INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 33, NUMBER 4, APRIL 2019

Wolters Kluwer

www.WoltersKluwerLR.com

INSIGHTS

The Corporate & Securities Law Advisor

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INSIGHTS (ISSN No. 0894-3524) is published monthly by Wolters Kluwer, 28 Liberty Street, New York, NY 10005. POSTMASTER: Send address changes to **INSIGHTS,** 7201 McKinney Circle, Frederick, MD 21704. To subscribe, call 1-800-638-8437. For customer service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

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SECURITIES REGISTRATION

The Rise of Unicorns and the Decline of Public Markets

More than 35 years after the adoption of Regulation D, methods of capital-raising have changed dramatically, as amounts raised in exempt offerings now exceed those raised in registered offerings, and even very large private issuers defer registration as public companies. In order to advise clients how to plan their use of the capital markets, practitioners must know not only the rules for different types of exempt offerings but also the underlying reasons for the trend toward exempt offerings.

By Robert B. Robbins and Ella M. Lvov

In 2013, venture capitalist Aileen Lee coined the term "unicorn" to describe the new phenomenon of private startups—primarily Silicon Valley technology companies—that had never raised a dollar from the public markets and yet boasted valuations of a billion dollars or more.[1] At the time, there were only 39 unicorns, but the number rose to over 300 around the world as of January 2019.[2] This group that included "decacorns," valued at over $10 billion, and "hectocorns," with valuations exceeding $100 billion. Instead of the traditional path to a public offering that was followed by dot-com companies in the 1990's, unicorns and smaller but successful companies increasingly are foregoing public registration in favor of a prolonged private existence.[3]

While the private placement market has expanded rapidly to accommodate companies that are resolutely staying private, IPOs have declined markedly. An aggregate of $2.4 trillion was raised in private placements in 2017, compared with $2.1 trillion raised in the public markets.[4] Meanwhile, there have been few new public companies added to the markets to replace the inevitable churn of companies dropping out of the market as a result of acquisition or economic failure, and the number of public companies has halved since 1996.[5]

The Sarbanes-Oxley Act of 2002 and the rising costs and burdens of public registration are often blamed for the decline in public companies, and these critiques have validity. Less attention has been paid, however, to the steady relaxation and dismantling of the regulatory scheme governing private offerings over the last 37 years, which has given the private markets enormous advantages over the public markets. Because the changes have been scattered among changes in laws, regulations and case law, the dramatic cumulative impact of the changes has not been widely understood. Yet the result has been to turn issuers' focus from the public markets to exempt offerings.

The purpose of this review is to give practitioners a brief history of the development of exempt offerings, as background for understanding how to advise clients going forward. The incremental deregulation of the private markets began in 1982 with the adoption of Regulation D.

Regulation D (1982)

The Securities Act of 1933 (Securities Act) provides statutory exemptions from the registration provisions of the Act. The most significant of these has been Section 4(a)(2), which exempts transactions by an issuer not involving a public offering (a phrase not defined by regulation). Because of uncertainty regarding what offerings would qualify for exemption under 4(a)(2), private offerings before

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Regulation D were used primarily by small businesses and investment partnerships.

With three new safe harbors—Rules 504, 505 and 506—and additional rules providing detailed guidance for issuers, Regulation D provided a basis for widespread commercial use of private offerings. Rule 505 (since repealed) and Rule 504 provided exemptions for offerings of limited size. Regulation D also introduced a new safe harbor under the statutory exemption provided by Section 4(a)(2), Rule 506, for private offerings that could be of unlimited size, to an unlimited number of investors, if limited to a new category of "accredited investors" based on income and net worth tests. The income and net worth thresholds for accredited investor qualification have not been adjusted for inflation since 1982, and time has greatly eroded the significance of this proxy for sophistication. In 1983, only approximately 1.8 percent of U.S. households qualified as accredited investors.[6] Thirty years later, more than 10 percent of households could meet the definition.[7]

Regulation D provided a basis for widespread commercial use of private offerings.

Rule 506 proved to be a very forgiving exemption, with relaxed standards for the amount of inquiry required to determine an investor's accredited status, and no prescribed disclosure requirements for offerings that are limited to accredited investors, with the result that more than 90 percent of 506 offerings now are limited to accredited investors.

Today, Rule 506 is the most commonly-used exemption for private offerings, accounting for the vast majority of the trillions of dollars raised through unregistered offerings.[8] This safe harbor has enabled even the largest companies to engage in massive capital raises without bearing the financial and disclosure burdens of public registration.

Rule 701 (1988)

Offerings of securities to employees of the issuer normally require an exemption from registration, but because many employees are not accredited investors, Rule 506 was not an available solution for these offerings. Six years after the adoption of Regulation D, the SEC enacted Rule 701. It exempts offerings of securities to employees and other persons who provide services to issuers that are not subject to the reporting obligations of the Securities Exchange Act of 1934 (Exchange Act), pursuant to a written compensatory plan or employment contract, regardless of the sophistication or accreditation of the offerees.

Rule 701 provides relatively generous limitations on the volume of securities sold annually, and no limit on the number of participating employees. The aggregate amount of securities that may be granted annually under Rule 701 is limited to the greater of $1 million, 15 percent of the issuer's total assets, and 15 percent of the outstanding amount of the class of securities being offered.[9] The original version of Rule 701 also imposed a $5 million ceiling on aggregate annual volume, but the SEC lifted this restriction in 1999, in recognition of the fact that it was too restrictive for large private companies.[10]

Rule 701 offerings are not subject to any filing requirements at the federal level (although state filings may be required) and require, at most, minimal disclosure. Under the original rule, employees were not entitled to any disclosure from issuers because of the compensatory nature of the offerings.[11] In return for lifting the $5 million ceiling in 1999, the SEC imposed a new disclosure requirement for sales exceeding this threshold (recently raised to $10 million) in any 12-month period, including financial statements and information about investment risks. Nevertheless, the disclosure requirements are comparatively light, reflecting the SEC's continued belief that compensatory arrangements present less incentive for abuse than capital-raising transactions.

Rule 701 is not available for capital-raising offerings, but it has served as a significant part of the private company toolkit and has permitted even very large private companies to delay going public, by permitting them to grant large amounts of equity compensation to large numbers of employees without public disclosure, registration or review, or even a federal filing requirement.

Rule 144A (1990)

Perhaps the greatest impediment to the use of exempt offerings is the lack of liquidity in the securities, as securities purchased in an exempt offering cannot be resold without either registration or an exemption from registration. Whether the securities are being sold to employees or to institutional investors, the ability to resell is key to the value of the securities.

Section 4(a)(1) of the Securities Act exempts "transactions by any person other than an issuer, underwriter, or dealer" from the registration requirements of Section 5,[12] but the definition of "underwriter" proved to be particularly difficult to pin down, spurring a body of common law and SEC releases attempting to interpret the exact boundaries of the statutory exemption,[13] and limiting the commercial expansion of private placements. Rule 144, adopted in 1972, created a safe harbor from "underwriter" status to permit purchasers to resell unregistered securities after a specified holding period.

In its original form, the safe harbor typically applied only if there was adequate public information available about the issuer. To address resales of securities by private, non-reporting companies, for which public information was not available, practitioners developed what was eventually designated as the Section "4(1-1/2)" (now "4(a)(1-1/2))" exemption. The analysis was grounded in the assumption that if an issuer can permissibly complete a private placement under Section 4(a)(2), then a purchaser should also be able to privately resell in a similarly structured transaction under Section 4(a)(1)—hence "1-1/2." The interpretive flexibility offered by Section 4(a)(1-1/2) may have been appealing to practitioners, but large institutional investors desired more clarity and certainty for investments in privately offered securities. The SEC responded by adopting Rule 144A in April 1990.[14] The rule effectively sanctioned the concept of the 4(a)(1-1/2) exemption, but only for resales to large institutional investors.[15]

Rule 144A provides a safe harbor from the registration requirements of Section 5 for the resale of restricted securities to qualified institutional buyers (QIBs), determined by their regulatory status or the maintenance of a portfolio of investment securities valued at $100 million or more. Despite the limited pool of eligible purchasers, this focus on huge financial institutions enabled Rule 144A to quickly become the standard for capital-raising among institutional investors, as QIBs can freely buy and trade restricted securities without the restrictions imposed on non-QIBs. In addition, electronic markets have developed for resales among QIBs, further increasing liquidity and reducing transactional costs.

Rule 144A now accounts for hundreds of billions of dollars in securities transactions each year.

Rule 144A now accounts for hundreds of billions of dollars in securities transactions each year. This safe harbor initially was most commonly used for private placements of investment-grade debt securities, but it is also popular for facilitating large offerings of common stock by private companies that are quickly resold to QIBs—sometimes referred to as a "backdoor IPO."

The typical "144A offering" commences with a Regulation D sale to a financial intermediary that is immediately followed by resales to QIBs. By creating a robust secondary market for mega private placements, Rule 144A helped expand and accelerate the use of Regulation D

Gustafson v. Alloyd (1995)

One rarely mentioned advance in the deregulation of private placements came not from changes in the law or SEC rulemaking, but from the Supreme Court. Section 12(a)(2) of the Securities Act provides an express private right of action for offers or sales of a security

> by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.[16]

Before *Gustafson v. Alloyd Co.*,[17] it was assumed, by courts and commentators alike, that such liability attached to private offerings as well, for either intentional or negligent misrepresentations. The *Gustafson* court, however, held that Section 12(a)(2) does not grant a private right of action for misrepresentations in private offering documents, because private offerings are not made by means of a "prospectus," as that term is "confined to documents related to public offerings by an issuer or its controlling shareholders."[18]

Gustafson effectively foreclosed the availability of Section 12(a)(2) for investors in a Rule 506 offering and limited such investors to a cause of action under Section 10(b) of the Exchange Act. The Supreme Court, however, had ruled in a 1976 case, *Ernst & Ernst v. Hochfelder*, [19] that Section 10(b) and the corresponding Rule 10b-5 do not provide a private right of action for negligent misrepresentations. Rather, a claim under Rule 10b-5 requires proof of scienter, meaning an intent to deceive, manipulate, or defraud, or reckless indifference to the truth of the statements. By limiting the claims available to investors in a private offering to Section 10(b) and Rule 10b-5, the *Gustafson* decision eliminated negligence as a basis for a private right of action for negligent misrepresentation in a private placement, and required that disappointed investors allege an actual intent to defraud.

The *Gustafson* decision also affected liability for private resales under both Rule 144 and Rule 144A. Rule 144 deems qualifying resales not to be distributions (i.e. not public offerings); thus, resellers under Rule 144 are not underwriters and a Rule 144 resale is not subject to Section 12(a)(2) liability under *Gustafson's* reasoning. Rule 144A operates similarly by exempting qualifying transactions from the definition of a distribution, and exempting sellers from the definition of "underwriter." Consequently, Section 12(a)(2) liability would also not apply to QIB resales under Rule 144A.

This is not to say that purchasers in Rule 506 offerings and exempt resales are left entirely without recourse when harmed by negligent misrepresentations. But while creative plaintiffs can pursue claims under state securities laws or common law, as a result of *Gustafson*, a private placement presents substantially less risk of liability, or of claims being asserted, under the federal securities laws, than an IPO or other public offering.

