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Foreword

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I am pleased to author the Foreword to this Symposium Issue of the Pepperdine Law Review. The Symposium, entitled "Current Issues in Securities Regulation," was a lively event held on February 22, 1992. The edited transcript should prove quite useful and is included herein.

The articles contained in this Symposium are authored by leading scholars and practitioners. Subjects addressed include corporate governance, proxy and tender offer regulation, definition of the term "security," liability under the state blue sky statutes, and class actions. By addressing such key and diverse developments, the articles in this Symposium constitute one of the better compilations of recent works in the corporate and securities law area.

"Corporate Governance: Some Unanswered Questions" by Mr. Henry Lesser provocatively leads off this Symposium Issue. Focusing on the corporate governance debate, Mr. Lesser opines that this debate thus far has failed to address the fundamental question regarding whether the corporation in its present form remains viable as the optimal structure for a publicly-held enterprise. After examining several recent developments that impact this fundamental question, the author concludes that serious consideration should be given to the replacement of the existing corporate structure with a new, more efficient "second generation" corporation that would provide solutions to the current corporate governance dilemmas.[1]

The second article, by Mr. Bryant B. Edwards, Mr. Jeffrey A. Herbst and Ms. Selina K. Hewitt, addresses the decisions faced by holders of public debt securities when they are presented with a re-

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1. For Symposiums addressing corporate governance, *see, e.g.*, 8 CARDOZO L. REV. No. 4 (1987); 52 GEO. WASH. L. REV. Nos. 4 & 5 (1984); 30 HASTINGS L.J. No. 5 (1979); 8 HOFSTRA L. REV. No. 1 (1979); 45 OHIO ST. L.J. No. 3 (1984); 37 U. MIAMI L. REV. No. 2 (1983). *See also*, The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (Proposed Final Draft March 31, 1992).

structuring proposal by a troubled company. When such a proposal is structured as an exchange offer, bondholders have responded by forming unofficial bondholder committees to negotiate with the issuer. As the authors point out, however, such committees act solely as a "sounding board." Even if negotiations result in an apparent agreement, there is no assurance that a sufficient number of bondholders will favor the terms bargained for by the "unofficial" committee. Hence, the agreement may not be accepted by the requisite number of bondholders to consummate the exchange. The authors assert that a better solution, at least in certain situations, would be the bringing of a mandatory federal class action by bondholders (with no right to opt out) against the issuer of the bonds upon the occurrence of a payment default, other material breach, or a restructuring proposal set forth by such issuer. The representatives of the class would negotiate a settlement providing for a restructuring of the securities which, upon receiving a court's approval after a fairness hearing, would bind all class members.

The next article, authored by Mr. John C. Maguire, addresses the many regulatory issues that arise with respect to international tender and exchange offers. Given the presence of a global marketplace, acquirers are penetrating foreign markets, thereby implicating the laws of different countries. The extent to which the United States and in particular, the Securities and Exchange Commission (SEC), should prescribe regulatory standards in this setting is a question of paramount importance. In this article, Mr. Maguire surveys the emergence of the international securities markets, followed by a description of the SEC's regulatory efforts in this area.[2] Although the Commission continues to assert broad subject matter jurisdiction concerning the securities acts' antifraud provisions, it has relaxed its position with respect to the reach of the registration mandated by adopting such regulations as Rule 144A and Regulation S. Nonetheless, there arises with some regularity the problem of conflicting regulation in international transactions. By entering the international marketplace, acquirers may be subject to more than one regulatory framework. Complying with more than one such framework often is onerous and, when the regulations of different countries are contradictory, this can be particularly perplexing. When confronted with such a situation, Mr. Maguire points out that prospective acquirers may abandon the tender or exchange offer, avoid one or more of the conflicting jurisdictions, seek an accommodation from the applicable regulators on an ad hoc basis, or seek a deferral from regulators in

2. For Symposiums addressing international securities regulation, *see, e.g.*, 4 BOSTON U. INT'L L.J. No. 1 (1986); 16 BROOKLYN J. INT'L L. No. 1 (1990); 11 MD. J. INT'L LAW & TRADE No. 2 (1987); 9 MICH. YEARBOOK OF INT'L LEGAL STUDIES (1988).

countries that have relatively little connection to the offer in favor of that country which has the closest nexus. Nonetheless, as Mr. Maguire acknowledges, regardless of the SEC's cooperation in the registration area, the antifraud provisions may continue to be invoked by private litigants.

