SUPPLEMENTAL MATERIALS

FOR

BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS

(Third Edition, Carolina Academic Press 2008)

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Page 21, New Sec. 1.8.A. Add at the end of the page the following:
New Sec. 1.8.A. **Update on M&A Marketplace, June 2009**

Thompson, Update on M&A Marketplace, June 2009

Update on M&A Marketplace

June 2009

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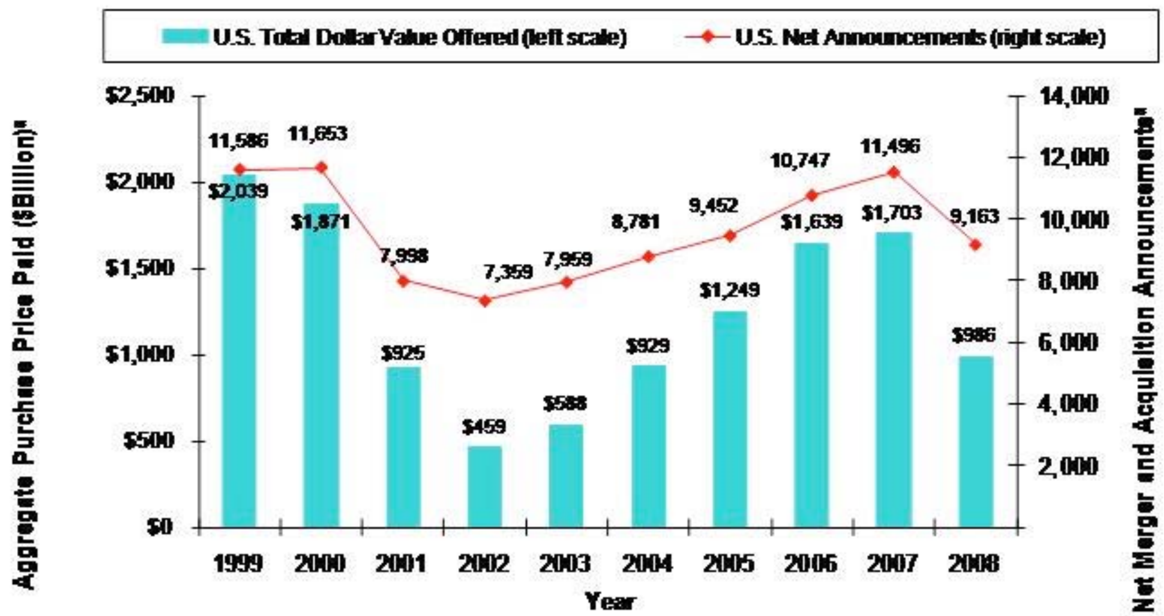
Thank you to Brian Doyle and Marc Boiron, research assistants at Penn State Dickinson, for their assistance in the preparation of this presentation

Slide 1: Trends in U.S. Mergers and Acquisitions Activity
1999-2008



YEAR	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Percent Change in US Deals Volume	69.14%	16.85%	-8.24%	-50.56%	-50.38%	28.10%	57.99%	34.45%	31.22%	3.90%	-42.1%
Percent Change in No. of Deals	9.99%	-11.29%	0.58%	-31.37%	-7.99%	8.15%	10.33%	7.65%	13.70%	6.97%	-20.29%
US $100 Million + Deals	1,314	1,351	1,372	813	716	822	934	1,086	1,271	1,346	*
US $1 Billion + Deals	171	203	248	252	150	68	143	196	255	311	*

Source: Thomson Financial Securities Data; Announcement Date - All

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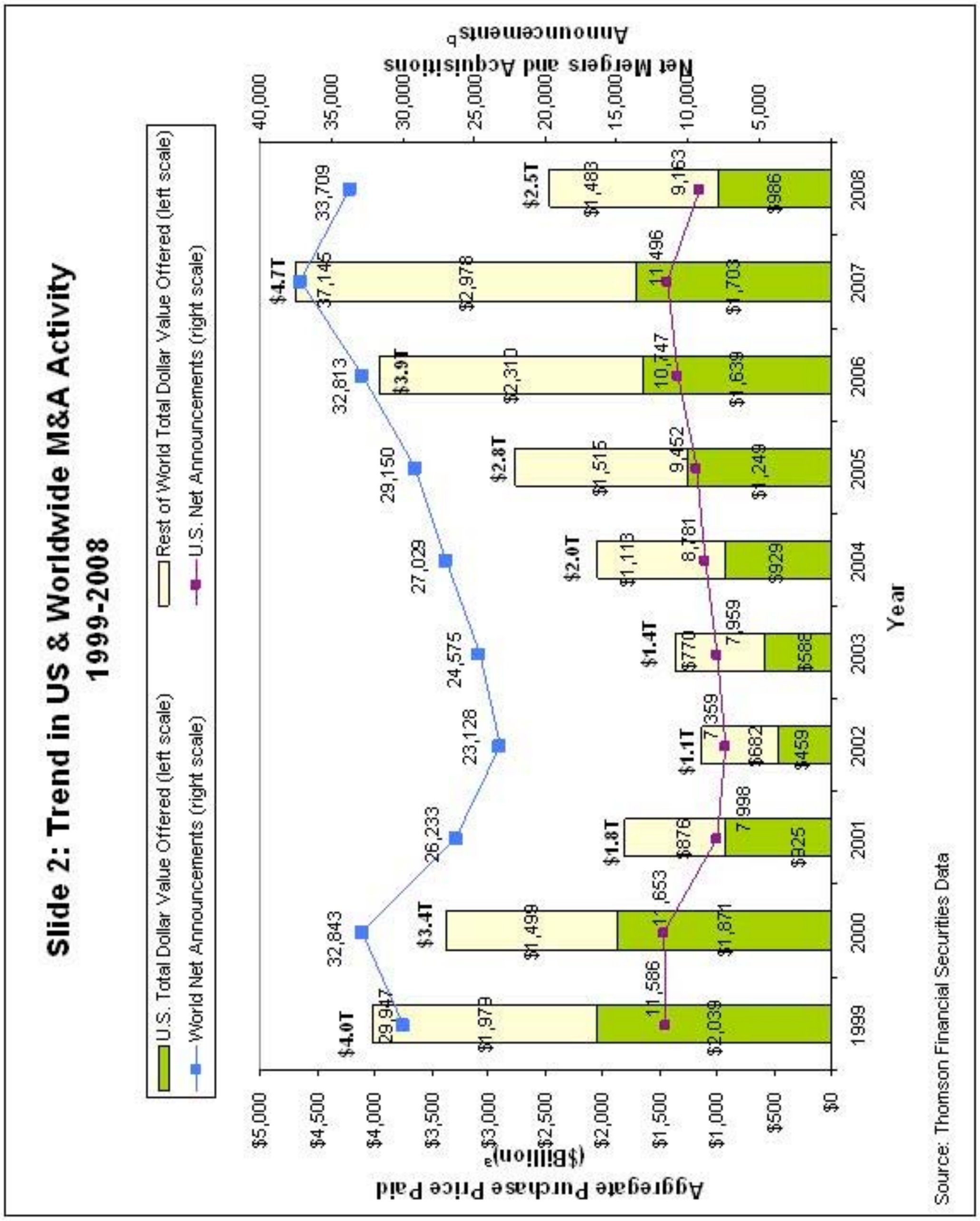

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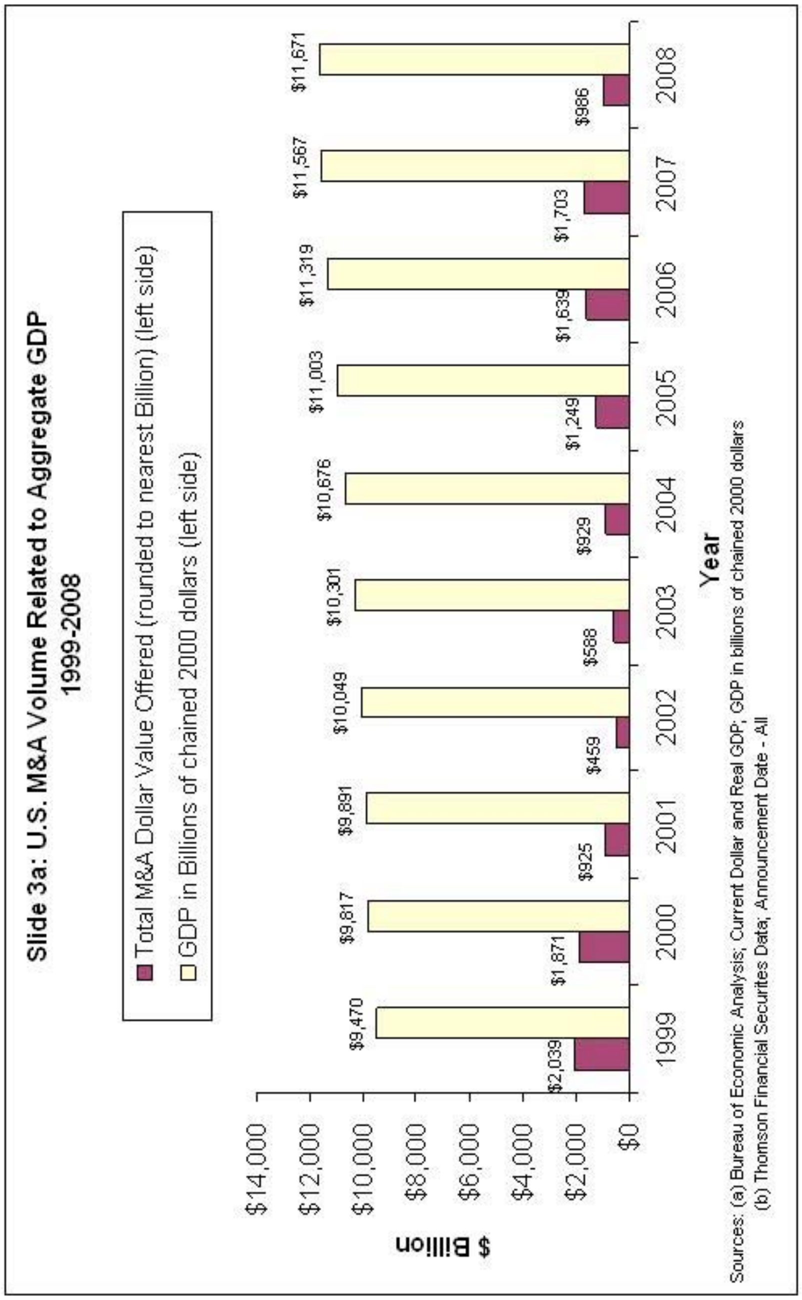

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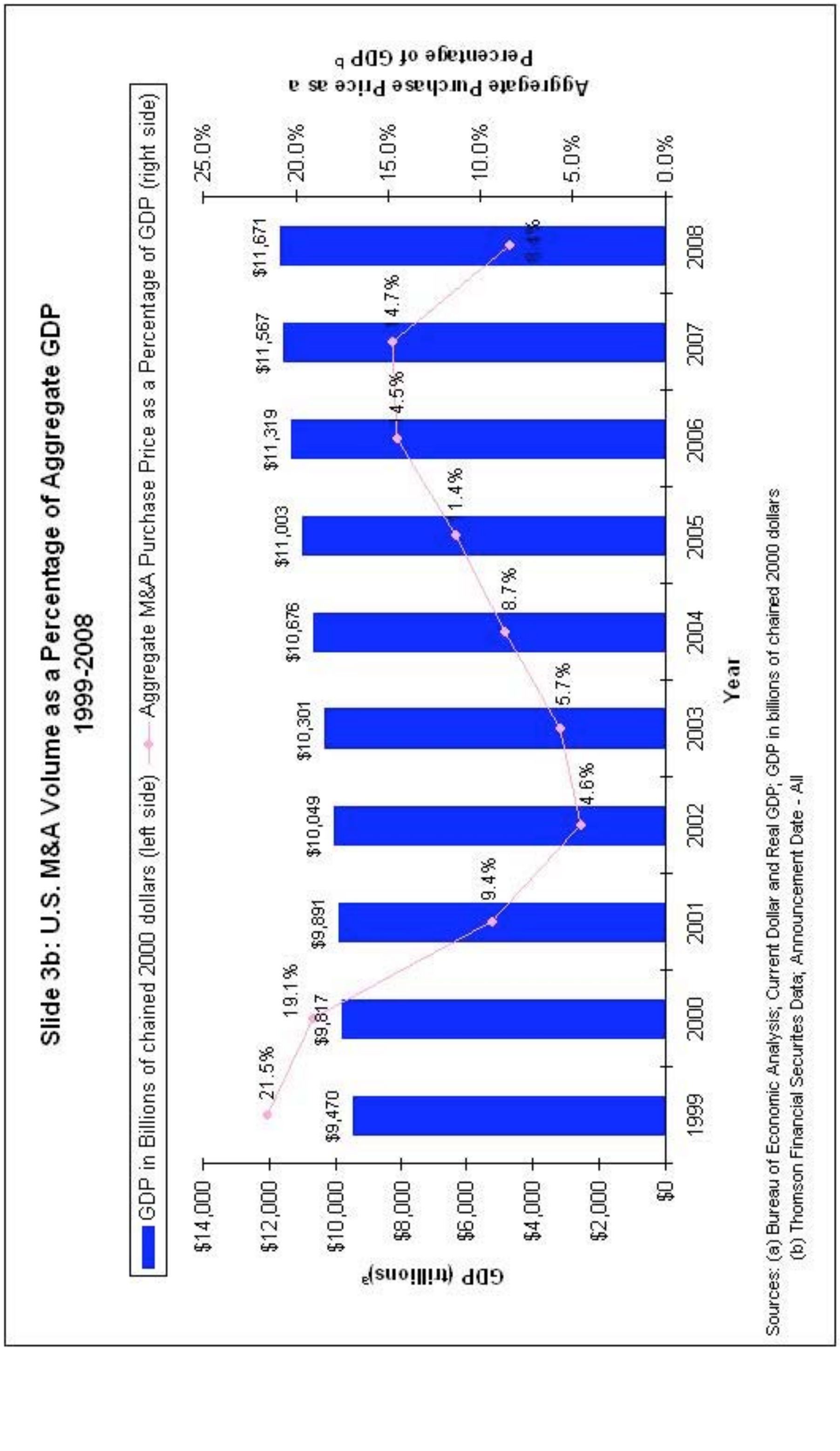

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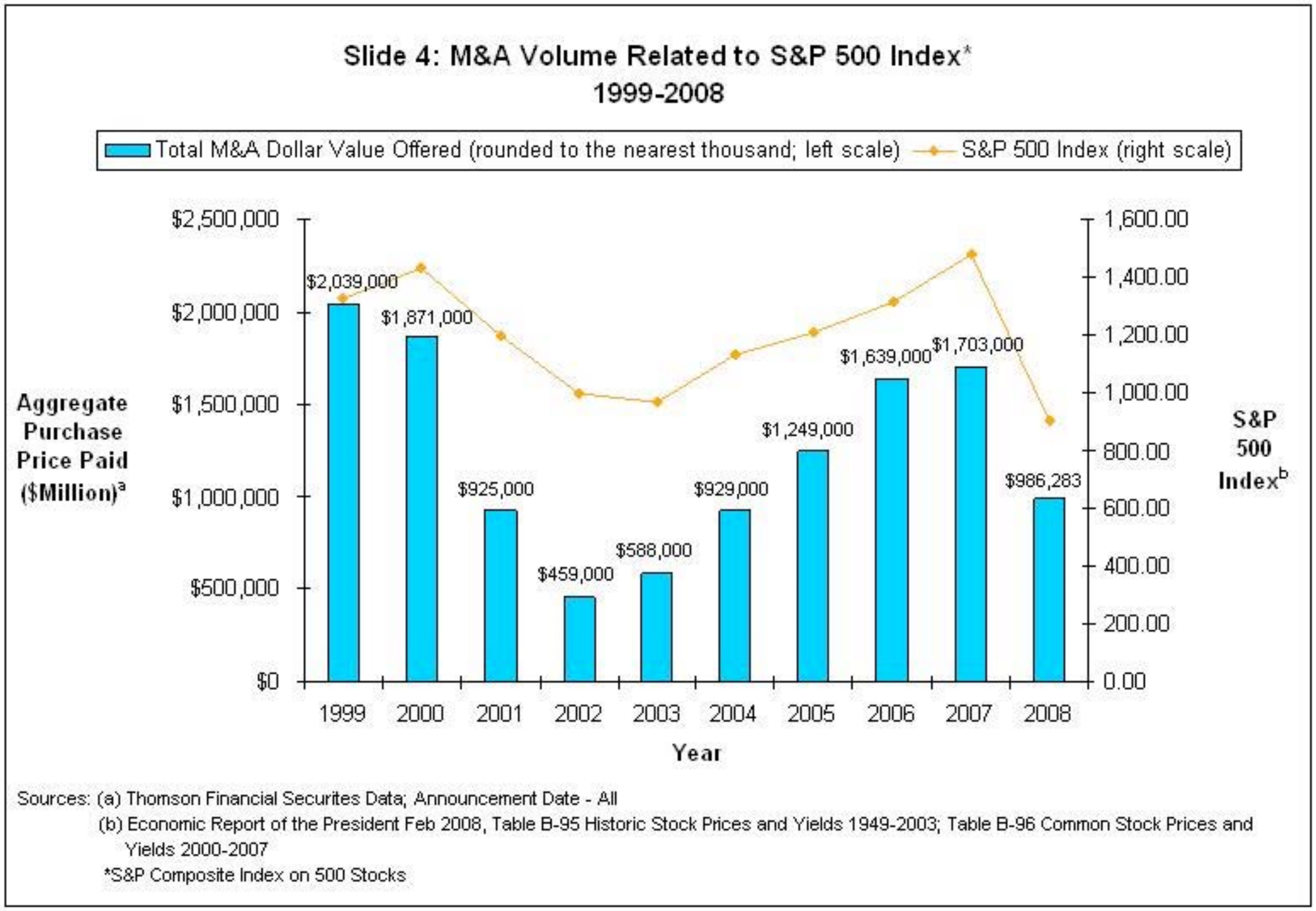

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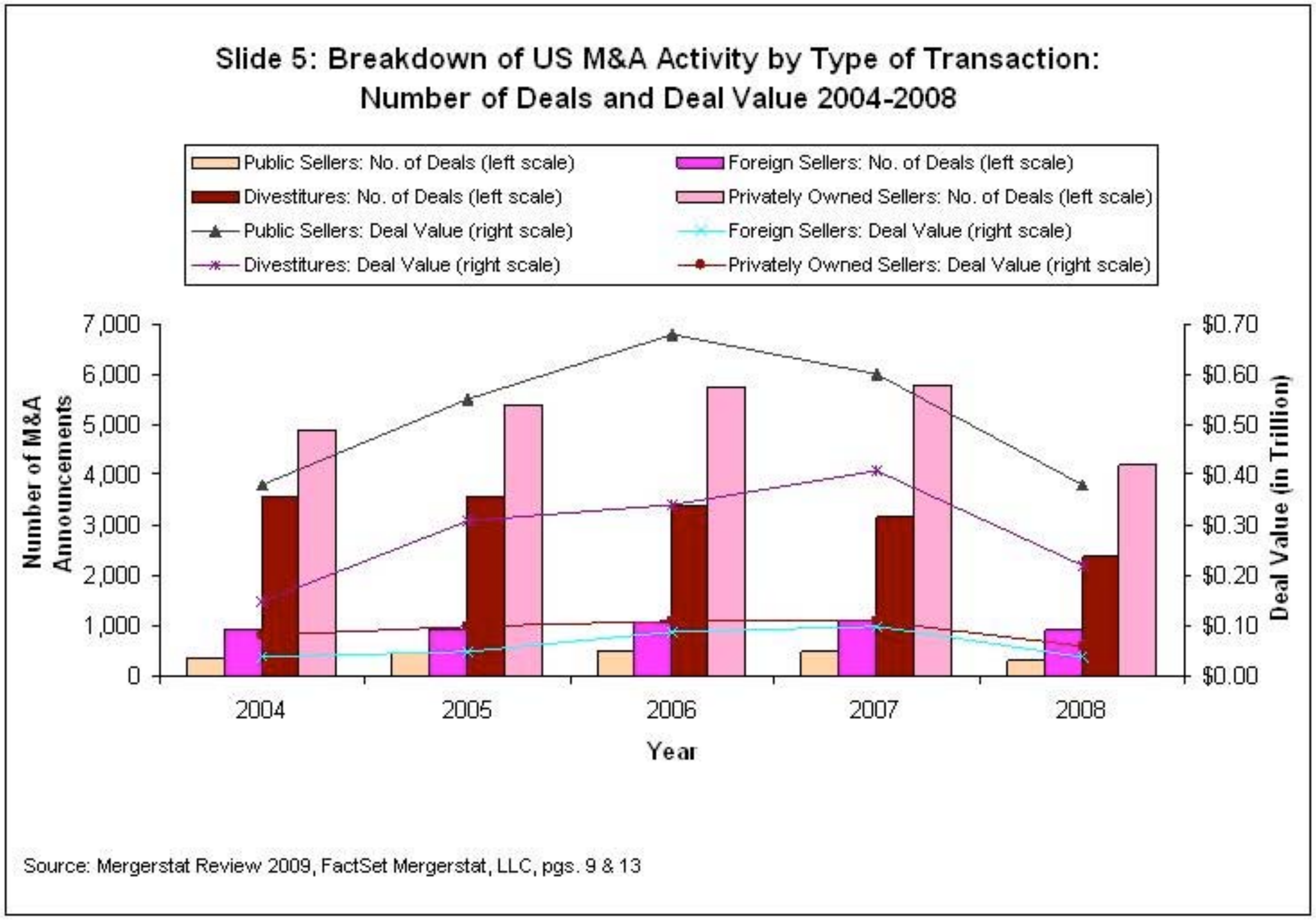

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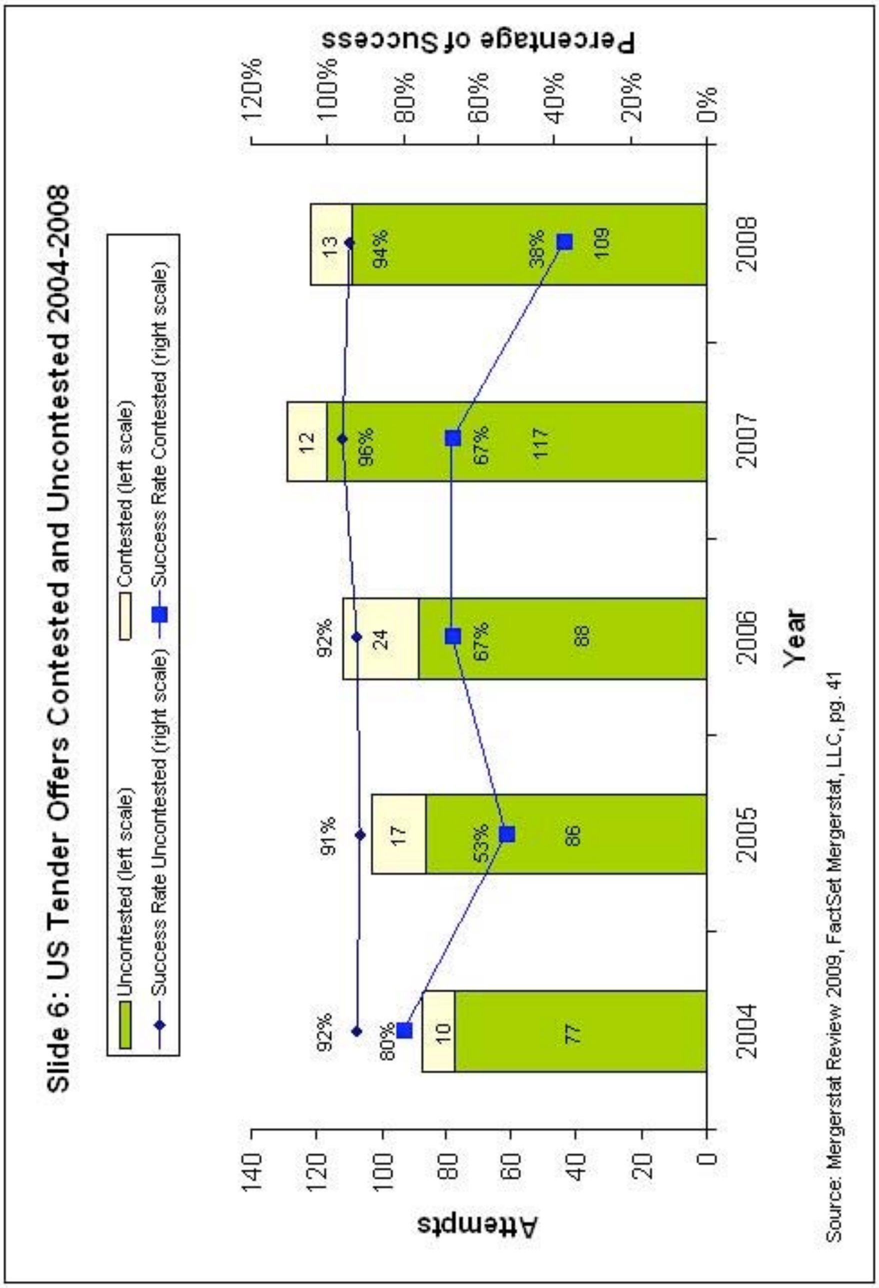