National Securities Markets Improvement Act (1996)

In 1996, the National Securities Markets Improvement Act of 1996 (NSMIA) was signed into law. NSMIA amended the Securities Act so as to preempt certain state securities laws. Specifically, Section 18 of the Securities Act was amended to preclude states from requiring the registration or qualification of "covered securities" or imposing conditions on the use of offering documents with respect to such covered securities.[20] Amended Section 18 also prohibits states from prohibiting or limiting sales of covered securities based on the merits of such an offering.[21]

This marked a notable departure from the status quo: prior to the enactment of NSMIA, at least thirty-nine states conducted some form of merit-based review of offerings prior to approval.[22] In a merit regime, states examine issuers and offerings

to determine whether they meet certain standards. By contrast, a disclosure regime—such as the federal registration process—requires substantial disclosure but does not judge the merits of the investment. Under the new Section 18, states lost the ability to weigh in on the merits of private offerings.

Covered securities under NSMIA include, among others, those that are listed or authorized for listing on a national securities exchange, such as the NYSE or Nasdaq, and securities offered in certain exempt offerings—most notably, those issued in a Rule 506 offering. The SEC requires only a notice filing for a Rule 506 offering; the elimination of state merit review for Rule 506 offerings has meant that the state filings are also notice filings. It is sometimes said that in dealing with Rule 506 offerings, when the states lost the ability to perform merit reviews, they were left with "the three F's"—filings, fees and fines. The result has been that there is no longer any substantive review of Rule 506 offerings at either the federal or state level.

NSMIA therefore largely eliminated what substantive review had remained for private offerings, and further bolstered the appeal of Rule 506 as an IPO alternative. Issuers can now avoid both the cumbersome federal registration process and merit-based review of their offering.

Amendments to Rule 144 (1997 and 2007)

As discussed above, Rule 144 provides a safe harbor for the resale of restricted securities and control securities. (Restricted securities are those acquired in certain enumerated transactions, including Regulation D private offerings, Rule 701 employee compensation offerings, and Rule 144A resales.[23] The term "control securities," while not expressly defined in Rule 144, typically refers to securities held by an affiliate of the issuer: one who controls, is controlled by, or is under common control with the issuer.[24])

As a general matter, Rule 144 provides that a person who complies with the safe harbor provisions of the rule will not be deemed an underwriter, and therefore will have available the Section 4(a)(1) exemption for resales. In its original form, Rule 144 required a two-year holding period during which the securities could not be resold. After two years, restricted securities could be resold, with limitations. These resale limitations included the availability of "adequate current public information" about the issuer, limits on sales volume, and requirements for the manner of sale.[25] A non-affiliate holding restricted securities could resell freely and without regard to the resale limitations after three years.

The first of two significant amendments to Rule 144 came in 1997. The SEC reduced the holding periods for both limited resales of restricted securities and unlimited resales by non-affiliates. Resales of restricted securities were now subject to a one-year holding period, after which resales were permitted but subject to the resale limitations. Resales by non-affiliates could occur with resale limitations after a one-year holding period, and without resale limitations after a two-year holding period.[26] Additionally, the SEC reasoned that a "shorter holding period should lower the illiquidity discount given by companies raising capital in private placements and increase the usefulness of the Rule 144 safe harbor."

In 2007, the SEC further reduced the holding periods. Under today's version of Rule 144, non-affiliates of non-reporting issuers have a one-year holding period, but thereafter may engage in unlimited resales free of any limitations or conditions. As a consequence, non-affiliates are free to resell after one year even without the availability of adequate public information about the issuer. While there is still a substantial difference between the liquidity of restricted securities and securities sold in registered offerings, the amendments to Rule 144 have substantially reduced the illiquidity burden on purchasers of privately placed securities.

The JOBS Act (2012)

Three features of the Jumpstart Our Business Startups Act of 2012 (JOBS Act) greatly expanded

the use of private placements and effectively enabled issuers to defer public registration and reporting: raised Exchange Act reporting thresholds; and permitted some general solicitation under Rule 506 and Rule 144A.

Exchange Act Reporting Thresholds

Prior to the adoption of the JOBS Act, a private company could avoid registration as a reporting company under the Exchange Act only so long as its total assets did not exceed $10 million and it did not have a class of equity security held by 500 shareholders of record. Section 501 of the JOBS Act raised the shareholder threshold to 2,000 shareholders of record, excluding

> persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5,[27]

while retaining the 500-shareholder threshold for non-accredited investors. With this increase, even large private companies can avoid the reporting and disclosure obligations of the Exchange Act with careful planning. In fact, the JOBS Act's legislative history suggests that Congress was focused specifically on unicorns when crafting the new provisions. They were responding to concerns of companies like Google and Facebook that felt pressured to go public by the low shareholder thresholds, despite wanting to remain private.[28]

The JOBS Act instructed the SEC to issue rules adopting a safe harbor for excluding employee stock recipients from the shareholder count. Final rules were adopted in 2016, [29] confirming that employees who receive stock in either a Rule 701 offering or any transaction exempt from Securities Act registration could be excluded, whether or not they are currently employees of the issuer.[30] This non-exclusive safe harbor also permits issuers to exclude securities issued in a transaction that the issuer *reasonably believed*, at the time of the issuance, was exempt from the registration requirements of Section 5.

The second major exclusion from the shareholder count is that of crowdfunding securities. The JOBS Act added Section 12(g)(6) to the Exchange Act, excluding from the "held of record" calculation owners of securities sold in crowdfunding offerings – offerings made in reliance on Section 4(a)(6) of the Securities Act, which targets relatively small offerings conducted via the internet and social media. Rule 12g-6 of the Exchange Act, which implements and clarifies the exclusion's parameters, permits issuers to exclude qualifying stockholders from the record-holder calculation permanently.

Issuers that wish to remain private will benefit from the combination of increased reporting thresholds and the exclusion of Rule 701 stockholders. Even the largest private companies now have greater control over the decision to go public and more flexibility to avoid the attendant costs and burdens of public reporting.

Rule 506(c) and General Solicitation

Before the enactment of the JOBS Act in 2012, offerings made pursuant to Rule 506 could not include any general solicitation or advertising. Section 201(a)(1) of the JOBS Act directed the SEC to revise Rule 506 to provide that the prohibition against general solicitation or general advertising in Rule 506 offerings shall not apply to 506 offerings, provided that all purchasers of the securities are accredited investors, and that the issuer takes reasonable steps to verify the accreditation of purchasers. Section 201 led the SEC to substantively amend Rule 506 for the first time in thirty-one years, with the adoption of a new safe harbor under Rule 506(c), for general solicitation in offerings in which all purchasers are accredited investors, the accreditation of which the issuer makes reasonable efforts to verify.

It is still unclear what standards of verification ultimately will be accepted as market practice, or how comfortable the existing private placement market will be with general solicitation and general advertising. So far, there has not been a dramatic change in private placement selling processes, but the lifting of the prohibition on general solicitation

and advertising will at some point lead to widespread use for appropriate types of offerings.

Rule 144A and General Solicitation

The JOBS Act's third noteworthy contribution to private offering deregulation was a directive to amend Rule 144A to permit general solicitation or advertising for resale transactions. This stands in direct contrast to Section 4(a)(1-1/2) offerings, in which resellers typically avoid solicitation and advertisement based on the corresponding prohibitions applicable to private placements under Section 4(a)(2). Unlike Rule 506(c), amended Rule 144A permits sellers to engage in broad public advertising, so long as they reasonably believe that the ultimate purchasers are all QIBs. The result will be even greater liquidity in the resale market among QIBs.

The 2012 JOBS Act revisions marked a recognition that the securities laws needed to accommodate very large private companies and smoothed the path for the growth of unicorns. Indeed, the years following the JOBS Act saw explosive growth in the number of mega-rounds of venture capital raises, with more than five times the number of financings exceeding $500 million occurring in 2014-2015 than in the previous four years combined.[31] In just a few years, unicorn statistics transitioned from focusing on valuations exceeding a billion dollars to *individual rounds of financing* exceeding that milestone. The end of 2015 marked more than a dozen such "B+ Rounds"—including a staggering $51 billion valuation placed on Uber in a $1 billion dollar funding round.[32]

Section 4(a)(7) (2015)

The latest effort to improve liquidity in the private resale market came in 2015, when Congress passed the Fixing America's Surface Transportation Act (FAST Act). Among other things, the FAST Act added Section 4(a)(7) to the Securities Act, creating a safe harbor for private resales that effectively codified the presumed conditions of the hypothetical, but widely accepted, Section 4(a)(1-1/2) exemption.

Section 4(a)(7) mirrors many of the best practices under 4(a)(1-1/2). Among other conditions, purchasers must be accredited investors and sellers must avoid general solicitation and advertising. No holding periods are imposed, making this a more attractive safe harbor than Rule 144. The one drawback lies in the disclosure obligations. If the issuer is not a reporting company under the Exchange Act, offerees have the right to demand limited disclosure, similar to that of Rule 144A. Upon request, the seller must obtain and provide some basic business and financial information about the issuer, including the nature of its business, corporate governance information, and financial statements.

Not only do sellers have more certainty under Section 4(a)(7) that the offering is not a distribution and they will not be subject to underwriter liability, but they also benefit from the fact that securities sold under this section are "covered securities" and thus generally exempt from blue sky laws. Section 4(a)(7) confirmed the long-held belief that a resale offering conducted in a sufficiently private manner would withstand regulatory scrutiny. But Congress did not make Section 4(a)(7) an exclusive safe harbor; instead, it explicitly clarifies that Section 4(a)(7) is not the only means for establishing an exemption from registration requirements for resales of restricted securities.[33] Thus, holders of private securities who cannot furnish the required information can nevertheless rely on the theoretical Section 4(a)(1-1/2) exemption or any other safe harbor for resales.

Conclusion

A confluence of factors, starting with the passage of Regulation D, enabled the boom in private placements and corresponding decline in public offerings. Developments in the last decade only accelerated this trend.

Regulation D, and especially Rule 506(b), began the developments by allowing issuers to engage in unlimited private capital raises free from the uncertainty of the underlying statutory exemptions, without SEC review and without required disclosures.

Rule 701 permitted companies to engage in broad-based equity compensation schemes without public registration, and the JOBS Act further shielded companies from reporting requirements by excluding employees from the shareholder count threshold for registration as a reporting company. Rules 144 and 144A, as well as newly-added Section 4(a)(7), made private offerings more attractive by bringing liquidity to the resale market. The Supreme Court in *Gustafson* relieved issuers from concerns about claims based on negligent misrepresentations, and NSMIA ensured that there would no longer be substantive review of Rule 506 offerings at the state level. The JOBS Act further tipped the scales in favor of private placements by raising the Exchange Act reporting threshold and doing away with a long-standing prohibition on advertisement in both Rule 506 offerings and Rule 144A resales.

When faced with the enormous transaction costs and risks of liability associated with becoming a publicly traded company, it is no wonder that companies increasingly choose to remain private even after they have reached a size that once would have made public registration and reporting inevitable. Over time, the increasingly relaxed regulatory environment has made private company status a comfortable one, free from many of the costs and risks of being public. These factors may not have caused the unicorn phenomenon, per se, but they did remove the pressures that historically had pushed companies into the public realm.

The public markets still offer liquid resale markets, which many efforts by credible sponsors, from SecondMarket to NASDAQ, have failed to deliver for privately placed securities.[34] There is no broad public base of information about private issuers on which investors can rely, and the large number of entities offering their securities privately contributes to the challenge of establishing a viable resale platform.

Nevertheless, private companies of all sizes continue to raise enormous amounts of capital, and even if some unicorns will always be in the news about plans to become public companies, the continuing supply of new large private companies seems always to exceed the number that exit to the public markets.[35]

The deregulation of the private capital markets since the adoption of Regulation D in 1982 has taken place through diverse causes rather than through an organized effort, but the cumulative effect has been the greatest shift in the capital markets since the enactment of the Securities Act and the Exchange Act. Practitioners should no longer view an initial public offering as the default goal for their private clients—even the unicorns—but rather should advise clients how to navigate the many available avenues for raising capital. Although the pendulum may eventually swing back toward the public markets, exempt offerings are, at least for the moment, at the forefront.

