*

89. *Id.*

Similarly, Proposed Rule 1.6 of the Public Discussion Draft of the ABA's Commission on Evaluation of the Rules of Professional Conduct, known informally as "Ethics 2000,"[90] would confer discretion on a lawyer to reveal ethically protected "information relating to the representation" without client consent in limited circumstances. First, such information could be disclosed "to prevent the client from committing a crime or fraud that is likely to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services." Second, a disclosure could be made to "rectify or mitigate substantial injury to the financial interests or property of another resulting from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services."[91]

As noted above, however, under Rule 4.1(b), there is no duty to disclose on the part of the lawyer because the disclosure duty is trumped and completely prohibited by the lawyer's ethical duty of client confidentiality under the current version of Rule 1.6. This is true even when the client is engaged in an ongoing fraud. Of course, if the client is engaged in fraud, the lawyer is ethically precluded from assisting the client by the current version of Rule 1.2(d), regardless of the fact that the lawyer may have no liability under Rule 10b-5.

So, this then takes us to withdrawal from representation under Rule 1.16. Rule 1.16(a) provides that "a lawyer . . . shall withdraw from the representation of a client if: (1) the representation will result in violation of the rules of professional conduct or other law . . . ."[92] On the other hand, under Rule 1.16(b), the attorney is permitted to resign if the withdrawal "can be accomplished without material adverse effect on the interests of the client, or if, [*inter alia*]: (1) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent, [or] (3) a client insists upon pursing an objective that the lawyer considers repugnant or imprudent . . . ."[93]

What should Patricia Black have done, given Rule 1.16(b) and the unconditional prohibition on counsel's ability to reveal to William Bottomline the Consumers Choice negotiations? Is this a case of permissible silence (perhaps even mandated silence under Rule 1.6) or an impermissible concealment or omission of material facts?

The panelists reached different conclusions. Arthur Fleischer says,

90. Proposed Rule 1.6, ABA, Commission on Evaluation of the Rules of Professional Conduct, Public Discussion Draft (1999) [hereinafter Ethics 2000].

91. *Id.*

92. ABA MODEL RULES ANN., Rule 1.16, *supra* note 2.

93. *Id.*

from the point of view of the lawyer, there is a "disciplinary rule that says the lawyer cannot engage in conduct involving dishonesty, fraud, deceit or misrepresentation." When there is a "serious issue about a violation of 10b-5, which is fraud or deceit, the lawyer could not participate in that conduct." He further says that Robert would have to disclose to William the "status and details of the negotiations with Consumers Choice, before the lawyer could proceed." Alternatively, Robert Mundheim says that there "may be reasons not to disclose the deal with Consumers Choice, but Robert should in such case set aside a portion of the price so that when the deal is consummated, Robert will give William the higher price." Ed Labaton agrees that in his view the lawyer "should set aside a good portion of his or her fee, because the lawyer has a disclosure obligation." He adds that, "in the Third Circuit, lawyers can be directly liable under Rule 10b-5 as a primary violators."[94] If the "attorney has a material fact, namely that there is another several million dollars available for William Bottomline, the attorney has a real problem."

Chancellor Allen asserted that the purchase of William's shares would be a "clear violation of fiduciary obligations Robert Bottomline has to William Bottomline, and that although there may be good reasons not to disclose, the question is if the rest of the deal price is going to be a satisfactory remedy in view of the very unclear recessionary damages concept in Delaware." He further says that if there is a "clear breach of fiduciary duty, then there is a risk under Delaware law that Robert could be hammered with a remedy that was greater than the deal price."

But Bob Mundheim commented that if "Consumers Choice is legitimately requiring that the negotiations be kept confidential, there must be a way to permit this to be done." Chancellor Allen responded that one alternative is for Robert Bottomline "to not go forward, that is, to abstain under the 'disclose or abstain' from trading principle under Rule 10b-5." But Bob Mundheim then asked, "What if William Bottomline wants to do the deal immediately?"

James Freund stated "the solution to the ethical dilemma is to give William Bottomline price protection, by providing in the deal that if Robert Bottomline sells within the next six months to a year, William will get the higher price." This would be the "practical solution to this problem, and if "Robert doesn't want to disclose the issue to William Bottomline, the matter is by definition material."

Anthony Alfieri asks whether or not the price protection feature "vitiates the lawyer's duty to correct the misapprehension that William

94. *See generally*, Klein v. Boyd, No. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. Feb. 12, 1998), *rehearing in banc granted, judgment vacated* on Mar. 9, 1998.

Bottomline is going to sue on." Both James Freund and Arthur Fleischer agreed that the price protection feature should eliminate the disclosure obligation in this situation. James Freund also pointed out that the confidentiality agreement may prohibit disclosure. Arthur Fleischer, however, responded that the confidentiality agreement will likely contain an exception for disclosures required by law. Additionally, in the circumstance in which Robert Bottomline will share in the proceeds he realizes on the sale to Consumers Choice, there is "no fraud."

## X. Eighth Issue: Disclosing One Client's Confidential Information to Another Client

Was attorney Patricia Black's disclosure to firm client, Robert Bottomline, of the developer-client's plans in violation of her ethical duty under Rule 1.6 not to reveal such information without the developer's consent, even though the disclosure was made to Robert who, in his capacity as a shareholder of Technology, has given up his interest in the Technology stock to Consumers Choice? Patricia Black's receipt of this information pits the attorney's ethical commitment of confidentiality to the developer-client against her ethical duties of loyalty and communication to disclose material information to the Technology client.

Regardless, there was uniform agreement among the panelists that Patricia Black should not have made the disclosure.

## XI. Ninth Issue: Lawyer's Obligation to a Non-client

Was attorney Patricia Black required to disclose to a non-client, Consumers Choice, the material information regarding the developer's plans for the real estate that Robert is buying from Technology? If not required to make such a disclosure, was she ethically permitted to do so? Or, as an ethical matter, was she prohibited from doing so? In this regard, it should be noted that she acted as counsel for Technology in the transaction.

Rule 1.13(a) provides that a "lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[95] Thus, it is clear that Black's loyalty in the transaction was to Technology. At the time of "the trade" however, Robert Bottomline owned 100% of Technology's shares, although these shares would later be transferred to Consumers Choice. Did Technology really lose? Did attorney Patricia Black breach any duty owed to Technology

95. Model Rules of Professional Conduct, *supra* note 2, Rule 1.13(a).

when she facilitated Robert Bottomline's purchase of Technology's real estate?

Although the entity-representation theory reflected in Rule 1.13(a) is deeply rooted in our system's approaches to analyzing conflicts of interest and other ethical issues, the entity theory offers little guidance here. Who is Patricia Black's client? And, what is the significance, if any, of the fact that Consumers Choice's acquisition of Technology is imminent? Further, does Robert Bottomline have any potential liability under Rule 10b-5? Does this constitute a failure to disclose material inside information in connection with the sale of securities? If so, has Patricia Black also violated Rule 10b-5?

Arthur Fleischer says that Patricia Black cannot represent Technology in making the purchase because of the contract with Consumers Choice. He says that there is "no way Black could talk about the transaction with Consumers Choice without lying." Furthermore, the purchase of the property might give rise to a claim by Consumers Choice that there was a violation of Rule 10b-5 for Robert Bottomline to purchase the property without giving Consumers Choice full notice of the developer's plans. Arguably, however, this was not fraud "in connection" with the purchase and sale of a security.