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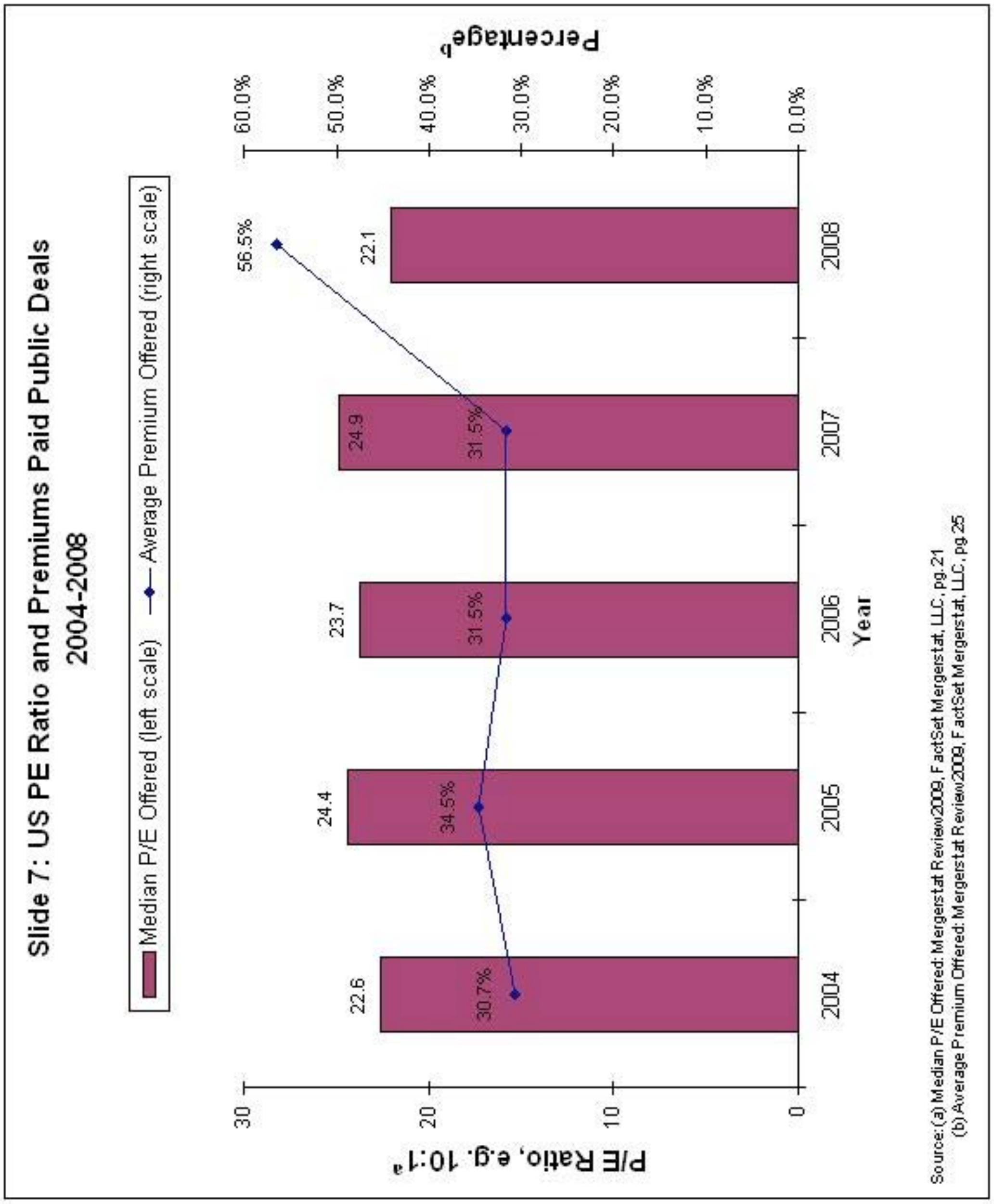

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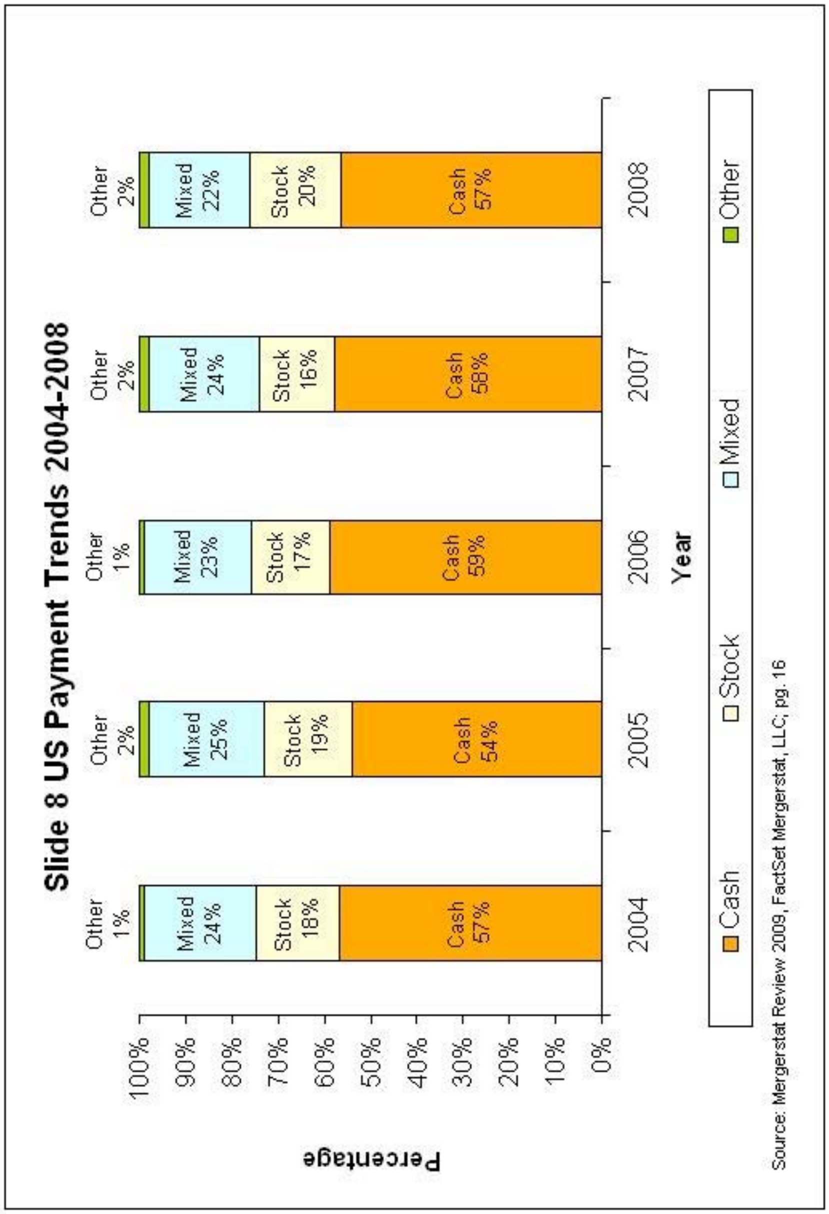
Slide 7b Illustration of Acquisition Meeting the Median P/E and Average Premium Offered

Slide 7a shows that for 2006 the median P/E offered was 23.7%, say 24%, and the average premium offered was 31.5%, say 33%.

To illustrate how these two measures interrelate assume that the Target Corporation (TC) has $1 of earnings per share and a pre-merger trading value of $18 per share. If TC is purchased for the 24% median P/E offered, the purchase price would be $24 per share, and the premium of $6 would be 33% of the $18 pre-merger trading value.

In the 2006 acquisition of Freescale Semiconductor, Inc. in a going private transaction, the P/E offered was 20.4 and the premium was 30.1%, close to the 24% median P/E and 31.5% average premium offered in 2006. Going Private: Twenty Largest Deals, Mergerstat Review 2007, FactSet Mergerstat, LLC, pg. 44.



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Slide 9: Acquisitions of Publicly Traded Companies 2004-2008

Year	Total Transactions (a)	Dollar Value offered (in billions) (a)	Method of Payment Cash	Stock	Combination	Other	Going Private as a Percent of Public Takeovers (c)
2004	372	$380	51%	22%	26%	1%	26.3%
2005	448	$551	55%	19%	26%	0%	31.7%
2006	488	$683	70%	14%	16%	0%	41.4%
2007	480	$603	66%	12%	21%	0%	33.5%
2008	309	$382	63%	18%	19%	0%	35%

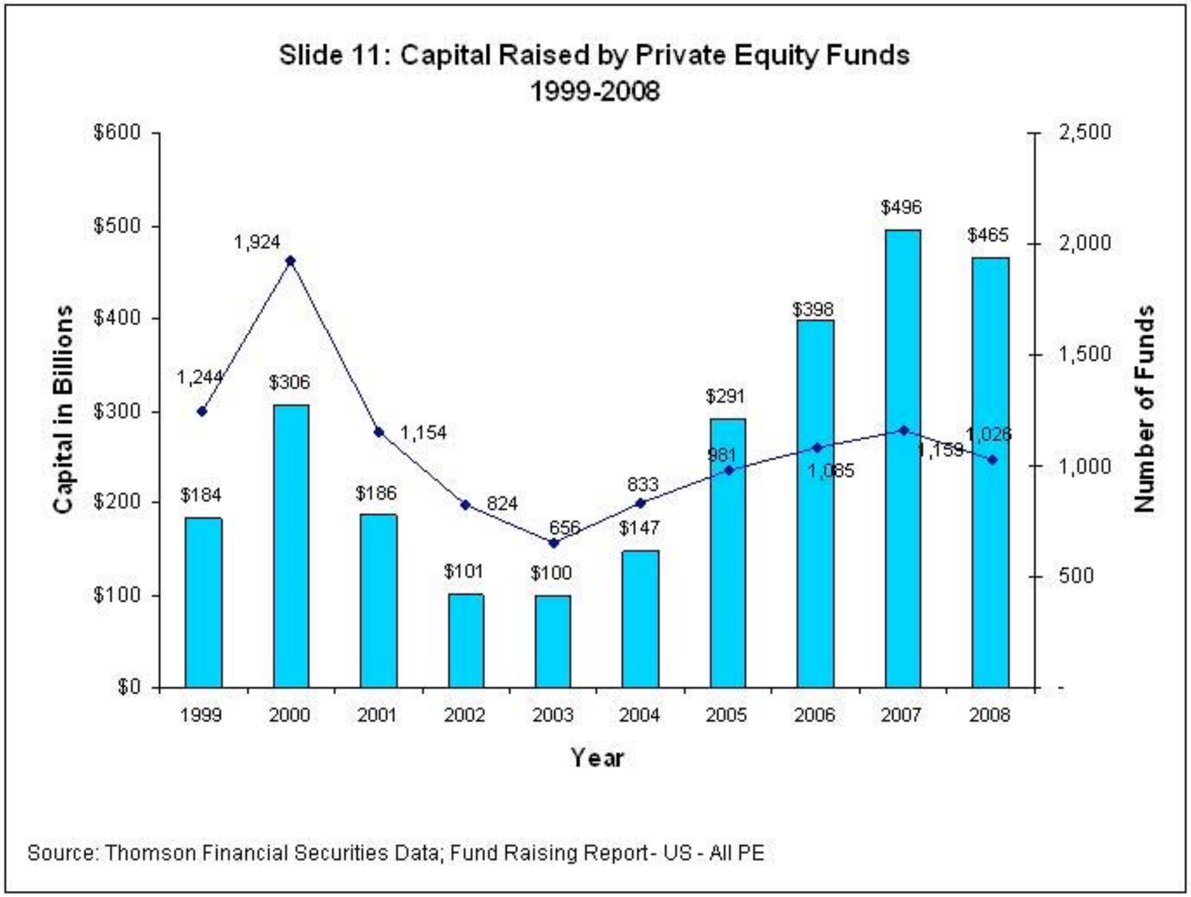
Sources:
(a) Publically Traded Sellers, Mergerstat Review 2009, FactSet Mergerstat LLC, pg. 37
(b) Acquisitions of Public Traded Companies by Method of Payment, Mergerstat Review 2009, FactSet Mergerstat LLC, pg. 38

Going Private, Mergerstat Review 2009, FactSet Mergerstat LLC, pg. 42 ("'going private' refers to an acquisition of a publicly traded company by a private investment group, individual, or a private company.")

Slide 10: Acquisitions of Privately Owned Companies 2004-2008

Year	Total Transactions (a)	Total Dollar Value offered (a) (in billions)	Method of Payment (b)			
			Cash	Stock	Combination	Other
2004	4,916	$79	40%	31%	28%	1%
2005	5,385	$104	41%	25%	32%	2%
2006	5,744	$110	48%	21%	30%	1%
2007	5,795	$113	47%	21%	31%	1%
2008	4,187	$58	44%	26%	28%	2%

Sources: (a) Privately Owned Sellers, Mergerstat Review 2009, FactSet Mergerstat LLC, pg. 46
Acquisitions of Privately Owned Companies by Method of Payment, Mergerstat Review 2009, FactSet Mergerstat LLC, pg. 4



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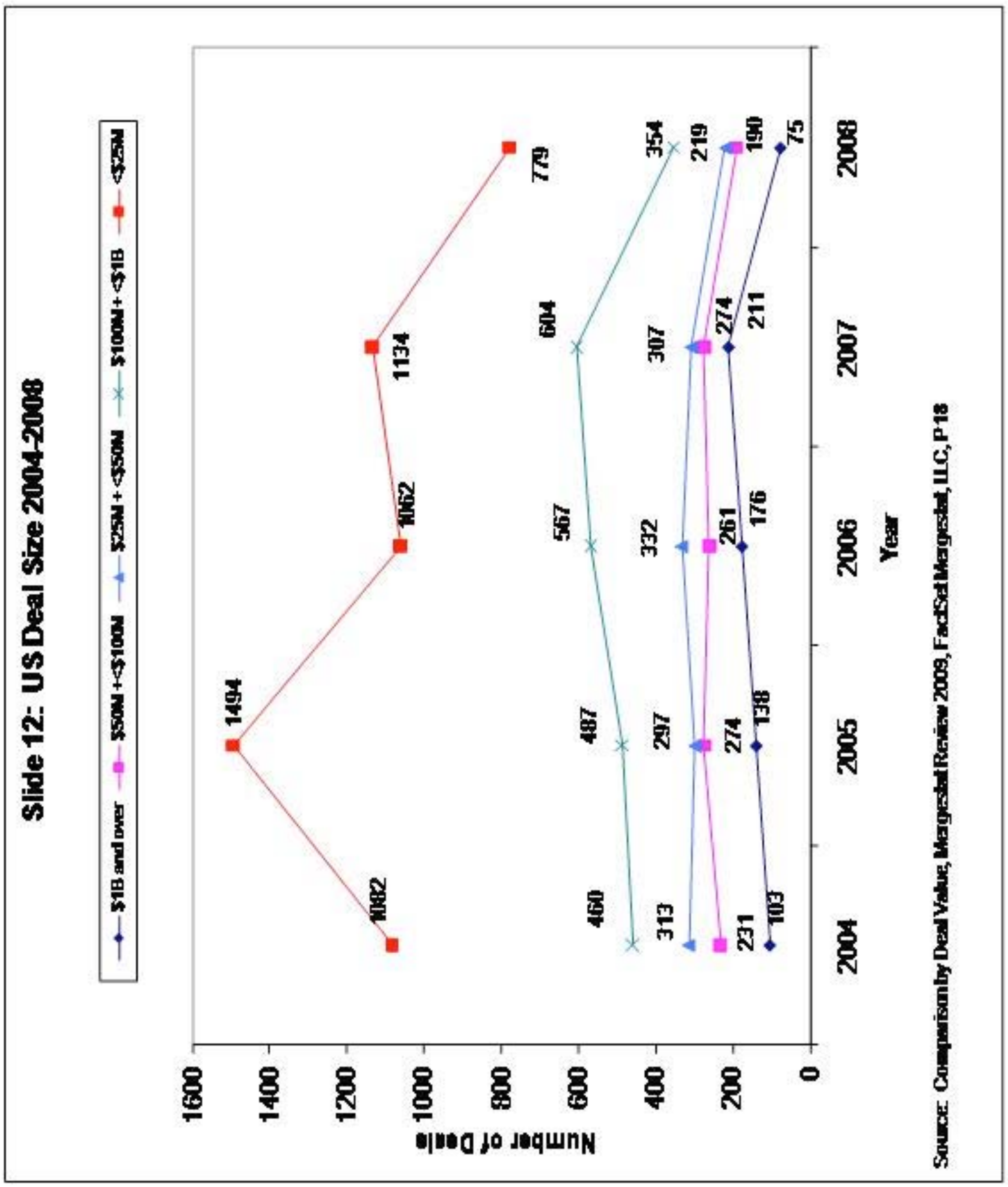

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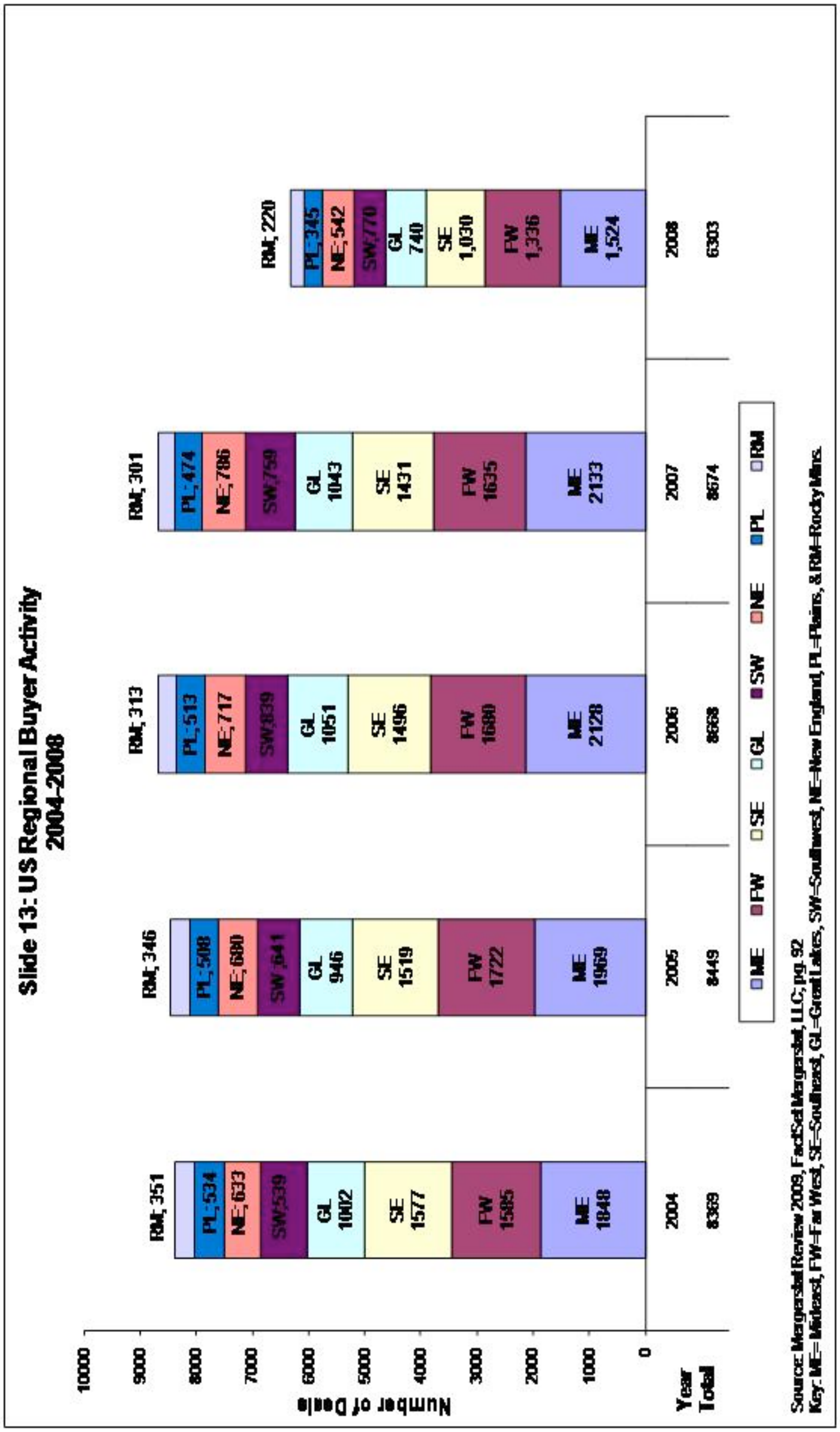