Notes

1. Aileen Lee, "Welcome to the Unicorn Club: Learning from Billion-Dollar Startups," *TechCrunch* (Nov. 2, 2013), *https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/*.
2. "The Global Unicorn Club," *CB Insights* (Jan. 2019), *https://www.cbinsights.com/research-unicorn-companies*.
3. "2018 Unicorn Report," *PitchBook* (Aug. 14, 2018), *https://pitchbook.com/news/reports/2018-vc-unicorn-report*. The average age of a venture-backed company at the time of its IPO in 2017 was 6.83 years. *See* 2018 Yearbook, Nat'l Venture Capital Ass'n (Mar. 2018), available at *https://nvca.org/research/research-resources/*.
4. *See* Jean Eaglesham & Coulter Jones, "The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising," *Wall St. J.* (Apr. 3, 2018), *https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249*.
5. *See id.*
6. *See* Report on the Review of the Definition of "Accredited Investor", SEC Report, Table 4.2 (Dec. 18, 2015), available at *https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf*.
7. *Id.*
8. *See* Scott Bauguess, Rachita Gullapalli & Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market

for Unregistered Securities Offerings, 2009-2017," SEC Division of Economic & Risk Analysis (2018), *https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf*.

9. *See* Final *Rule: Rule 701*, Securities Act Release No. 33-7645 (Feb. 25, 1999).
10. *Id.*
11. *Id.*
12. 15 U.S.C. §77d(a)(1).
13. *See, e.g.*, *In re Ira Haupt & Co*, 23 S.E.C. 589 (1946); *United States v. Wolfson*, 45 F.2d 779 (2d Cir. 1968); Securities Act Release No. 33-4982 (July 2, 1969).
14. *See Resale of Restricted Securities*, Securities Act Release No. 33-6862 (Apr. 23, 1990).
15. Congress has since brought even more certainty to the theory behind a Section 4(a)(1-1/2) transaction by adding a new Section 4(a)(7) to the Securities Act in 2015, as discussed below.
16. 15 U.S.C. §77l(a)(2).
17. 513 U.S. 561 (1995).
18. *Gustafson*, 513 U.S. at 569.
19. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
20. 15 U.S.C. §77r(a)(1)–(2).
21. 15 U.S.C. § 7r(a)(3).
22. *See* Rutherford B. Campbell, Jr., "The Role of Blue Sky Laws after NSMIA and the JOBS Act," 66 *Duke L.J.* 605, 609 (2016).
23. 17 C.F.R. §230.144(a)(3).
24. 17 C.F.R. §230.144(a)(1).
25. *Revisions to Rules 144 and 145*, Securities Act Release No. 33-8869 (Dec. 6, 2007).
26. *Revision of Holding Period Requirements in Rules 144 and 145*, Securities Act Release No. 33-7390 (Feb. 20, 1997).
27. 15 U.S.C. §78l(g)(5).
28. *See* Abraham J.B. Cable, "Fool's Gold? Equity Compensation & The Mature Startup," 11 *Va. L. & Bus. Rev.* 613, 625–27 (2017).
29. *See Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*, Exchange Act Release No. 34-77757 (May 3, 2016).
30. 17 C.F.R. §240.12g5-1(a)(8).
31. *See* "The Half-Billion Dollar Round Explosion," *CB Insights* (June 8, 2015), *https://www.cbinsights.com/research/half-billion-dollar-explosion/?utm_source=CB+Insights*.
32. *See* "Forget Billion-Dollar Valuations: These 10 Companies Raised $1B or More in a Single Round," *CB Insights* (Oct 1, 2015), *https://www.cbinsights.com/research/billion-dollar-rounds/*.
33. 15 U.S.C. §77d(e)(2).
34. Such efforts include SecondMarket Solutions and NASDAQ Private Market, both now owned by NASDAQ. The latter has completed only 200 secondary transactions in the five years it has been operating, many of these attributable to unicorns. *See* "Nasdaq Private Market Celebrates Its 200th Secondary Transaction," *GlobeNewsire* (Oct. 17, 2018), *https://globenewswire.com/news-release/2018/10/17/1622809/0/en/Nasdaq-Private-Market-Celebrates-Its-200th-Secondary-Transaction.html*. By contrast, there were nearly 5,000 venture capital funds at the close of 2017, evidencing that venture capital firms are still doing most of the private investment legwork themselves. *See* 2018 Yearbook, Nat'l Venture Capital Ass'n (Mar. 2018), available at *https://nvca.org/research/research-resources/*.
35. *See* "2018 Unicorn Report," *PitchBook* (Aug. 14, 2018), *https://pitchbook.com/news/reports/2018-vc-unicorn-report*.

CORPORATION LAW

2019 Proposed Amendments to the General Corporation Law of the State of Delaware

Proposed amendments to the Delaware General Corporation Law would, among other things, add new provisions relating to documentation of transaction by electronic means, revise the default provisions applicable to stockholder notices, including those governing appraisal, clarify the timing of unanimous consents of directors, and make other technical changes.

By John Mark Zeberkiewicz, Brigitte V. Fresco, and Robert B. Greco

Legislation proposing to amend the General Corporation Law of the State of Delaware (General Corporation Law) has been released by the Corporate Council of the Corporation Law Section of the Delaware State Bar Association and, if approved by the Corporation Law Section, is expected to be introduced to the Delaware General Assembly. If enacted, the 2019 amendments to the General Corporation Law (the 2019 Amendments) would, among other things: (1) add new provisions relating to the documentation of transactions and the execution and delivery of documents, including by electronic means, and make conforming changes to existing provisions; (2) significantly revise the default provisions applicable to notices to stockholders under the General Corporation Law, the certificate of incorporation or the bylaws, including by providing that notices may be delivered by electronic mail, except to stockholders who expressly "opt out" of receiving notice by electronic mail; (3) consistent with the foregoing, update the provisions governing notices of appraisal rights and demands for appraisal; (4) update the procedures applicable to stockholder consents delivered by means of electronic transmission; (5) clarify the time at which a unanimous consent of directors in lieu of a meeting becomes effective; and (6) make various other technical changes, including with respect to incorporator consents and the resignation of registered agents.

If enacted, the 2019 Amendments (other than the amendments to Section 262 (appraisal rights)) would be effective on August 1, 2019, and the amendments to Section 262 would be effective with respect to a merger or consolidation consummated pursuant to an agreement of merger or consolidation entered into on or after August 1, 2019.

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Document Forms, Including Electronic Signatures and Delivery

Although the General Corporation Law has for years included provisions relating to the execution and delivery of consents, notices and other instruments by means of electronic transmission, it does not currently address in a comprehensive manner the form and effect of electronic signatures or delivery by electronic means. Instead, key provisions of the General Corporation Law governing notices and consents contain individual provisions governing the form and effect of "electronic transmissions," with Delaware's version of the Uniform Electronic Transactions Act expressly providing that it does not apply to a transaction to the extent it is governed by the General Corporation Law.

General Application: The "Safe Harbor" Provision

The 2019 Amendments change numerous sections of the General Corporation Law to address

comprehensively the documentation of acts or transactions through electronic means, as well as the execution and delivery of documents through the use of electronic signatures and by electronic transmission. The lynchpin of these changes is new Section 116. Section 116(a) provides that, except as otherwise expressly provided in Section 116(b), any act or transaction contemplated or governed by the General Corporation Law or the certificate of incorporation or bylaws may be provided for in a "document" and an electronic transmission will be deemed the equivalent of a written document. The term "document" is defined in Section 116(a) to mean any tangible medium on which information is inscribed, and includes handwritten, typed, printed, or similar instruments, and copies of those instruments, and an electronic transmission. The term "electronic transmission," which is currently defined in Section 232 of the General Corporation Law, continues to mean any form of communication, not directly involving the physical transmission of paper, including the use of, or participation in, one or more electronic networks or databases, including one or more distributed electronic networks or databases, that creates a record that may be retained, retrieved and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

A wide variety of corporate documents may be executed by means of electronic signatures.

Section 116(a) provides that, whenever the General Corporation Law or the certificate of incorporation or bylaws requires or permits a signature, the signature may be a manual, facsimile, conformed or "electronic signature," which is defined to mean an electronic symbol or process that is attached to, or logically associated with, a document and executed or adopted by a person with an intent to authenticate or adopt the document. Thus, a wide variety of corporate documents, including merger agreements, voting agreements and other documents contemplated by the General Corporation Law, may be executed by means of electronic signatures, such as DocuSign®.

Section 116(a) further provides that, unless otherwise agreed between the sender and recipient, an electronic transmission will be deemed delivered to a person for purposes of the General Corporation Law and the certificate of incorporation and bylaws at the time it enters an information-processing system that the person has designated for the purpose of receiving electronic transmissions of the type delivered, so long as the electronic transmission is in a form capable of being processed by that system and the person is able to retrieve the electronic transmission. Section 116(a) provides guidance on the issue of whether a person has so designated such a system, stating that the question will be governed by the certificate of incorporation or bylaws or from the context and surrounding circumstances, including the parties' conduct. Thus, the prior use of electronic mail between or among specified parties may supply evidence that the parties have made the designation required by Section 116(a).

Section 116(a) sets forth non-exclusive means of reducing specified acts or transactions to a written or electronic document, as well as means of executing and delivering documents manually or electronically. It states that the General Corporation Law shall not prohibit one or more persons from conducting a transaction in accordance with Delaware's Uniform Electronic Transactions Act so long as the part or parts of the transaction that are governed by the General Corporation Law are documented, signed and delivered in accordance with Section 116(a) or the other relevant provisions of the General Corporation Law. Thus, to the extent Delaware's Uniform Electronic Transactions Act does not apply to a transaction because the transaction is governed by the General Corporation Law, the parties to the transaction can satisfy the requirements of the General Corporation Law by complying with Section 116(a).

The "safe harbor" provisions in Section 116(a) apply solely for purposes of determining whether an act or transaction has been documented, and whether a document has been signed and delivered, in accordance with the General Corporation Law and the corporation's certificate of incorporation and bylaws. As its application is limited to the General Corporation Law and the corporation's certificate of incorporation and bylaws, Section 116(a) does not preempt any applicable statute of frauds, nor does it override any other applicable law requiring actions to be documented, or signed and delivered, in a specified manner.