James Freund questioned whether in this situation there is a duty to disclose to Consumers Choice, and he suggested that Robert might give Consumers Choice a "heads up" that there may be something happening and let Consumers Choice do its own investigation. But Edward Labaton and Robert Mundheim agree that this would be a misrepresentation in and of itself.

Anthony Alfieri raised the option of "noisy withdrawal" by Patricia Black if Robert Bottomline insists on proceeding with the purchase. Chancellor Allen agreed that any withdrawal in a transaction like this would be a noisy withdrawal.

The general consensus of the panelists was that even though Patricia Black communicated the information to Robert Bottomline, she cannot represent him without violating Rule 4.1(a), i.e., "knowingly" making a "false statement of material fact to a third person."[96]

## XII. TENTH ISSUE: REPRESENTING BOTH THE TARGET AND THE ACQUIROR

The partners of Stone & Cold argue that since Wachtell Lipton has represented both firms in the $30 billion acquisition by Banc One of First Chicago, Stone & Cold should be able to do the same as long as the

96. *Id.* at Rule 4.1.

clients, ALO and Consumers Choice, have no problem and give their consent. Also, Silk & Stockings is prepared to move forward with the dual representation, because they have often done so with appropriate firewalls between the teams of bankers working for the two sides.

The starting point for the analysis of whether Stone & Cold can undertake this dual representation is Rule 1.7.[97] This rule prohibits a lawyer from representing a "client if the representation of that client will be directly adverse to another client, unless: (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation."[98] The Annotations to the Model Rules explain that, "[l]oyalty is an essential element in the lawyer's relationship to a client," and "loyalty to a client prohibits undertaking representation directly adverse to that client without the client's consent."[99]

Although the two clients are prepared to give their consent, the Annotations to the Model Rules provide that "when a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the seller's consent."[100] Thus, as a threshold matter Stone & Cold, acting in their capacity as "disinterested lawyers," would have to determine that under the circumstances, Consumers Choice and ALO should not withhold their consent. It is difficult to see how Stone & Cold could act in the capacity of disinterested lawyers in this regard. Would Stone & Cold have to consult with a truly disinterested lawyer to make this determination? Furthermore, is it not likely that a truly disinterested lawyer would determine that the clients should not agree to dual representation when dealing with a public company acquisition such as this one, where the parties have not yet agreed on price. It would appear that Stone & Cold would have a difficult time negotiating this first hurdle. In this connection, the *New York Times* reports that in the Banc One-First Chicago transaction, "Wachtell was not called until after Banc One and First Chicago negotiated most of the details themselves, including price . . . ."[101]

In regard to the absence of an agreement on price, the Annotations to the Model Rules say, "a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally

97. *Id.* at Rule 1.7.
98. *Id.*
99. *Id.* at Rule 1.7.
100. *Id.*
101. *It Takes 2 to Merge*, *supra* note 4.

aligned in interest even though there is some difference of interest among them."[102]

Obviously, if Stone & Cold undertakes the dual representation, appropriate firewalls will have to be developed between the lawyers in the firm representing the two sides. Also, if they undertake the dual representation and, for example, the parties are not able to agree on the exchange ratio or a third party makes a competing offer for one of the merging firms, the interest of the two parties may become fundamentally inconsistent. In such circumstances the Annotations to the Model Rules provide that, "if a conflict arises after representation has been undertaken, the lawyer should withdraw from the representation."[103] In other circumstances, the lawyer may have to withdraw from representing both parties.

Stone & Cold might negotiate at the outset with ALO and Consumers Choice regarding which of the two firms it will cease to represent in the event of a conflict developing. This mechanism was used by the law firm of Brown, Wood, Fuller, Caldwell and Ivey ("Brown Wood"), which represented both Merrill Lynch and two of its managers in an action by the SEC charging both Merrill and the managers with a failure to supervise.[104] Brown Wood explained to the managers that it had a long-standing representation of Merrill, and that "if a conflict of interest appeared to develop, Brown Wood would have to withdraw as [the manager's] counsel and that, in turn, if a respondent felt that there was divergence of interest 'he need only advise us and we would withdraw.'"[105] The Administrative Law Judge permitted the dual representation to proceed on the assumption that the decision of the managers was an "informed" decision.[106] The judge reasoned that this approach "is consistent with the precept that a litigant's choice of counsel is an extremely important right which should not be denied him, absent considerations compelling a contrary conclusion . . . ."[107]

Given the many unforeseen events that can occur in a public company acquisition where there is an absence of an agreement on price, it seems prudent for Stone & Cold not to undertake the dual representation; and that under the circumstances, a "disinterested lawyer" would conclude that the client should not agree to the representation.[108]

102. *See generally* MODEL RULES OF PROFESSIONAL CONDUCT.

103. *Id.*

104. Matter of Merrill, Lynch, Pierce, Fenner & Smith, Inc., [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,608, at 83,631 (A.L.J. 1973).

105. *Id.* at 83,633.

106. *Id.* at 83,631.

107. *Id.* at 83,634.

108. *See* MODEL RULES OF PROFESSIONAL CONDUCT.

Regarding dual representation by lawyers and investment bankers, in this connection, the *New York Times* quotes Professor Samuel Hayes, a finance professor at the Harvard Business School, saying, "I'm a director, and I would never let someone be on both sides of the table. I find that so contrary to my perception about the way things should work."[109] Although dual representation by investment bankers seems to be more common than dual representation by lawyers, the *New York Times* reports that in the Wells Fargo-Norwest transaction, "Goldman dispatched two separate teams, one for each company, and Credit Suisse First Boston, a unit of CS HOLDING, was hired by Wells Fargo to give a fairness opinion, for some added assurance."[110]

Panelist Joseph Flom said, in representing both sides, Skadden Arps has gone through "elaborate procedures, making certain that separate counsel would be "on the scene" for any issue that could be really controversial between the two sides." Also, he said Skadden would ensure that the clients "understand the implications of representing both sides, and would have elaborate internal procedures ensuring that information is not passed to the wrong person." He further stated, "if the waiver is right you really don't have a problem because both the parties are assuming you have all [relevant] information." However, he indicated, that the issue could also be determined by the kind of work the attorney was doing. For example, in some transactions, the general counsel may be running the deal; or the attorneys "might not be involved in the price negotiation" or in the negotiation of "price sensitive issues." In any event, Joseph Flom would insist that both clients have independent counsel if some major dispute arises.

As a justification for dual representations in certain circumstances, he said that he is reminded of a statement made by Justice Brandeis that there is "such a thing as an attorney for the situation." Lastly, Joseph Flom jokingly added that a senior partner in one of New York's large law firms said in response to a question concerning dual representation that, "it is not representing both sides that worries me, it is representing neither." The bottom line is that Joseph Flom would agree to represent the two clients if they insisted on it.

Arthur Fleischer's concern is first, whether there is an "informed waiver," and second, whether the firm can "effectively represent both clients." He says, "generally there would be no need for a back up counsel in a merger-of-equals ("MOE"), like the one here, because there is "a coincidence of interest." Therefore, in a true MOE, there should be no problem with dual representation. He pointed out, however, that the law

109. *It Takes 2 to Merge*, *supra* note 4.
110. *Id.*

firm should have "separate teams, and should insure that each board was aware that the firms had common counsel."