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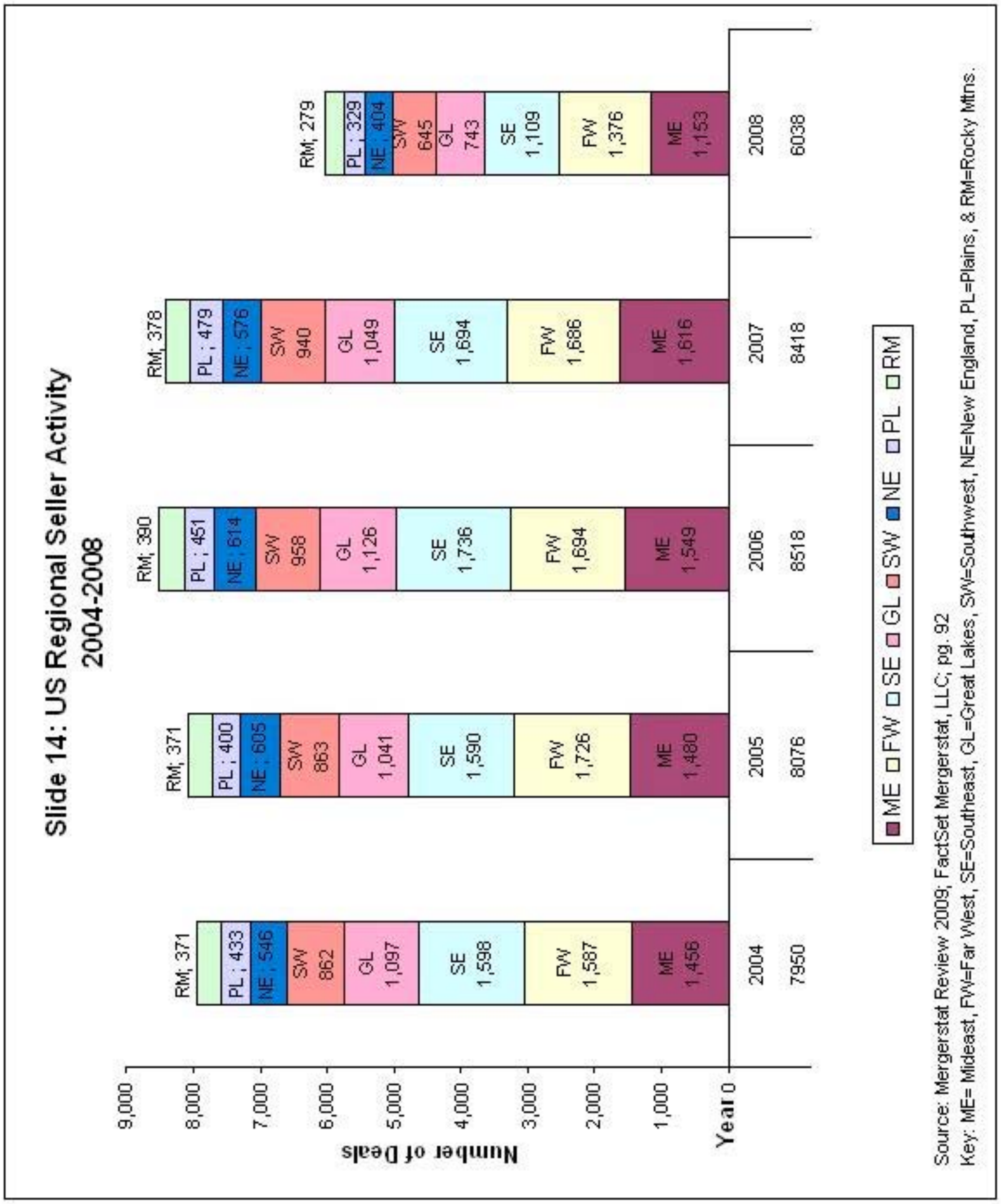
Slide 14: US Regional Seller Activity
2004-2008
Number of Deals
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
Year
2004
7950
2005
8076
2006
8518
2007
8418
2008
6038
RM; 371
PL ; 433
NE ; 546
SW 862
GL 1,097
SE 1,598
FW 1,587
ME 1,456
RM; 371
PL ; 400
NE ; 605
SW 863
GL 1,041
SE 1,590
FW 1,726
ME 1,480
RM; 390
PL ; 451
NE ; 614
SW 958
GL 1,126
SE 1,736
FW 1,694
ME 1,549
RM; 378
PL ; 479
NE ; 576
SW 940
GL 1,049
SE 1,694
FW 1,686
ME 1,616
RM; 279
PL ; 329
NE ; 404
SW 645
GL 743
SE 1,109
FW 1,376
ME 1,153
ME FW SE GL SW NE PL RM
Source: Mergerstat Review 2009; FactSet Mergerstat, LLC; pg. 92
Key: ME= Mideast, FW=Far West, SE=Southeast, GL=Great Lakes, SW=Southwest, NE=New England, PL=Plains, & RM=Rocky Mtns.
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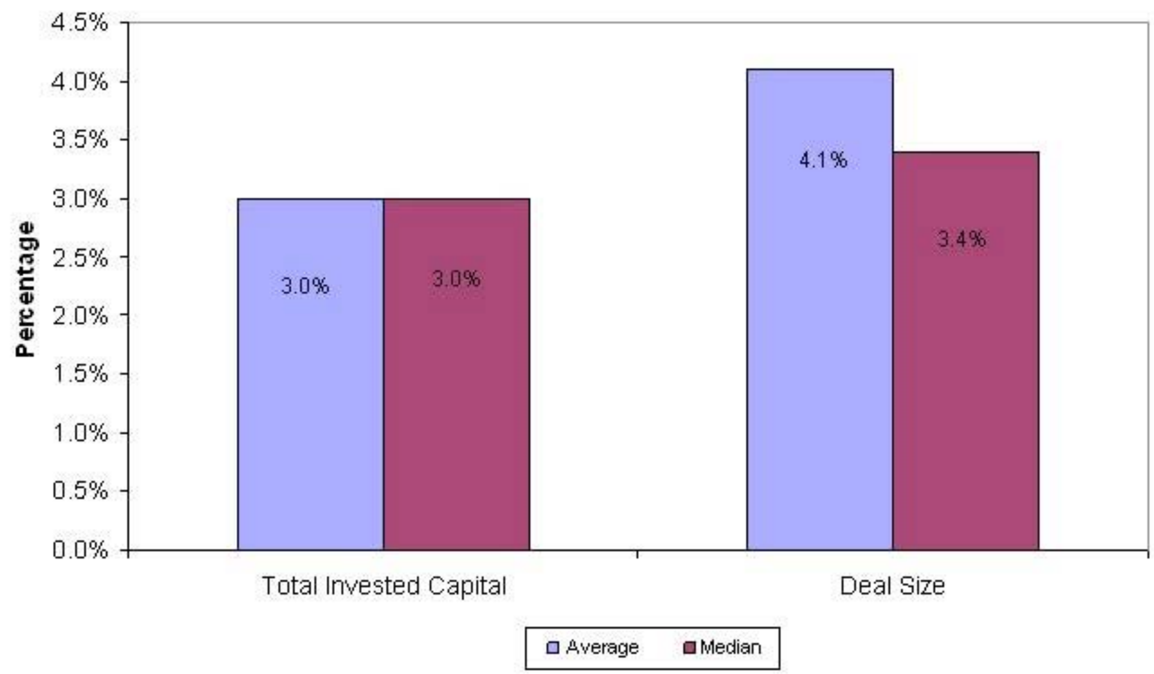
Slide 15: US Termination Fees Average and Median Percentage of Total Invested Capital and Deal Size (74% of Public Deals had Termination Fees, Less Than 1% of Other) for 2008



Source:Mergerstat Review 2009, FactSet Mergerstat, LLC, pg. 57

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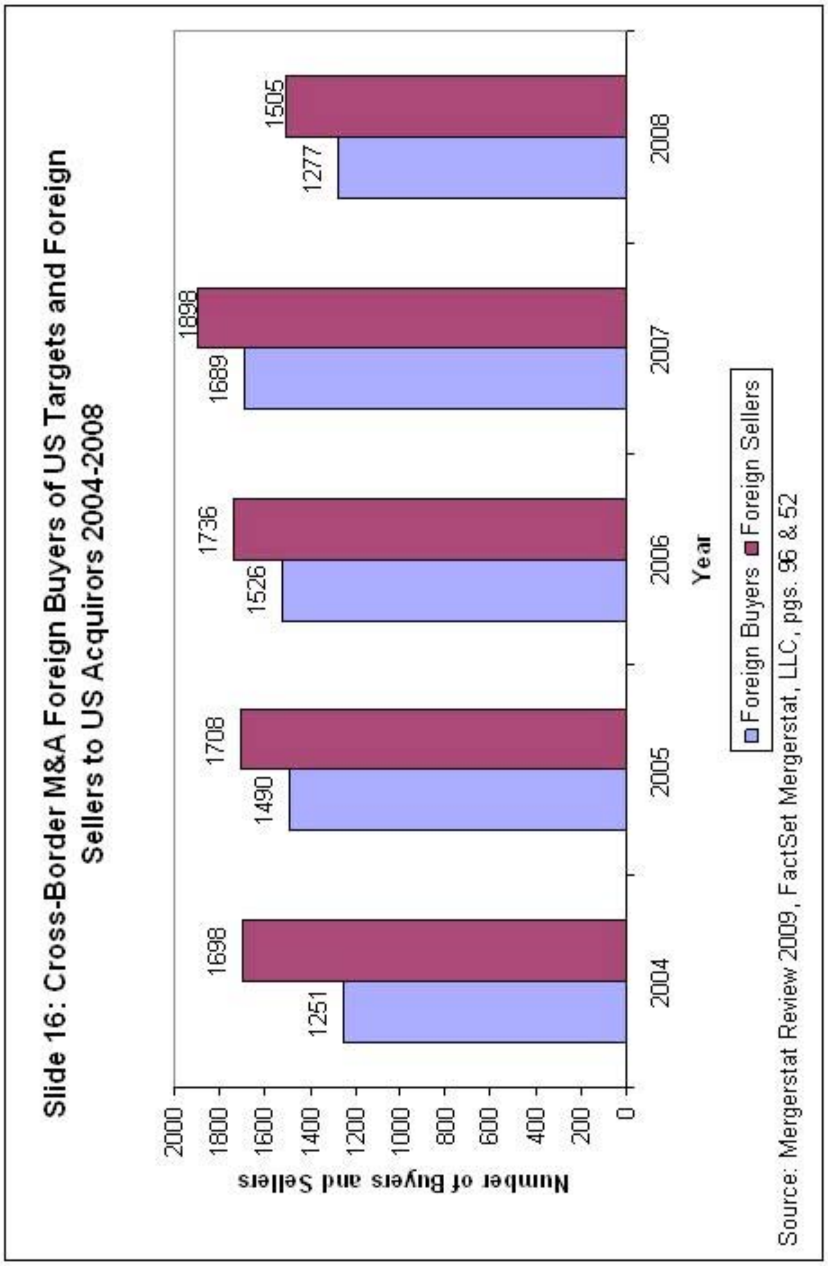

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Slide 17: Top 10 Foreign Buyer Countries by Deal Volume 2007 and 2008

2007			2008		
1	United Kingdom	66.5 Billion	1	Belgium	50.8 Billion
2	Canada	44.5 Billion	2	Switzerland	42.9 Billion
3	Netherlands	26.8 Billion	3	Japan	28.6 Billion
4	Germany	19.7 Billion	4	United Kingdom	15.7 Billion
5	Spain	17.1 Billion	5	France	14.5 Billion
6	Australia	15.3 Billion	6	Israel	8.4 Billion
7	Saudi Arabia	12.7 Billion	7	Canada	7.4 Billion
8	Bermuda	12.4 Billion	8	India	4.6 Billion
9	Japan	11.8 Billion	9	Italy	4.2 Billion
10	France	9.0 Billion	10	Brazil	4.2 Billion

Source: Mergerstat Review 2009, FactSet Mergerstat, LLC, pg. 100-101 (Buyers) and pg. 104-105 (Sellers)

Slide 18: Top 10 Foreign Seller Countries by Deal Volume 2007 and 2008

2007			2008		
1	United Kingdom	59.8 Billion	1	United Kingdom	22.3 Billion
2	Netherlands	50.5 Billion	2	Spain	12.9 Billion
3	Canada	27.9 Billion	3	China	11.9 Billion
4	Japan	21.7 Billion	4	Canada	7.7 Billion
5	Germany	16.6 Billion	5	Germany	7.5 Billion
6	France	13.5 Billion	6	Netherlands	5.8 Billion
7	Australia	7.1 Billion	7	Luxembourg	3.4 Billion
8	China	5.5 Billion	8	France	3.2 Billion
9	South Africa	3.5 Billion	9	Chile	2.7 Billion
10	Switzerland	3.0 Billion	10	Russian Federation	2.2 Billion
Source: Mergerstat Review 2009, FactSet Mergerstat, LLC, pg. 100-101 (Buyers) and pg. 104-105 (Sellers)					

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Slide 19: Top 10 M&A Investment Banking Firms and Law Firms Ranked by U.S. Deal Volume 2008

	Investment Banker Firms	Law Firm
1	Goldman Sachs Group, Inc.	Wachtell Lipton Rosen & Katz
2	JP Morgan Chase & Co., Inc.	Cravath, Swaine & Moore LLP
3	Perella Weinberg Partners LP	Sullivan & Cromwell LLP
4	Merrill Lynch & Co., Inc.	Weil, Gotshal & Manges LLP
5	Bank of America Corp.	Debevoise & Plimpton
6	Fox-Pitt Kelton Cochran Caronia Waller LLC	Shearman & Sterling LLP
7	J.C. Flowers & Co. LLC	Skadden, Arps, Slate, Meagher & Flom LLP
8	Citigroup, Inc.	Lantham & Watkins LLP
9	Morgan Stanley	Simpson Thacker & Bartlett LLP
10	Lazard	Freshfields Bruckhaus Deringer
Source: MergerStat 2009; FactSet Mergerstat, LLC; pg. 54-55		

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II. CHAPTER 3, DIRECTORS' DUTIES IN MERGERS AND ACQUISITIONS

A. Page 117, New Sec. 3.10.D.1. Delaware Supreme Court's View of Caremark Claims and Elaboration on Good Faith--Stone

Page 117, New Sec. 3.10.D.1. Add before Sec. 3.10.E the following:
New Sec. 3.10.D.1. **Delaware Supreme Court's View of Caremark Claims and Elaboration on Good Faith—*Stone***

Stone v. Ritter
Delaware Supreme Court 2006
911 A.2d 362

HOLLAND, Justice:

This is an appeal from a final judgment of the Court of Chancery dismissing a derivative complaint against fifteen present and former directors of AmSouth Bancorporation ("AmSouth"), a Delaware corporation. The plaintiffs-appellants, William and Sandra Stone, are AmSouth shareholders and filed their derivative complaint without making a pre-suit demand on AmSouth's board of directors (the "Board"). The Court of Chancery held that the plaintiffs had failed to adequately plead that such a demand would have been futile. The Court, therefore, dismissed the derivative complaint under Court of Chancery Rule 23.1.

The Court of Chancery characterized the allegations in the derivative complaint as a "classic *Caremark* claim," a claim that derives its name from *In re Caremark Int'l Deriv. Litig.* [1] In *Caremark*, the Court of Chancery recognized that: "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." [2]

FOOTNOTES

1 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

2 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d at 971; *see also David B. Shaev Profit Sharing Acct. v. Armstrong*, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *5 (Del. Ch.); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).

In this appeal, the plaintiffs acknowledge that the directors neither "knew [n]or should have known that violations of law were occurring," *i.e.*, that there were no "red flags" before the directors. Nevertheless, the plaintiffs argue that the Court of Chancery erred by dismissing the derivative complaint which alleged that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention." The defendants argue that the plaintiffs' assertions are contradicted by the derivative complaint itself and by the documents incorporated therein by reference.

Consistent with our opinion in *In re Walt Disney Co. Deriv Litig*, we hold that *Caremark* articulates the necessary conditions for assessing director oversight liability. [3] We also conclude that the *Caremark* standard was properly applied to evaluate the derivative complaint in this case. Accordingly, the judgment of the Court of Chancery must be affirmed.

FOOTNOTES

3 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

Facts

This derivative action is brought on AmSouth's behalf by William and Sandra Stone, who allege that they owned AmSouth common stock "at all relevant times." The nominal defendant, AmSouth, is a Delaware corporation with its principal executive offices in Birmingham, Alabama. During the relevant period, AmSouth's wholly-owned subsidiary, AmSouth Bank, operated about 600 commercial banking branches in six states throughout the southeastern United States and employed more than 11,600 people.

In 2004, AmSouth and Amsouth Bank paid $40 million in fines and $10 million in civil penalties to resolve government and regulatory

investigations pertaining principally to the failure by bank employees to file "Suspicious Activity Reports" ("SARs"), as required by the federal Bank Secrecy Act ("BSA") [4] and various anti-money-laundering ("AML") regulations. [5] Those investigations were conducted by the United States Attorney's Office for the Southern District of Mississippi ("USAO"), the Federal Reserve, FinCEN and the Alabama Banking Department. No fines or penalties were imposed on AmSouth's directors, and no other regulatory action was taken against them.

FOOTNOTES

4 31 U.S.C. 5318 (2006) *et seq.* The Bank Secrecy Act and the regulations promulgated

thereunder require banks to file with the Financial Crimes Enforcement Network, a bureau of the U.S. Department of the Treasury known as "FinCEN," a written "Suspicious Activity Report" (known as a "SAR") whenever, *inter alia*, a banking transaction involves at least $5,000 "and the bank knows, suspects, or has reason to suspect" that, among other possibilities, the "transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities. . . ." 31 U.S.C. 5318(g) (2006); 31 C.F.R. 103.18(a)(2) (2006).

5 *See*, *e.g.*, 31 C.F.R. 103.18(a)(2) (2006).

The government investigations arose originally from an unlawful "Ponzi" scheme operated by Louis D. Hamric, II and Victor G. Nance. In August 2000, Hamric, then a licensed attorney, and Nance, then a registered investment advisor with Mutual of New York, contacted an AmSouth branch bank in Tennessee to arrange for custodial trust accounts to be created for "investors" in a "business venture." That venture (Hamric and Nance represented) involved the construction of medical clinics overseas. In reality, Nance had convinced more than forty of his clients to invest in promissory notes bearing high rates of return, by misrepresenting the nature and the risk of that investment. Relying on similar misrepresentations by Hamric and Nance, the AmSouth branch employees in Tennessee agreed to provide custodial accounts for the investors and to distribute monthly interest payments to each account upon receipt of a check from Hamric and instructions from Nance.

The Hamric-Nance scheme was discovered in March 2002, when the investors did not receive their monthly interest payments. Thereafter, Hamric and Nance became the subject of several civil actions brought by the defrauded investors in Tennessee and Mississippi (and in which AmSouth also was named as a defendant), and also the subject of a federal grand jury investigation in the Southern District of Mississippi. Hamric and Nance were indicted on federal money-laundering charges, and both pled guilty.

The authorities examined AmSouth's compliance with its reporting and other obligations under the BSA. On November 17, 2003, the USAO advised AmSouth that it was the subject of a criminal investigation. On October 12, 2004, AmSouth and the USAO entered into a Deferred Prosecution Agreement ("DPA") in which AmSouth agreed: first, to the filing by USAO of a one-count Information in the United States District Court for the Southern District of Mississippi, charging AmSouth with failing to file SARs; and second, to pay a $40 million fine. In conjunction with the DPA, the USAO issued a "Statement of Facts," which noted that although in 2000 "at least one" AmSouth employee suspected that Hamric was involved in a possibly illegal scheme, AmSouth failed to file SARs in a timely manner. In neither the Statement of Facts nor anywhere else did the USAO ascribe any blame to the Board or to any individual director.

On October 12, 2004, the Federal Reserve and the Alabama Banking Department concurrently issued a Cease and Desist Order against AmSouth, requiring it, for the first time, to improve its BSA/AML program. That Cease and Desist Order required AmSouth to (among other things) engage an independent consultant "to conduct a comprehensive review of the Bank's AML Compliance program and make recommendations, as appropriate, for new policies and procedures to be implemented by the Bank." KPMG Forensic Services ("KPMG") performed the role of independent consultant and issued its report on December 10, 2004 (the "KPMG Report").

Also on October 12, 2004, FinCEN and the Federal Reserve jointly assessed a $10 million civil penalty against AmSouth for operating an inadequate anti-money-laundering program and for failing to file SARs. In connection with that assessment, FinCEN issued a written Assessment of Civil Money Penalty (the "Assessment"), which included detailed "determinations" regarding AmSouth's BSA compliance procedures. FinCEN found that "AmSouth violated the suspicious activity reporting requirements of the Bank Secrecy Act," and that "[s]ince April 24, 2002, AmSouth has been in violation of the anti-money-laundering program requirements of the Bank Secrecy Act." Among FinCEN's specific determinations were its conclusions that "AmSouth's [AML compliance] program lacked adequate board and management oversight," and that "reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient." AmSouth neither admitted nor denied FinCEN's determinations in this or any other forum.

Demand Futility and Director Independence

It is a fundamental principle of the Delaware General Corporation Law that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ." [6] Thus, "by its very nature [a] derivative action impinges on the managerial freedom of directors." [7] Therefore, the right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation. [8] Court of Chancery Rule 23.1, accordingly, requires that the complaint in a derivative action "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort." [9]

FOOTNOTES

6 Del. Code Ann. tit. 8, 141(a) (2006). *See Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993).

7 *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984).

8 *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

9 Ch. Ct. R. 23.1. Allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner*, 746 A.2d at 254.

———

In this appeal, the plaintiffs concede that "[t]he standards for determining demand futility in the absence of a business decision" are set forth in *Rales v. Blasband*. [10] To excuse demand under *Rales*, "a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." [11] The plaintiffs attempt to satisfy the *Rales* test in this proceeding by asserting that the incumbent defendant directors "face a substantial likelihood of liability" that renders them "personally interested in the outcome of the decision on whether to pursue the claims asserted in the complaint," and are therefore not disinterested or independent. [12]

FOOTNOTES

10 *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

11 *Id*. at 934.

12 The fifteen defendants include eight current and seven former directors. The complaint concedes that seven of the eight current directors are outside directors who have never been employed by AmSouth. One board member, C. Dowd Ritter, the Chairman, is an officer or employee of AmSouth.

———

Critical to this demand excused argument is the fact that the directors' potential personal liability depends upon whether or not their conduct can be exculpated by the section 102(b)(7) provision contained in the AmSouth certificate of incorporation. [13] Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty. [14] The standard for assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities has evolved beginning with our decision in *Graham v. Allis-Chalmers Manufacturing Company*, [15] through the Court of Chancery's *Caremark* decision to our most recent decision in *Disney*. [16] A brief discussion of that evolution will help illuminate the standard that we adopt in this case.

FOOTNOTES

13 Del. Code Ann. tit. 8, 102(b)(7) (2006).

14 *Id.*; *see In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

15 *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963).

16 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

Graham and Caremark

Graham was a derivative action brought against the directors of Allis-Chalmers for **[*368]** failure to prevent violations of federal anti-trust laws by Allis-Chalmers employees. There was no claim that the Allis-Chalmers directors knew of the employees' conduct that resulted in the corporation's liability. Rather, the plaintiffs claimed that the Allis-Chalmers directors *should have known* of the illegal conduct by the corporation's employees. In *Graham*, this Court held that "*absent cause for suspicion* there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." [17]

FOOTNOTES

17 *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d at 130 (emphasis added).

In *Caremark*, the Court of Chancery reassessed the applicability of our holding in *Graham* when called upon to approve a settlement of a derivative lawsuit brought against the directors of Caremark International, Inc. The plaintiffs claimed that the Caremark directors should have known that certain officers and employees of Caremark were involved in violations of the federal Anti-Referral Payments Law. That law prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. The plaintiffs claimed that the *Caremark* directors breached their fiduciary duty for having "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance." [18]

FOOTNOTES

18 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

In evaluating whether to approve the proposed settlement agreement in *Caremark*, the Court of Chancery narrowly construed our holding in *Graham* "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior

officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." [19] The *Caremark* Court opined it would be a "mistake" to interpret this Court's decision in *Graham* to mean that:
corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance. [20]

FOOTNOTES

19 *Id*. at 969.

20 *Id*. at 970.

To the contrary, the *Caremark* Court stated, "it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility." [21] The *Caremark* Court recognized, however, that "the duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise." [22] The Court of Chancery then formulated the following standard for assessing the liability of directors where the directors are unaware of employee misconduct that results in the corporation being held liable:
Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in this case, . . . only a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists-will establish the lack of good faith that is a necessary condition to liability. [23]

FOOTNOTES

21 *Id*.

22 *Id*. at 971.

23 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d at 971.

Caremark Standard Approved

As evidenced by the language quoted above, the *Caremark* standard for so-called "oversight" liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent *Disney* [24] decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). [25] In *Disney*, we identified the following examples of conduct that would establish a failure to act in good faith:

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. [26]

FOOTNOTES

24 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

25 *Id*. at 66.

26 *Id*. at 67.

The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* court held was a "necessary condition" for director oversight liability, i.e., "a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists . . . ." [27]

Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition. [28] Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case where failure to exercise oversight was the basis or theory of the plaintiffs' claim for relief.

FOOTNOTES

27 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

28 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 67 n.111.

It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here--describing the lack of good faith as a "necessary condition to liability"--is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. [29] The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." [30] It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

FOOTNOTES

29 That issue, whether a violation of the duty to act in good faith is a basis for the direct imposition of liability, was expressly left open in *Disney*. 906 A.2d at 67 n.112. We address that issue here.

30 *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, [31] the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest." [32]

FOOTNOTES

31 *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

32 *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. [33] Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, [34] they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. [35]

FOOTNOTES

33 *Id*. at 506.

34 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006).

35 *See Guttman v. Haung*, 823 A.2d at 506.