Specific Exclusions from the "Safe Harbor"

Section 116(b) sets forth the actions and documents to which Section 116(a) will not apply. The items excluded from the scope of Section 116(a) consist primarily of those that are governed by other provisions of the General Corporation Law that already address electronic signature or transmission. Thus, Section 116(b) provides that Section 116(a) does not apply to the following:

- Documents filed with or submitted to the Delaware Secretary of State, which continue to be governed by Section 103(h), which will continue to provide that any signature on an instrument authorized to be filed with the Delaware Secretary of State under the General Corporation Law may be a facsimile, a conformed signature or an electronically transmitted signature;
- Documents filed with or submitted to the Register in Chancery, or a court or other judicial or governmental body—all of which must be filed or submitted under the rules or procedures adopted by such courts or other judicial or governmental bodies;
- A document comprising part of the stock ledger;
- Any certificate representing a security;
- Any document expressly referenced as a notice by the General Corporation Law, the certificate of incorporation or the bylaws, which matters are governed by other provisions of the General Corporation Law, including, in the case of notices to stockholders, Section 232, and the certificate of incorporation and bylaws;
- Any document expressly referenced as a waiver of notice by the General Corporation Law, Section 229 of which already permits directors and stockholders to give waivers by electronic transmission;
- Consents by directors in lieu of a meeting, which are governed by Section 141(f), which already provides for consents delivered by electronic transmission;
- Consents of stockholders, which are governed by Section 228, which currently provides for the delivery of consents by electronic transmission and is the subject of amendments summarized below;
- Consents of incorporators, which are governed by Section 108, which is also the subject of amendments summarized below;
- Ballots to vote on actions at a meeting of stockholders;
- Acts effected pursuant to Section 280 of the General Corporation Law, which sets forth the procedures for giving notice to claimants and other matters in connection with a so-called "long-form" dissolution;
- Any acts or transactions effected pursuant to subchapter III of the General Corporation Law, which contains the provisions addressing the requirement to maintain a registered office in the State of Delaware and includes the principal provisions governing registered agents as well as notices between the corporation and its registered agent;
- Any acts or transactions effected pursuant to subchapter XIII of the General Corporation Law, which deals with suits against corporations, directors, officers or stockholders, including the means of serving process on corporations; and
- Any acts or transactions effected pursuant to subchapter XVI of the General Corporation Law, which deals with foreign corporations,

including the requirements of foreign corporations to qualify to do business in the State of Delaware.

Although Section 116(b) excludes the foregoing matters from the automatic operation of Section 116(a), the statute expressly states that the exclusion shall not create any presumption regarding the lawful means of documenting a matter governed by Section 116(b) or the lawful means of signing or delivering a document addressed by Section 116(b). Accordingly, the mere inclusion of any item in Section 116(b)'s "excluded items list" should not, in and of itself, be deemed to create a negative implication that the item may not otherwise be validly executed, delivered or authenticated through electronic means, including DocuSign®. Indeed, many of the instruments in the "excluded items list" are currently executed and delivered, and will continue to be permitted to be executed and delivered, through electronic means.

Section 116(b) also states that no provision of the certificate of incorporation or bylaws shall limit the application of Section 116(a), unless the provision expressly restricts one or more of the means of documenting an act or transaction, or of signing or delivering a document, permitted by that subsection. Thus, a corporation may, through the adoption of an express provision in its certificate of incorporation or bylaws, restrict the application and use of Section 116(a). Any such provision, however, must clearly and expressly restrict the use of electronic signatures and electronic transmissions for documenting an act or transaction or signing and delivering any document. Thus, provisions in certificates of incorporation or bylaws stating that a particular act or transaction must be "signed" or "in writing," as well as provisions stating that documents must be manually delivered, sent or given, will not, in and of themselves, be sufficient to limit the application of Section 116(a). Unless a corporation desires to limit the application of Section 116(a), it will not in most cases be required to amend its certificate of incorporation or bylaws to allow for the documentation by electronic means of acts or transactions covered by that subsection, nor for the signing or delivery of documents falling within its scope.

Interplay with the Federal E-Sign Act

Finally, Section 116(c) addresses the interaction between the provisions of the General Corporation Law and the U.S. federal Electronic Signatures in Global and National Commerce Act (E-Sign Act). In general, the E-Sign Act provides that, with respect to a transaction in or affecting interstate or foreign commerce (and subject to specified exceptions and limitations), a signature, contract, or other record relating to the transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form, and a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation. Section 116(c) states that, if any provision of the General Corporation Law is deemed to modify, limit or supersede the E-Sign Act, the provisions of the General Corporation Law will control to the fullest extent permitted by Section 7002(a)(2) thereof. Section 7002(a)(2) of the E-Sign Act provides:

> A State statute, regulation, or other rule of law may modify, limit, or supersede the provisions of section 7001 of [the E-sign Act] with respect to State law only if such statute, regulation, or rule of law . . . specifies the alternative procedures or requirements for the use or acceptance (or both) of electronic records or electronic signatures to establish the legal effect, validity, or enforceability of contracts or other records, if (A) (i) such alternative procedures or requirements are consistent with [subchapters I and II of the E-Sign Act]; and (ii) such alternative procedures or requirements do not require, or accord greater legal status or effect to, the implementation or application of a specific technology or technical specification for performing the functions of creating, storing, generating, receiving, communicating,

> or authenticating electronic records or electronic signatures; and (B) if enacted or adopted after June 30, 2000, makes specific reference to [the E-Sign Act].

Thus, Section 116(c) provides express evidence of the intent to allow the General Corporation Law to govern the documentation of actions, and the signature and delivery of documents, to the fullest extent the General Corporation Law is not preempted by the E-Sign Act.

Ancillary Amendments

The 2019 Amendments also effect changes to Section 212(c) (which deals with the manner in which a stockholder may authorize another person to act as its proxy) and Section 212(d) (which generally provides that copies of proxies may be substituted for an original) to conform to Section 116(a). Specifically, Section 212(c)(1), which currently provides that a stockholder may execute a "writing" authorizing another person or persons to act for such stockholder as proxy and provides that execution of the proxy may be accomplished by the stockholder (or authorized officer, director, employee or agent "signing such writing or causing such person's signature to be affixed to such writing by any reasonable means, including, but not limited to, by facsimile signature"), is being updated to provide simply that a stockholder may execute a "document" granting such authorization, thus confirming that a proxy may be documented, executed and delivered in accordance with Section 116(a).

Section 212(c)(2) also is being updated to eliminate references to the transmission of proxy by "telegram" or "cablegram," opting instead for "electronic transmission," a broader term that would include telegrams and cablegrams in the unlikely event those means of proxy transmission are deployed. Similarly, Section 212(d) is being updated to replace the reference to copies or reproductions of the "writing" granting a proxy with a reference to the "document" and to eliminate the specific references to telegrams and cablegrams, opting again to use the broader concept of "electronic transmission."

In addition, Sections 251(b) (merger or consolidation of Delaware stock corporations) and 255(b) (merger or consolidation of Delaware nonstock corporations) are being amended to permit any authorized person to execute an agreement of merger or consolidation, except that any agreement filed with the Secretary of State must be executed by a person, and in the manner, authorized by Section 103. The changes are unlikely to have significant practical effect, given that certificates of merger or consolidation (as opposed to agreements of merger or consolidation) are frequently filed.

Notices

Along with the amendments dealing with the documentation of transactions and execution and delivery of documents (including through the use of electronic signatures and electronic transmissions), the 2019 Amendments include significant revisions to the provisions of the General Corporation Law dealing with the form and manner of notices to stockholders.

Default Delivery of Notices

Section 232, which currently addresses notice by electronic transmission, will be substantially revised to set forth the statutory defaults for notices to stockholders. Section 232(a), as amended, will provide that, without limiting the manner in which they may otherwise be effectively given, notices to stockholders may be given by (1) U.S. mail, postage prepaid, (2) courier service, or (3) electronic mail. Section 232(a) further specifies the time at which notices are given, providing that, if mailed, a notice is given when deposited in the U.S. mail, postage prepaid (thus preserving the concept currently appearing in Section 222(b), which is being updated to eliminate that provision, as it will become redundant); if delivered by courier service, the notice is given at the earlier of the time it is received or left at the stockholder's address; and if given by electronic mail,

the notice is given at the time it is directed to the stockholder's electronic mail address.

Additional Provisions Applicable to Notices by Electronic Mail

Since 2000, Section 232(a) has permitted notices to stockholders to be given by means of "electronic transmission," defined broadly to include electronic mail. Section 232(b), however, has since that time provided that notice given by electronic mail will be deemed given only when directed to an electronic mail address at which the stockholder has consented to receive notice. As the initial set of amendments allowing for notices by electronic transmission were adopted in 2000, at a time when electronic mail was not nearly as ubiquitous, the consent requirement was intended as a means of protecting stockholders. The requirement to obtain such consent from stockholders has in many cases limited the usefulness of notice by electronic mail, with corporations effectively being forced to give notices by traditional means, even in cases where they have valid electronic mail addresses for their entire stockholder base. As revised, Section 232(a) will reverse the statutory default as it relates to notices to stockholders by electronic mail.

Notices to stockholders by electronic mail generally will become effective when directed to the stockholder's electronic mail address.

Despite the change in the statutory default, revised Section 232 contains several provisions governing the validity of notice by electronic mail. First, while notices to stockholders by electronic mail generally will become effective when directed to the stockholder's electronic mail address, they will not be effective as to any stockholder that has notified the corporation in writing or by electronic transmission of an objection to receiving notice by electronic mail. Second, any notice given by electronic mail must include a prominent legend that the communication is an important notice regarding the corporation. Third, Section 232(a) will not affect, limit, eliminate or override the application of any other law, rule or regulation applicable to a corporation or by which such corporation or its securities may be bound. Thus, for example, public companies will remain subject to the obligations under Regulation 14A or Regulation 14C promulgated under the Securities Exchange Act of 1934 and accordingly will be unable to send notices thereunder by electronic mail.

Revised Section 232 will expressly define the terms "electronic mail" and "electronic mail address" based on similar terms defined in the Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act of 2003. As so defined, the term "electronic mail" means an electronic transmission directed to a unique electronic mail address, and is deemed to include any files attached to it as well as any information hyperlinked to a website, but only if the electronic mail itself includes the contact information of an officer or agent of the corporation who is available to assist with accessing the files and information. Given that many notices to stockholders are likely to include attachments—for example, a consent solicitation statement, form of written consent, or notice of merger and appraisal—corporations will need to ensure that they provide, in the body of the electronic mail, the contact information for the corporate secretary or other officer or agent of the corporation who can assist stockholders with accessing the files. The term "electronic mail address" is defined to mean a destination, commonly expressed as a string of characters, consisting of a unique user name or mailbox and a reference to an internet domain, to which electronic mail can be sent or delivered. Finally, revised Section 232 provides that a notice may not be given by an electronic transmission (including any electronic mail) from and after the time that the corporation

is unable to deliver by such electronic transmission two consecutive notices and the inability becomes known to the secretary, assistant secretary, transfer agent or other person responsible for giving the notice (although the inadvertent failure to discover the inability will not invalidate any meeting or other action).

Section 232(a), as amended, will set forth the statutorily recognized means of providing notice to stockholders; it will apply not only to meetings of stockholders, but to any notice required to be given to stockholders under the General Corporation Law or the corporation's certificate of incorporation or bylaws. Thus, under revised Section 232(a), a corporation will be able to give all types of notices required under the General Corporation Law or its certificate of incorporation and bylaws, including notices of meetings, notices of actions by written consent of stockholders in lieu of a meeting and notices of appraisal rights, by electronic mail. As noted in the synopsis to the proposed legislation containing the 2019 Amendments, "Section 232(a) applies to any notice that is required to be given under [the General Corporation Law] or under the certificate of incorporation or bylaws" and, accordingly,

> no provision of the certificate of incorporation or bylaws (including any provision requiring notice to be in writing or mailed) may prohibit the corporation from giving notice in the form, or delivering notice in the manner, permitted by Section 232(a).

Thus, while it is often advisable for corporations to review their certificates of incorporation and bylaws periodically to ensure they are current, they will not be precluded from taking advantage of the means of giving notice set forth in Section 232(a). Thus, existing provisions of a corporation's certificate of incorporation or bylaws that require, for example, that notices to stockholders be given in writing or delivered by U.S. mail will not override the statutory provisions allowing for notice to be given by courier or electronic mail in accordance with Section 232.