Although a law firm can represent both sides, Arthur Fleischer does not advise doing it. Further, he would really advise against doing so in a family owned firm where there could be competing interests." "There are no bright line or axiomatic test in this area," and therefore, the area has to be "approached carefully."

Robert Mundheim asked whether or not it matters if you have the same investment banker. He suggested that it would be "easier if the firms had separate investment banking firms to focus on the pricing issue."

James Freund mentioned the idea of "counsel for the situation," in which two firms hired one investment banker to help them decide upon the deal. In addition, both parties hired separate investment bankers to give fairness opinions. The separate bankers each advised their client that the price was unfair. As a result, both sides "turned on the middle man, the deal folded, and the middleman was out of a job." His bottom line is that "it is very tough to be in the middle." Jokingly, he said in this situation he would "try to find out who was going to end up [in control] and represent that person."

Lewis Kaden asked whether the attorney could get involved in the technical detail regarding the management of the combined company, even though both parties want the lawyer to act as a mediator, and be counsel "for the situation." James Freund cautioned that, if things go wrong the client could claim that the "informed consent does not cover the circumstance that has arisen." Informed consent may solve the basic "ethical problem," but the burden on just what is informed consent shifts to the lawyer.

For Edward Labaton, there are "situations in which even with informed consent the lawyer cannot proceed." He gives the following example: What if the lawyer discovers a slight understatement in the earnings of one of the companies? Is the lawyer barred from telling the other client about that fact which may or may not have an affect on the price of the stock? And what happens if a law suit develops six months later as a result of the understatement?

## XIII. Eleventh Issue: Are Success Fees Permissible in Mergers and Acquisitions Transactions?

Steve and Jenny both read the recent *Wall Street Journal* article about Cravath's success fee in the Time Warner-AOL transaction and think it is a good idea for Stone & Cold in this deal. The *Journal* article reports that Cravath's fee for representing Time Warner in the transaction could be $35 million.[111] Another *Journal* article reports fees in the amount of $50 million could be earned by each of Time Warner's investment bankers.[112] Thus, lawyers' fees are moving closer to those of the investment bankers.

The starting point in analyzing whether Stone & Cold can undertake this representation on the basis of a success fee is Rule 1.5 of the Model Rules. Rule 1.5(a) sets the general rule that a lawyer's fee must be "reasonable," and sets out factors for determining the reasonableness of fees, including the time spent on the matter and the skill required.[113] Rule 1.5(c) provides that a fee may be "contingent on the outcome of the matter for which the service is rendered:" some exceptions exists, but none are relevant here.[114] The contingent fee arrangement must be in writing, "must state the method by which the fee is to be determined," and upon conclusion of the matter, the lawyer is required to provide the client with an accounting statement.[115]

In an informal opinion, the ABA Committee of Ethics and Professional Responsibility held that the lawyer normally has an obligation to offer a prospective client an alternative fee arrangement before accepting a matter on a contingent fee basis.[116] Here, the client is well aware of Stone & Cold's normal fee practices and has suggested the contingent fee arrangement. There is nothing in the Model Rules that prohibits Stone & Cold from entering into the success fee arrangement. It should be noted that the contingent fee is subject to the reasonableness standard set out in Rule 1.5(a) and that a court might find that the fee is unreasonable if only a small amount of work is performed by the attorney.[117]

In discussing attorney's fees, Lewis Kaden asked whether the attorney could take stock options as part of the fee. Chancellor Allen responded that lawyers are not bound to a per hour fee basis, and many factors go into determining the reasonableness of the fee. Moreover, "assuming informed sophisticated clients there should not be a problem with a success fee." However, options present special problems if the "incentive structure of the fee impairs the independent judgment of the attorney." There is nothing wrong "in principle or ethically with some

111. *Cravath, Swaine & Moore*, *supra* note 5.

112. *See* Randall Smith, *Did Success Rob Goldman of AOL Deal?*, WALL ST. J., Jan. 12, 2000, at C1.

113. MODEL RULES OF PROFESSIONAL CONDUCT, *supra* note 2, Rule 1.5.

114. *Id.*

115. *Id.*

116. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 86-1521 (1986). *See generally* MODEL RULES OF PROFESSIONAL CONDUCT.

117. MODEL RULES OF PROFESSIONAL CONDUCT, *supra* note 2, Rule 1.5.

sort of incentive compensation, but on a case–by–case basis a judgment has to be made that independence of judgment will not be impaired by the size of the potential success fee."

Justice Moore asserts that "a contingent fee where the investment banker is going to have to give a fairness opinion must be avoided." James Freund agreed, in that an investment banker giving a fairness opinion and receiving a success fee may not be believed by the client. He adds, "a lot of the advice you give a client is toward getting a deal done, whether there is a fixed or contingent fee," but the "client may get in his or her head that maybe the lawyer's advice is tainted by the contingent fee."

Edward Labaton stated that the client should "understand that the lawyer is obviously going to be affected by a contingent fee, consciously or unconsciously." Arthur Fleischer on the other hand, says that if "the lawyer thinks that he or she can give the same advice without regard to the structure of the fee, the lawyer should not have a problem going forward." He adds that the nature of the client has to be factored into the analysis. For example, companies with sophisticated inside counsel, should have no problems with contingent fees; a "disinterested lawyer may conclude that an experienced sophisticated client could do certain things that a less experienced client could not." Joseph Flom said, and Arthur Fleischer agreed, that the advisability of a contingent fee may be dependent on what percentage the contingent fee is of the firm's revenues, . . . and a "contingent fee should be okay as long as it is not a material part of the firm's revenues."

Professor John Coffee raises the insider trading problem inherent in this situation. For example, if the lawyer knows the regulatory environment has become more favorable, but the client perceives great regulatory risk, there is a problem of "asymmetric information, which is a lot like insider trading." He believes there should be a "continuing obligation on the lawyer to disclose how little or how much risk there may be in a particular situation." Chancellor Allen said that in all situations the consent of the client must be "informed consent;" therefore the client must be fully informed so "there is no asymmetric information" and the client is not being "coerced."

In both the dual representation and the contingent fee issues, Barry Alberts raised the issue of "whether there are issues as to which a lawyer ought not be able to act even with the informed consent of the client, even in the context of very sophisticated clients with significant in-house capabilities?" He suggested that there are "points at which the lawyer ought to be inhibited, notwithstanding consent, . . . for certain core values of the legal profession, i.e., lawyerly independence, loyalty, confidentiality, may trump another core value, i.e., client autonomy. He further asked, "how can the lawyer be simultaneously loyal to both sides when the interest by definition cannot be entirely and completely coincident? "If there is no expectation of confidentiality and no expectation of loyalty, then the question is whether the lawyer is really acting as a lawyer."

## XIV. THIRTEENTH ISSUE: THE LAWYER'S RESPONSE TO AN EXECUTIVE'S POSSIBLE BREACH OF FIDUCIARY DUTY

Can the lawyers for Consumers Choice merely accept this deal on salary? What if they have a reasonable suspicion that the primary reason Jenny Sharpeye gave in on the request for fifty-five percent for her shareholders was the increase in her salary, thereby violating her fiduciary duty to the shareholders? Who do the lawyers represent: the firm, the shareholders, Jenny Sharpeye? What is the impact, if any, of Rule 1.13, pertaining to organizations as clients? What are the lawyer's responsibilities with respect to this issue under the federal securities laws?