Chancery Court Decision

The plaintiffs contend that demand is excused under Rule 23.1 because AmSouth's directors breached their oversight duty and, as a result, face a "substantial likelihood of liability" as a result of their "utter failure" to act in good faith to put into place policies and procedures to ensure compliance with BSA and AML obligations. The Court of Chancery found that the plaintiffs did not plead the existence of "red flags" -- "facts showing that the board ever was aware that AmSouth's internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed." In dismissing the derivative complaint in this action, the Court of Chancery concluded:

This case is not about a board's failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls. . . . With the benefit of hindsight, it is beyond question that AmSouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine--$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible. [36]

This Court reviews *de novo* a Court of Chancery's decision to dismiss a derivative suit under Rule 23.1. [37]

FOOTNOTES

36 *Stone v. Ritter*, 2006 Del. Ch. LEXIS 20, C.A. No. 1570-N (Del. Ch. 2006) (Letter Opinion).

37 *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

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Reasonable Reporting System Existed

The KPMG Report evaluated the various components of AmSouth's longstanding BSA/AML compliance program. The KPMG Report reflects that AmSouth's Board dedicated considerable resources to the BSA/AML compliance program and put into place numerous procedures and systems to attempt to ensure compliance. According to KPMG, the program's various components exhibited between a low and high degree of compliance with applicable laws and regulations.

The KPMG Report describes the numerous AmSouth employees, departments and committees established by the Board to oversee AmSouth's compliance with the BSA and to report violations to management and the Board:
BSA Officer. Since 1998, AmSouth has had a "BSA Officer" "responsible for all BSA/AML-related matters including employee training, general communications, CTR reporting and SAR reporting," and "presenting AML policy and program changes to the Board of Directors, the managers at the various lines of business, and participants in the annual training of security and audit personnel[;]"

BSA/AML Compliance Department. AmSouth has had for years a BSA/AML Compliance Department, headed by the BSA Officer and comprised of nineteen professionals, including a BSA/AML Compliance Manager and a Compliance Reporting Manager;

Corporate Security Department. AmSouth's Corporate Security Department has been at all relevant times responsible for the detection and reporting of suspicious activity as it relates to fraudulent activity, and William Burch, the head of Corporate Security, has been with AmSouth since 1998 and served in the U.S. Secret Service from 1969 to 1998; and

Suspicious Activity Oversight Committee. Since 2001, the "Suspicious Activity Oversight Committee" and its predecessor, the "AML Committee," have actively overseen AmSouth's BSA/AML compliance program. The Suspicious Activity Oversight Committee's mission has for years been to "oversee the policy, procedure, and process issues affecting the Corporate Security and BSA/AML Compliance Programs, to ensure that an effective program exists at AmSouth to deter, detect, and report money laundering, suspicious activity and other fraudulent activity."

The KPMG Report reflects that the directors not only discharged their oversight responsibility to establish an information and reporting system, but also proved that the system was designed to permit the directors to periodically monitor AmSouth's compliance with BSA and AML regulations. For example, as KPMG noted in 2004, AmSouth's designated BSA Officer "has made annual high-level presentations to the Board of Directors in each of the last five years." Further, the Board's Audit and Community Responsibility Committee (the "Audit Committee") oversaw AmSouth's BSA/AML compliance program on a quarterly basis. The KPMG Report states that "the BSA Officer presents BSA/AML training to the Board of Directors annually," and the "Corporate Security training is also presented to the Board of Directors."

The KPMG Report shows that AmSouth's Board at various times enacted written policies and procedures designed to ensure compliance with the BSA and AML regulations. For example, the Board adopted an amended bank-wide "BSA/AML Policy" on July 17, 2003--four months before AmSouth became aware that it was the target of a government investigation. That policy was produced to plaintiffs in response to their demand to inspect AmSouth's books and records pursuant to section 220 [38] and is included in plaintiffs' appendix. Among other things, the July 17, 2003, BSA/AML Policy directs all AmSouth employees to immediately report suspicious transactions or activity to the BSA/AML Compliance Department or Corporate Security.

FOOTNOTES

38 Del. Code Ann. tit. 8, 220 (2006).

Complaint Properly Dismissed

In this case, the adequacy of the plaintiffs' assertion that demand is excused depends on whether the complaint alleges facts sufficient to show that the defendant *directors* are potentially personally liable for the failure of non-director bank *employees* to file SARs. Delaware courts have recognized that "[m]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention." [39] Consequently, a claim that directors are subject to personal liability for employee failures is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." [40]

FOOTNOTES

39 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d at 968.

40 *Id.* at 967.

For the plaintiffs' derivative complaint to withstand a motion to dismiss, "only a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." [41] As the *Caremark* decision noted:

Such a test of liability--lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight--is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors. [42]

FOOTNOTES

41 *Id*. at 971.

42 *Id*. (emphasis in original).

The KPMG Report--which the plaintiffs explicitly incorporated by reference into their derivative complaint--refutes the assertion that the directors "never took the necessary steps . . . to ensure that a reasonable BSA compliance and reporting system existed." KPMG's findings reflect that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.

With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs' argument is a failure to recognize that the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham*, *Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome. [43] Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs' derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.

FOOTNOTES

43 *Id*. at 967-68, 971.

Conclusion

The judgment of the Court of Chancery is affirmed.

B. Page 117, New Sec. 3.10.D.2. The Business Judgment Rule and the Financial Crisis-Citigroup and AIG

Page 117, New Sec. 3.10.D.2. Add after the New Sec. 3.10.D.1 the following:
New Sec. 3.10.D.2. **The Business Judgment Rule and the Financial Crisis-Citigroup and AIG**

In Re Citigroup Inc. Shareholder Derivative Litigation,
Delaware Chancery Court, 964 A.2d 106, 2009
(**The AIG case is discussed in Citigroup**.)

CHANDLER, Chancellor

This is a shareholder derivative action brought on behalf of Citigroup Inc. ("Citigroup" or the "Company"), seeking to recover for the Company its losses arising from exposure to the subprime lending market. Plaintiffs, shareholders of Citigroup, brought this action against current and former directors and officers of Citigroup, alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets. Plaintiffs allege that there were extensive "red flags" that should have given defendants notice of the problems that were brewing in the real estate and credit markets and that defendants ignored these warnings in the pursuit of short term profits and at the expense of the Company's long term viability.

Plaintiffs further allege that certain defendants are liable to the Company for corporate waste for (1) allowing the Company to purchase $ 2.7 billion in subprime loans from Accredited Home Lenders in March 2007 and from Ameriquest Home Mortgage in September 2007; (2) authorizing and not suspending the Company's share repurchase program in the first quarter of 2007, which allegedly resulted in the Company buying its own shares at "artificially inflated prices;" (3) approving a multi-million dollar payment and benefit package for defendant Charles Prince, whom plaintiffs describe as largely responsible for Citigroup's problems, upon his retirement as Citigroup's CEO in November 2007; and (4) allowing the Company to invest in structured investment vehicles ("SIVs") that were unable to pay off maturing debt.

Pending before the Court is defendants' motion (1) to dismiss or stay the action in favor of an action pending in the Southern District of New York (the "New York Action") or (2) to dismiss the complaint for failure to state a claim under Court of Chancery Rule 12(b)(6) and for failure to properly plead demand futility under Court of Chancery Rule 23.1. For the reasons set forth below, the motion to stay or dismiss in favor of the New York Action is denied. The motion to dismiss is denied as to the claim in Count III for waste for approval of the November 4, 2007 Prince letter agreement. All other claims are dismissed for failure to adequately plead demand futility pursuant to Rule 23.1.

I. BACKGROUND * * *

II. MOTION TO DISMISS OR STAY IN FAVOR OF THE NEW YORK ACTION * * *

III. THE MOTION TO DISMISS UNDER RULE 23.1

A. The Legal Standard for Demand Excused

The decision whether to initiate or pursue a lawsuit on behalf of the corporation is generally within the power and responsibility of the board of directors. [25] This follows from the "cardinal precept of the General Corporation Law of the State of Delaware . . . that directors, rather than shareholders, manage the business and affairs of the corporation." [26] Accordingly, in order to cause the corporation to pursue litigation, a shareholder must either (1) make a pre-suit demand by presenting the allegations to the corporation's directors, requesting that they bring suit, and showing that they wrongfully refused to do so, or (2) plead facts showing that demand upon the board would have been futile. [27] Where, as here, a plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile. [28] The purpose of the demand requirement is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 "exist[] to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation." [29]

FOOTNOTES

25 8 *Del. C.* § 141(a).

26 *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

27 *See Stone v. Ritter*, 911 A.2d 362, 366-67 (Del. 2006).

28 Ct. Ch. R. 23.1(a); *see Stone*, 911 A.2d at 367 n.9; *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

29 *Am. Int'l Group, Inc., Consol. Derivative Litig.*, C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15, 2009 WL 366613, at *29 (Del. Ch. Feb. 10, 2009).

Under the familiar *Aronson* test, to show demand futility, plaintiffs must provide particularized factual allegations that raise a reasonable doubt that “(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.” [30] Where, however, plaintiffs complain of board inaction and do not challenge a specific decision of the board, there is no “challenged transaction,” and the ordinary *Aronson* analysis does not apply. [31] Instead, to show demand futility where the subject of the derivative suit is not a business decision of the board, a plaintiff must allege particularized facts that “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” [32]

FOOTNOTES

30 *Brehm*, 746 A.2d at 253 (quoting *Aronson*, 473 A.2d at 814).

31 *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993).

32 *Id.* at 934.

In evaluating whether demand is excused, the Court must accept as true the well pleaded factual allegations in the Complaint. The pleadings, however, are held to a higher standard under Rule 23.1 than under the permissive notice pleading standard under Court of Chancery Rule 8(a). To establish that demand is excused under Rule 23.1, the pleadings must comply with “stringent requirements of factual particularity” and set forth “particularized factual statements that are essential to the claim.” [33] “A prolix complaint larded with conclusory language . . . does not comply with these fundamental pleading mandates.” [34]

FOOTNOTES

33 *Brehm*, 746 A.2d at 254.

34 *Id.*

Plaintiffs have not alleged that a majority of the board was not independent for purposes of evaluating demand. Rather, as to the claims for waste asserted in Count III, plaintiffs allege that the approval of certain transactions did not constitute a valid exercise of business judgment under the second prong of the *Aronson* test. Plaintiffs allege that demand is futile as to Counts I, II, and IV because the director defendants are not able to exercise disinterested business judgment in responding to a demand because their failure of oversight subjects them to a substantial likelihood of personal liability. According to plaintiffs, the director defendants face a substantial threat of personal liability because their conscious disregard of their duties and lack of proper supervision and oversight caused the Company to be overexposed to risk in the subprime mortgage market.

Demand is not excused solely because the directors would be deciding to sue themselves. [35] Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is "so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." [36]

FOOTNOTES

35 *Jacobs v. Yang*, C.A. No. 206-N, 2004 Del. Ch. LEXIS 117, 2004 WL 1728521, at *6 n.31 (Del. Ch. Aug. 2, 2004).

36 *Aronson*, 473 A.2d at 815. The Complaint appears to allege that demand on defendants Rubin and Ramirez would be futile because 1) Rubin faces a substantial threat of personal liability because he benefited personally by wrongfully selling stock while in possession of material non-public information; 2) Rubin is beholden to defendants Belda, Derr, and Parsons due to the extraordinary monetary compensation and other benefits they approved for him while he was a director and despite his lack of operational responsibility; and 3) Ramirez is not independent because he ran a subsidiary of Citigroup and received security and other services valued at more than $ 2 million from Citigroup while doing so. *See* Compl. PP 181-82. The Court does not need to determine the adequacy of these demand futility allegations because plaintiffs have not made similar individualized allegations regarding the other director defendants. Thus, even if the allegations in the Complaint are sufficient to excuse demand as to Rubin and Ramirez, plaintiffs have still failed to properly plead demand futility for a majority of the director defendants. As further explained below, instead of providing similar individualized assertions for the other director defendants, plaintiffs rely on the "group" accusation mode of pleading demand futility. Had plaintiffs provided individual allegations as to each of the director defendants, the outcome of this case may have been different.

B. Demand Futility Regarding Plaintiffs' Fiduciary Duty Claims

Plaintiffs' argument is based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark.* [37] Before *Caremark*, in *Graham v. Allis-Chalmers Manufacturing Company,* [38] the Delaware Supreme Court, in response to a theory that the Allis-Chalmers directors were liable because they should have known about employee violations of federal anti-trust laws, held that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." [39] Over thirty years later, in the context of approval of a settlement of a class action, former-Chancellor

Allen took the opportunity to revisit the duty to monitor under Delaware law. In *Caremark,* the plaintiffs alleged that the directors were liable because they should have known that certain officers and employees were violating the federal Anti-Referral Payments Law. In analyzing these claims, the Court began, appropriately, by reviewing the duty of care and the protections of the business judgment rule.

FOOTNOTES

37 *In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996).

38 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963).

39 *Id.* at 130.

With regard to director liability standards, the Court distinguished between (1) "*a board decision* that results in a loss because that decision was ill advised or 'negligent'" and (2) "an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss." [40] In the former class of cases, director action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available--a standard measured by concepts of gross negligence. [41] As former-Chancellor Allen explained:

What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule--one that permitted an "objective" evaluation of the decision--would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions. [42]

FOOTNOTES

40 *Caremark,* 698 A.2d at 967.

41 *Id; see Brehm,* 746 A.2d at 259.

42 *Caremark,* 698 A.2d at 967-68 (footnotes omitted).

In the latter class of cases, where directors are alleged to be liable for a failure to monitor liability creating activities, the *Caremark* Court, in a reassessment of the holding in *Graham,* stated that while directors could be liable for a failure to monitor, "only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." [43]

FOOTNOTES

43 *Id.* at 971.

In *Stone v. Ritter*, the Delaware Supreme Court approved the *Caremark* standard for director oversight liability and made clear that liability was based on the concept of good faith, which the *Stone* Court held was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty that could independently give rise to liability. [44] As the *Stone* Court explained:

Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. [45]

Thus, to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act. [46] The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a *necessary condition* to director oversight liability. [47]

FOOTNOTES

44 *Stone*, 911 A.2d at 370.

45 *Id.* (footnotes omitted).

46 *See Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) ("[T]he [*Caremark*] opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith. Put otherwise, the decision premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.") (footnote omitted).

47 *Stone*, 911 A.2d at 369; *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) ("*Caremark* itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director--bad faith--because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance. By reinforcing that a scienter-based standard applies to claims in the delicate monitoring context, *Stone* ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded.") (footnotes omitted).

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1. Plaintiffs' *Caremark* Allegations

Plaintiffs' theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim. In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law. For example, in *Caremark* the board allegedly failed to monitor employee actions in violation of the federal Anti-Referral Payments Law; in *Stone*, the directors were charged with a failure of oversight that resulted in liability for the company because of employee violations of the federal Bank Secrecy Act. [48]

FOOTNOTES

48 *See, e.g., David B. Shaev Profit Sharing Account v. Armstrong*, C.A. No. 1449-N, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *2 (Del. Ch. Feb. 13, 2006) (*Caremark* claims for failure to discover involvement in allegedly fraudulent business practices).

In contrast, plaintiffs' *Caremark* claims are based on defendants' alleged failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market. In their answering brief, plaintiffs allege that the director defendants are personally liable under *Caremark* for failing to "make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." [49] Plaintiffs point to so-called "red flags" that should have put defendants on notice of the problems in the subprime mortgage market and further allege that the board should have been especially conscious of these red flags because a majority of the directors (1) served on the Citigroup board during its previous Enron related conduct and (2) were members of the ARM Committee and considered financial experts.

FOOTNOTES

49 Pls.' Answering Br. at 2.

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Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them--the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, [50] to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.

FOOTNOTES

50 "Hindsight bias is the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted." Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 587 (1994).

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The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." [51] The burden is on plaintiffs, the party challenging the directors' decision, to rebut this presumption. [52] Thus, absent an allegation of interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information. The standard of director liability under the business judgment rule "is predicated upon concepts of gross negligence." [53]

FOOTNOTES

51 *Aronson*, 473 A.2d at 812.

52 *Id.*

53 *Id.*

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Additionally, Citigroup has adopted a provision in its certificate of incorporation pursuant to 8 *Del. C.* § 102(b)(7) that exculpates directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Because the director defendants are "exculpated from liability for certain conduct, 'then a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts.'" [54] Here, plaintiffs have not alleged that the directors were interested in the transaction and instead root their theory of director personal liability in bad faith.

FOOTNOTES

54 *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) (quoting *Guttman*, 823 A.2d at 501).

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The Delaware Supreme Court has stated that bad faith conduct may be found where a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation, . . . acts with the intent to violate applicable positive law, or . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." [55] More recently, the Delaware Supreme Court held that when a plaintiff seeks to show that demand is excused because directors face a substantial likelihood of liability where "directors are exculpated from liability except for claims based on 'fraudulent,' 'illegal' or 'bad faith' conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper." [56] A plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties.

FOOTNOTES

55 *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006).

56 *Wood*, 953 A.2d at 141.

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Turning now specifically to plaintiffs' *Caremark* claims, one can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business.

The Delaware Supreme Court made clear in *Stone* that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however, this obligation does not eviscerate the core protections of the business judgment rule--protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher. Additionally, as former-Chancellor Allen noted in *Caremark,* director liability based on the duty of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." [57] The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.

FOOTNOTES

57 *Caremark,* 698 A.2d at 967.

To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions. Risk has been defined as the chance that a return on an investment will be different that expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses--and particularly financial institutions--make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision. [58] In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got "unlucky" in that a huge loss--the probability of which was very small--actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

FOOTNOTES

58 *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 114-15 (2004) ("[T]here is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management because bad outcomes often will be regarded, ex post, as having been foreseeable and, therefore, preventable ex ante. If liability results from bad outcomes, without regard to the ex ante quality of the decision or the decision-making process, however, managers will be discouraged from taking risks.") (footnotes omitted).

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. With these considerations and the difficult standard required to show director oversight liability in mind, I turn to an evaluation of the allegations in the Complaint.

a. The Complaint Does Not Properly Allege Demand Futility for Plaintiffs' Fiduciary Duty Claims

In this case, plaintiffs allege that the defendants are liable for failing to properly monitor the risk that Citigroup faced from subprime securities. While it may be possible for a plaintiff to meet the burden under some set of facts, plaintiffs in this case have failed to state a *Caremark* claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company.

The allegations in the Complaint amount essentially to a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks related to Citigroup's investments in subprime assets. Plaintiffs then conclude that because defendants failed to prevent the Company's losses associated with certain business risks, they must have consciously ignored these warning signs or knowingly failed to monitor the Company's risk in accordance with their fiduciary duties. [59] Such conclusory allegations, however, are not sufficient to state a claim for failure of oversight that would give rise to a substantial likelihood of personal liability, which would require particularized factual allegations demonstrating bad faith by the director defendants.

FOOTNOTES

59 Pls.' Answering Br. at 39-40.

Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk. Plaintiffs admit that Citigroup established the ARM Committee and in 2004 amended the ARM Committee charter to include the fact that one of the purposes of the ARM Committee was to assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management. [60] The ARM Committee was also charged with, among other things, (1) discussing with management and independent auditors the annual audited financial statements, (2) reviewing with management an evaluation of Citigroup's internal control structure, and (3) discussing with management Citigroup's major credit, market, liquidity, and operational risk exposures and the steps taken by management to monitor and control such exposures, including Citigroup's risk assessment and risk management policies. [61] According to plaintiffs' own allegations, the ARM Committee met eleven times in 2006 and twelve times in 2007. [62]

FOOTNOTES

60 Compl. P 185.

61 *Id.* P 187.

62 *Id.* P 189.

Plaintiffs nevertheless argue that the director defendants breached their duty of oversight either because the oversight mechanisms were not adequate or because the director defendants did not make a good faith effort to comply with the established oversight procedures. To support this claim, the Complaint alleges numerous facts that plaintiffs argue should have put the director defendants on notice of the impending problems in the subprime mortgage market and Citigroup's exposure thereto. Plaintiffs summarized some of these "red flags" in their answering brief as follows:

. the steady decline of the housing market and the impact the collapsing bubble would have on mortgages and subprime backed securities since as early as 2005;

. December 2005 guidance from the FASB staff--"The FASB staff is aware of loan products whose contractual features may increase the exposure of the originator, holder, investor, guarantor, or servicer to risk of nonpayment or realization.";

. the drastic rise in foreclosure rates starting in 2006;

. several large subprime lenders reporting substantial losses and filing for bankruptcy starting in 2006;

. billions of dollars in losses reported by Citigroup's peers, such as Bear Stearns and Merrill Lynch.

Plaintiffs argue that demand is excused because a majority of the director defendants face a substantial likelihood of personal liability because they were charged with management of Citigroup's risk as members of the ARM Committee and as audit committee financial experts and failed to properly oversee and monitor such risk. [63] As explained above, however, to establish director oversight liability plaintiffs would ultimately have to prove bad faith conduct by the director defendants. Plaintiffs fail to plead any particularized factual allegations that raise a reasonable doubt that the director defendants acted in good faith.

FOOTNOTES

63 Compl. P 189; Pls.' Answering Br. at 41-45. Directors with special expertise are not held to a higher standard of care in the oversight context simply because of their status as an expert. *See Canadian Commercial Workers Indus. Pension Plan v. Alden,* C.A. No. 1184-N, 2006 Del. Ch. LEXIS 42, 2006 WL 456786, at *7 n.54 (Del. Ch. Feb. 22, 2006); *see also* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments,* 153 U. PA. L. REV. 1399, 1445-47 (2005). Directors of a committee charged with oversight of a company's risk have additional responsibilities to monitor such risk; however, such responsibility does not change the standard of director liability under *Caremark* and its progeny, which requires a showing of bad faith. Evaluating director action under the bad faith standard is a contextual and fact specific inquiry and what a director knows and understands is, of course, relevant to such an inquiry. *See In re Emerging Commc'ns, Inc. S'holders Litig.*, C.A. No. 16415, 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *39-40 (Del. Ch. May 3, 2004). Even accepting, however, that a majority of the directors were members of the ARM Committee and considered audit committee financial experts, plaintiffs have not alleged facts showing that they demonstrated a conscious disregard for duty, or any other conduct or omission that would constitute bad faith. Even directors who are experts are shielded from judicial second guessing of their business decisions by the business judgment rule.

The warning signs alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions. The "red flags" in the Complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally. Plaintiffs fail to plead "particularized facts suggesting that the Board was presented with 'red flags' alerting it to potential misconduct" at the Company. [64] That the director defendants knew of signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further, is not sufficient to show that the directors were or should have been aware of any wrongdoing at the Company or were consciously disregarding a duty somehow to prevent Citigroup from suffering losses. [65] Nothing about plaintiffs' "red flags" supports plaintiffs' conclusory allegation that "defendants have not made a good faith attempt to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market."[66] Indeed, plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. Rather, plaintiffs seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses.

FOOTNOTES

64 *Shaev*, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *3.

65 That plaintiffs are unable to point to specific wrongdoing within the Company that caused Citigroup's losses from exposure to the subprime mortgage market further supports my hypothesis that this case is not truly a *Caremark* case, but rather a straightforward claim of breach of the fiduciary duty of care.

66 Pls.' Answering Br. at 62.

Moving from such general ipse dixit syllogisms to the more specific, plaintiffs argue that the director defendants, and especially those nine directors who were on the board at the time, "should have been especially sensitive to the red flags in the marketplace in light of the Company's prior involvement in the Enron Corporation debacle and other financial scandals earlier in the decade." [67] Plaintiffs also allege that the director defendants should have been especially alert to the dangers of transactions involving SIVs because SIVs were involved in Citigroup's transactions with Enron that resulted in liability for the Company. Plaintiffs allege that Citigroup helped finance transactions that allowed Enron to hide its true financial condition and resulted in Citigroup paying approximately $ 120 million in penalties and disgorgement as well as agreeing to new risk management procedures designed to prevent similar conduct.

FOOTNOTES

67 *Id.* at 47.