Other Changes

New Section 232(c) (which substantially incorporates the provisions that are currently set forth in Section 232(b)) provides the three other means of giving notice by electronic transmission: (1) facsimile telecommunication; (2) posting on an electronic network (with separate notice of the posting); and (3) other forms of electronic transmission. In the case of a facsimile notice, the notice is deemed given when directed to a number at which the stockholder has consented to receive notice; in the case of a posting on an electronic network, the notice is given upon the later of the posting and the giving of the separate notice to the stockholder of the posting; and if given by other means of electronic transmission, the notice is deemed given when directed to the stockholder.

Last, Section 232(f) of the General Corporation Law includes provisions (similar to the provisions formerly in Section 222(b) and Section 232(b)) for transmittal affidavits that serve as prima facie evidence that notice has been given to stockholders. Section 232(g) (formerly designated as Section 232(e)) identifies certain types of notices that must continue to be given in the manner specified by those provisions addressed in Section 232(g).

Ancillary Provisions

Section 160(d), which currently generally provides that shares called for redemption will not be deemed outstanding for purposes of quorum and voting after "written" notice has been sent to stockholders and a sum sufficient to pay the redemption price has been irrevocably deposited or set aside, will be revised to eliminate the requirement of a "written" notice, thus clarifying that such notice may be given in the form and manner provided in revised Section 232. Section 163, which generally requires notices to be given with respect to partly paid shares, is similarly being amended to clarify that such notices may be given in the manner and form provided in revised Section 232.

The 2019 Amendments also amend Section 230 of the General Corporation Law, which sets forth the exceptions to the requirement to provide

notice. In general, Section 230(b)(1) of the General Corporation Law eliminates the requirement to give notice to any stockholder to whom notice of two consecutive annual meetings, and all notices of meetings or of the taking of action by written consent without a meeting to such stockholder during the period between such two consecutive meetings, have been returned undeliverable. Section 230(c) currently renders Section 230(b)(1)'s exception to the requirement to give notice inapplicable to any notice if the notice was given by electronic transmission. The 2019 Amendments will add a new sentence to Section 230(c) to provide that Section 230(b)(1)'s exception shall not be applicable to any stockholder whose electronic mail address appears on the records of the corporation and to whom notice is not prohibited by Section 232. Thus, if a corporation has an electronic mail address for a stockholder and notice to such stockholder by electronic mail is not prohibited under Section 232, then the corporation will not be relieved of the obligation to send that stockholder notices pursuant to the "returned mail exception" in Section 230(b)(1).

The 2019 Amendments also would change Sections 251 (merger or consolidation of Delaware stock corporations), 253 (short-form merger of corporations), 255 (merger or consolidation of Delaware nonstock corporations), 266 (conversion of Delaware corporations to other entities), 275 (dissolution) and 390 (transfer, domestication or continuance of Delaware corporations) to provide that the notices required thereunder may be "given," rather than mailed, thereby clarifying that such notices may be provided in the form, and delivered in the manner, permitted by Section 232, as revised.

Appraisal Rights

The 2019 Amendments make several technical changes to Section 262(d), which sets forth the provisions for notices to stockholders in circumstances where they are entitled to appraisal rights, to clarify such notice provisions and conform them to amended Section 232(a). The amendments to Section 262(d) will permit a corporation to deliver a notice of appraisal rights by courier or electronic mail (in addition to by U.S. mail). In addition, Section 262(d) is being amended to permit stockholders to deliver demands for appraisal by electronic transmission. The corporation, however, is only required to receive such demands if it expressly has designated, in the notice of appraisal rights, an information-processing system for receipt of electronic delivery of demands. Thus, a corporation that desires to receive appraisal demands by, for example, electronic mail would need to provide expressly in the appraisal notice that such demands may be delivered to a specified electronic mail address. Similarly, Section 262(e), which requires the provision of specified information regarding the statement of the number of shares and holders entitled to appraisal, is being amended to clarify that the information may be given in any manner permitted by Section 232(a). As indicated above, the foregoing amendments to Section 262 will be effective with respect to a merger or consolidation consummated pursuant to an agreement of merger or consolidation entered into on or after August 1, 2019.

Stockholder Consents

As part of the overall update to the provisions of the General Corporation Law dealing with electronic signatures and electronic transmissions, the 2019 Amendments effect several changes to Section 228(d), which currently governs the manner and circumstances under which stockholder consents may be delivered through electronic means. In 2000, Section 228(d) was amended to provide that a "telegram, cablegram or other electronic transmission consenting to an action to be taken and transmitted" by a stockholder or proxy holders (or authorized agent) "shall be deemed to be written, signed and dated" for purposes of Section 228, provided that the telegram, cablegram or other electronic transmission sets forth or is delivered with information from which the corporation can determine (x) that it was transmitted by the stockholder, proxyholder

or authorized agent, and (y) the date on which the stockholder, proxyholder or agent transmitted it. Nevertheless, while the amendments to Section 228 adopted in 2000 essentially allowed for electronic transmissions to be used in connection with consent solicitations, subject to certain procedural requirements, they also specified that, unless the board of directors otherwise provides, consents delivered by electronic transmission may not be given directly to the corporation or its registered agent. Thus, Section 228(d)(1), as enacted in 2000 and currently in effect, requires that, unless the board otherwise provides, stockholder consents delivered by electronic transmission must first be reduced to paper form and delivered in such paper form to the corporation's registered office in Delaware, to its principal place of business, or to an officer having custody of its books. Thus, current Section 228(d)(1), by default, contemplates a consent solicitation in which stockholders provide consents by electronic transmission to an agent, which agent then reduces the consents to paper form and delivers them to the corporation as required by the statute, with the statutorily specified information.

The 2019 Amendments would overhaul the basic regime governing stockholder consents delivered by electronic transmission.

The 2019 Amendments would overhaul the basic regime governing stockholder consents delivered by electronic transmission. First, as with other provisions of the General Corporation Law, the 2019 Amendments will eliminate references to consents given by telegram and cablegram, using instead only the term "electronic transmission". Next, the 2019 Amendments will replace the provisions of Section 228(d)(1) requiring that, unless otherwise provided by the board, consents given by electronic means be reduced to paper form and delivered through traditional means with provisions that expressly allow for the delivery of consents by electronic transmission. Specifically, the 2019 Amendments will update Section 228(d)(1) to provide that a consent given by electronic transmission is delivered upon the earliest of: (1) the time the consent enters an information-processing system designated by the corporation for receiving consents (so long as the transmission is capable of being processed by the system and the corporation is able to retrieve it); (2) the time at which a paper reproduction of the consent is delivered to the corporation's principal place of business or the appropriate officer or agent; (3) the time at which a paper reproduction is delivered, by hand or certified or registered mail, to the corporation's registered agent in Delaware; or (4) the time at which it is delivered in any other manner authorized by the board.

As with Section 116, for purposes of determining whether the corporation has "designated" an information-processing system for the receipt of consents, revised Section 228(d)(1) looks to the certificate of incorporation, the bylaws or the context and surrounding circumstances, including the corporation's conduct. In addition, revised Section 228(d)(1) expressly provides that a consent is delivered even if no person is aware of its receipt. Thus, for example, no party will be able to disclaim the validity of a consent validly transmitted to the corporation's information-processing system by electronic transmission on the grounds that the corporation had failed to open the electronic mail or other transmission. Moreover, the receipt of an electronic acknowledgment from an information-processing system will establish that a consent was received, although it would not, in and of itself, establish that the content corresponds to the content received.

Director Consents

The 2019 Amendments will revise Section 141(f) of the General Corporation Law, which deals with director action by consent in lieu of a meeting, to clarify that the filing of the consent (whether in

writing or by electronic transmission) to action by the board or any committee is not a condition precedent to the effectiveness of the action. Section 141(f) currently provides that, unless restricted by the certificate of incorporation or bylaws, any action required or permitted to be taken at a meeting of the board or any committee may be taken without a meeting if all members of the board or committee consent thereto in writing, or by electronic transmission, and the writing(s) or electronic transmissions are filed with the minutes of the proceedings of the board or committee. In practice, consents may be obtained from directors—and delivered to the corporation's secretary or outside counsel—and the action may be considered duly authorized before the consents are physically placed with the minute book.

To avoid the implication that an action taken by unanimous consent of directors in lieu of a meeting does not become effective until such time as the relevant instruments are so placed with the minute book, the 2019 Amendments will remove from the first sentence of Section 141(f) the requirement that the consents or electronic transmissions be filed with the minutes of the proceedings of the board or committee. The 2019 Amendments will add to the end of Section 141(f) a requirement that

> [a]fter an action is taken, the consent or consents relating thereto shall be filed with the minutes of the proceedings of the board of directors, or the committee thereof, in the same paper or electronic form as the minutes are maintained.

As the amendments to Section 141(f) are clarifying in nature, they should not, by negative implication or otherwise, give rise to the timing of effectiveness of actions taken by unanimous consent of directors before their adoption.

Incorporator Consents

Section 108(b) of the General Corporation Law, which deals with the principal matters within the power of incorporators (generally, the power to elect the initial board of directors and adopt the initial bylaws), are being amended to clarify that notice of an initial organization meeting may be given in writing or by electronic transmission. The 2019 Amendments also eliminate from Section 108(b) the express requirement that a waiver of that notice be signed. Instead, any such waiver may be given in the manner provided by Section 229, which permits waivers in writing and by electronic transmission. Finally, consistent with the 2014 amendments to Section 141(f) allowing for director consents to become effective at a future date, Section 108(c) is being amended to clarify that a consent of incorporator may become effective in the future in the same manner that a consent of directors may become effective.

Registered Agent Resignation; Revival of Certificate of Incorporation of Exempt Corporations

The 2019 Amendments will amend Section 136(a) to permit the registered agent of a Delaware corporation, including a corporation that has become void pursuant to Section 510 of Title 8 of the Delaware Code, to resign by filing a certificate of resignation. The amendments to Section 136(a) also will require the certificate to include the last known information for a communications contact provided to the resigning registered agent. The communications contact information will not be deemed public, and falls within the exception set forth in Section 10002(l)(6) of Title 29 of the Delaware Code to the definition of "public record" for purposes of the Freedom of Information Act.

In addition, the 2019 Amendments will revise Section 313(a) of the General Corporation Law, which deals with the revival of exempt corporations, to provide that Section 313 applies to an exempt corporation whose certificate of incorporation or charter has become forfeited pursuant to Section 136(b) for failure to obtain a registered agent.

CORPORATE GOVERNANCE

Mitigating the Impact of a Material Weakness on the Election of Directors

A company's disclosure of a material weakness in internal controls over financial reporting can result in audit committee and other board members receiving negative voting recommendations from the proxy advisory firms. There are, however, steps the company can take to mitigate the impact of such recommendations.

By Jodi A. Simala and Candace R. Jackson

Where companies have disclosed repeated or ongoing material weaknesses in internal controls over financial reporting, or where a company's first material weakness requires a restatement of its financial statements, audit committee and other board members can receive negative voting recommendations from proxy advisory firms. There, however, are targeted disclosure and shareholder outreach strategies that mitigate the impact of material weaknesses on the election of directors.

Relevant Viewpoints

Institutional Shareholder Services 2019 U.S. Proxy Voting Guidelines

When poor accounting practices have been identified, including fraud, misapplication of GAAP or material weaknesses, Institutional Shareholder Services (ISS) will determine, on a case-by-case basis, whether to recommend a withhold/against vote for audit committee members and potentially the full board of directors. In making its determination, ISS will consider the severity, breadth, chronological sequence and duration, as well as the company's efforts to remediate or take corrective action.