The subject of nonshareholder constituency statutes is addressed by Professor Stephen M. Bainbridge. Emerging from the hostile takeover battles of the 1980s, these statutes have been enacted by twenty-eight states. Their unifying principle is that boards of directors may consider nonshareholder interests when making corporate decisions. Such "stakeholders" include, for example, the corporation's employees and the communities in which the entity conducts a significant amount of business. Professor Bainbridge points out that, as written, the statutes are silent as to the standard of review to be applied to director action allegedly motivated by concern for such stakeholders. To remedy this uncertainty, he suggests that the Delaware Supreme Court's *Unocal* standard[3] is adaptable to this analogous situation. Under the first prong, the subject directors would be required to show that they had reasonable grounds for believing that a threat existed to nonshareholder interests. The second prong relates to the proportionality between the perceived threat and the subsequent board action; hence, the directors must establish that the action taken was a reasonable response to the threat. Professor Bainbridge asserts that the modified two-prong *Unocal* standard provides the board with the necessary incentives to balance the competing interests consistent with the fiduciary duties owed.[4]

The fifth article of this Symposium, authored by Professor Douglas M. Branson, addresses the timely subject of collateral participant liability under state blue sky law. Since the mid-1970s, the United States Supreme Court has handed down several decisions restricting the scope of the federal securities laws. With respect to Section 10(b), for example, the Court has limited standing to purchasers and

3. Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

4. For a recent Symposium focusing on nonshareholder constituency statutes, *see* 21 STETSON L. REV. No. 1 (1991). For articles authored by Professor Bainbridge on somewhat related subjects, *see* Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239 (1990); Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 68 WASH. U.L.Q. 565 (1991).

sellers,[5] required scienter to be established,[6] held that manipulation or deception (rather than "mere" breach of fiduciary duty) must be shown,[7] and, more recently, adopted a relatively short statute of limitations with no equitable tolling permitted.[8] Under Section 12, the Court in *Pinter v. Dahl*[9] set forth a definition of "seller" more restrictive than the position that had been adhered to by a number of lower federal courts.[10] As Professor Branson observes, these developments, combined with certain state statutes having a broader scope and providing for attorneys' fees, have induced plaintiffs to seek relief under the state securities laws. In this article, Professor Branson analyzes collateral participant liability under a number of the state blue sky laws and asserts that claims based on common law negligence may gain favor as courts abandon the traditional privity requirement.[11]

The three articles that follow in this Symposium Issue address whether certain instruments are "securities." The first, authored by Professor Mark A. Sargent, posits that limited liability company (LLC) interests should be presumed not to be securities. Generally, LLCs, effective in a number of states,[12] are vehicles which allow their members to enjoy limited liability, pass-through taxation, flexibility in management and financial structure, and unrestricted participation in control (without risk of incurring personal liability as in a limited partnership). As Professor Sargent points out, the LLC must "walk a tightrope" to satisfy certain criteria for designation as a partnership (rather than a corporation) for tax purposes. After providing insight with respect to LLCs from a general perspective, Professor

5. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

6. Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

7. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

8. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S. Ct. 2773 (1991). It should be noted that a number of the Court's decisions in the Section 10(b) area are favorable to plaintiffs. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (permitting presumption of reliance pursuant to fraud on the market theory); Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (adhering to cumulative construction of remedies). *See generally* Alan Bromberg and Louis Lowenfels, Securities Fraud and Commodities Fraud (1991); Marc I. Steinberg, Securities Regulation: Liabilities and Remedies (1991).

9. 486 U.S. 622 (1988).