Plaintiffs fail in their attempt to impose some sort of higher standard of liability on the director defendants that were on Citigroup's board at the time of its involvement with Enron. They have utterly failed to show how Citigroup's involvement with the financial scandals at Enron has any relevance to Citigroup's investments in subprime securities. Plaintiffs cite *McCall v. Scott* [68] to support the proposition that directors who were on the board during previous misconduct should be sensitive to similar circumstances which had previously prompted investigations. That case, however, actually shows how plaintiffs' attempt to impose a higher standard on the directors because of the Enron scandal is inadequate. Unlike here, the plaintiffs in *McCall* alleged numerous specific instances of widespread, prevalent wrongdoing throughout the company and the mechanisms by which the wrongdoing came to the board's attention. [69] The Sixth Circuit in *McCall* did *not*, as plaintiffs assert, hold that alleged prior, *unrelated* wrongdoing would make directors "sensitive to similar circumstances." [70] Unlike plaintiffs' allegations about Enron, the prior "experience" referenced in *McCall* was an investigation and settlement for the *same type* of questionable billing practices before the Sixth Circuit. [71] Plaintiffs have not shown how involvement with the Enron related scandals should have in any way put the director defendants on a heightened alert to problems in the subprime mortgage market. Additionally, the use of SIVs in the Enron related conduct would not serve to put the director defendants on any type of heightened notice to the unrelated use of SIVs in structuring transactions involving subprime securities.

FOOTNOTES

68 239 F.3d 808 (6th Cir. 2001).

69 *Id.* at 819-24 (noting allegations of numerous financial irregularities in reports brought to the board's attention).

70 Pls.' Answering Br. at 48.

71 *See McCall*, 239 F.3d at 821.

The Complaint and plaintiffs' answering brief repeatedly make the conclusory allegation that the defendants have breached their duty of oversight, but nowhere do plaintiffs adequately explain what the director defendants actually did or failed to do that would constitute such a violation. Even while admitting that Citigroup had a risk monitoring system in place, plaintiffs seem to conclude that, because the director defendants (and the ARM Committee members in particular) were charged with monitoring Citigroup's risk, then they must be found liable because Citigroup experienced losses as a result of exposure to the subprime mortgage market. The only factual support plaintiffs provide for this conclusion are "red flags" that actually amount to nothing more than signs of continuing deterioration in the subprime mortgage market. These types of conclusory allegations are exactly the kinds of allegations that do not state a claim for relief under *Caremark.*

To recognize such claims under a theory of director oversight liability would undermine the long established protections of the business judgment rule. It is well established that the mere fact that a company takes on business risk and suffers losses--even catastrophic losses--does not evidence misconduct, and without more, is not a basis for personal director liability. [72] That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk. What plaintiffs are asking the Court to conclude from the presence of these "red flags" is that the directors failed to see the extent of Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.

FOOTNOTES

72 *See Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996) ("The business outcome of an investment project that is unaffected by director self-interest or bad faith, cannot itself be an occasion for director liability.") (footnote omitted).

This Court's recent decision in *American International Group, Inc. Consolidated Derivative Litigation* [73] demonstrates the stark contrast between the allegations here and allegations that are sufficient to survive a motion to dismiss. In *AIG*, the Court faced a motion to dismiss a complaint that included "well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG." [74] In concluding that the complaint stated a claim for relief under Rule 12(b)(6), [75] the Court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives running those divisions knew of and approved much of the wrongdoing. The Court reasoned that huge fraudulent schemes were unlikely to be perpetrated without the knowledge of the executive in charge of that division of the company. [76] Unlike the allegations in this case, the defendants in *AIG* allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a "criminal organization" and that "[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary." [77]

FOOTNOTES

73 C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15, 2009 WL 366613 (Del. Ch. Feb. 10, 2009).

74 2009 Del. Ch. LEXIS 15, [WL] at *3.

75 It is also significant that the *AIG* Court was analyzing the Complaint under the

plaintiff-friendly standard of Rule 12(b)(6), rather than the particularized pleading standard of Rule 23.1.

76 *AIG*, 2009 Del. Ch. LEXIS 15, 2009 WL 366613 at *22.

77 2009 Del. Ch. LEXIS 15, [WL] at *23.

Contrast the *AIG* claims with the claims in this case. Here, plaintiffs argue that the Complaint supports the reasonable conclusion that the director defendants acted in bad faith by failing to see the warning signs of a deterioration in the subprime mortgage market and failing to cause Citigroup to change its investment policy to limit its exposure to the subprime market. Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark-type* duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk. [78]

FOOTNOTES

78 If defendants had been able to predict the extent of the problems in the subprime mortgage market, then they would not only have been able to avoid losses, but presumably would have been able to make significant gains for Citigroup by taking positions that would have produced a return when the value of subprime securities dropped. Compl. P 78. Query: if the Court were to adopt plaintiffs' theory of the case--that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup's exposure to them--then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?

Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called "red flags," plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the "right" decision if they had been in the directors' position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large.

2. Plaintiffs' Disclosure Allegations

Plaintiffs argue that demand is excused as futile because the director defendants face a substantial likelihood of personal liability for violating their duty of disclosure and would therefore be unable to exercise independent and disinterested business judgment in responding to a demand. [79] Plaintiffs allege that the director defendants violated their duty of disclosure by, among other things, failing to properly disclose the value of certain financial instruments, [80] placing underperforming assets in SIVs without fully disclosing the risk that Citigroup might have to bring the assets back onto its balance sheet, [81] and failing to properly account for guarantees, specifically the liquidity puts that allowed buyers of CDOs to sell the products back to Citigroup at face value. [82] Plaintiffs argue that the "red flags" alleged in the Complaint lead to a reasonable inference that the director defendants, and particularly the ARM Committee members, knew that certain disclosures regarding the Company's exposure to subprime assets were misleading.

FOOTNOTES

79 Plaintiffs argue that the disclosure claims relate to actions taken by the board and are therefore subject to the *Aronson* standard. Plaintiffs request, however, that the Court review demand futility under the substantial likelihood of liability standard and present their demand futility arguments under that standard.

80 Compl. P 172.

81 *Id.* at P 70.

82 *Id.* at PP 163-65.

“[E]ven in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith.” [83] When there is no request for shareholder action, a shareholder plaintiff can demonstrate a breach of fiduciary duty by showing that the directors “*deliberately* misinform[ed] shareholders about the business of the corporation, either directly or by a public statement.” [84] Citigroup’s certificate of incorporation exculpates the director defendants from personal liability for violations of fiduciary duty except for, among other things, breaches of the duty of loyalty and acts or omissions not in good faith or that involve intentional misconduct or knowing violation of law. Thus, to show a substantial likelihood of liability that would excuse demand, plaintiffs must plead particularized factual allegations that “support the inference that the disclosure violation was made in bad faith, knowingly or intentionally.” [85] Additionally, directors of Delaware corporations are fully protected in relying in good faith on the reports of officers and experts. [86]

FOOTNOTES

83 *In re infoUSA, Inc. S’holders Litig.*, 953 A.2d 963, 990 (Del. Ch. 2007).

84 *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998) (emphasis added); *see infoUSA*, 953 A.2d at 990 (finding that directors violate their fiduciary duties “where it can be shown that the directors involved issued their communication with the knowledge that it was deceptive or incomplete”).

85 *O’Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 915 (Del. Ch. Aug. 20, 1999).

86 8 *Del. C.* § 141(e) (“A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member’s duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.”); *see Brehm,* 746 A.2d at 261.

The factual allegations in the Complaint are not sufficient to allow me to reasonably conclude that the director defendants face a substantial likelihood of liability that would prevent them from impartially considering a demand. This is so for at least three reasons. First, plaintiffs fail to allege with sufficient specificity the actual misstatements or omissions that constituted a violation of the board’s duty of disclosure. [87] The Complaint merely alleges, in general and conclusory terms, that the director defendants did not adequately disclose certain risks faced by the Company--for example, the risks posed by Citigroup’s SIVs and the liquidity puts that allowed purchasers of CDOs to sell the instruments back to Citigroup at face value. [88] The Complaint does not identify any actual disclosure that was misleading or any statement that was made misleading as a result of an omission of a material fact. Instead, plaintiffs allege, for instance, that the Citigroup board "abdicated its fiduciary duties by not disclosing information on the fair value of VIEs, CDOs and SIVs" [89] and that "the ARM Committee abdicated its fiduciary duties . . . to ensure the integrity of Citigroup's financial statements and financial reporting process, including earnings press releases and financial information provided to analysts and rating agencies." [90]

FOOTNOTES

87 *See Pfeffer v. Redstone,* No. 115, 2008, A.2d , 2009 Del. LEXIS 37, 2009 WL 188887, at *6 (Del. Jan. 23, 2009) ("Although there is 'no reason to depart from the general pleading rules when alleging duty of disclosure violations,' 'it is inherent in disclosure cases that the misstated or omitted facts be identified and that the pleading not be merely conclusory.'") (quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 140 (Del. 1997)).

88 Compl. PP 160-73. To be fair, plaintiffs point to some specific statements in the Complaint. For example, paragraph 82 of the Complaint alleges that the director defendants "caused or allowed" Citigroup to issue a press release that highlighted, among other things, "positive trends from Citigroup's strategic actions." Paragraphs 88 and 99 of the Complaint allege that the director defendants "caused" Citigroup to issue press releases that stated that the Company had "generated strong momentum this quarter" and that cited decreasing credit costs "reflecting a stable global credit environment." Even these allegations, however, fail to meet the strict pleading requirements under Rule 23.1. Pleading that the director defendants "caused" or "caused or allowed" the Company to issue certain statements is not sufficient particularized pleading to excuse demand under Rule 23.1. It is unclear from such allegations how the board was actually involved in creating or approving the statements, factual details that are crucial to determining whether demand on the board of directors would have been excused as futile. These allegations also fail for the other reasons described below, most notably because the Complaint fails to adequately plead facts reasonably suggesting that the director defendants made disclosures with knowledge that they were false or misleading or in bad faith.

89 Compl. P 172.

90 *Id.* at P 161.

In other words, the disclosure allegations in the complaint do not meet the stringent standard of factual particularity required under Rule 23.1. They fail to allege with particularity which disclosures were misleading, when the Company was obligated to make disclosures, what specifically the Company was obligated to disclose, and how the Company failed to do so. [91] This information is critical because to establish a threat of director liability based on a disclosure violation, plaintiffs must plead facts that show that the violation was made knowingly or in bad faith, a showing that requires allegations regarding what the directors knew and when. Without knowing when and how the alleged disclosure violations occurred, it is impossible to determine if the directors made the misstatements or omissions knowingly or in bad faith. As a result, the disclosure allegations in the complaint do not meet the stringent requirements of factual particularity under Rule 23.1.

FOOTNOTES

91 The closest plaintiffs come to alleging a specific disclosure violation are the allegations that the Company failed to disclosure the existence of the liquidity puts until November 2007 and failed to disclose that the Company may have to take certain assets held by SIVs back onto its balance sheet. Compl. PP 70, 165-69. Even these claims, however, are vague and relatively light on the details of what the Company was required to disclose, when it was required to disclose it, and how its failure to do so would constitute a violation of the duty of disclosure. In any event, as discussed below, these claims fail to plead demand futility because plaintiffs have (1) failed to sufficiently allege facts showing that the director defendants were involved in preparing (or were otherwise responsible for) the alleged misleading disclosures and (2) failed to allege facts that would lead to a reasonable inference that the director defendants made any false or misleading statements or omissions knowingly or in bad faith.

Second, the Complaint does not contain specific factual allegations that reasonably suggest sufficient board involvement in the preparation of the disclosures that would allow me to reasonably conclude that the director defendants face a substantial likelihood of personal liability. [92] Plaintiffs do not allege facts suggesting that the director defendants prepared the financial statements or that they were directly responsible for the misstatements or omissions. The Complaint merely alleges that Citigroup's financial statements contained false statements and material omissions and that the director defendants reviewed the financial statements pursuant to their responsibilities under the ARM Committee charter. Thus, I am unable to reasonably conclude that the director defendants face a substantial likelihood of liability.

FOOTNOTES

92 *See Wood*, 953 A.2d at 142 ("The Board's execution of [the company's] financial reports, without more, is insufficient to create an inference that the directors had actual or constructive notice of any illegality.").

Third, and perhaps most importantly, the Complaint does not sufficiently allege that the director defendants had knowledge that any disclosures or omissions were false or misleading or that the director defendants acted in bad faith in not adequately informing themselves. [93] Plaintiffs have not alleged particular facts showing that the director defendants were even aware of any misstatements or omissions. Instead, plaintiffs conclusorily assert that the members of the ARM Committee, as financial experts, knew the relevant accounting standards, knew or should have known the extent of the Company's exposure to the subprime mortgage market, and are therefore responsible for alleged false statements or omissions in Citigroup's financial statements. [94] Instead of providing factual allegations regarding the knowledge or bad faith of the individual director defendants, the Complaint makes broad group allegations about the director defendants or the members of the ARM Committee. [95] A determination of whether the alleged misleading statements or omissions were made with knowledge or in bad faith requires an analysis of the state of mind of the individual director defendants, and plaintiffs have not made specific factual allegations that would allow for such an inquiry. Plaintiffs' alleged "red flags," which amount to nothing more than indications of worsening economic conditions, do not support a reasonable inference that the director defendants approved or disseminated the financial disclosures knowingly or in bad faith. Merely alleging that there were signs of problems in the subprime mortgage market is not sufficient to show that the director defendants knew that Citigroup's disclosures were false or misleading. The allegations are not sufficiently specific to Citigroup or to the director defendants to meet the strict pleading requirements of Rule 23.1.

FOOTNOTES

93 *See Pfeffer,* A.2d , 2009 Del. LEXIS 37, 2009 WL 188887, at *6 ("When pleading a breach of fiduciary duty based on the . . . Directors' knowledge, [the plaintiff] must, at a minimum, offer 'well-pleaded facts from which it can be reasonably inferred that this 'something' was knowable and that the defendant was in a position to know it.'") (quoting *IOTEX Commc'ns, Inc. v. Defries,* C.A. No. 15817, 1998 Del. Ch. LEXIS 236, 1998 WL 914265, at *4 (Del. Ch. Dec. 21, 1998)).

94 Compl. P 191.

95 *See AIG,* 2009 Del. Ch. LEXIS 15, 2009 WL 366613 at *21 ("Although these allegations are varied and far reaching, . . . these allegations are supported by the pled facts. For starters, the Complaint is not laden with such accusations against the D & O Defendants as a group; these group accusations are used sparingly.").

Although the members of the ARM Committee were charged with reviewing and ensuring the accuracy of Citigroup's financial statements under the ARM Committee charter, director liability is not measured by the aspirational standard established by the internal documents detailing a company's oversight system. Under our law, to establish liability for misstatements when the board is not seeking shareholder action, shareholder plaintiffs must show that the misstatement was made knowingly or in bad faith. Additionally, even board members who are experts are fully protected under § 141(e) in relying in good faith on the opinions and statements of the corporation's officers and employees who were responsible for preparing the company's financial statements. Plaintiffs' allegations that the members of the ARM Committee were financial experts and were aware of the "red flags" alleged in the Complaint do not support a reasonable inference that the director defendants' reliance on the officers and experts who prepared the financial statements was not in good faith.

Even accepting plaintiffs' allegations as true, the Complaint fails to plead with particularity facts that would lead to the reasonable inference that the director defendants made or allowed to be made any false statements or material omissions with knowledge or in bad faith. Accordingly, plaintiffs have failed to plead with particularity facts creating a reasonable doubt that the director defendants face a threat of personal liability that would render them incapable of exercising independent and disinterested business judgment in responding to a demand. Plaintiffs' disclosure claims are therefore dismissed pursuant to Rule 23.1

C. Demand Futility Allegations Regarding Plaintiffs' Waste Claims

Count III of the Complaint alleges that certain of the defendants are liable for waste for (1) approving the Letter Agreement dated November 4, 2007 between Citigroup and defendant Prince; (2) allowing the Company to purchase over $ 2.7 billion in subprime loans from Accredited Home Lenders at one of its "fire sales" in March 2007 and from Ameriquest Home Mortgage in September 2007; (3) approving the buyback of over $ 645 million worth of the Company's shares at artificially inflated prices pursuant to a repurchase program in early 2007; and (4) allowing the Company to invest in SIVs that were unable to pay off maturing debt. [96]

FOOTNOTES

96 Plaintiffs do not adequately plead that the asset purchases or the investments in SIVs were the result of board action rather than inaction. To establish demand futility in the absence of director action the Complaint would have to plead facts sufficient to create a reasonable doubt that the director defendants could exercise disinterested and independent business judgment in responding to a demand. It is not clear to the Court on exactly what theory plaintiffs believe that demand is excused for these allegations. Pls.' Answering Br. at 56 nn.45-46. In any event, the Complaint does not properly allege demand futility as to these claims because it does not create a reasonable doubt that the director defendants would be unable to exercise disinterested and independent business judgment in responding to a demand. First, because plaintiffs have failed to adequately plead that the challenged asset purchases or investments in SIVs were the result of board action, the director defendants cannot possibly face a substantial likelihood of personal liability for these transactions. *See Highland Legacy Ltd. v. Singer*, C.A. No. 1566-N, 2006 Del. Ch. LEXIS 55, 2006 WL 741939, at *7 (Del. Ch. Mar. 17, 2006) ("To excuse demand on the grounds of waste, the complaint must allege particularized facts sufficient to create a reasonable doubt that the *board authorized action on the corporation's behalf* on terms that no person of ordinary, sound business judgment could conclude represents a fair exchange.”) (emphasis added).

Second, and in the alternative, the director defendants do not face a substantial likelihood of personal liability for these claims because the Complaint is devoid of any allegation that would lead to the conclusion that allowing the Company to purchase these assets or invest in the SIVs constituted bad faith conduct by the director defendants. For similar reasons as I explained with regard to the *Caremark* claims, the alleged “red flags” are not sufficient to support an inference that the director defendants did not act in good faith by not preventing those charged with making business decisions for the Company from purchasing subprime assets or investing in the SIVs. That these investments turned out poorly for the Company is not evidence of bad faith conduct. The decision to purchase certain investment assets, or to allow others in the Company to purchase certain investment assets, is the essence of the business judgment of directors and officers. Additionally, the Complaint makes no factual allegation that the decision to invest in the subprime assets or the SIVs was of no value to the Company. As I have said numerous times now, judges are in no position to second guess well-informed business decisions made in good faith, and the allegations in the Complaint are not sufficient to suggest that the directors knowingly or in bad faith disregarded their duty to monitor. Accordingly, the claims for waste for the asset purchases and the investments in SIVs fail to properly plead demand futility pursuant to Rule 23.1.

Demand futility is analyzed under *Aronson* when plaintiffs have challenged board action or approval of a transaction. With regard to the claims based on the approval of the Letter Agreement and the repurchase of Citigroup stock, plaintiffs do not argue that a majority of the director defendants were not disinterested and independent. Rather, plaintiffs argue that demand is excused under the second prong of the *Aronson* analysis, which requires that the plaintiffs plead particularized factual allegations that raise a reasonable doubt at to whether “the challenged transaction was otherwise the product of a valid exercise of business judgment.” [97]

FOOTNOTES

97 *Aronson*, 473 A.2d at 814.

Delaware law provides stringent requirements for a plaintiff to state a claim for corporate waste, and to excuse demand on grounds of waste the Complaint must allege particularized facts that lead to a reasonable inference that the director defendants authorized “an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.” [98] The test to show corporate waste is difficult for any plaintiff to meet; indeed, “[t]o prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests." [99]

FOOTNOTES

[98] *Brehm,* 746 A.2d at 263 (quoting *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 362 (Del. Ch. 1998); *see Highland,* 2006 Del. Ch. LEXIS 55, 2006 WL 741939, at *7.

[99] *White v. Panic,* 783 A.2d 543, 554 n.36 (Del. 2001).

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1. Approval of the Stock Repurchase Program

Plaintiffs' claim for waste for the board's approval of the stock repurchase program falls far short of satisfying the standard for demand futility. Plaintiffs allege that "in spite of its prior buybacks below $ 50 per share and in spite of the Company's expanding losses and declining stock price, Citigroup repurchased 12.1 million shares during the first quarter of 2007 at an average price of $ 53.37." [100] Plaintiffs then claim that at the time the buyback of Citigroup stock was halted, the stock was trading at $ 46 per share. Plaintiffs conclude that the director defendants "authorized and did not suspend the Company's share repurchase program, which resulted in the Company's buying back over $ 645 million worth of the Company's shares at artificially inflated prices." [101]

FOOTNOTES

[100] Pls.' Answering Br. at 61.

[101] *Id.*

Specifically, plaintiffs argue the following:
As set forth in the Complaint, the Director Defendants recklessly failed to consider and account for the subprime lending crisis, the Company's exposure to falling CDO values by virtue of its liquidity puts, and the collective impact on the Company's billions in warehoused subprime loans. Consequently, the Director Defendants are not entitled to the presumption of business judgment and are liable for waste for approving the buyback of over $ 645 million worth of the Company's shares at artificially inflated prices pursuant to the repurchase program. Under the circumstances, the repurchase program should have been suspended, and would have saved the Company hundreds of millions of dollars. The magnitude of the Director Defendants' utter failure to properly inform themselves of the Company's dire straits has only been highlighted by the Company's recent historically low share prices. [102]

To say the least, this argument demonstrates that the Complaint utterly fails to state a claim for waste for the board's approval of the stock repurchase. Plaintiffs seem to completely ignore the standard governing corporate waste under Delaware law--a standard that requires that plaintiffs plead facts overcoming the presumption of good faith by showing "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." [103] Plaintiffs attempted to meet this standard by alleging that the director defendants approved a repurchase of Citigroup stock *at the market price.* Other than a conclusory allegation, plaintiffs have alleged nothing that would explain how buying stock at the market price--the price at which presumably ordinary and rational businesspeople were trading the stock--could possibly be so one sided that no reasonable and ordinary business person would consider it adequate consideration. Again, plaintiffs merely allege "red flags" and then conclude that the board is liable for waste because Citigroup repurchased its stock before the stock dropped in price as a result of Citigroup's losses from exposure to the subprime market. In short, the Complaint states no particularized facts that would lead to any inference that the board's approval of the stock repurchase constituted corporate waste. Accordingly, plaintiffs have not adequately alleged demand futility as to this claim pursuant to Rule 23.1.

FOOTNOTES

102 *Id.* (citation omitted).

103 *Brehm*, 746 A.2d at 263 (quoting *Disney*, 731 A.2d at 362).

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2. Approval of the Letter Agreement

Plaintiffs allege that the board's approval of the November 4, 2007 letter agreement constituted corporate waste. Because approval of the letter was board action, demand is evaluated under the *Aronson* standard. Plaintiffs claim that demand is excused under the second prong of *Aronson* because the particularized factual allegations in the Complaint raise a reasonable doubt as to whether the approval was "the product of a valid exercise of business judgment." [104]

FOOTNOTES

104 *Aronson*, 473 A.2d at 814.

The directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions. The standard under which the Court evaluates a waste claim is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." [105] It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that "there is an outer limit" to the board's discretion to set executive compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste." [106]

FOOTNOTES

105 *Brehm*, 746 A.2d at 263.

106 *Id.* at 262 n.56 (citing *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602, 610 (Del. Ch. 1962)); *see Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996).

According to plaintiffs' allegations, the November 4, 2007 letter agreement provides that Prince will receive $ 68 million upon his departure from Citigroup, including bonus, salary, and accumulated stockholdings. [107] Additionally, the letter agreement provides that Prince will receive from Citigroup an office, an administrative assistant, and a car and driver for the lesser of five years or until he commences full time employment with another employer. [108] Plaintiffs allege that this compensation package constituted waste and met the "so one sided" standard because, in part, the Company paid the multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup. In exchange for the multi-million dollar benefits and perquisites package provided for in the letter agreement, the letter agreement contemplated that Prince would sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company. [109] Even considering the text of the letter agreement, I am left with very little information regarding (1) how much additional compensation Prince actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by Prince. Without more information and taking, as I am required, plaintiffs' well pleaded allegations as true, there is a reasonable doubt as to whether the letter agreement meets the admittedly stringent "so one sided" standard or whether the letter agreement awarded compensation that is beyond the "outer limit" described by the Delaware Supreme Court. Accordingly, the Complaint has adequately alleged, pursuant to Rule 23.1, that demand is excused with regard to the waste claim based on the board's approval of Prince's compensation under the letter agreement.