Glass, Lewis & Co. 2019 US Proxy Paper™ Guidelines

Glass, Lewis & Co. (Glass Lewis) typically defers to the judgment of the audit committee when assessing its decisions and actions and generally votes in favor of audit committee members. The quality of the financial statements and earnings reports and the effectiveness of internal controls generally serve as the barometer on which Glass Lewis assesses the audit committee. However, where accounting fraud, failures to timely file financial reports, financial statement restatements or material weaknesses occur, Glass Lewis may recommend a vote against all members of the audit committee.

Where a material weakness has been reported since the last annual meeting or is ongoing from a prior year and has not yet been corrected, Glass Lewis's policy is to consider whether to vote against all members of the audit committee. Glass Lewis takes into consideration the transparency of the audit committee report in the proxy statement in making its determination.

Mitigating the Impact of a Material Weakness on the Election of Directors

Proxy Disclosure

If proxy advisory firms view a company as transparent with shareholders, and the material weakness does not have a significant impact on the financial statements, it is possible that the proxy advisory firms will not make negative voting recommendations for the audit committee members.

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ISS and Glass Lewis will only rely on a company's public disclosures in making voting recommendations, and Glass Lewis's voting guidelines specifically consider the transparency of the audit committee report in making its determination. It is important, and ideal, for companies to be proactive and use the proxy statement or other filings with the U.S. Securities and Exchange Commission (SEC) as an opportunity to address the material weakness in detail to avoid the negative voting recommendation. The audit committee report should answer these key questions:

- *What is the scope of the material weakness?* If the material weakness is limited to a very narrow issue (*e.g.*, accounting for income taxes or the proper classification of cash received from suppliers), be sure to highlight this fact.
- *Did the material weakness result in a restatement of the financial statements? Are the affected audited financial statements still fairly presented?* If the accounting errors resulting from the material weakness were immaterial and led to immaterial revisions of the financial statements, emphasize that a restatement was not required and the financial statements continue to be reliable.
- *Is the auditor's opinion affected?* If the auditor's opinion on the audited financial statements considered the material weakness and the material weakness did not affect the opinion on the financial statements, this is a good fact to clarify.
- *What steps has the audit committee taken in response to the discovery of the material weakness?* Disclose whether the audit committee engaged an advisor to conduct an independent investigation into the accounting errors. An independent investigation overseen by the audit committee demonstrates the audit committee's engagement and the seriousness with which the issue has been addressed.
- *What is the company's remediation plan, and what steps has the company taken to be transparent with shareholders?* Because transparency is a significant factor in avoiding a negative voting recommendation, it is important that the proxy statement not only explain the material weakness, remediation plan and other efforts being taken to improve internal controls, but also include references to the previous Form 10-K, Form 10-Q and Form 8-K disclosures that have been made to date. If the material weakness continues to be ongoing, explain what is required before the company will consider it remediated (*i.e.*, passage of time).

Additional Soliciting Material

Additional soliciting material (which can take a variety of forms, such as a proxy supplement, letter to shareholders, slides, script or talking points) can be used to provide shareholders with information about a material weakness to the extent not covered in the proxy statement. These materials must be filed with the SEC on EDGAR and posted online with the annual report and proxy statement by the date first used. In practice, this disclosure can have a positive outcome on the voting results, even when a company initially fails to address the material weakness in the proxy statement so as to avoid receiving negative voting recommendations from the proxy advisory firms.

For example, ISS recommended a vote against the members of one company's audit committee when the company did not address the material weakness in its proxy statement. The company filed additional soliciting material strongly disagreeing with the ISS recommendation and making the case for why shareholders should vote for the audit committee members. The company explained that the scope of the material weakness was limited to its income tax accounting and that the errors were immaterial and did not require a restatement of the financial statements, which continued to fairly present the company's financial condition and results of operations.

In addition, the company highlighted the transparency of its previous disclosure about the steps it was taking to remediate and enhance its internal controls, and reiterated those plans. The company also emphasized that its audit committee members were all qualified and that the committee had been

vigilant in its oversight of the company's financial reporting and remediation efforts. The voting results showed that the ISS recommendation had a minimal negative impact on the final results for the audit committee members, each of whom was re-elected.

Similarly, after another company failed to address a material weakness in its proxy statement, Glass Lewis recommended a vote against its audit committee members. The company also filed additional soliciting material emphasizing that the material weakness was related to a very narrow issue. The company pointed out that it was the audit committee's oversight and decision to appoint the company's auditor that led to the discovery of the deficiency. The company then highlighted in detail the significant experience, skills and expertise of each audit committee member. Although the audit committee members received more votes against their election than other directors, the impact was small, and each was re-elected.

Shareholder Outreach

A proactive plan to engage in shareholder outreach is also helpful where a vote against directors has been recommended by the proxy advisory firms. A proxy solicitor can help a company to identify those of its large shareholders that do not strictly follow ISS or Glass Lewis recommendations and to make sure that these shareholders understand the nature of the material weakness, its impact on the financial statement, and the company's corrective efforts.

It is important to note that some institutions will not engage with companies during the proxy solicitation season due to workload and other constraints, so it is recommended that shareholder outreach be done as a supplement to (and not in place of) the preparation of additional soliciting material. In fact, the additional soliciting material can facilitate shareholder engagement because the material can be emailed to the company's contact at an institutional investor who might be too busy to schedule a telephone call or meeting but might be willing to read or pass along the material to others within the organization who are responsible for proxy voting.

Role of the Audit Committee

Generally, an audit committee does not participate in the design and evaluation of internal controls but does have a responsibility to oversee the audit and the financial reporting process. It is important that audit committees do not simply rely on the audit of the company's internal controls to identify significant deficiencies and material weaknesses before they result in a misstatement. In 2015, the Public Company Accounting Oversight Board (PCAOB) issued a communication to audit committees, *Audit Committee Dialogue*,[1] that reported that many audit opinions concluding that a material weakness had been identified had been issued concurrently with (or after) the company's disclosure of the related accounting error. In some cases, the error came to the company's attention from outside of the financial reporting process entirely, through a regulatory investigation or whistleblower activity.

The PCAOB recommended that audit committees proactively engage auditors in dialogue to help ensure that audits of internal controls achieve their objective to identify material weaknesses before a material misstatement occurs. Questions that the PCAOB recommended audit committees ask auditors include:

- What are the points within the company's critical systems processes where material misstatements could occur?
- How has the audit plan addressed the risks of material misstatement at those points?
- How will the auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?
- What is the auditor's approach to evaluating the company's controls for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in a business combination, divestitures, and major litigation claims?
- If the company enters into a significant or unusual transaction during the year, how will

the auditor adjust the audit plan, including the plan for testing internal controls related to the transaction? For example, how would the company's acquisition of a significant enterprise during the third quarter affect the audit plan for the year? How might the auditor's materiality assumptions change?

Where a company or its auditor has identified a potential material weakness, the PCAOB recommended that the audit committee ask key questions of the auditor, including:

- What has been done to probe the accuracy of its description?
- Could the material weakness identified be broader than initially described?
- Could it be an indication of a deficiency or material weakness in another component of internal control?

Note

1. *https://pcaobus.org/sites/digitalpublications/audit-committee-dialogue.*

IN THE COURTS

Second Circuit Holds General Statements of Regulatory Compliance Cannot Sustain Securities Fraud Claim

By Roger Cooper, Jared Gerber, Lisa Vicens, and Breon Peace

It has been a not infrequent occurrence over the past years that, after a company announces bad news or corporate mismanagement, securities class actions have been filed challenging general statements made by the company about its compliance with regulatory requirements or its own ethics policies and procedures. In *Singh v. Cigna Corp.*, the Second Circuit issued yet another strong decision rejecting that tactic. In the wake of *Cigna*, it is now clear in the Second Circuit that generalized statements that a company has established policies to comply with regulatory requirements, and that it expects every employee to act with integrity and to comply with regulatory requirements, cannot provide a basis for a securities fraud claim—even if it turns out that during the time the company is making such public statements, the company is not complying with regulatory requirements and its employees are not acting with integrity.

Background

The general facts alleged in *Cigna* will be familiar to the readers of many recent securities fraud complaints, although they are particular in their detail. During the relevant time period, Cigna, a multi-national health services organization, filed annual reports with the SEC on Form 10-K in which Cigna stated, among other things, that it had "established policies and procedures to comply with applicable requirements" and that it "expect[ed] to continue to allocate significant resources to various compliance efforts."[1] During this time period, it also published a "Code of Ethics and Principles of Conduct" that "includ[ed] statements from senior Cigna executives affirming the importance of compliance and integrity."[2] The Code of Ethics stated that it was "important for every employee . . . to handle, maintain, and report on [Cigna's financial] information in compliance with all laws and regulations" and that Cigna employees had "a responsibility to act with integrity in all [they] do, including any and all dealings with government officials."[3]

The complaint alleged that at the same time Cigna was making these statements, a Medicare insurer, HealthSpring Inc., which Cigna had just acquired, was experiencing a series of regulatory compliance failures in its Medicare operations.[4] Specifically, during the time period after Cigna had made the statements touting its compliance efforts in the Form 10-Ks and after it had published its Code of Ethics, it received more than seventy-five notices from the Centers for Medicare and Medicaid Services (CMS), a federal agency within the United States Department of Health and Human Services that administers the Medicare program, for a variety of regulatory compliance infractions.[5] In fact, CMS determined that Cigna had "'substantially failed to comply with CMS requirements' regarding coverage determinations, appeals, benefits administration, compliance program effectiveness and similar matters" and had a "longstanding history of noncompliance with CMS requirements."[6] Cigna did

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not disclose the notices of non-compliance contemporaneous with their receipt.

CMS ultimately sent Cigna a notice setting forth Cigna's history of noncompliance and imposing sanctions on Cigna, including the suspension of enrollment of Medicare beneficiaries.[7] Cigna immediately filed a Form 8-K disclosing receipt of the notice from CMS and the accompanying sanctions.[8] "Cigna's stock price fell substantially,"[9] and Plaintiffs sued, alleging that Cigna's statements about its policies and procedures and its commitment to regulatory compliance, ethics and integrity were materially misleading in light of the contemporaneous, undisclosed history of regulatory non-compliance with Medicare regulations.[10] Several months later, "Cigna announced that it had already spent nearly $30 million to remedy the compliance violations, but that it [might] 'not be able to address matters arising from the [CMS Sanctions] Notice in a timely and satisfactory manner.'"[11] Cigna's stock price again fell, and Plaintiffs filed an amended securities fraud complaint extending the class period through the later disclosure and stock price drop.[12]

On September 28, 2017, the United States District Court for the District of Connecticut, Hon. Vanessa L. Bryant, dismissed the complaint for failure to allege materially false statements and scienter.[13] She held that, among other things, the Code of Ethics statements "reflect the precise meaning" of "puffery."[14] Moreover, the court stated that Plaintiffs "[did] not allege at what point these individuals actually made these statements": the executives "could have uttered these words years before they were actually published in the Code of Ethics."[15] Thus, Plaintiffs failed to make the requisite showing that the statements were false at the time they were made.[16]

As to the statements in the Form 10-K, the District Court stated that, "although a company cannot be expected to maintain 100% compliance with every applicable regulation, the existence of 'ongoing and substantial' violations of regulations that are left undisclosed can lead to a material misstatement or omission if a reasonable investor would consider such information important."[17] Here, however, the omissions regarding the violations at the time the Form 10-K statements were made were "'*obviously* unimportant to a reasonable investor' because these early stage notices could [have] be[en] rectified at any time without risking a threat to earnings."[18] And, while the 2013 Form 10-K stated that Cigna "established policies and procedures to comply with applicable requirements, . . . Cigna made no contention that it was in 'substantial compliance' with all laws."[19]

The Second Circuit's Decision

In a unanimous decision affirming the District Court, the Second Circuit held that Plaintiffs had failed to allege a materially false statement as a matter of law.[20] The Second Circuit's ruling was broader than the District Court's decision.