10. Under the *Pinter* standard, a seller is one who parts with title, is an agent for the vendor, or one who solicits the purchase with the motivation to benefit him or herself or the securities owner. *Compare* Junker v. Crory, 670 F.2d 1349 (5th Cir. 1981) (deeming one who is a "substantial factor" in causing the sale to be a Section 12 seller). *But see* Collins v. Signetics Corp., 605 F.2d 110 (3d Cir. 1979) (requiring privity under Section 12).

11. For a previous work by Professor Branson on collateral liability, *see* Douglas M. Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 Ore. L. Rev. 327 (1986).

12. These states include Colorado, Florida, Kansas, Nevada, Texas, Utah, Virginia, and Wyoming.

Sargent analyzes whether LLC interests are securities. Applying the *Howey* investment contract test,[13] and drawing analogies to the securities law status of limited and general partnership interests,[14] he concludes that LLC interests should be presumed not to be securities. The same conclusion should be drawn, Professor Sargent concludes, under the risk capital test.[15]

In an article which I coauthor with Ms. Karen L. Conway, we respond to Professor Sargent's position. We analyze whether LLC interests are securities under four different approaches: the *Howey* test, the risk capital standard, the attributes of stock test as set forth in a number of Supreme Court decisions,[16] and as instruments commonly known as securities. Upon application of these standards, we conclude that LLC interests normally should be entitled to securities law coverage.

The third article focusing on the security law status of certain instruments is authored by Professor Janet E. Kerr and Ms. Karen M. Eisenhauer. In this article, the authors, analyzing the Supreme Court's "family resemblance" test enunciated in *Reves v. Ernst & Young*,[17] address the issue of when a "note" is a security. As Professor Kerr and Ms. Eisenhauer point out, the *Reves* Court left a number of issues unresolved. For example, the factors set forth as comprising the family resemblance test may be viewed as vague. To provide much needed clarification, the authors define the various factors, elaborating upon such elements as the plan of distribution, the buyer's motivation for entering into the transaction, the expectations of the investing public viewed from the perspective of the average reasonable investor, and the presence (or lack) of a risk-reducing alternative regulatory framework. Another important issue is whether notes having a maturity of nine months or less should be presumed to be securities. The authors opine that while long-term notes merit this presumption, no such presumption should apply to those notes viewed as short-term (i.e., having a maturity of nine months or less).

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13. SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

14. *See, e.g.*, Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991); Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982); Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981).

15. *See* Mark A. Sargent, *The Limited Liability Company Handbook* (forthcoming). For applications of the risk capital test, *see, e.g.*, Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); State Commissioner of Securities v. Hawaii Market Center, Inc., 52 Haw. 642, 485 P.2d 105 (1971).

16. Gould v. Ruefenacht, 471 U.S. 701 (1985); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

17. 110 S. Ct. 945 (1990). *See* Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 Ohio St. L.J. 675 (1990).

Moreover, if the short-term notes are commercial paper, the authors assert that a presumption against securities law coverage should apply.

The concluding article of this Symposium, authored by Mr. Kenneth R. Lehman, addresses the need for reforming the SEC's proxy rules relating to shareholder communications.[18] Mr. Lehman recognizes that the current rules inhibit communication among institutional shareholders as well as between such large-block shareholders and individual shareholders. Because such communications may redound to the corporation's benefit, they should be fostered. In order to promote reform in this area, the author sets forth a number of proposals, such as: increasing the safe harbor to fifty shareholders (from the current ten shareholders) before a "testing the waters" type of communication is viewed as a "solicitation"; providing that no SEC filing should be mandated when solely sophisticated shareholders are solicited; and generally permitting shareholder solicitation prior to the proxy statement's filing, if certain conditions are met. Mr. Lehman's suggestions merit consideration as the Commission hopefully will engage in meaningful (rather than cosmetic) proxy reform.

In conclusion, I wish to thank Dean Ronald Phillips, Professor Janet Kerr and the members of the Pepperdine Law Review. The Symposium was a huge success. I'm confident that I speak for all participants that we enjoyed the hospitality extended and the scenic Pepperdine campus on a sunny February day overlooking the Malibu coast.

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18. *See* Securities Exchange Act Release No. 29315 (June 25, 1991).