FOOTNOTES

107 Compl. P 122; Pls.' Answering Br. at 57-58.

108 Compl. P 124.

109 The Court takes judicial notice of the letter agreement, a publicly available document that was integral to plaintiffs' waste claim and incorporated into the Complaint. *See Vanderbilt Income & Growth Assocs., L.L.C. v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996).

D. The Motion to Dismiss under Rule 12(b)(6)

The only claim as to which plaintiffs adequately pleaded demand futility is the claim for corporate waste for the board's approval of the letter agreement granting a multi-million dollar compensation package to Prince upon his departure as Citigroup's CEO. When considering a motion to dismiss for failure to state a claim under Rule 12(b)(6), the Court is required to accept as true all well-pleaded factual allegations in the complaint and make all reasonable inferences that logically flow from the face of the complaint in the plaintiff's favor. [110] The Court can only dismiss the complaint if it "determines with 'reasonable certainty' that the plaintiff could prevail on no set of facts that may be inferred from the well-pleaded allegations in the complaint." [111]

FOOTNOTES

110 *See Malpiede v. Townson*, 780 A.2d 1075, 1082-83 (Del. 2001).

111 *Id.*

The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6), and "a complaint that survives a motion to dismiss pursuant to Rule 23.1 will also survive a 12(b)(6) motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim." [112] Accordingly, for the same reasons stated in the demand futility analysis, the Complaint contains well-pleaded factual allegations regarding the claim for waste for the approval of the Prince letter agreement that make it impossible for me to conclude with reasonable certainty that the plaintiff could prevail on no set of facts that could be reasonably inferred from the allegations in the Complaint. [113]

FOOTNOTES

112 *McPadden v. Sidhu*, C.A. No. 3310-CC, 2008 Del. Ch. LEXIS 123, 2008 WL 4017052, at *7 (Del. Ch. Aug. 29, 2008).

113 I am also not convinced that defendants would be exculpated under Citigroup's certificate for committing waste. *See In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.") (citing *White v. Panic*, 783 A.2d 543, 553-55 (Del. 2001)).

IV. CONCLUSION

Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

For the foregoing reasons, the motion to dismiss or stay in favor of the New York Action is denied. Defendants' motion to dismiss is denied as to the claim in Count III of the Complaint for waste for approval of the November 4, 2007 Prince letter agreement. All other claims in the complaint are dismissed for failure to adequately plead demand futility pursuant to Court of Chancery Rule 23.1.

An Order has been entered consistent with this Opinion.

C. Page 196, New Sec. 3.14.G. Delaware Supreme Court's Elaboration on Revlon Duties--Lyondell

Page 196, New Sec. 3.14.G. Add before Sec. 3.15 the following:
New Sec. 3.14.G. **Delaware Supreme Court's Elaboration on *Revlon* Duties—*Lyondell***

Lyondell Chemical Company v. Ryan,
Delaware Supreme Court, 970 A.2d 235, 2009

BERGER, Justice:

We accepted this interlocutory appeal to consider a claim that directors failed to act in good faith in conducting the sale of their company. The Court of Chancery decided that "unexplained inaction" permits a reasonable inference that the directors may have consciously disregarded their fiduciary duties. The trial court expressed concern about the speed with which the transaction was consummated; the directors' failure to negotiate better terms; and their failure to seek potentially superior deals. But the record establishes that the directors were disinterested and independent; that they were generally aware of the company's value and its prospects; and that they considered the offer, under the time constraints imposed by the buyer, with the assistance of financial and legal advisors. At most, this record creates a triable issue of fact on the question of whether the directors exercised due care. There is no evidence, however, from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty. Accordingly, the directors are entitled to the entry of summary judgment.

FACTUAL AND PROCEDURAL BACKGROUND

Before the merger at issue, Lyondell Chemical Company ("Lyondell") was the third largest independent, publicly traded chemical company in North America. Dan Smith ("Smith") was Lyondell's Chairman and CEO. Lyondell's other ten directors were independent and many were, or had been, CEOs of other large, publicly traded companies. Basell AF ("Basell") is a privately held Luxembourg company owned by Leonard Blavatnik ("Blavatnik") through his ownership of Access Industries. Basell is in the business of polyolefin technology, production and marketing.

In April 2006, Blavatnik told Smith that Basell was interested in acquiring Lyondell. A few months later, Basell sent a letter to Lyondell's board offering $ 26.50 - $ 28.50 per share. Lyondell determined that the price was inadequate and that it was not interested in selling. During the next year, Lyondell prospered and no potential acquirors expressed interest in the company. In May 2007, an Access affiliate filed a Schedule 13D with the Securities and Exchange Commission disclosing its right to acquire an 8.3% block of Lyondell stock owned by Occidental Petroleum Corporation. The Schedule 13D also disclosed Blavatnik's interest in possible transactions with Lyondell.

In response to the Schedule 13D, the Lyondell board immediately convened a special meeting. The board recognized that the 13D signaled to the market that the company was "in play," [1] but the directors decided to take a "wait and see" approach. A few days later, Apollo Management, L.P. contacted Smith to suggest a management-led LBO, but Smith rejected that proposal. In late June 2007, Basell announced that it had entered into a $ 9.6 billion merger agreement with Huntsman Corporation ("Huntsman"), a specialty chemical company. Basell apparently reconsidered, however, after Hexion Specialty Chemicals, Inc. made a topping bid for Huntsman. Faced with competition for Huntsman, Blavatnik returned his attention to Lyondell.

FOOTNOTES

1 On the day that the 13D was made public, Lyondell's stock went from $ 33 to $ 37 per share.

On July 9, 2007, Blavatnik met with Smith to discuss an all-cash deal at $ 40 per share. Smith responded that $ 40 was too low, and Blavatnik raised his offer to $ 44- $ 45 per share. Smith told Blavatnik that he would present the proposal to the board, but that he thought the board would reject it. Smith advised Blavatnik to give Lyondell his best offer, since Lyondell really was not on the market. The meeting ended at that point, but Blavatnik asked Smith to call him later in the day. When Smith called, Blavatnik offered to pay $ 48 per share. Under Blavatnik's proposal, Basell would require no financing contingency, but Lyondell would have to agree to a $ 400 million break-up fee and sign a merger agreement by July 16, 2007.

Smith called a special meeting of the Lyondell board on July 10, 2007 to review and consider Basell's offer. The meeting lasted slightly less than one hour, during which time the board reviewed valuation material that had been prepared by Lyondell management for presentation at the regular board meeting, which was scheduled for the following day. The board also discussed the Basell offer, the status of the Huntsman merger, and the likelihood that another party might be interested in Lyondell. The board instructed Smith to obtain a written offer from Basell and more details about Basell's financing.

Blavatnik agreed to the board's request, but also made an additional demand. Basell had until July 11 to make a higher bid for Huntsman, so Blavatnik asked Smith to find out whether the Lyondell board would provide a firm indication of interest in his proposal by the end of that day. The Lyondell board met on July 11, again for less than one hour, to consider the Basell proposal and how it compared to the benefits of remaining independent. The board decided that it was interested, authorized the retention of Deutsche Bank Securities, Inc. ("Deutsche Bank") as its financial advisor, and instructed Smith to negotiate with Blavatnik.

Basell then announced that it would not raise its offer for Huntsman, and Huntsman terminated the Basell merger agreement. From July 12 - July 15 the parties negotiated the terms of a Lyondell merger agreement; Basell conducted due diligence; Deutsche Bank prepared a "fairness" opinion; and Lyondell conducted its regularly scheduled board meeting. The Lyondell board discussed the Basell proposal again on July 12, and later instructed Smith to try to negotiate better terms. Specifically, the board wanted a higher price, a go-shop provision, [2] and a reduced break-up fee. As the trial court noted, Blavatnik was "incredulous." He had offered his best price, which was a substantial premium, and the deal had to be concluded on his schedule. As a sign of good faith, however, Blavatnik agreed to reduce the break-up fee from $ 400 million to $ 385 million.

FOOTNOTES

2 A "go-shop" provision allows the seller to seek other buyers for a specified period after the agreement is signed.

On July 16, 2007, the board met to consider the Basell merger agreement. Lyondell's management, as well as its financial and legal advisers, presented reports analyzing the merits of the deal. The advisors explained that, notwithstanding the no-shop provision in the merger agreement, Lyondell would be able to consider any superior proposals that might be made because of the "fiduciary out" provision. In addition, Deutsche Bank reviewed valuation models derived from "bullish" and more conservative financial projections. Several of those valuations yielded a range that did not even reach $ 48 per share, and Deutsche Bank opined that the proposed merger price was fair. Indeed, the bank's managing director described the merger price as "an absolute home run." [3] Deutsche Bank also identified other possible acquirors and explained why it believed no other entity would top Basell's offer. After considering the presentations, the Lyondell board voted to approve the merger and recommend it to the stockholders. At a special stockholders' meeting held on November 20, 2007, the merger was approved by more than 99% of the voted shares.

FOOTNOTES

3 Appellants' Appendix, A-447.

The first stockholders to litigate this merger filed suit in Texas on July 23, 2007. Walter E. Ryan, Jr., the plaintiff in this action, participated in the Texas litigation and filed suit in Delaware on August 20, 2007. The Texas court denied an application for a preliminary injunction on November 13, 2007, while the defendants in Delaware were briefing their motion for summary judgment. The Court of Chancery issued its opinion on July 29, 2008, denying summary judgment as to the "*Revlon*" and the "deal protection" claims. This Court accepted the Lyondell directors' application for certification of an interlocutory appeal on September 15, 2008.

DISCUSSION

The class action complaint challenging this $ 13 billion cash merger alleges that the Lyondell directors breached their "fiduciary duties of care, loyalty and candor ... and . . . put their personal interests ahead of the interests of the Lyondell shareholders." [4] Specifically, the complaint alleges that: 1) the merger price was grossly insufficient; 2) the directors were motivated to approve the merger for their own self-interest; [5] 3) the process by which the merger was negotiated was flawed; 4) the directors agreed to unreasonable deal protection provisions; and 5) the preliminary proxy statement omitted numerous material facts. The trial court rejected all claims except those directed at the process by which the directors sold the company and the deal protection provisions in the merger agreement.

FOOTNOTES

4 Complaint, P 109. A-184.

5 The directors' alleged financial interest is the fact that they would receive cash for their stock options.

The remaining claims are but two aspects of a single claim, under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, [6] that the directors failed to obtain the best available price in selling the company. As the trial court correctly noted, *Revlon* did not create any new fiduciary duties. It simply held that the "board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise." [7] The trial court reviewed the record, and found that Ryan might be able to prevail at trial on a claim that the Lyondell directors breached their duty of care. But Lyondell's charter includes an exculpatory provision, pursuant to 8 *Del. C.* § 102 (b) (7), protecting the directors from personal liability for breaches of the duty of care. Thus, this case turns on whether any arguable shortcomings on the part of the Lyondell directors also implicate their duty of loyalty, a breach of which is not exculpated. Because the trial court determined that the board was independent and was not motivated by self-interest or ill will, the sole issue is whether the directors are entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith.

FOOTNOTES

6 506 A.2d 173, 182 (Del. 1986).

7 *Malpiede v. Townson*, 780 A.2d 1075, 1083 (Del 2000).

This Court examined "good faith" [8] in two recent decisions. In *In re Walt Disney Co. Deriv Litig.*, [9] the Court discussed the range of conduct that might be characterized as bad faith, and concluded that bad faith encompasses not only an intent to harm but also intentional dereliction of duty:
[A]t least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label. The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm . . . . [S]uch conduct constitutes classic, quintessential bad faith ....

The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care - that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent .... [W]e address the issue of whether gross negligence (including failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.

* * *

That leaves the third category of fiduciary conduct, which falls in between the first two categories .... This third category is what the Chancellor's definition of bad faith - intentional dereliction of duty, a conscious disregard for one's responsibilities - is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith. In our view, it must be .... [10]

The *Disney* decision expressly disavowed any attempt to provide a comprehensive or exclusive definition of "bad faith."

FOOTNOTES

8 Our corporate decisions tend to use the terms "bad faith" and "failure to act in good faith" interchangeably, although in a different context we noted that, "[t]he two concepts – bad faith and conduct not in good faith are not necessarily identical." *25 Massachusetts Avenue Property LLC v. Liberty Property Limited Partnership*, Del. Supr., No. 188, 2008, Order at p.5, (November 25, 2008). For purposes of this appeal, we draw no distinction between the terms.

9 906 A.2d 27 (Del. 2006).

10 *Id*. at 64-66.

A few months later, in *Stone v. Ritter,"* [11] this Court addressed the concept of bad faith in the context of an "oversight" claim. We adopted the standard articulated ten years earlier, in *In re Caremark Int'l Deriv. Litig.:* [12]
[W]here a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability.

The *Stone* Court explained that the *Caremark* standard is fully consistent with the *Disney* definition of bad faith. *Stone* also clarified any possible ambiguity about the directors' mental state, holding that "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." [13]

FOOTNOTES

11 911 A.2d 362 (Del. 2006).

12 698 A.2d 959, 971 (Del. Ch. 1996).

13 *Stone*, 911 A.2d at 370.

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The Court of Chancery recognized these legal principles, but it denied summary judgment in order to obtain a more complete record before deciding whether the directors had acted in bad faith. [14] Under other circumstances, deferring a decision to expand the record would be appropriate. [15] Here, however, the trial court reviewed the existing record under a mistaken view of the applicable law. Three factors contributed to that mistake. First, the trial court imposed *Revlon* duties on the Lyondell directors before they either had decided to sell, or before the sale had become inevitable. Second, the court read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process. Third, the trial court equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith.

FOOTNOTES

14 "Our standard of review is *de novo. Aeroglobal Capital Management, LLC v. Cirrus Industries, Inc*., 871 A.2d 428, 444 (Del. 2005).

15 *Ibid.*

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Summary judgment may be granted if there are no material issues of fact in dispute and the moving party is entitled to judgment as a matter of law. The facts, and all reasonable inferences, must be considered in the light most favorable to the nonmoving party. [16] The Court of Chancery identified several undisputed facts that would support the entry of judgment in favor of the Lyondell directors: the directors were "active, sophisticated, and generally aware of the value of the Company and the conditions of the markets in which the Company operated." [17] They had reason to believe that no other bidders would emerge, given the price Basell had offered and the limited universe of companies that might be interested in acquiring Lyondell's unique assets. Smith negotiated the price up from $ 40 to $ 48 per share -- a price that Deutsche Bank opined was fair. Finally, no other acquiror expressed interest during the four months between the merger announcement and the stockholder vote.

FOOTNOTES

16 *Ibid.*

17 *Ryan v. Lyondell Chemical Co*., 2008 Del. Ch. LEXIS 105, 2008 WL 2923427 at *13 (Del.Ch.) *(Lyondell I).*

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Other facts, however, led the trial court to "question the adequacy of the Board's knowledge and efforts . . . ." [18] After the Schedule 13D was filed in May, the directors apparently took no action to prepare for a possible acquisition proposal. The merger was negotiated and finalized in less than one week, during which time the directors met for a total of only seven hours to consider the matter. The directors did not seriously press Blavatnik for a better price, nor did they conduct even a limited market check. Moreover, although the deal protections were not unusual or preclusive, the trial court was troubled by "the Board's decision to grant considerable protection to a deal that may not have been adequately vetted under *Revlon.*" [19]

FOOTNOTES

18 2008 Del. Ch. LEXIS 105, [WL] at *14.

19 2008 Del. Ch. LEXIS 105, [WL] at *17.

The trial court found the directors' failure to act during the two months after the filing of the Basell Schedule 13D critical to its analysis of their good faith. The court pointedly referred to the directors' "two months of slothful indifference despite *knowing* that the Company was in play," [20] and the fact that they "languidly awaited overtures from potential suitors . . . ." [21] In the end, the trial court found that it was this "failing" that warranted denial of their motion for summary judgment:

[T]he Opinion clearly questions whether the Defendants "engaged" in the sale process . . . . This is where the 13D filing in May 2007 and the subsequent two months of (apparent) Board inactivity become critical . . . . [T]he Directors made *no apparent effort* to arm themselves with *specific knowledge* about the present value of the Company in the May through July 2007 time period, despite *admittedly knowing* that the 13D filing . . effectively put the Company "in play," and, therefore, presumably, also knowing that an offer for the sale of the Company could occur at any time. It is these facts that raise the specter of "bad faith" in the present summary judgment record . . . [22]

FOOTNOTES

20 *Ibid.*

21 *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *14.

22 *Ryan v. Lyondell Chemical Co.,* 2008 Del. Ch. LEXIS 125, 2008 WL 4174038 at *2 (Del.Ch.) *(Lyondell II).*

The problem with the trial court's analysis is that *Revlon* duties do not arise simply because a company is "in play." [23] The duty to seek the best available price applies only when a company embarks on a transaction -- on its own initiative or in response to an unsolicited offer-- that will result in a change of control. [24] Basell's Schedule 13D did put the Lyondell directors, **[*17]** and the market in general, on notice that Basell was interested in acquiring Lyondell. The directors responded by promptly holding a special meeting to consider whether Lyondell should take any action. The directors decided that they would neither put the company up for sale nor institute defensive measures to fend off a possible hostile offer. Instead, they decided to take a "wait and see" approach. That decision was an entirely appropriate exercise of the directors' business judgment. The time for action under *Revlon* did not begin until July 10, 2007, when the directors began negotiating the sale of Lyondell.

FOOTNOTES

[23] *Paramount Communications, Inc. v. Time, Inc*., 571 A.2d 1140, 1151 (Del. 1989).

[24] *In re Santa Fe Pac. Corp. S'holder Litig*., 669 A.2d 59, 71 (1995).

The Court of Chancery focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basell's offer. During that one week, the directors met several times; their CEO tried to negotiate better terms; they evaluated Lyondell's value, the price offered and the likelihood of obtaining a better price; and then the directors approved the merger. The trial court acknowledged that the directors' conduct during those seven days might not demonstrate anything more than lack of due care. [25] But the court remained skeptical about the directors' good faith -- at least on the present record. That lingering concern was based on the trial court's synthesis of the *Revlon* line of cases, which led it to the erroneous conclusion that directors must follow one of several courses of action to satisfy their *Revlon* duties.

FOOTNOTES

[25] *Lyondell II* 2008 Del. Ch. LEXIS 125, [WL] at *4.

There is only one *Revlon* duty -- to "[get] the best price for the stockholders at a sale of the company." [26] No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. As we noted in *Barkan v. Amsted Industries, Inc.*, "there is no single blueprint that a board must follow to fulfill its duties. [27] That said, our courts have highlighted both the positive and negative aspects of various boards' conduct under *Revlon.* [28] The trial court drew several principles from those cases: directors must "engage actively in the sale process," [29] and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating "an impeccable knowledge of the market." [30]

FOOTNOTES

26 *Revlon*, 506 A.2d at 182.

27 567 A.2d 1279, 1286 (Del. 1989).

28 *See, e.g.: Barkan v Amsted Industries, Inc*., 567 A.2d at 1287 (Directors need not conduct a market check if they have reliable basis for belief that price offered is best possible.); *Paramount Communications, Inc. v. QVC Network, Inc*., 637 A.2d 34,49 (Del. 1994) (No-shop provision impermissibly interfered with directors' ability to negotiate with another known bidder); *In re Netsmart Technologies, Inc., Shareholders Litig*., 924 A.2d 171, 199 (Del. Ch. 2007) (Plaintiff likely to succeed on claim based on board's failure to consider strategic buyers.)

29 *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *12.

30 2008 Del. Ch. LEXIS 105, [WL] at *19.

The Lyondell directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the "impeccable" market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under *Revlon.* In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise. But we would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care. Where, as here, the issue is whether the directors failed to act in good faith, the analysis is very different, and the existing record mandates the entry of judgment in favor of the directors.

As discussed above, bad faith will be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." [31] The trial court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that "known set of *[Revlon]* 'duties'." [32] But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.

FOOTNOTES

31 *Disney* at 67.

32 *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *19.

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Directors' decisions must be reasonable, not perfect. [33] "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." [34] The trial court denied summary judgment because the Lyondell directors' "unexplained inaction" prevented the court from determining that they had acted in good faith. [35] But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price. [36]

FOOTNOTES

33 *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d at 45.

34 *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 2008 Del. Ch. LEXIS 121, 2008 WL 4053221 at *11 (Del. Ch.).

35 *Lyondell II* 2008 Del. Ch. LEXIS 125, [WL] at *5.

36 *See Stone* at 369.

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Viewing the record in this manner leads to only one possible conclusion. The Lyondell directors met several times to consider Basell's premium offer. They were generally aware of the value of their company and they knew the chemical company market. The directors solicited and followed the advice of their financial and legal advisors. They attempted to negotiate a higher offer even though all the evidence indicates that Basell had offered a "blowout" price. [37] Finally, they approved the merger agreement, because "it was simply too good not to pass along [to the stockholders] for their consideration." [38] We assume, as we must on summary judgment, that the Lyondell directors did absolutely nothing to prepare for Basell's offer, and that they did not even consider conducting a market check before agreeing to the merger. Even so, this record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith.

In concluding otherwise, the Court of Chancery reversibly erred.

FOOTNOTES

37 *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *1. The trial court disparages the Lyondell directors' characterization of $ 48 per share as a "blowout" premium. But the record evidence -- including testimony from Basell directors who voted against the merger because they believed the price was too high -- supports such a description.

38 *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *8.

CONCLUSION

Based on the foregoing, the decision of the Court of Chancery is reversed and this matter is remanded for entry of judgment in favor of the Lyondell directors. Jurisdiction is not retained.

III.CHAPTER 4, INTRODUCTION TO SECURITIES REGULATION

A. Page 304, New Sec. 4.17.F. 2007 Final Amendments to Rule 144

Page 304, New Sec. 4.17.F. Add after Sec. 4.17.E the following:
New Sec. 4.17.F. **2007 Final Amendments to Rule 144**

Securities Act Release No. 8869, Amendments to Rule 144 and 145
December 6, 2007
(The amended Rule 144 is at the end of this document.)

ACTION: Final rule.

SUMMARY: Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. We are shortening the holding period requirement under Rule 144 for "restricted securities" of issuers that are subject to the reporting requirements of the Securities Exchange Act of 1934 to six months. Restricted securities of issuers that are not subject to the Exchange Act reporting requirements will continue to be subject to a one-year holding period prior to any public resale. The amendments also substantially reduce the restrictions applicable to the resale of securities by non-affiliates. In addition, the amendments simplify the Preliminary Note to Rule 144, amend the manner of sale requirements and eliminate them with respect to debt securities, amend the volume limitations for debt securities, increase the Form 144 filing thresholds, and codify several staff interpretive positions that relate to Rule 144. Finally, we are eliminating the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and revising the resale requirements in Rule 145(d). We believe that the amendments will increase the liquidity of privately sold securities and decrease the cost of capital for all issuers without compromising investor protection. [The amendments to Rule 144 are discussed in Chapter 13.] * * *

I. Background

The Securities Act of 1933 ("Securities Act") requires registration of all offers and sales of securities in interstate commerce or by use of the U.S. mails, unless an exemption from the registration requirement is available. [8] Section 4(1) of the Securities Act provides such an exemption for transactions by any person other than an issuer, underwriter or dealer. [9] [footnotes are at the end of the document]

The definition of the term "underwriter" is key to the operation of the Section 4(1) exemption. Section 2(a)(11) of the Securities Act defines an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking." [10] The Securities Act does not, however, provide specific criteria for determining when a person purchases securities "with a view to ... the distribution" of those securities. In 1972, the Commission adopted Rule 144 to provide a safe harbor from this definition of "underwriter" to assist security holders in determining whether the Section 4(1) exemption is available for their resale of securities. [11]

Rule 144 regulates the resale of two categories of securities - restricted securities and control securities. Restricted securities are securities acquired pursuant to one of the transactions listed in Rule 144(a)(3). [12] Although it is not a term defined in Rule 144, "control securities" is used commonly to refer to securities held by an affiliate of the issuer, [13] regardless of how the affiliate acquired the securities. [14] Therefore, if an affiliate acquires securities in a transaction that is listed in Rule 144(a)(3), those securities are both restricted securities and control securities. A person selling restricted securities, or a person selling restricted or other securities on behalf of the account of an affiliate, who satisfies all of Rule 144's applicable conditions in connection with the transaction, is deemed not to be an "underwriter," as defined in Section 2(a)(11) of the Securities Act, and therefore may rely on the Section 4(1) exemption for the resale of the securities.