The Second Circuit based its ruling largely on its earlier decision in *City of Pontiac Policemen's & Firemen's Retirement System v. UBS AG*.[21] In that earlier decision, the Second Circuit held that

> [t]o be "material" within the meaning of § 10(b), [an] alleged misstatement must be sufficiently specific for an investor to reasonably rely on that statement as a guarantee of some concrete fact or outcome which, when it proves false or does not occur, forms the basis for a § 10(b) fraud claim.[22]

In *City of Pontiac*, plaintiffs alleged that the company represented that it "(1) avoided 'concentrated positions' of assets; (2) implemented asset portfolio limits, and (3) engaged in limited 'proprietary' investing."[23] The court held that representations that the company

> prioritized "*adequate* diversification of risk" and "avoidance of *undue* concentrations," [were] too open-ended and subjective to constitute a guarantee that [the company] would not accumulate a $100 billion RMBS portfolio, comprising 5% of [its] overall portfolio, or 16% of its trading portfolio.[24]

And *City of Pontiac* itself built upon *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*,[25] in which the Second Circuit held that statements about the defendant bank's risk management and integrity were inactionable generalizations, cautioning that "[p]laintiffs conflate the importance of a bank's reputation for integrity with the materiality of a bank's statements regarding its reputation" and declining to broaden the scope of the securities laws to statements that "almost every investment bank makes," stating that "[n]o investor would take such statements seriously in assessing a potential investment."[26]

Following *ECA* and *City of Pontiac*, the Court found that Cigna's statements in its Code of Ethics were "a textbook example of 'puffery.'"[27] According to the court, they amounted to "general declarations about the importance of acting lawfully and with integrity" on which no reasonable stockholder would rely.[28] The court also rejected the argument that the statements regarding Cigna's compliance contained in its Form 10-K were materially misleading, noting that they were "simple and generic assertions about having 'policies and procedures' and allocating 'significant resources'" to assure regulatory compliance.[29] The court highlighted the fact that the statements were "framed by acknowledgments of the complexity and numerosity of applicable regulations" and, read in that context, reflected Cigna's uncertainty about whether it could maintain compliance in the face of the complex web of government regulations.[30]

Perhaps most significantly, the court distinguished its earlier decision in *Meyer v. Jinkosolar Holdings Co.*[31] There, the court sustained a securities fraud complaint where the defendant company had both "described its compliance mechanisms in confident detail" and pointed out its "clean compliance record."[32] In particular, in *Jinkosolar*, the company had highlighted particular features of its compliance program, such as having environmental teams on duty twenty-four hours a day and maintaining such teams at each of the company's manufacturing facilities.[33] The Second Circuit distinguished the statements made by Cigna from the "actionable assurances of actual compliance" in *Jinkosolar*.[34]

Significance of *Cigna*

The Second Circuit's decision in *Cigna*, along with its earlier decisions in *City of Pontiac* and *ECA*, provides powerful ammunition to companies sued for securities fraud in the wake of announcements of corporate mismanagement or regulatory violations. The shareholders of such companies frequently suffer through a stock price drop when such bad news is announced, and the companies then become the targetof litigation. *Cigna* is a welcome reminder that in the absence of well-pled allegations of actual material misstatements on which stockholders could have relied in the purchase of their securities, the company and its current shareholders should not be punished a second time through the cost and burden of a securities fraud lawsuit.

The decision also gives comfort that a company's disclosure of its Code of Ethics and description of its compliance efforts cannot provide the basis for an investor to later turn around and sue the company when—and if—it turns out that company employees have violated its ethics or compliance policies. A Code of Ethics is not a guarantee that every employee has acted legally, ethically or with integrity.

At the same time, for disclosure lawyers, *Cigna* makes clear that companies should avoid making overly confident and detailed "assurances of actual compliance," or using language that could be read as a guarantee of such compliance.

Notes

1. *Singh v. Cigna Corp.*, No. 17-3484-CV, 2019 WL 1029597, at *2 (2d Cir. Mar. 5, 2019) (citation omitted).
2. *Id*.
3. *Id*. (first and second alterations in original) (citation omitted).
4. *Id*. at *1-2.

5. *Id*. at *2.
6. *Id*. (citation omitted).
7. *Id*.
8. *Id*.
9. *Id*. at *3.
10. *Id*.
11. *Id*. (second alternation in original) (citation omitted).
12. *Id*.
13. *Singh v. Cigna Corp.*, 277 F. Supp. 3d 291 (D. Conn. 2017), *aff'd*, No. 17-3484-CV, 2019 WL 1029597 (2d Cir. Mar. 5, 2019).
14. *Id*. at 311 (citing *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014)).
15. *Id*. at 312.
16. *Id*. (citing *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir. 2011); *In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 728 (S.D.N.Y. 2015)).
17. *Id*. at 313 (citing *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245, 251-52 (2d Cir. 2014)).
18. *Id*. at 315 (quoting *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009)) (citing *Jinkosolar*, 761 F.3d at 252).
19. *Id*. at 314 (citation omitted).
20. *Singh*, 2019 WL 1029597, at *1. The court did not reach the separate question of whether the complaint adequately alleged scienter. *Id*. at *3.
21. 752 F.3d 173 (2d Cir. 2014).
22. *City of Pontiac*, 752 F.3d at 185 (citing *ECA*, 553 F.3d at 206; *Lasker v. N.Y. State Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir.1996)).
23. *Id*. (citation omitted).
24. *Id*. at 186 (citation omitted).
25. 553 F.3d 187 (2d Cir. 2009).
26. *ECA*, 553 F.3d at 206.
27. *Singh*, 2019 WL 1029597, at *4 (citing *City of Pontiac*, 752 F.3d at 183).
28. *Id*.
29. *Id*. at *5.
30. *Id*.
31. 761 F.3d 245 (2d Cir. 2014).
32. *Singh*, 2019 WL 1029597, at *4 (citing *Jinkosolar*, 761 F.3d at 247-48).
33. *Id*. (citing *Jinkosolar*, 761 F.3d at 247-48).
34. *Id*. (citing *Jinkosolar*, 761 F.3d at 251).

CLIENT MEMOS

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

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

SEC Approves Nasdaq Rule Change to Permit Direct Listings without an IPO (March 5, 2019)

A discussion of SEC approval of NASDAQ rule changes to permit direct listings without an initial public offering similar to NYSE rule changes approved in 2018.

Davis Polk & Wardwell LLP New York, NY (212-450-4000)

Regulators Join in Event-Driven Securities Litigation (March 21, 2019)

A discussion of the SEC suit against Volkswagen AG, alleging fraud in connection with offerings of the company's corporate and collateralized debt. The SEC allege that Volkswagen made false statements related to its compliance with environmental regulations and omitted information regarding its use of "defeat devices."

Eversheds-Sutherland Ltd. Atlanta, GA (404-853-8000)

Annual Analysis of FINRA Disciplinary Actions (March 4, 2019)

A discussion of an annual study of the disciplinary actions reported by the Financial Industry Regulatory Authority (FINRA) in 2018, highlighting the following key takeaways: (1) increase in fines; (2) number of actions and amount of restitution decreased; and (3) top enforcement issues were anti-money laundering, suitability, variable annuities and short selling.

Fried, Frank, Harris, Shriver & Jacobson LLP New York, NY (212-859-6600)

SEC Staff Request Industry Input on Custody Issues (March 19, 209)

A discussion of a SEC staff letter to the Investment Adviser Association seeking input regarding the regulatory status of investment adviser and custodial trade practices that are not processed or settled on a delivery versus payment basis and the application of the custody rule under the Investment Advisers Act of 1920 to digital assets.

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

SEC Continues to Modernize and Simplify Disclosure Requirements (March 26, 2019)

A discussion of the SEC's adoption of amendments to modernize and simplify disclosure requirements for public companies, investment advisers and investment companies, including changing the content of Management's Discussion and Analysis and the process for redacting confidential information in certain exhibits.

Goodwin Procter LLP Boston, MA (617-570-1000)

NYSE Amends Shareholder Approval Requirements for Securities Issuance (March 26, 209)

A discussion of SEC approval of amendments to two NYSE rules that provide exceptions to requirements that listed companies obtain shareholder approval before the company issues common stock or securities convertible into common stock.

Jones Day LLP
Cleveland, OH (216-586-3939)

SEC and FINRA Broker-Dealer Priorities for 2019 (March 2019)

A discussion of FINRA's 2019 Annual Risk Monitoring and Examination Priorities Letter and the SEC's Office of Compliance Inspection and Examinations' 2019 examination priorities.

Locke Lord LLP
Dallas, TX 75201 (214-740-8000)

Delaware Decision Limits Coverage of D&O Insurance Policies (March 21, 2019)

A discussion of a Delaware court decision, *Goggin v. National Union Fire Insurance Company of Pittsburgh, PA*, excluding coverage of an underlying claim that arose out of the directors' position as investors in the company, despite the fact their alleged misconduct was a breach of their duties as directors.

Mayer Brown LLP
Chicago, IL (312-782-0600)

SEC Settles Charges with 79 Self-Reporting Advisers in Share Class Selection Disclosure Initiative (March 22, 2019)

A discussion of the SEC's announcement that it had settled charges against 79 investment advisers who self-reported violations in connection with the SEC's Share Class Selection Disclosure Initiative.

McDermott, Will & Emery, LLP
Chicago, IL (312-372-2000)

Assistant AG Provides Clarity on FCPA Self-Disclosure Credit (March 14, 2019)

A discussion of remarks by an Assistant Attorney General clarifying the U.S. Department of Justice's self-disclosure program under its Foreign Corrupt Practices Act Corporate Enforcement Policy.

McGuire Woods Richmond, VA (804-775-1000)

Another Court Rejects Privilege Protection for Outside Consultant (March 6, 2019)

A discussion of *SEC v. Navellier & Associates, Inc.*, a federal district court decision rejecting as privileged communications those with an outside consultant.

Morgan, Lewis & Bockius LLP
Philadelphia, PA (215963-5000)

SEC Staff Relieves Fund Boards of Certain In-Person Voting Requirements (March 4, 2019)

A discussion of a SEC staff February 28 no-action letter relieving fund boards of directors from in-person voting requirements in certain circumstances.

Ropes & Gray LLP
Boston, MA (617-951-7000)

In Delaware, Notices and Deadlines Matter (March 20, 2019)

A discussion of a Delaware Court of Chancery decision, *Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc.*, illustrating the principle that merger parties should not assume that anything less than strict compliance with notice requirements and deadlines in a merger agreement will be enforced.

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

The PCAOB Provides Guidance regarding Implementation of Critical Audit Matters (March 25, 2019)

A discussion of three sets of staff guidance issued by the Public Company Accounting Oversight Board regarding implementation of new critical audit matter standards that auditors of large accelerated filers will be required to include in their audit reports for fiscal years ending on or after June 30, 2019.