The starting point in analyzing this ethical issue is Rule 1.13(b).[118] This rule provides in part that "[i]f a lawyer for an organization knows an officer, employee or other person associated with the organization is engaged in action . . . that is a violation of a legal obligation to the organization . . . and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably in the best interest of the organization."[119] The rule further provides that "[i]n determining how to proceed, the lawyer shall give due consideration to [*inter alia*] the seriousness of the violation and its consequences."[120] Measures taken by the lawyer may include, among others,

> (1) asking for reconsideration of the matter; (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law."[121]

In terms of this rule, it seems clear that if Stone & Cold has reason to believe that Jenny Sharpeye, in agreeing to the higher salary and price concession, has breached her fiduciary duties to Consumers Choice and its shareholders, Stone & Cold should: (1) ask Jenny Sharpeye to recon-

118. *See* MODEL RULES OF PROFESSIONAL CONDUCT, *supra* note 2, Rule 1.13.
119. *Id.*
120. *Id.*
121. *Id.*

sider the arrangement; and if that does not succeed, (2) bring the matter to the attention of the board. If Stone & Cold does not take this course of action, or if it does and there is not an appropriate response from the board, then under Rule 1.16(a)(1), it would appear that Stone & Cold would have an obligation to withdraw, because the "representation will result in violation of the rules of professional conduct, i.e., prohibition in Rule 1.2(d) against assisting a client in a fraud, or other violation of law, i.e., violation of fiduciary duty and disclosure duty under Rule 10b-5."[122]

If the breach of fiduciary duty is not corrected and the transaction goes forward without full disclosure of the background of the increased salary and price concession, there would arguably be a misstatement of material fact in the proxy statement. This could potentially result in liability for Stone & Cold under Rule 10b-5 or Rule 14a-9, the antifraud provision relating to proxy statements, if it is found that Stone & Cold has a duty to disclose to the shareholders of Consumers Choice. Stone & Cold seems to be in the same position as the lawyers to the target firm in the *National Student Marketing* case and it is conceivable that a court could find that Stone & Cold is a primary violator of Rule 10b-5.

Stone & Cold should also be concerned about possible sanctions by the S.E.C. Pursuant to the S.E.C.'s Rules of Practice, Rule 102(e) provides that the S.E.C. may "censure a person" or deny the person the right of practicing before it, if the S.E.C. finds, after notice and opportunity for hearing, that the person has, *inter alia*, "willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules or regulations thereunder."[123]

Alternatively, the SEC may take action under Section 15(c)(4) of the Securities Exchange Act of 1934 against a person that has violated certain disclosure provisions. This provision applies if, after notice and opportunity for hearing, the S.E.C. finds that "any person subject to the provisions of [inter alia the proxy and tender offer rules] has failed to comply with any such provision, rule or regulation in any material respect"[124] In such instances, the S.E.C. may "issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure [1] to comply, or [2] to take steps to effect compliance, with such provision or such rule or regulation."[125]

122. ABA Standing Comm. on Ethics and Professional Responsibility, Formal Op. 92-366 (1992) (discussing withdrawal when a lawyer's services will otherwise be used to perpetuate a fraud).

123. SEC Procedural Rules, 17 C.F.R. § 201.102 (1999).

124. Rule 15c-4, Securities Exchange Act of 1934, 15 U.S.C. § 78a.

125. *Id.*

In addition, the S.E.C. may bring a cease and desist proceeding under Section 21C of the Securities Exchange Act of 1934.[126] Under Section 21C(a), if after notice and an opportunity for hearing, the S.E.C. finds:

> that any person is violating, has violated, or is about to violate any provision of the [federal securities laws] or any rule or regulation thereunder, the [S.E.C.] may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule or regulation.[127]

The order may require the person "to comply or to take steps to effect compliance," and may "require future compliance or steps to effect future compliance"[128] Under Section 21C(c), in certain circumstances the S.E.C. may issue a temporary cease and desist order without notice and opportunity for a prior hearing.[129]

It is instructive to look more closely at two very visible S.E.C. actions under Rule 102(e) and Section 15(c)(4). In *In the Matter of George C. Kern, Jr. (Allied Stores Corp.)*, the S.E.C. brought an action under Section 15(c)(4) of the Securities Exchange Act of 1934 against an attorney of a target company for violation of Rule 14d-9 disclosure rules for tender offers.[130] The S.E.C. charged that target lawyer with failure to disclose, in response to the target offer that (1) it was in negotiations with a "white knight" which would result in a sale of a "material amount" of the target's assets and a "material change" in the target's capitalization or result in an "extraordinary transaction," (2) the target and the white knight reached an agreement in principle to merge, and (3) the target's board adopted a resolution authorizing the execution of a merger agreement with the white knight.[131] The Administrative Law Judge pointed out that under Rule 14d-9(b), the target was required to disclose "promptly" any "material change" in the information set forth

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126. Section 21C, Securities Exchange Act of 1934, 15 U.S.C. § 78a. The Senate Report to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which added Section 21C to the 1934 Act, explains that a "cease and desist order . . . will provide a more effective remedy than is currently available under Section 15(c)(4)." S. Rep. No. 101-337 at 18 (1990). The Senate Report to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which added Section 21C to the 34 Act, explains that a "cease-and-desist order . . . will provide a more effective remedy than is currently available under Section 15(c)(4).

127. *Id.*

128. *Id.*

129. *Id.*

130. *SEC Admin. Proceeding File No. 3-6869* (Nov. 14, 1988), 1988-1989 FED SEC. L. REP. (CCH) ¶ 84,342 [hereinafter *Kern*].

131. *Id.* at 89,580.

in its Schedule 14D-9.[132] Applying the probability-magnitude test of materiality of merger negotiations set out by the Supreme Court in *Basic Incorporated v. Levinson*, the Judge found that each of the facts was material and should have been disclosed.[133] Although the Administrative Law Judge found a violation, the full SEC vacated the decision on the grounds that it did not have the power to issue general prospective compliance orders under Section 15(c)(4).[134] Professor Coffee and his coauthors explain this was a retreat from prior S.E.C. positions, and the "retreat appeared to have been based on the new 'cease and desist' powers that the Congress gave [the S.E.C.] in 1990 under the Remedies Act [see Section 21C], which expressly authorized administrative orders against future violations of any provision, rule, or regulation."[135] Thus, in a similar situation, it could be expected that the S.E.C. would proceed under Section 21C rather than under Section 15(c)(4), and it is, therefore, instructive to review the facts and substantive holding of the Administrative Law Judge in that matter. Applying the substantive holding of *Kern* to the facts in the hypothetical, if the increased salary for Jenny were linked with the concession on price and this was a material fact, and if Stone & Cold does not take appropriate steps to ensure that the fact is properly disclosed, it could be open to a cease and desist order under Section 21C without respect to whether it is liable.