Since its adoption, we have reviewed and revised Rule 144 several times. We last made major changes in 1997 ("1997 amendments"). [15] At that time, we shortened the required holding periods for restricted securities. [16] Before the 1997 amendments, security holders could resell restricted securities under Rule 144, subject to limitation, after two years, and persons who were not affiliates and had not been affiliates during the prior three months, could resell restricted securities without limitation after three years. The 1997 amendments changed these two-year and three-year periods to one-year and two-year periods, respectively.

On the same day that we adopted those changes, we also proposed and solicited comment on several possible additional changes to Rule 144, Rule 145 and Form 144, including reducing the holding period further ("1997 Proposing Release" and "1997 proposals"). [17] We received 38 comment letters on those proposed changes. While some commenters supported further shortening the holding periods, others suggested that we monitor the results of the 1997 amendments before making further changes. We did not take further action to adopt the 1997 proposals.

Rule 144 states that a selling security holder shall be deemed not to be engaged in a distribution of securities, and therefore not an underwriter, with respect to such securities, thus making available the Section 4(1) exemption from registration, if the resale satisfies specified conditions. The conditions include the following:

l There must be adequate current public information available about the issuer; [18]

l If the securities being sold are restricted securities, the security holder must have held the security for a specified holding period; [19]

l The resale must be within specified sales volume limitations; [20]

l The resale must comply with the manner of sale requirements; [21] and

l The selling security holder must file Form 144 if the amount of securities being sold exceeds specified thresholds. [22]

Rule 144, as it existed before today's amendments, permitted a non-affiliate to publicly resell restricted securities without being subject to the above limitations if the securities had been held for two years or more, provided that the security holder was not, and, for the three months prior to the sale, had not been, an affiliate of the issuer. [23]

On July 5, 2007, we again proposed to amend several aspects of Rule 144 and Rule 145, including by further shortening the holding periods (the "2007 Proposing Release"). [24] We proposed to shorten the holding period requirement in Rule 144(d) for restricted securities of issuers that are subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") [25] to six months. Restricted securities of issuers that are not subject to Exchange Act reporting requirements would continue to be subject to a one-year holding period under Rule 144(d). We also proposed to relieve non-affiliates of reporting issuers from having to comply with all conditions in Rule 144, except the current public information requirement, after a six-month holding period. Non-affiliates of non-reporting issuers would be allowed to resell their securities freely after a one-year holding period. In addition, we proposed to:

l Simplify the Preliminary Note to Rule 144 and text of Rule 144;

l Toll the holding period during the time that security holders engage in certain hedging transactions;

l Eliminate the "manner of sale" requirements with respect to the resale of debt securities;

l Increase the thresholds triggering the requirement to file Form 144; and

l Codify several staff positions relating to Rule 144.

We also solicited comment on amending the Form 144 filing deadline to coincide with the deadline for filing a Form 4 [26] under Section 16 [27] of the Exchange Act and permitting persons who are subject to Section 16 to meet their Form 144 filing requirement by filing a Form 4. [28] Finally, we proposed to eliminate the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and to harmonize the resale provisions in Rule 145 with the Rule 144 provisions applicable to resales of securities of shell companies.

We received 32 comment letters from 30 commenters on the proposals in the 2007 Proposing Release. [29] A majority of the commenters expressed support for the proposals in general. [30] Several of these commenters expressed support for the proposed amendments to shorten the holding period requirement in Rule 144 for both affiliates and non-affiliates of Exchange Act reporting issuers. [31] Two commenters opposed shortening the holding period, as proposed. [32]

Some commenters expressed opposition to the proposed reintroduction of a provision that would toll, or suspend, for up to six months, the holding period during any period that a security holder engages in hedging activities with respect to any equity securities of the same class as the restricted securities or any securities convertible into that class (or, in the case of nonconvertible debt, with respect to any nonconvertible debt securities). [33] The commenters thought that the tolling provision could have a negative effect on capital raising transactions. These commenters provided several recommendations on how we should modify the tolling provision, if we decide to adopt it. We received general support for the other aspects of the proposed amendments, including the proposals relating to Form 144, the elimination of the manner of sale requirements for debt securities and the codification of several staff interpretations.

II. Discussion of Final Amendments

A. Simplification of the Preliminary Note and Text of Rule 144

In the 2007 Proposing Release, we noted that the current Preliminary Note is complex and may be confusing to some security holders. We proposed amendments to simplify and clarify the Preliminary Note to Rule 144 and to incorporate plain English principles. The proposed amendments to the Preliminary Note were not intended to alter the substantive operation of the rule. In addition, we proposed changes throughout the rule to make the rule less complex and easier to read.

We received a few comments on the proposed changes to simplify Rule 144 and the Preliminary Note. One commenter believed that the Preliminary Note to Rule 144 is no longer necessary, because the purpose and meaning of the rule are well-understood. [34] Some commenters recommended that we further explain how Rule 144 can be used for the resale of control securities. [35]

We are adopting the amendments to the Preliminary Note with some modification from the proposed version. The revised Preliminary Note retains an explanation of the relationship among the exemption in Section 4(1) of the Securities Act, the Section 2(a)(11) definition of “underwriter” and the Rule 144 safe harbor. Consistent with the proposal, the revised Preliminary Note also clarifies that any person who sells restricted securities, and any person who sells restricted securities or other securities on behalf of an affiliate, shall be deemed not to be engaged in a distribution of such securities and therefore shall be deemed not to be an underwriter with respect to such securities if the sale in question is made in accordance with all the applicable provisions of the rule. The revised Preliminary Note further states that, although Rule 144 provides a safe harbor for establishing the availability of the Section 4(1) exemption, it is not the exclusive means for reselling restricted and control securities. Therefore, Rule 144 does not eliminate or otherwise affect the availability of any other exemption for resales. [36] Consistent with a statement that was included in the original Rule 144 adopting release, [37] we are adding a statement to the Preliminary Note that the Rule 144 safe harbor is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. [38] We also are adopting plain English changes throughout the rule text substantially as proposed.

B. Amendments to Holding Periods for Restricted Securities

1. Six-Month Rule 144(d) Holding Period Requirement for Exchange Act Reporting Companies

As stated above, in 1997, we reduced the Rule 144 holding periods for restricted securities for both affiliates and non-affiliates. [39] Before the 1997 amendments, security holders could sell limited amounts of restricted securities after holding those securities for two years if they satisfied all other conditions imposed by Rule 144. [40] Under Rule 144(k), non-affiliates could sell restricted securities without being subject to any of the conditions in Rule 144 after holding their securities for three years. The 1997 amendments to Rule 144 reduced the two-year Rule 144(d) holding period to one year and amended the three-year Rule 144(k) holding period to two years.

In the 1997 Proposing Release, we solicited comment on whether the Rule 144(d) holding period should be further reduced for both affiliates and non-affiliates, and whether restrictions applicable to sales by non-affiliates also should be reduced. We received numerous comments on this issue. Twelve commenters recommended that we further reduce the holding period to six months. [41] Two other commenters thought that we should maintain the holding periods that we had just recently adopted. [42] Eight commenters recommended that we gain more experience with the new holding periods before proposing further amendments to those holding periods. [43]

In the 2007 Proposing Release, we again proposed to shorten the Rule 144(d) holding period for restricted securities held by affiliates and non-affiliates. [44] The proposal would have permitted both affiliates and non-affiliates to publicly sell restricted securities of Exchange Act reporting issuers [45] after holding the securities for six months, subject to any other applicable condition of Rule 144, if they had not engaged in hedging transactions with respect to the securities. Because of our concern that the market does not have sufficient information and safeguards with respect to non-reporting issuers, we proposed to retain the one-year holding period for restricted securities of issuers that are not subject to Exchange Act Section 13(a) or Section 15(d) reporting obligations for both affiliates and non-affiliates.

Several commenters supported the proposal to shorten the holding period to six months for securities of reporting issuers. [46] These commenters noted that the shortened holding period would increase liquidity for issuers, make capital investment more attractive, and decrease costs of capital for smaller companies without sacrificing investor protection. [47] In this regard, one commenter noted that today's markets now function at an accelerated pace, and technology, particularly the Internet, has caused the markets to become more efficient. [48] Two commenters advocated an even shorter holding period requirement than the proposed six-month period, with one commenter advocating a four-month holding period and the other a three-month holding period. [49] Two commenters opposed shortening the holding period requirement under Rule 144, as proposed. [50]

The purpose of Rule 144 is to provide objective criteria for determining that the person selling securities to the public has not acquired the securities from the issuer for distribution. A holding period is one criterion established to demonstrate that the selling security holder did not acquire the securities to be sold under Rule 144 with distributive intent. We do not want the holding period to be longer than necessary or impose any unnecessary costs or restrictions on capital formation. After observing the operation of Rule 144 since the 1997 amendments, we believe that a six-month holding period for securities of reporting issuers provides a reasonable indication that an investor has assumed the economic risk of investment in the securities to be resold under Rule 144. Therefore, we are adopting a six-month holding period for reporting companies, as proposed. [51] Most commenters agreed that shortening the holding period to six months for restricted securities of reporting issuers will increase the liquidity of privately sold securities and decrease the cost of capital for reporting issuers, while still being consistent with investor protection. [52] By reducing the holding period for restricted securities, these amendments are intended to help companies to raise capital more easily and less expensively. For example, by making private offerings more attractive, the amendments may allow some companies to avoid certain types of costly financing structures involving the issuance of extremely dilutive convertible securities. Many commenters supported the proposal to maintain the existing one-year holding period for restricted securities of non-reporting issuers. [53]

Under the amendments that we are adopting, the six-month holding period requirement will apply to the securities of an issuer that has been subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act for a period of at least 90 days before the Rule 144 sale. [54] Restricted securities of a "non-reporting issuer" will continue to be subject to a one-year holding period requirement. [55] A non-reporting issuer is one that is not, or has not been for a period of at least 90 days before the Rule 144 sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act. [56]

We believe that different holding periods for reporting and non-reporting issuers are appropriate given that reporting issuers have an obligation to file periodic reports with updated financial information (including audited financial information in annual filings) that are publicly available on EDGAR, the Commission's electronic filing system. Although non-reporting issuers must make some information publicly available before resales can be made under Rule 144, this information typically is much more limited in scope than information included in Exchange Act reports, is not required to include audited financial information, and is not publicly available via EDGAR. [57] For these reasons, we believe that continuing to require security holders of non-reporting issuers to hold their securities for one year is not unduly burdensome and is consistent with investor protection.

2. Significant Reduction of Conditions Applicable to Non-Affiliates

Before adoption of these amendments, both non-affiliates and affiliates were subject to all other applicable conditions of Rule 144, in addition to the Rule 144(d) holding period requirement, including the condition that current information about the issuer of the securities be publicly available, the limitations on the amount of securities that may be sold in any three-month period, the manner of sale requirements and the Form 144 notice requirement. However, pursuant to paragraph (k) of Rule 144 as it existed prior to the amendments that we are adopting, a non-affiliate of the issuer at the time of the Rule 144 sale who had not been an affiliate during the three months prior to the sale, could sell the securities after holding them for two years without complying with these other conditions.

In the 2007 Proposing Release, we proposed to permit non-affiliates to resell their restricted securities freely after meeting the applicable holding period requirement (i.e., six months with respect to a reporting issuer and one year with respect to a non-reporting issuer), except that non-affiliates of reporting issuers still would be subject to the current public information requirement in Rule 144(c) for an additional six months after the end of the initial six-month holding period.

In general, commenters supported the proposal to reduce substantially the requirements for the resale of restricted securities by non-affiliates under Rule 144. [58] Noting the importance of the current public information condition, two commenters expressed support for the proposed retention of that requirement for the resales of restricted securities by non-affiliates occurring between six months and one year after acquisition of the securities. [59] Some commenters expressed support for removal of the manner of sale requirements and the Form 144 notice requirement, [60] while a few objected to removal of those requirements. [61] The commenters objecting to the removal of those requirements expressed concern about the transparency of Rule 144 transactions and the potential increase in violations of the holding period requirement if the manner of sale requirements and the Form 144 notice requirement were eliminated. [62] The two commenters that opposed shortening the Rule 144(d) holding period also opposed the proposals to permit non-affiliates to resell without being subject to any other condition (except the public information requirement, with respect to resales of securities of reporting companies) after they meet the holding period. [63]

We are adopting the amendments for the sale of restricted securities by non-affiliates after the holding period, as proposed. [64] Under the amendments, after the applicable holding period requirement is met, the resale of restricted securities by a non-affiliate under Rule 144 will no longer be subject to any other conditions of Rule 144 except that, with regard to the resale of securities of a reporting issuer, the current public information requirement in Rule 144(c) will apply for an additional six months after the six-month holding period requirement is met. [65] Therefore, a non-affiliate will no longer be subject to the Rule 144 conditions relating to volume limitations, manner of sale requirements, and filing Form 144. [66]

We believe that the complexity of resale restrictions may inhibit sales by, and imposes costs on, non-affiliates. Because Rule 144 is relied upon by many individuals to resell their restricted securities, we believe that it is particularly helpful to streamline and reduce the complexity of the rule as much as possible while retaining its integrity. We continue to believe that retaining the current public information requirement with regard to resales of restricted securities of reporting issuers for up to one year after the acquisition of the securities is important to help provide the market with adequate information regarding the issuer of the securities. In addition, we generally believe that most abuses in sales of unregistered securities involve affiliates of issuers [67] and securities of shell companies. As discussed below, we are codifying the staff's current interpretive position that Rule 144 cannot be relied upon for the resale of the securities of reporting and non-reporting shell companies. [68]

The final conditions applicable to the resale under Rule 144 of restricted securities held by affiliates and non-affiliates of the issuer can be summarized as follows:

	Affiliate or Person Selling on Behalf of an Affiliate	**Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)**
Restricted Securities of Reporting Issuers	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period</u> – may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period but before one year</u> – unlimited public resales under Rule 144 except that the current public information requirement still applies. <u>After one-year holding period</u> – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	<u>During one-year holding period</u> - no resales under Rule 144 permitted. <u>After one-year holding period</u> – may resell in accordance with all	<u>During one-year holding period</u> - no resales under Rule 144 permitted. <u>After one-year holding period</u> – unlimited public resales under

	Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	Rule 144;need not comply with any other Rule 144 requirements.

3. Tolling Provision

In 1990, we eliminated a Rule 144 provision that tolled, or suspended, the holding period of a security holder maintaining a short position in, or any put or other option to dispose of, securities equivalent to the restricted securities owned by the security holder. [69] We eliminated this provision in conjunction with an amendment to broaden a security holder's ability to tack the holding periods of prior owners to the security holder's own holding period. [70]

We previously have expressed concern regarding the effect of hedging activities designed to shift the economic risk of investment away from the security holder with respect to restricted securities. [71] In the 1997 Proposing Release, we solicited comment on several alternatives designed to address these concerns. [72] Seven commenters recommended that we adopt measures to eliminate or restrict hedging activities during the holding period. [73] Six commenters recommended maintaining the status quo. [74] Six other commenters suggested that we adopt a safe harbor for certain hedging activities that would be deemed permissible under Rule 144. [75]

In the 2007 Proposing Release, we acknowledged a concern about the effect of hedging activities in connection with the adoption of a six-month holding period for securities of reporting issuers. We noted that, when we eliminated the tolling provision in 1990, the Rule 144 holding periods were longer. [76] We also expressed the view that the proposal to shorten the holding period to six months could make the entry into such hedging arrangements significantly easier and less costly because these arrangements would cover a much shorter period. [77] We therefore proposed to reintroduce a Rule 144 tolling provision that would have suspended the holding period for restricted securities of Exchange Act reporting issuers while a security holder engaged in certain hedging transactions. [78] However, we proposed that any suspension due to hedging would not have caused, under any circumstances, the holding period to extend beyond one year.

Because the proposed tolling provision also would have worked in conjunction with the Rule 144 provisions that permit tacking of holding periods, a selling security holder would have been required to determine whether a previous owner of the securities had engaged in hedging activities with respect to the securities, if the selling security holder wished to tack the previous owner's holding period to the holding period of the selling security holder. The proposed provision would have tolled the holding period during any period in which the previous owner held a short position or put equivalent position with respect to the securities, however, there would have been no tolling of the previous owner's holding period if the security holder for whose account the securities were to be sold reasonably believed that no such short or put equivalent position was held by the previous owner.

In connection with the proposed tolling provision, we also proposed other related changes to Rule 144. First, we proposed to require that information be provided in Form 144 regarding any short or put equivalent position held with respect to the securities prior to the resale of the securities. The second proposal related to the manner of sale requirements in paragraphs (f) and (g) of Rule 144. [79]

Several commenters objected to the proposed reintroduction of the tolling provision and suggested modifications to the proposed provision, if the Commission chose to adopt it. [80] Commenters objecting to the proposed tolling provision provided the following reasons, among others, why the Commission should not adopt the proposed tolling provision:

- Hedging transactions involve costs and risks for the security holder and do not entirely transfer risk of the economic investment of the securities; [81]
- Any concern that the Commission has about hedging activities immediately after the acquisition is outweighed by the belief that hedging activities can enhance private placements as a means of capital formation and should be allowed to continue because they do not raise substantial concerns about unregistered distributions; [82]
- In the current environment, a security holder may hold long and short positions across multiple trading desks and complex financial institutions and positions may change daily or even intra-day. The task of tracing and processing such positions would necessitate the development of costly custom software and hardware systems. Consequently, security holders might ultimately choose to hold the securities for the default one-year period rather than implement these costly systems, thereby frustrating the intent of the Commission in adopting the six-month holding period; [83]
- There is a natural ceiling on the amount of hedging activity in restricted securities because the supply of unrestricted securities is limited; [84]
- The Commission has adequate enforcement tools to address abuses in hedging with respect to restricted securities; [85] and
- The Commission's reasoning for eliminating the tolling provision in 1990 was that a single holding period running from the date of purchase from the issuer, or an

affiliate of the issuer, is sufficient to prevent unregistered distributions to the public. [86] This reasoning still applies, even if the holding period is reduced to six months for securities of reporting issuers. [87]

Some commenters reasoned that if the Commission detects an increase in abuse after implementation of the revised holding period, as proposed, the Commission could modify its treatment of hedging activities. [88] This would be consistent with the approaches taken by the Commission when it first adopted Rule 144, and in 1997 when commenters recommended that the Commission gain more experience with the shortened holding periods before making additional revisions. [89]

After considering the comments, we are not adopting the proposed tolling provision and related amendments. We note, in particular, the comments asserting that, in the current environment, the tolling provision would unduly complicate Rule 144 and could require security holders or brokers to incur significant costs to monitor hedging positions for purposes of determining whether they have met the holding period requirement. This would frustrate our primary objectives to streamline Rule 144 and reduce the costs of capital for issuers. We will revisit the issue if we observe abuse relating to the hedging activities of holders of restricted securities. [90]

C. Amendments to the Manner of Sale Requirements Applicable to Resales by Affiliates

Before today's amendments, the manner of sale requirements in Rule 144(f) required securities to be sold in "brokers' transactions" [91] or in transactions directly with a "market maker," as that term is defined in Section 3(a)(38) of the Exchange Act. [92] Additionally, the rule prohibits a selling security holder from: (1) soliciting or arranging for the solicitation of orders to buy the securities in anticipation of, or in connection with, the Rule 144 transaction; or (2) making any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities.

In the 1997 Proposing Release, we proposed to eliminate the manner of sale requirements for the sale of both equity and debt securities alike, reasoning that the manner of sale requirements are not necessary to satisfy the purposes of Rule 144 and limit the liquidity of the security. [93] Some commenters opposed this proposal, asserting that brokers help ensure that selling security holders are complying with the applicable Rule 144 conditions to resale. [94] As discussed below, although we proposed to eliminate the manner of sale requirements only for debt securities and not equity securities in the 2007 Proposing Release, we requested comment on whether it would be appropriate to eliminate the manner of sale requirements for the sale of equity securities as well.

The comments were mixed on this point. One commenter strongly discouraged the elimination of the manner of sale requirements for equity securities, [95] while another supported such a change. [96] One commenter did not object to retaining the manner of sale requirements for resales of equity securities of affiliates, on the grounds that affiliates generally find the assistance of a broker useful in navigating compliance with Rule 144 and thus brokers serve a useful function that is not unduly burdensome. [97] Instead of completely eliminating the manner of sale requirements, some commenters requested that we consider expanding the methods to sell the securities permitted by the manner of sale requirements. [98] For example, two commenters discussed amending the requirement to permit sales through alternative trading systems such as electronic venues where the broker's identity is anonymous prior to trade execution. [99]

In response to comments, we are adopting amendments to the manner of sale requirements that apply to resales of equity securities of affiliates. [100] We last made substantive amendments to the manner of sale requirements in 1978. [101] Since then, the growth of technological and other developments directed at meeting the investment needs of the public and reducing the cost of capital for companies have led us to refine the rules governing the trading of securities. [102] We believe that it is appropriate now to adopt two amendments to the manner of sale requirements so that the restrictions better reflect current trading practices and venues.

First, we are adopting a change to Rule 144(f) to permit the resale of securities through riskless principal transactions in which trades are executed at the same price, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee, and the rules of a self-regulatory organization permit the transaction to be reported as riskless. [103] We believe that these riskless principal transactions are equivalent to agency trades. [104] As with agency trades, in order to qualify as a permissible manner of sale under the revised rule, the broker or dealer conducting the riskless principal transaction must meet all the requirements of a brokers' transaction, as defined by Rule 144(g), except the requirement that the broker does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold. The broker or dealer must neither solicit nor arrange for the solicitation of customers' orders to buy the securities in anticipation of or, in connection with, the transaction, must receive no more than the usual and customary markup or markdown, commission equivalent, or other fee, and must conduct a reasonable inquiry regarding the underwriter status of the person for whose account the securities are to be sold.

Second, we are amending Rule 144(g) which defines "brokers' transactions" for purposes of the manner of sale requirements. Under the definition of brokers' transactions, a broker must neither solicit nor arrange for the solicitation of customers' orders to buy the securities in anticipation of, or in connection with, the transaction. However, certain activities specified in three subparagraphs of Rule 144(g)(2) are deemed not to be a solicitation. [105] We are adding another subparagraph covering the posting of bid and ask quotations in alternative trading systems that will also be deemed not to be a solicitation. This new provision permits a broker to insert bid and ask quotations for the security in an alternative trading system, as defined in Rule 300 of Regulation ATS, [106] provided that the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last 12 business days. [107]

D. Changes to Rule 144 Conditions Related to Resales of Debt Securities by Affiliates

1. Comments Received on Proposed Amendments Relating to Debt Securities

In the 2007 Proposing Release, we proposed to eliminate the manner of sale requirements in Rule 144 with regard to sales of debt securities by affiliates. [108] We also requested comment on whether there were any other conditions in Rule 144, such as the volume limitations, to which debt securities should not be subject. In the 2007 Proposing Release, we included preferred stock and asset-backed securities in the "debt securities" category for purposes of the proposed elimination of the manner of sale requirements.

Four commenters expressly supported the proposal to eliminate the manner of sale requirements for resales of debt securities, [109] and we did not receive any comments objecting to the proposal. We also did not receive any comments objecting to the proposed inclusion of preferred stock and asset-backed securities in the definition of debt securities. We received a few comments that we should expand the definition of debt securities for the purposes of proposed changes to the manner of sale requirements. [110]

2. No Manner of Sale Requirements Regarding Resales of Debt Securities

We are adopting the amendments to eliminate the manner of sale requirements for resales of debt securities held by affiliates, as proposed. [111] We agree that, as financial intermediaries, brokers serve an important function as gatekeepers for promoting compliance with Rule 144, [112] and we are concerned that eliminating the manner of sale requirements for equity securities would lead to abuse. However, we do not believe that the fixed income securities market raises the same concerns about abuse, [113] and are persuaded that the manner of sale requirements may place an unnecessary burden on the resale of fixed income securities. [114] Combined with the changes that we are making to the Rule 144(e) volume limitations, these amendments will permit holders of debt securities to rely on the Rule 144 to resell their debt securities in a way and amount that was not possible previously.