INSIDE THE SEC

Supreme Court Adopts Broad Interpretation of Primary Liability in SEC Antifraud Case

By Ivan Harris, Amy Greer, Sagiv Edelman, and Silki Patel

The US Supreme Court handed a significant victory to the US Securities and Exchange Commission (SEC) on March 27 by affirming a U.S. Court of Appeals for the D.C. Circuit holding that an investment banker was primarily liable for sending clients emails drafted by his supervisor that contained false statements. In *Lorenzo v. SEC*, the Court, by a 6–2 margin,[1] held that those who do not make statements but "disseminate false or misleading statements to potential investors with the intent to defraud" can be found to have committed primary violations of the antifraud provisions under those subsections that provide for "scheme" liability.[2] The Court's decision resolves several important questions that had existed since the Court narrowed the scope of primary liability to "makers" of statements in *Janus Capital Group, Inc. v. First Derivative Traders*.[3]

Significantly, the Court endorsed the SEC's approach to scheme liability against those who distribute materially misleading statements with scienter, regardless of whether they are actually the maker of the statements. By holding that a nonmaker can still violate Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder, it is expected that private securities litigants will rely on *Lorenzo* to assert claims against secondary actors—including bankers, lawyers, and accountants—who, with scienter, disseminate alleged misstatements made by others. *Lorenzo* may also further embolden the SEC to allege primary violations against "gatekeepers" and others who did not make the alleged misstatements, but are nonetheless alleged to have been involved in their dissemination.

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Background

Under Section 17(a)(1) of the Securities Act, it is unlawful to "employ any device, scheme, or artifice to defraud." Similarly, Section 10(b) of the Exchange Act makes it unlawful to "use or employ . . . any manipulative or deceptive device or contrivance" that contravenes the SEC's rules and regulations. *Lorenzo* is the latest Supreme Court decision that seeks to distinguish primary from secondary liability under these sections of the federal securities laws.

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[4] the Supreme Court held that there is no private cause of action for aiding and abetting liability under Section 10(b). This decision was seen as offering significant protection to secondary actors, such as lawyers, investment bankers, and accountants.

Seventeen years later, *Janus* added further limits to secondary liability and narrowly construed the scope of Rule 10b-5(b) under the Exchange Act, which makes it unlawful to "*make* any untrue statement of a material fact." *Janus* held that the "maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[5] Thus, under *Janus*, one can be primarily liable for a violation of

Rule 10b-5(b) only if he or she has the "ultimate authority" over a statement. *Janus* therefore was seen as foreclosing the possibility of being primarily liable under Section 10(b) and the other provisions of Rule 10b-5 for merely participating in the drafting of a materially false statement.

Whereas *Central Bank* foreclosed aiding and abetting liability in private actions under Rule 10b-5, and *Janus* confined Rule 10b-5(b) liability to "makers" of statements, the question remained whether primary liability could be established through so-called "scheme liability" under Rules 10b-5(a) and (c). Rule 10b-5(a)—like Section 17(a)(1)—makes it unlawful to "employ any device, scheme, or artifice to defraud." Rule 10b-5(c) makes it unlawful to "engage in any act, practice, or course of business [that] operates . . . as a fraud or deceit." A narrow construction of those provisions would have further limited the ability of the Commission and private litigants to assert claims of primary liability against persons who do not "make" actionable statements.

Facts and Procedural History of *Lorenzo*

At the request of his supervisor, Lorenzo, an investment banker, sent two emails that he did not draft to prospective investors. Lorenzo's supervisor provided the content of the two emails, which Lorenzo merely copy and pasted into his own emails. Lorenzo then transmitted the emails and included his signature block with a note that he could be contacted with any questions, but also stated in each email that he had sent it at the request of his supervisor. Although Lorenzo did not draft the content of the emails, the SEC found that he acted with intent to defraud because he knew some of the content was false or misleading when he sent them.

The SEC commenced administrative proceedings against Lorenzo and charged him with violating Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. An administrative law judge concluded that Lorenzo had "willfully violated the antifraud provisions of the Securities and Exchange Acts," which the SEC affirmed on appeal. In doing so, the SEC concluded that Lorenzo had violated Section 17(a)(1), Section 10(b), and Rules 10b-5(a), (b), and (c).

On appeal, the D.C. Circuit overturned the SEC's finding that Lorenzo had violated Rule 10(b)-5(b), determining that Lorenzo's supervisor, not Lorenzo himself, was the "maker" of the false statements under *Janus*.[6] But the court affirmed the SEC's conclusion that Lorenzo violated the "scheme liability" provisions of Rules 10b-5(a) and (c), and Section 17(a)(1). The D.C. Circuit agreed that, "regardless of whether he was the 'maker' of the false statements for purposes of Rule 10b-5(b)," Lorenzo produced email messages containing false statements and sent them directly to potential investors . . . with scienter," and therefore "can be found to have infringed Section 10(b), Rules 10b-5(a) and (c), and Section 17(a)(1)."[7]

Lorenzo appealed the D.C. Circuit's opinion to the Supreme Court, presenting the question of whether someone who is not a "maker" of a misstatement under *Janus* can nevertheless be found to have violated the other subsections of Rule 10b-5 and related provisions of the securities laws when the only conduct involved circulating the misstatement of another, with scienter. The Supreme Court granted certiorari on June 18, 2018, and heard oral argument on December 3, 2018.

Lorenzo Decision: Dissemination of False Information with Intent to Defraud Is Sufficient

In its *Lorenzo* decision, the Supreme Court explained that "the words" used in Section 17(a)(1), Section 10(b), and Rules 10b-5(a) and (c) were "sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud."[8] Indeed, the Court saw "nothing borderline about this case, where the relevant conduct (as found by the Commission) consists of disseminating false or misleading information to

prospective investors with the intent to defraud."[9] The Court went on to explain that as opposed to the "mailroom clerk" and other tangential actors for whom liability would be inappropriate, Lorenzo "sent false statements directly to investors, invited them to follow up with questions, and did so in his capacity as vice president of an investment banking company."[10]

The Court went on to explain why a finding of primary liability under these facts was consistent with its rulings in *Janus*, *Central Bank*, and other cases. The Court distinguished *Janus* because it involved an investment adviser who drafted misstatements that were then "issued by a different entity that controlled the statements' content."[11] The Court further emphasized that *Janus* did not involve the application of Rule 10b-5(b) to the *dissemination* of false or misleading statements.[12] The Court concluded that it expected *Janus* to "remain relevant" in situations where an "individual neither makes nor disseminates false information."[13]

Further, although Lorenzo argued that holding him primarily liable would vitiate, or at least weaken, the distinction between primary and secondary liability as established by *Central Bank*, the Court rejected this argument. Instead, it explained that its holding created an "administrable" line:

> Those who disseminate false statements with intent to defraud are primarily liable under Rules 10b–5(a) and (c), §10(b), and §17(a)(1), even if they are secondarily liable under Rule 10b–5(b).[14]

The Court compared this to its holding in *Janus*, which "neatly divide[d] primary violators and actors too far removed from the ultimate decision to communicate a statement."[15]

The Court also distinguished its prior holding in *Stoneridge Investment Partners, LLC v. Scientific–Atlanta, Inc.*,[16] where it rejected an attempt to bring claims against persons who allegedly committed undisclosed deceptions upon which a plaintiff could not have relied. As the Court explained, reliance is irrelevant in Commission actions, and even if it were relevant, Lorenzo's conduct "involved the direct transmission of false statements to prospective investors intended to induce reliance."[17]

Lorenzo's Effect on Future SEC Enforcement Cases and Private Actions

SEC Enforcement

Lorenzo likely will boost the SEC's ability to bring enforcement actions involving false and misleading statements. This is an area in which the distinction between primary liability and secondary liability is crucial. Under Section 20(e)—the Exchange Act's "aiding and abetting" statute—an entity is secondarily liable only if there is a primary violator to whom the entity provided "substantial assistance." Additionally, the secondary violator is "deemed to be in violation" only to the "same extent" as the primary violator.[18]

To bring an action asserting aiding and abetting liability, therefore, the SEC must show that the primary actor violated the federal securities laws. As the *Lorenzo* Court noted, this creates a potential gap where, for example, the disseminator of a statement knows it is false but the maker of a statement does not. Under these circumstances, the innocent maker of the statement cannot be held primarily liable, which means that the more culpable disseminator could not have aided and abetted anything.

After *Lorenzo,* the SEC is clear to charge such persons as primary violators without demonstrating the person who actually made the statement also violated the federal securities laws. By holding that someone who disseminates a materially misleading statement and acts with scienter can be held primarily liable under Rules 10b-5(a) and (c), the *Lorenzo* Court avoided a result that it deemed inconsistent with Congress's intent in enacting the federal securities laws.

Private Actions

Before *Lorenzo*, the *Janus* and *Central Bank* decisions seemed to impose strict limits on claims brought by private plaintiffs. The Supreme Court's new decision affirms that those who disseminate misstatements can commit a primary violation of Rule 10b-5, rather than just a secondary aiding and abetting violation, for which there is no private right of action. Accordingly, *Lorenzo* may curtail the effect of *Janus* and *Central Bank*, and could be interpreted to mean that, under similar facts, a secondary actor (*e.g.*, banker, lawyer, accountant) may be held primarily liable under a scheme liability theory.[19]

At minimum, private plaintiffs likely will argue that *Lorenzo* allows them to bring an action under Section 10(b) and Rule 10b-5 when someone transmits a materially false or misleading statement, even though he or she did not make that statement, and that person allegedly knew or recklessly disregarded the statement's falsity. This could allow plaintiffs to attempt to add additional "nonmakers" as defendants to Section 10(b) lawsuits—including professionals such as bankers, lawyers, and accountants who forward or send registration statements or other offering documents containing material misrepresentations or omissions. Indeed, Justice Thomas's dissent warned that if Lorenzo's conduct qualifies as primary liability,

> virtually any person who assists with the making of a fraudulent misstatement will be primarily liable and thereby subject not only to SEC enforcement, but private lawsuits.[20]

It will therefore be left to lower courts to determine how far *Lorenzo*—which on its face appears to limit primary liability to "those who disseminate false statements with intent to defraud"—will stretch primary liability in private actions, if at all. Indeed, plaintiffs still will be required to plead with particularity that the "nonmaker" had such an intent.

Takeaways

While the precise ramifications of *Lorenzo* are yet to be determined, the Court's opinion is a clear victory for the SEC and could lead to an increase in private securities cases against gatekeepers. Although the *Lorenzo* Court believes its decision provides an "administrable" line that separates primary from secondary liability, the SEC and private litigants are likely to test—and require lower courts to determine—how flexible that line is.

Notes

1. Justice Brett Kavanaugh was recused from the case because he had participated in the D.C. Circuit Court decision.
2. *Lorenzo v. SEC*, No. 17-1077, slip op. at 2 (U.S. Mar. 27, 2019).
3. 564 U.S. 135, 142, 131 S. Ct. 2296, 180 L. Ed. 2d 166 (2011).
4. 511 U.S. 164 (1994).
5. *Janus*, 564 U.S. at 142.
6. *Lorenzo v. SEC*, 872 F.3d 578, 588 (D.C. Cir. 2017).
7. *Id.* at 588-89.
8. *Lorenzo*, slip op. at 5-6.
9. *Id.* at 7.
10. *Id.*
11. *Id.* at 10.
12. *Id.*
13. *Id.*
14. *Id.* at 11.
15. *Id.*
16. 552 U.S. 148 (2008).
17. *Lorenzo*, slip. op at 12.
18. In dissent, Justice Clarence Thomas disagreed that this gap might exist if not for the majority's view of primary liability. According to the dissent, makers of false statements would not so easily avoid primary liability, and conduct such as that committed by Lorenzo is more "appropriately assessed under principles of secondary liability." *Id.* at 8 (Thomas, J., dissenting).
19. 511 U.S. 164 (1994).
20. *Lorenzo*, slip op. at 9 (Thomas, J., dissenting).

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