In *In re Carter and Johnson*, the S.E.C. brought an action under the predecessor of Rule 102(e) against two attorneys who represented an issuer in a public offering that contained a material misrepresentation.[136] The S.E.C. charged two lawyers of a publicly traded company "with failing to carry out their professional responsibilities with respect to appropriate disclosure to all concerned, including stockholders, directors and the investing public . . . and thus knowingly engaging in unethical and improper professional conduct" which is prohibited by Rule 102(e) and its predecessor.[137] The lawyers urged the CEO of the issuer to make a proper disclosure of problems with its lease maintenance plan, but the CEO refused to follow the lawyers' advice, and as a result the issuer made several material misrepresentations in public documents.[138] The Administrative Law Judge found that both attorneys had failed to carry out their professional responsibilities as charged.[139] The S.E.C. reversed

132. *Id.* at 89,582.

133. *See id.* at 89,585, (citing Basic Inc. v. Levinson, 485 U.S. 224 (1988)).

134. *Id.* at 89,583.

135. JENNINGS, MARSH, COFFEE, & SELIGMAN, SECURITIES REGULATION 1524 (1998).

136. *SEC Release No.* 17,597 (1981), FED. SEC. L. REP. (CCH) 82,847 at 84,169 [hereinafter *Carter*].

137. *Id.*

138. *Id.*

139. *Id.* at 84,172.

the judgment of the Administrative Law Judge, finding that the "ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws have not been so firmly and unambiguously established."[140] The S.E.C. went on to say, however, that the "attorneys' conduct raises serious questions about the obligations of securities lawyers, and the Commission is hereby giving notice of its interpretation of 'ethical or improper professional conduct' as that term is used in [the predecessor of Rule 102(e)]."[141]

The S.E.C. explained that the focus of its concern was on the "professional obligation of the lawyer who gives essentially correct disclosure advice to a client that does not follow that advice and as a result violates the federal securities laws."[142] In response to this issue, the S.E.C. set out the following circumstances that are considered "unethical or improper professional conduct" if engaged in by a lawyer:

> When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.[143]

In addition, the lawyer is in the "best position to choose the next step;" resignation may be an option in certain circumstances; and a direct approach to the board, a member of the board, or to another member of the issuer's management may be appropriate.[144] In conclusion, "[w]hat is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided, client."[145]

Professor Coffee notes that in *Carter*, the S.E.C. abandoned its position in *National Student Marketing* to the effect that the attorney should have notified the S.E.C.[146]

Although the S.E.C. explained that it would apply this new standard in future proceedings, since 1982 the S.E.C. has followed the practice of not instituting Rule 102(e) proceedings against lawyers "unless there has been a prior judicial determination [that] the lawyer has vio-

140. *Id.* at 84,170.
141. *Id.*
142. *Id.*
143. *Id.* at 84, 172.
144. *Id.*
145. *Id.*
146. *See* JENNINGS ET AL, *supra* note 135, at 1509.

lated the law in connection with the purchase or sale of securities."[147] Thus, Stone & Cold might face an action by the S.E.C. under Rule 102(e) if there is a finding that the firm has violated Rule 10b-5.

As to the reactions of the panelist, Joseph Flom said that the "only way to deal with this type of situation is to take the decision on compensation matters away from the person being compensated and place it with the board." He further said that in litigation this situation gives rise to potential problems under the "smell test" which judges will apply. And in this context "if the smell test gets applied [Jenny Sharpeye] is going to lose." If Jenny is isolated from the consideration of the issue by the board, the effect of her involvement will be "ameliorated," but the court will still be "suspicious."

But Arthur Fleischer expressed the view that if the "board is fully informed of the issues this should take care of the matter." He further said that the board process should "cleanse" the matter by giving the "board the opportunity to review the matter in executive session to decide in their own minds whether the salary being offered to the CEO makes sense and more importantly whether the terms of the transaction make sense."

Joseph Flom also emphasized that the compensation arrangements may be linked to the determination of price. But if the parties agree first on price without resolving the compensation issues, the party may be giving up negotiating leverage.

## XV. Thirteenth Issue: Law Firm's and Investment Banking Firm's Potential Liability for Insider Trading Violations of Employees

The insider-trading scheme in ALO's stock started at Blue & Blood as a result of the statement by the head of the firm's mergers and acquisitions group to the summer associates. The statement made it clear that Macro Ware would be making a premium offer for ALO. The statement did not say whether the offer would be a friendly offer or an unsolicited tender offer. Macro Ware, however, intended to open with a friendly offer and then proceed with a hostile tender offer if the friendly proposal was not successful. Blue & Blood had no procedures in effect to guard against insider trading, as relied on the honesty and integrity of its employees.

The insider-trading scheme at Quick & Easy started by an unauthorized and unexpected breach of its computer systems that were part of its

147. Greene, *Lawyer Disciplinary Proceedings Before the Securities Exchange Commission*, 14 Sec Reg. & L. Rep. (BNA) 168 (1982).

firewall mechanism. It is clear that Quick & Easy was not negligent in maintaining the system. The employee who breached the system learned that Macro Ware was prepared to make a hostile tender offer.

As a result of the insider-trading schemes, the price of ALO's stock increased from $100 to $110, and as a result of Macro Ware's plan to make an offer at a forty percent premium over the trading price of the ALO stock on the day of the offer, Macro Ware was required to offer $144 per share rather than $140. Macro Ware thus paid an additional $50 million in acquiring ALO.

This situation raises the issue of how law firms and investment banking firms can most effectively police and control dissemination internally of nonpublic client information that may be misused in securities or other commercial transactions. Law firms and investment banking firms have an interest in having procedures to control the dissemination of confidential information because the firm's potential liability for unauthorized disclosures made by its partners or employees.

We start with a discussion of the potential liability Blue & Blood and Quick & Easy could face under the 34 Act. First, under Section 20A(a) of the Act,

> any person who violates any provision of [the 34 Act] or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable to any person who, contemporaneously with the purchase or sale of securities has purchased or sold securities of the same class.[148]

Section 20A(b)(3) makes it clear that a person is not liable under this provision "solely by reason of employing another person who is liable under this section, but the liability of a controlling person under this section shall be subject to section 20(a)."[149] Section 20(4)(a) provides that a controlling person

> shall be jointly and severally liable with and to the same extent as [the] controlled person to any person to whom [the] controlled person is liable, unless the controlling person acted in good faith and did not directly induce the act or acts constituting the violation or cause of action.[150]

Under Section 20A(a) it is first necessary to determine whether the employees of Blue & Blood and Quick & Easy that traded in ALO's stock have violated any provision of the 34 Act or the rules or regulations thereunder. If the employees have violated any such rule, it is then

148. Section 20(A)(a), Securities Exchange Act of 1934, 15 U.S.C. § 78a.
149. *Id.*
150. *Id.*

necessary to determine whether Blue & Blood or Quick & Easy have controlling person liability.

As a result of the Supreme Court's decision in *United States v. O'Hagan*,[151] the misappropriation theory applies in Rule 10b-5 actions. This theory " . . . holds that a person commits fraud 'in connection with' a securities transaction and thereby violates . . . Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[152] Both the employees of Blue & Blood and Quick & Easy have misappropriated confidential client information; they each have violated Rule 10b-5; and they each have liability under the "contemporaneous trading" provisions of Section 20(A).

In addition, the Supreme Court in *O'Hagan* held that the requirement in Rule 14e-3 to "disclose or abstain" from trading under the tender offer provisions of the Act is a valid exercise of the S.E.C.s' authority.[153] This rule applies, "if any person has taken a substantial step or steps to commence, or has commenced, a tender offer . . . ."[154] In such instances, Rule 14e-3(a) provides that:

> it shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) . . . for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person . . . to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.[155]

Clearly, the employee of Quick & Easy who learned that Macro Ware was prepared to make a tender offer is also in violation of Rule 14e-3. There is also a strong argument that the summer associate for Blue & Blood is in violation of Rule 14e-3, even though he may not have been specifically aware that Macro Ware was prepared to make a "tender offer," because he was aware that Macro Ware planned to make *an* offer. As illustrated in *S.E.C. v. Mayhew*, where the court found a violation under Rule 14e-3 even though there was a two month lag between a tip and a tender offer, courts are likely to interpret the "substantial step" and "in connection with" elements of Rule 14e-3 very

151. 521 U.S. 642 (1997).
152. *Id.* at 652.
153. *Id.* at 674.
154. S.E.C. 1934 Act, Rule 14e-3a.
155. *Id.*

broadly.[156]

Thus, the employees of both Blue & Blood and Quick & Easy who engaged in the trading are liable under the misappropriation theory of Rule 10b-5, and as discussed above, are in violation of Rule 14e-3.

We next turn to the question of whether Blue & Blood or Quick & Easy are liable for the trading activities of their employees. Starting with the potential liability of Blue & Blood under Rule 14e-3, Rule 14e-3(d)(1) provides that it shall be unlawful for, *inter alia*, an advisor to Macro Ware to "communicate material nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section *except* that this paragraph shall not apply to a communication made in good faith."[157] The issue here is whether the head of Blue & Blood's M&A department violated this rule in making the disclosure to the summer associates.

In this connection, it is instructive to note that Section 112(1)(b) of the ALI, Law Governing Lawyers, requires the lawyer to "take steps reasonable under the circumstances to protect confidential client information against impermissible use or disclosure by the lawyer's associates or agents that may adversely affect a material interest of the client."[158] The comment to this provision says that a

> "lawyer must take reasonable steps so that law office personnel and other agents . . . properly handle confidential client information. That includes devising and enforcing appropriate policies and practices concerning confidentiality and supervising such personnel in performing those duties . . . a lawyer must not engage in casual or frivolous conversation about a client's matters that creates an unreasonable risk of harm to the interests of the client.[159]

The Reporters' note to this comment draws a "distinction between beneficial and justifiable shop-talk within a 'rule of reason' that notes factors such as need of listener to know, utility of conversation in lawyer's practice, degree of confidence lawyer can have that client remains anonymous, and innocuous nature of information."[160]

The ALI standard may have been violated by Blue & Blood's disclosure to its summer associates, and by the absence of any clear policies in place at Blue & Blood concerning such disclosures. Assuming this to be the case, more weight would be lent to the argument that the

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156. 121 F.3d 44 (2d Cir. 1997).
157. Rule 14e-3(d)(1).
158. ALI, Law Governing Lawyers, *supra* note 87, at 112.
159. *Id.*
160. *Id.*

head of the mergers and acquisitions department violated Rule 14e-3(d)(1).

With regard to the potential liability of Quick & Easy under Rule 14e-3, Rule 14e-3(b) provides that an investment banking firm will have no liability if it can show that it had:

> "implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate [the disclose or abstain rule]."

The policies and procedures may include, *inter alia*, "those which prevent such individual(s) from knowing such information."[161]

Also, Section 15(f) of the 34 Act requires every broker or dealer to "establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information."[162] Assuming that Quick & Easy was not negligent in constructing and maintaining its firewall and is in full compliance with Section 15(f), it seems that Quick & Easy has not violated Rule 14e-3.

As to Quick & Easy's possible liability under Rule 10b-5, Proposed Rule 10b5-1(c)(ii) provides limited affirmative defenses that resolves the possession-use dichotomy by providing that liability attaches when the trader "was aware of nonpublic information."[163] The defense applies to entities that trade, such as Quick & Easy, provided that they have "implemented reasonable policies and procedures taking into consideration the nature of the person's business to ensure that individuals making investment decisions would not violate laws prohibiting trading on the basis of material non-public information."[164] The preamble to the Rule says this provision is derived from a similar provision in Rule 14e-3(b).[165]

In any event, one can conclude that Quick & Easy has not violated Rule 10b-5, nor is it liable as a control person under Section 20(a) because it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation of [Rule 10b-5 and Rule 14e-3]."[166]

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161. Rule 14e-3(b)(2).

162. Section 15(f) 1934 Act.

163. Proposed Rule 10b5-1(c)(ii).

164. *Id.*

165. Also, some guidance on the issue of the policing by firms of potential insider trading may be deduced from the newly adopted Rule 17j-1 under the Investment Company Act, relating to the required adoption by investment companies of "codes of ethics." The code of ethics addresses "conflicts of interest activities that arise from personal trading activities of investment company personnel." Investment Company Act Release No. 23958 (Aug 20, 1999).

166. Rule 20(a).

On the other hand, it is possible that the head of the mergers and acquisitions department at Blue & Blood has violated Rule 14e-3(d)(1). Further, in view of the lack of any specific procedures at Blue & Blood governing the handling of client confidences, it is possible that Blue & Blood could be liable as a control person under Section 20(a) for the Rule 10b-5 and Rule 14e-3 violations by the employee who traded (assuming the employee is a labeled "person" under Section 20(a)) and for the Rule 14e-3 violations by the head of the mergers and acquisitions department. The issue here is whether Blue & Blood can establish that it "acted in good faith and did not directly or indirectly induce the acts or acts constituting the violation of [Rule 10b-5 or Rule 14e-3]."[167] If Blue & Blood has control person liability it will be liable under Section 20A to the sellers who contemporaneously traded during the course of the insider trading scheme that started at the firm.

In addition to potential liability under the contemporaneous trading rule of Section 20A, Blue & Blood as a controlling person of the person who violated Rule 10b-5 or Rule 14e-3 also faces the possibility of a fine under Section 21A of the 34 Act. Under Section 21A(a)(3), the fine on a controlling person "shall not exceed the greater of $1,000,000, or three times the amount of the profits gained . . . as a result of such controlled person's violation."

Section 21A(b) limits the liability of controlling persons. Under Section 21A(b)(1)(A), no person is liable as a controlling person unless the S.E.C. establishes that "such controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred . . . ." The legislative history of this provision elaborates on the standard:

> In order to seek imposition of a civil penalty, the Commission must establish that a controlling person objectively disregarded a risk that a controlled person was engaged in violations of the insider trading laws. The risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation.[168]

It is by no means certain that the S.E.C. could meet this standard in the case of Blue & Blood. However, Quick & Easy has no potential exposure to the fine under § 21A(a) because under Section 21A(b)(1)(B) it could have no control person liability unless the S.E.C. established that it "knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required by section 15(f) . . . and such failure

167. *Id.*
168. H.R. REP. No. 100-910, at 18 (1988).

substantially contributed to or permitted the occurrence of the act or acts constituting the violation."[169] Since Quick & Easy is in full compliance with Section 15(f), the S.E.C. could not meet this standard.

In addition to the fine, Blue & Blood could face a cease and desist action under Section 21C of the 34 Act, as is discussed above. Further, it is possible that Blue & Blood could have liability to Macro Ware for the portion of the $50 million overpayment, attributable to the insider-trading that originated at Blue & Blood. A similar issue was presented in *Litton Industries, Inc. v. Lehman Brothers Kuhn Loeb, Inc.*[170] In *Litton,* the court stated the issue as follows:

> "This litigation presents the question whether an acquiring corporation may hold its investment banker, employees of the banker and their tippees liable — pursuant to rule 10b-5, civil RICO, or common law fraud — for insider trading in the stock of the target company based on information misappropriated from the acquiring corporation."[171]

Lehman Brother's Kuhn Loeb, Inc. [hereinafter Lehman], an investment banking firm, was not named in the RICO and common law fraud counts, but was named in the Rule 10b-5 action as a "controlling person" and also in a negligence claim.[172]

In this case, the acquiring company, Litton Industries, Inc. [hereinafter Litton], retained Lehman to represent Litton in the acquisition of a target company, Itek.[173] Litton claimed that as a result of insider trading in the stock of Itek by Dennis Levine, an employee of Lehman, and his tippees, Litton was forced to "raise its tender offer for the outstanding Itek stock" and Litton sought "damages based on overpayment for its tender offer purchases of Itek stock."[174] The Second Circuit Court of Appeals reversed the district court's grant of the defendants' motion for dismissal of "all of Litton's claims for tender offer overpayment on the grounds that the insider trading as a matter of law, did not cause the injury alleged by Litton."[175] The Second Circuit held that "there is a genuine issue of material fact concerning whether the trader appellees, trading on the basis of confidential information belonging to Litton, caused Litton's injury."[176]

The court noted that for Litton to recover it must establish that the

169. Securities Exchange Act of 1934 § 21(A)(b)(a)(B).
170. 967 F.2d 742 (2d Cir. 1992).
171. *Id.* at 744.
172. *See id.*
173. *See id.*
174. *Id.*
175. *Id.* at 745.
176. *Id.*

traders' violations caused the loss.[177] The court said:

> In the case at hand, there are three links that are required to establish the chain of causation: (1) the trader[s] purchased stock on the basis of misappropriated information; (2) this trading inflated the market price of Itek stock; and (3) the Itek Board of Directors would have accepted a lower offer from Litton, if not for the artificially inflated market price of Itek stock.[178] The court held that Litton had the burden of showing that the "trading caused the market price of Itek stock to rise *and* that the market price was a substantial factor in Itek Board's assessment of Litton's offers."[179]

Putting this standard in the context of the hypothetical, Macro Ware would have to prove that (1) the trading by the Blue & Blood associate and the tippees caused the market price of the ALO stock to rise, and (2) the increased market price was a substantial factor in causing Macro Ware to pay a higher price for ALO than would have been paid in the absence of the insider trading. In addition, Macro Ware would have to establish that Blue & Blood has control person liability under Section 20(A).

Lehman was also named in a negligence claim. Both Blue & Blood and Quick & Easy could face a negligence claim under the facts presented in the hypothetical for failing to establish and maintain proper controls to prevent their employees from engaging in insider trading. It is instructive to consider the decision of the Delaware Chancery Court in the *Caremark* case when analyzing this issue.[180] *Caremark* arose in the context of a review by Chancellor Allen of a settlement of a derivative action and involved, inter alia, the question of whether a board of directors of a Delaware corporation could have liability for violation of its duty to monitor the actions of the corporation's employees, notwithstanding the presence of an exculpation provision pursuant to Section 102(b)(7) of the Delaware General Corporation Law.[181] Section 102(b)(7) permits a corporation to adopt a charter provision protecting its directors from liability for breaches of due care made in good faith.[182] In analyzing this issue the Chancellor reasoned:

> I turn to a consideration of . . . director inattention or 'negligence.' Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in Graham [*v. Allis Chalmers*, 188 A.2d 125 (Del.

177. *See id.* at 747.

178. *Id.*

179. *Id.* at 749.

180. *In re* Caremark Intern. Inc. Deriv. Lit., 698 A.2d 959 (Del. Ch. 1996).

181. *See id.* at 960.

182. DEL. GEN'L CORP. LAW § 102(b)(7) (1997).

> 1963) (setting out a red flag test for directorial liability)] or this case, in my opinion 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 a lack of good faith that is a necessary condition of liability.[183]

Although this standard may not be applicable for determining negligence in the context of the hypothetical (the standard may be lower), it would appear that the management of Blue & Blood but not of Quick & Easy might have exhibited an "utter failure to attempt to assure a reasonable . . . system "for preventing insider trading in the securities of Macro Ware.[184]

It would appear that Blue & Blood has potential liability to Macro Ware under both Rule 10b-5 and a common law negligence claim for the overpayment by Macro Ware in the tender offer. However, because Quick & Easy does not appear to have been negligent and it has no control person liability, it seems unlikely that it would have any liability to Macro Ware.

Law firms and investment banking firms participating as advisors in the merger and acquisition market should take appropriate measures to minimize the potential that their employees and agents may engage in insider trading — otherwise the firm itself may be liable to both investors and the injured client.

## XVI. Fourteenth Issue: Lawyer's and Investment Banker's Roles in Counseling a Target that Wants to "Just Say No!"

Steve Vision's reaction to Bill King's offer on behalf of Macro Ware for an acquisition by ALO was to "Just say no!" Steve directed ALO's lawyers, Stone & Cold, and its investment bankers, Silk & Stockings, to take every step to prevent the Macro Ware offer from succeeding. Silk & Stockings went so far as to issue an opinion, of questionable validity, that the $144 offer price was inadequate even though it represented a forty percent premium over the trading price of ALO's stock on the offer date.

What was the correct reaction of the lawyers and investment bankers in this situation, particularly in view of the fact that their success fees, as Steve has reminded them, are tied to the completion of the merger-of-equals with Consumers Choice? Clearly, the ALO shareholders were worse off with the defensive tactics than if ALO had immedi-

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183. *Caremark*, 698 A.2d at 971.
184. *Id.*

ately accepted the offer. Do Silk & Stockings and Stone & Cold have any potential liability to the ALO shareholders?

The starting point of the analysis is an examination of the state law governing the reaction of a target's directors to an unsolicited offer. It is assumed for this purpose that ALO is incorporated in Delaware. Under Delaware law, defensive actions undertaken by a target's directors are governed by the standard set out by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*[185] In *Unocal,* the court reasoned that because of the "omnipresent specter that a board [of a target in a hostile transaction] may be acting primarily in its own interests"[186] the directors undertaking defensive tactics have the burden of establishing that (1) "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . ."[187] and (2) the defensive measure was reasonable in relation to the threat posed.[188] Furthermore, in *Unitrin, Inc. v. American General Corp.*, the Delaware Supreme Court held that to satisfy the test of being "reasonable in relation to the threat posed" the defensive measure cannot be either "coercive or preclusive" and must be within "the range of reasonableness."[189]

If this test is not satisfied, the directors are denied the benefit of the business judgment rule, and they must then establish that the transaction is "entirely fair." They could be personally liable if they fail to meet that difficult burden, because a breach of the *Unocal* business judgment is generally a duty of loyalty violation and not protected by any charter provision limiting directors' liability for breaches of the duty of care under Section 102(b)(7) of the Delaware General Business Corporation Law. Thus, the potential liability of Steve Vision and the other directors of ALO is significant if they fail to satisfy the *Unocal* standard with respect to any defensive tactics they undertake.

Stone & Cold's first reaction to Steve's directive that all defensive measures be undertaken should be to explain to Steve and to ALO's board clearly and carefully the current state of the law governing defensive tactics. They should emphasize that there must be reasonable grounds for undertaking defensive actions and that the defensive tactics must be reasonable.

The second reaction of Stone & Cold should be to resign from representing either ALO or Consumers Choice or both, notwithstanding its success fee arrangement. It would appear that at the point Macro Ware

185. 493 A.2d 946 (Del. 1985).
186. *Id.* at 954.
187. *Id.* at 955.
188. *See id.*
189. 651 A.2d 1361 (1995).

makes the offer, Stone & Cold has a clear conflict between its duty of loyalty to Consumers Choice and its interest in merging with ALO and its duty of loyalty to ALO, which may have an interest in terminating its merger plans with Consumers Choice and being acquired by Macro Ware. The Annotations to Model Rule 1.7, relating to conflicts of interest, provide that "[w]hen a conflict of interest arises during the course of representation, the lawyer must withdraw in accordance with Rule 1.16."[190]

Silk & Stockings also has a conflict and should resign as well. However, the facts indicate that Silk & Stockings has issued a questionable opinion that the $144 offer price is inadequate. They did so at the urging of Steve Vision. Silk & Stockings may have exposed itself to potential liability to the shareholders of ALO for either negligently or intentionally preparing an inaccurate fairness opinion. In *Schneider v. Lazard Freres & Co.*, the court held that under New York law the investment banking firm of Lazard Freres had a duty of care to the shareholders of RJR Nabisco in advising a special committee of the directors on a proposed management buyout.[191] The court reasoned that in

> this 'buyout' context, if something less than the highest possible price was obtained, the loss was sustained by the shareholders, not the corporation, and, for that reason, we are of the view that the relationship between the shareholders and the Special Committee was essentially that of principal and agent on which principles of corporate law should not be superimposed.[192]

The holding in *Schneider* was distinguished in *Meyer v. Goldman Sachs & Co.*,[193] also decided under New York law. *Meyer* involved a claim by a target's shareholders that the target's investment bankers had given negligent advice to the target's outside directors in connection with the acquisition of the target.[194] Distinguishing *Schneider* and holding for the investment bankers, the court reasoned that the target's directors "were not members of a special committee set up specifically to advise and protect [the shareholders'] interest in a buyout auction in which management was a participant."[195] In analyzing *Meyer* and *Schneider*, Tariq Mundiya says:

> it appears that shareholders who claim that their financial interest have been harmed by an investment bank's negligent advice or opin-

190. MODEL RULES OF PROFESSIONAL CONDUCT, *supra* note 2, Rule 1.7.
191. 552 N.Y.S.2d 571 (N.Y. App. Div. 1990).
192. *Id.* at 575.
193. 651 N.Y.S.2d. 304 (1st Dep't 1996).
194. *See id.*
195. *Id.* at 304.

> ion where there is no special committee created for the purpose of protecting shareholders' interests may assert a cause of action under New York law for 'negligence' only if such shareholders can establish the elements of a cause of action for . . . negligent misrepresentation.[196]

On the other hand, in *In Re Daisy Systems*, the Ninth Circuit held that a bankruptcy trustee for an acquiring firm, Daisy, that went into bankruptcy after making an acquisition could bring an action against its investment banker, Bear Stearns, for professional negligence and breach of fiduciary duty.[197] The court found that the engagement letter between Bear Stearns and Daisy did not limit Bear Stearns' professional responsibility in advising Daisy. The court found the appropriate standard to be the "duty of care in the investment banking community."[198] The court remanded for a determination of whether Bear Stearns breached its duty of care.[199]

Furthermore, the court held that it was a question of fact whether Bear Stearns owed a fiduciary duty to Daisy. Rejecting Bear Stearns's position that its relationship with Daisy was "not a fiduciary relationship as a matter of law," the court found that the existence of such a relationship is a "question of fact which properly should be resolved by looking to the particular facts and circumstances of the relationship at issue."[200] The court continued:

> Two important issues of fact that must be resolved before it can be determined whether a fiduciary relationship existed between Daisy and Bear Stearns are the questions of agency and confidentiality. As confidentiality is an element of a fiduciary relationship, . . . resolution of the fiduciary question in this case will turn in part on whether Daisy reposed confidences in Bear Stearns. Moreover, among the terms of Bear Stearns's retention was a provision stating that it would be acting on Daisy's behalf. Should a fact finder determine from the record that an agency relationship existed between the parties, . . . then a fiduciary relation should be presumed to exist.[201]

The court however, said: "Every relationship between an investment advisor and client is not of a fiduciary nature, and determining when fiduciary obligations are in fact owed will depend in large part upon the particular facts involved."[202] The court therefore remanded for

196. Mundiya, *Liability of Investment Banks*, *supra* note 1, at 301-02.
197. 97 F.3d 1171 (9th Cir. 1996).
198. *Id.* at 1176.
199. *See id.* at 1181.
200. *Id.* at 1178.
201. *Id.*
202. *Id.* at 23.

a determination of whether a fiduciary relationship existed and if so whether Bear Stearns' breached that duty.

On remand the "jury found that (1) a fiduciary duty did exist between Bear Stearns and Daisy, (2) Bear Stearns did not breach that duty; and (3) Bear Stearns committed professional negligence. The jury awarded Daisy $108 million, or 39% of the $277 million in damages that Daisy claimed to have occurred."[203] Counsel for Daisy, "claimed that, had the jury found that Bear Stearns had breached its fiduciary duty, 'the award could have approached the billion dollar mark [and that] [i]t will, happen, perhaps in the next case.'"[204] The court reduced the jury verdict to $36 million, and this decision is now on appeal.[205]

Several Delaware courts have arrived at a different result, finding that investment bankers for a company do not have a fiduciary duty to shareholders.[206] For example, in In re Shoe-Town, Inc. Stockholders Litig., the court reasoned: "[B]ecause a fairness opinion or an outside valuation is not an absolute requirement [in a change of control situation] under Delaware law, it makes little sense to strap those investment banks, which are retained, with the duties of a fiduciary."[207]

The lesson here for Silk & Stockings is that by rendering the opinion that the price is inadequate, it may have exposed itself to liability on the grounds that it has violated (1) its fiduciary duty to ALO, along the lines of the claim in *Daisy*; or to the ALO shareholders, along the lines of the claim in *Schneider*, (2) it has engaged in malpractice in issuing a defective valuation opinion, along the lines of the claim in *Daisy*, or (3) it has engaged in negligent misrepresentation, which is a claim that would be allowed even under the approach in *Meyer*.

## XVII. CONCLUSION

This article demonstrates that the current private and public merger and acquisition landscape presents numerous ethical challenges for lawyers and investment bankers. A misstep can lead not only to sanctions for violation of ethical standards but also to liability for breach of fiduciary or statutory duties. The lesson is clear: "Proceed with caution."

203. *Id.*
204. *Id.*
205. *See* Mundiya, *Liability of Investment Bankers*, *supra* note 1, at 294, 318.
206. *See* Haire, *Investment Bankers*, *supra* note 1, at 281.
207. In re Shoe-Town, Inc Stockholders Litig., No. 9483, 1990 Del. Ch. LEXIS 14, at *22 (Del. Ch. Feb. 12, 1990).