As proposed, our definition of debt securities in Rule 144 includes non-participatory preferred stock (which has debt-like characteristics) [115] and asset-backed securities (where the predominant purchasers are institutional investors including financial institutions, pension funds, insurance companies, mutual funds and money managers) [116] in addition to other types of nonconvertible debt securities. This definition of debt securities is consistent with the treatment of such securities under Regulation S. [117]

3. Raising Volume Limitations for Debt Securities

We also are adopting amendments to raise the Rule 144(e) volume limitations for debt securities. Before the amendments that we are adopting, under Rule 144(e), the amount of securities sold in a three-month period could not exceed the greater of: (1) one percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or (2) the average weekly volume of trading in such securities, as calculated pursuant to provisions in the rule. [118] In response to our request for comment regarding whether we should eliminate or revise any other conditions in Rule 144 with regard to debt securities, three commenters noted that the Rule 144(e) volume limitations effectively precluded resales of debt securities by affiliates. [119]

Debt securities generally are issued in tranches. [120] We agree that, prior to our amendments, the volume limitations in Rule 144 constrained the ability of debt holders to rely on Rule 144 for the resales of their securities. For the same reasons that we are eliminating the manner of sale requirements for debt securities, we believe that it is appropriate to adopt an alternative volume limitation that is specifically applicable to the resale of debt securities. We are amending Rule 144(e) to permit the resale of debt securities in an amount that does not exceed ten percent of a tranche (or class when the securities are non-participatory preferred stock), together with all sales of securities of the same tranche sold for the account of the selling security holder within a three-month period. [121] We believe that this new ten percent limitation provision will permit a more reasonable amount of trading in debt securities than the one percent limitation has permitted. [122] These revised volume limitations also apply to resales of non-participatory preferred stock or asset-backed securities, which are defined as debt securities for purposes of Rule 144.

E. Increase of the Thresholds that Trigger the Form 144 Filing Requirement for Affiliates

Before today's amendments, Rule 144(h) required a selling security holder to file a notice on Form 144 if the security holder's intended sale exceeded either 500 shares or $10,000 within a three-month period. [123] These filing thresholds had not been modified since 1972. [124] In the 1997 Proposing Release, we proposed to increase the filing thresholds to 1,000 shares or $40,000. Thirteen commenters supported raising the filing threshold and no commenters opposed the idea. [125] Some commenters suggested that we eliminate Form 144 altogether. [126] One commenter suggested raising the threshold to $100,000. [127] Another commenter suggested raising it to $250,000. [128]

In the 2007 Proposing Release, we proposed to increase the Form 144 filing thresholds to cover sales of 1,000 shares or $50,000 within a three-month period. [129] Some commenters specifically expressed support for raising the Form 144 filing thresholds. [130] One of these commenters recommended filing thresholds of 10,000 shares or $100,000, if the Commission chose to retain a Form 144 filing requirement for affiliates. [131]

We are adopting the increased Form 144 filing thresholds with some modification. As proposed, we are raising the dollar threshold to $50,000 to adjust for inflation since 1972. [132] After considering the comments, we are raising the share threshold to 5,000 shares, rather than the proposed 1,000 shares. We believe that the 5,000 share threshold is an appropriate alternate threshold for trades in amounts that may not reach the $50,000 dollar threshold, but that merit notice to the market.

In the 2007 Proposing Release, we also solicited comment on whether we should coordinate the Form 144 filing requirements with Form 4 filing requirements. Many commenters supported a combination of the two forms. [133] Although we are not adopting those changes today, we expect to issue a separate release in the future to provide affiliates that are subject to both the Form 4 and Form 144 filing requirements with greater flexibility in satisfying their requirements.

F. Codification of Several Staff Positions

In the 2007 Proposing Release, we proposed to codify several interpretive positions issued by the staff of the Division of Corporation Finance. We proposed to codify the first three staff positions listed below in both the 1997 Proposing Release and the 2007 Proposing Release, but we proposed to codify the last four staff positions listed below only in the 2007 Proposing Release.

Some commenters expressed general support for the proposed codifications of staff interpretations relating to Rule 144. [134] One commenter specifically expressed the view that the action should help to resolve any lingering confusion regarding the calculation of holding periods in the circumstances addressed by the interpretations. [135] We are adopting all of the codifications substantially as proposed. The codifications should make these interpretations more transparent and readily available to the public.

1. Securities Acquired under Section 4(6) of the Securities Act are Considered "Restricted Securities"

In 1997, we first proposed to codify the Division of Corporation Finance's interpretive position that securities acquired from the issuer pursuant to an exemption from registration under Section 4(6) of the Securities Act [136] are considered "restricted securities" under Rule 144(a)(3). [137] We did not receive any comments on this proposal at the time. In the 2007 Proposing Release, we again proposed to codify this position. We did not receive any comments.

Section 4(6) provides for an exemption from registration for an offering that does not exceed $5,000,000 that is made only to accredited investors, that does not involve any advertising or public solicitation by the issuer or anyone acting on the issuer's behalf and for which a Form D has been filed. [138] Because the resale status of securities acquired in Section 4(6) exempt transactions should be the same as securities received in other non-public offerings that are included in the definition of restricted securities, we are of the view that securities acquired under Section 4(6) should be defined as restricted securities for purposes of Rule 144. Therefore, we are adopting an amendment to add securities acquired under Section 4(6) of the Securities Act to the definition of restricted securities, as proposed. [139]

2. Tacking of Holding Periods When a Company Reorganizes into a Holding Company Structure

In 1997, we also proposed to codify the Division of Corporation Finance's interpretive position that holders may tack the Rule 144 holding period in connection with transactions made solely to form a holding company. [140] When "tacking," holders may count the period during which they held the restricted securities of the predecessor company before the predecessor company reorganized into a holding company structure when calculating the holding period of the restricted securities of the holding company received in the reorganization. We did not receive any comments on this proposal.

We again proposed to codify this interpretive position in the 2007 Proposing Release. Two commenters recommended codification of the staff interpretive position covering tacking, in certain circumstances, in connection with the reincorporation of the issuer in a different state. [141] We did not receive any comments opposing this proposal.

We are adopting this amendment to Rule 144(d), as proposed. [142] This provision will permit tacking of the holding period if the following three conditions are satisfied:

- The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;

- Security holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor company, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and

- Immediately following the transaction, the holding company had no significant assets other than securities of the predecessor and its existing subsidiaries and had substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.

In such transactions, tacking is appropriate because the securities being exchanged are substantially equivalent, and there is no significant change in the economic risk of the investment in the restricted securities. The amendment that we are adopting does not change the staff interpretive position that permits tacking in connection with the reincorporation of the issuer in a different state in certain situations.

3. Tacking of Holding Periods for Conversions and Exchanges of Securities

The 1997 Proposing Release proposed codifying the Division of Corporation Finance's position that, if the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms. [143] As noted in the 1997 release, Rule 144 does not state whether the surrendered securities must have been convertible by their terms in order for tacking to be permitted, which led to some confusion on how to calculate the Rule 144 holding period. We did not receive any comments on this proposal.

We again proposed this amendment to Rule 144(d)(3)(ii) in the 2007 Proposing Release. In addition, we proposed a note to this provision that clarifies the Division's position that if:

- The original securities do not permit cashless conversion or exchange by their terms;
- The parties amend the original securities to allow for cashless conversion or exchange; and
- The security holder provides consideration, other than solely securities of the issuer, for that amendment,

then the newly acquired securities will be deemed to have been acquired on the date that the original securities were so amended. [144]

One commenter expressed support for this proposed amendment. [145] Another commenter provided a suggestion for a technical change to the proposed note, that the phrase "so long as the conversion or exchange itself meets the conditions of this section," be deleted. [146] We are adopting the changes to Rule 144(d), substantially as proposed. [147] In response to comment, we are further clarifying the note to Rule 144(d)(3)(ii) to clarify that the newly acquired securities shall be deemed to have been acquired at the same time as the amendment to the surrendered securities, so long as, in the conversion or exchange, the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer.

4. Cashless Exercise of Options and Warrants

Several commenters responding to the 1997 Proposing Release suggested that we codify the Division of Corporation Finance's position that, upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired, even if the options or warrants originally did not provide for cashless exercise by their terms. [148]

In the 2007 Proposing Release, we proposed to revise Rule 144 to codify that position. We also proposed to add two notes to this new paragraph. As proposed, the first note would codify the Division's position that if:

- The original options or warrants do not permit cashless exercise by their terms; and l The holder provides consideration, other than solely securities of the issuer, to amend the options or warrants to allow for cashless exercise,

then the amended options or warrants would be deemed to have been acquired on the date that the original options or warrants were so amended. [149] This treatment is analogous to our treatment of conversions and exchanges.

The second note would codify the Division's position that the grant of certain options or warrants that are not purchased for cash or property does not create an investment risk in a manner that would justify tacking the holding period for the options or warrants to the holding period for the securities received upon exercise of the options or warrants. [150] This is the case for options granted under an employee benefit plan. The note would clarify that, in such instances, the holder would not be allowed to tack the holding period of the option or warrant and would be deemed to have acquired the underlying securities on the date the option or warrant was exercised, if the conditions of Rule 144(d)(1) and Rule 144(d)(2) are met at the time of exercise.

Three commenters supported the codification of the staff interpretation relating to the cashless exercise of options and warrants. [151] Some commenters believed that the proposed rule should be expanded, [152] such as to include warrants and options that have only a de minimis exercise price. [153] One commenter suggested that we delete the phrase "so long as the conditions of Rule 144(d)(1) and Rule 144(d)(2) are met at the time of exercise," in the second proposed note. [154]

We are adopting the amendments, substantially as proposed. [155] In response to comment, we have further clarified the second note to Rule 144 to make it clear that the newly acquired securities shall be deemed to have been acquired at the same time as the amendment to the options or warrants so long as the exercise itself was cashless. [156]

5. Aggregation of Pledged Securities

In response to suggestions from commenters on the 1997 proposals, we proposed in the 2007 Proposing Release to add a note that would address how a pledgee of securities should calculate the Rule 144(e) volume limitation condition. [157] The note would codify the Division of Corporation Finance's position that, so long as the pledgees are not the same "person" under Rule 144(a)(2), a pledgee of securities may sell the pledged securities without having to aggregate the sale with sales by other pledgees of the same securities from the same pledgor, as long as there is no concerted action by those pledgees. [158] As an example, assume that a security holder (the pledgor) pledges the securities he owns in Company A to two banks, Bank X and Bank Y (the pledgees). If the pledgor defaults:

l Upon default, Bank X does not have to aggregate its sales of Company A securities with Bank Y's sales of Company A securities unless Bank X and Bank Y are acting in concert, but

l Bank X individually still must aggregate its sales with the pledgor's sales, and

l Bank Y individually still must aggregate its sales with the pledgor's sales.

Provided that the loans and pledges are bona fide transactions and there is no concerted action among pledgees and no other aggregation provisions under Rule 144(e) apply, we do not believe that extra burdens on pledgees to track and coordinate resales by other pledgees are warranted.

We received no comments on this proposal, and we are adopting the amendment to Rule 144(e), as proposed. [159]

6. Treatment of Securities Issued by "Reporting and Non-Reporting Shell Companies"

A blank check company is a company that:

l Is in the development stage;

l Has no specific business plan or purpose, or has indicated that its business plan is to merge with or acquire an unidentified third party; and

l Issues penny stock. [160]

Such companies historically have provided opportunity for abuse of the federal securities laws, particularly by serving as vehicles to avoid the registration requirements of the securities laws. [161] Rule 419 under the Securities Act [162] was adopted in 1992 to control the extent to which such companies are able to access funds from a public offering.

In 2005, we amended Securities Act Rule 405 [163] to define a "shell company" to mean a registrant, other than an asset-backed issuer, that has:

(1) no or nominal operations; and

(2) either:

l no or nominal assets;

l assets consisting solely of cash and cash equivalents; or l assets consisting of any amount of cash and cash equivalents and nominal other assets. [164]

On January 21, 2000, the Division of Corporation Finance concluded in a letter to NASD Regulation, Inc. that Rule 144 is not available for the resale of securities initially issued by companies that are, or previously were, blank check companies. [165] In an effort to curtail misuse of Rule 144 by security holders through transactions in the securities of blank check companies, we proposed to codify this position with some modifications. First, we proposed to modify the staff interpretation to address securities of all companies, other than asset-backed issuers, that meet the definition of a shell company, including blank check companies. The category of companies to whom the staff interpretation was proposed to apply is broader than the Rule 405 definition of a “shell company,” however, as it would apply to any “issuer” meeting that standard, whereas the Rule 405 definition refers only to “registrants.” For purposes of the discussion in this release only, we call these companies, “reporting and non-reporting shell companies.” Under the proposed rule, a person who wishes to resell securities of a company that is, or was, a reporting or a non-reporting shell company, other than a business combination related shell company, [166] would not be able to rely on Rule 144 to sell the securities.

Several commenters provided comments on the proposal to codify this staff interpretation with some modification. Some commenters expressed support for the proposed codification, [167] with one commenter noting that most micro-cap frauds result from the purchase and sale of securities issued by shell companies. [168] Two commenters expressed concern that expanding the staff interpretation to shell companies would prohibit reliance on Rule 144 by security holders of businesses attempting to implement real business plans that technically meet the definition of a shell company, but are not blank check companies. [169] One commenter recommended that the Commission only preclude reliance on Rule 144 for the resale of securities if they were issued at the time the issuer was a shell company. [170]

We are adopting, as proposed, the amendment to prohibit reliance on Rule 144 for the resale of securities of a company that is a reporting or a non-reporting shell company. [171] Under the amended rules, Rule 144 will not be available for the resale of securities initially issued by either a reporting or non-reporting shell company (other than a business combination related shell company) or an issuer that has been at any time previously a reporting or non-reporting shell company, unless the issuer is a former shell company that meets all of the conditions discussed below. [172]

In another part of our proposal regarding the resale of securities of reporting and non-reporting shell companies, we proposed to modify the staff interpretation to make Rule 144 available for resales of securities of companies that were formerly shell companies under provisions that are similar to other provisions that permit the use of a Securities Act Form S-8 [173] registration statement by reporting companies that were former shell companies. [174] Under the proposal, despite the general prohibition against reliance on Rule 144 with respect to securities acquired by shell companies or former shell companies, a security holder would have been able to resell securities subject to Rule 144 conditions if the issuer:

l had ceased to be a shell company;

l is subject to Exchange Act reporting obligations;

l has filed all required Exchange Act reports during the preceding twelve months; and

l at least 90 days have elapsed from the time the issuer files "Form 10 information" reflecting the fact that it had ceased to be a shell company before any securities were sold under Rule 144.

"Form 10 information" is equivalent to information that a company would be required to file if it were registering a class of securities on Form 10 or Form 20-F under the Exchange Act. [175] This information is ordinarily included in a Form 8-K if the former shell company has been filing Exchange Act reports. [176] As proposed, the Rule 144(d) holding period for restricted securities sold under this provision would have commenced at the time that the Form 10 information was filed.

We are adopting this part of the amendments, with some modification. [177] We have modified the proposal to require at least one year to elapse after Form 10 information is filed with Commission before a security holder can resell any securities of an issuer that was formerly a shell company subject to Rule 144 conditions. We believe that the one-year period is necessary for investor protection given the comments relating to the abuse and micro-cap fraud occurring in connection with the securities of shell companies. Both restricted securities and unrestricted securities will be subject to the same one-year waiting period. Thus, under the amendments that we are adopting, Rule 144 is available for the resale of restricted or unrestricted securities that were initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously a reporting or non-reporting shell company, only if the following conditions are met:

l The issuer of the securities that was formerly a reporting or non-reporting shell company has ceased to be a shell company;

l The issuer of the securities is subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act;

l The issuer of the securities has filed all reports and material required to be filed under Section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials), other than Form 8-K reports (§249.308 of this chapter); and l At least one year has elapsed from the time that the issuer filed current Form 10 type information with the Commission reflecting its status as an entity that is not a shell company.

One commenter requested clarification on when a Form 10 is deemed filed, if the staff is undertaking a review of the filing, and recommended that the Form 10 should be deemed filed when the information is filed initially with the Commission. [178] To promote consistency and to provide a date that security holders can rely upon, the Form 10 information will be deemed filed when the initial filing is made with the Commission, rather than when the staff of the Division of Corporation Finance has completed its review of the filing or an amendment is made in response to staff comments, for purposes of the amendments. [179]

Some commenters recommended that we permit security holders of non-reporting companies that have merged with a private operating company and therefore have ceased to be shell companies to be able to rely on Rule 144. [180] We are not adopting a provision to permit this, because we believe that Form 10 type information and Exchange Act reporting requirements are important in protecting against potential abuse.

7. Representations Required from Security Holders Relying on Exchange Act Rule 10b5-1(c)

Rule 10b5-1 [181] under the Exchange Act defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Exchange Act Section 10(b) [182] and Rule 10b-5. [183] Specifically, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale. However, Rule 10b5-1(c) provides an affirmative defense that a person's purchase or sale was not "on the basis of" material nonpublic information. For this defense to be available, the person must demonstrate that:

l before becoming aware of the material nonpublic information, he or she had entered into a binding contract to purchase or sell the securities, provided instructions to another person to execute the trade for the instructing person's account, or adopted a written plan for trading the securities;

l the contract, instructions or written trading plan satisfy the conditions of Rule 10b5-1(c); and

l the purchase or sale that occurred was pursuant to the contract, instruction, or plan.

Form 144 requires a selling security holder to represent, as of the date that the form is signed, that he or she "does not know any material adverse information in regard to the current and prospective operations of the issuer of the securities to be sold which has not been publicly disclosed." The Division of Corporation Finance has indicated that a selling security holder who satisfies Rule 10b5-1(c) may modify the Form 144 representation to indicate that he or she had no knowledge of material adverse information about the issuer as of the date on which the holder adopted the written trading plan or gave the trading instructions. In this case, the security holder must specify that date and indicate that the representation speaks as of that date. [184]

In order to reconcile the Form 144 representation with Rule 10b5-1, we proposed to codify this interpretive position. Under the proposed amendments, Form 144 filers would be able to make the required representation as of the date that they adopted written trading plans or gave trading instructions that satisfied Rule 10b5-1(c). We did not receive any comments specifically on this proposal. We are adopting this amendment, as proposed. [185]

H. Conforming and Other Amendments

1. Regulation S Distribution Compliance Period for Category Three Issuers

The purpose of the distribution compliance period in Regulation S [197] is to ensure that during the offering period and in the subsequent aftermarket trading that takes place offshore, the persons complying with the Rule 903 [198] safe harbor (issuers, distributors and their affiliates) are not engaged in an unregistered, non-exempt distribution of securities into the United States capital markets. [199] In the 2007 Proposing Release, we requested comment on whether to amend Regulation S to conform the one-year distribution compliance period in Rule 903(b)(3)(iii) for Category 3 issuers (U.S. reporting issuers) to the proposed six-month Rule 144(d) holding period, or to retain the one-year distribution compliance period.

Several commenters recommended revising the Regulation S distribution compliance period in Rule 903(b)(3)(iii) to coincide with the six-month holding period under a revised Rule 144. [200] Commenters reasoned, among other things, that such a revision is logical and would promote consistency among the rules. [201] We did not receive any comment letters objecting to such an amendment to Regulation S.

When Regulation S was amended in 1998, the distribution compliance period was revised to coincide with the Rule 144(d) holding period. [202] In making this revision, we noted that a distribution compliance period that is longer than the Rule 144 holding period is unnecessary and could be confusing to apply. For the same reason, we are amending Regulation S to conform the distribution compliance period in Rule 903(b)(3)(iii) for Category 3 reporting issuers to the amendments to the Rule 144 holding period. [203] As a result, U.S. reporting issuers will be subject to a distribution compliance period of six months under Regulation S. * * *

[1] 17 CFR 230.144.

[2] 17 CFR 230.145.

[3] 17 CFR 230.190.

[4] 17 CFR 230.701.

[5] 17 CFR 230.903.

[6] 17 CFR 239.144.

[7] 15 U.S.C. 77a *et seq*.

[8] See 15 U.S.C. 77e.

[9] 15 U.S.C. 77d(1).

[10] 15 U.S.C. 77b(a)(11). Section 2(a)(11) states that the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. Therefore, any person who purchased securities from an affiliate of an issuer is an underwriter under Section 2(a)(11) if that person purchased with a view to the distribution of the securities.

[11] Release No. 33-5223 (Jan. 11, 1972) [37 FR 591].

[12] 17 CFR 230.144(a)(3).

[13] An affiliate of the issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer. See 17 CFR 230.144(a)(1).

[14] See, *e.g.*, Release No. 33-7391 (Feb. 20, 1997) [62 FR 9246].

[15] See Release No. 33-7390 (Feb. 20, 1997) [62 FR 9242] ("the 1997 Adopting Release").

[16] We shortened the holding period requirements in paragraphs (d) and (k) of Rule 144.

[17] See the 1997 Proposing Release. In the 1997 Proposing Release, we proposed to (1) revise the Preliminary Note to Rule 144 to restate the intent and effect of the rule, (2) add a bright-line test to the Rule 144 definition of "affiliate," (3) eliminate the Rule 144 manner of sale requirements, (4) increase the Form 144 filing thresholds, (5) include in the definition of "restricted securities" securities issued pursuant to the Securities Act Section 4(6) exemption, (6) clarify the holding period determination for securities acquired in certain exchanges with the issuer and in holding company formations, (7) streamline and simplify several Rule 144 provisions, and (8) eliminate the presumptive underwriter provisions of Rule 145. We also solicited comment on (1) further revisions to the Rule 144 holding periods, (2) elimination of the trading volume tests to determine the amount of securities that can be resold under Rule 144, and (3) several possible

regulatory approaches with respect to certain hedging activities.

[18] 17 CFR 230.144(c).

[19] 17 CFR 230.144(d).

[20] 17 CFR 230.144(e).

[21] 17 CFR 230.144(f) and (g).

[22] 17 CFR 230.144(h).

[23] This provision was previously located in Rule 144(k).

[24] Release No. 33-8813 (June 22, 2007) [72 FR 36822] (Jul. 5, 2007).

[25] 15 U.S.C. 78a *et seq.*

[26] 17 CFR 249.104.

[27] 15 U.S.C. 78p.

[28] Section 16 applies to every person who is the beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the Exchange Act, and each officer and director (collectively, "reporting persons" or "insiders") of the issuer of such security. Section 16(a) of the Exchange Act generally requires reporting persons to report changes in their beneficial ownership of all equity securities of the issuer on Form 4 before the end of the second business day following the day on which the transaction that caused the change in beneficial ownership was executed.

[29] The comment letters on the 2007 Proposing Release are available on the Commission's public Web site at *http://www.sec.gov/comments/s7-11-07/s71107.shtml*.

[30] See, *e.g.*, comment letters on the 2007 Proposing Release from Jesse Brill (dated Aug. 1, 2007)("Brill 1"); Cleary Gottlieb Steen & Hamilton LLP ("Cleary Gottlieb"); Feldman Weinstein and Smith LLP ("Feldman"); Fried, Frank, Harris, Shriver, and Jacobsen LLP ("Fried Frank"); Barry Gleicher ("Gleicher"); Krieger & Prager, LLP ("Krieger"); U.S. Securities Lawyers in London ("London Forum"); Parsons/Burnett LLP ("Parsons"); Pink Sheets, LLC ("Pink Sheets"); Richardson Patel LLP ("Richardson Patel"); Roth Capital Partners ("Roth"); Society of Corporate Secretaries & Governance Professionals ("SCSGP"); Sichenzia Ross Friedman Ference LLP ("Sichenzia"); Sullivan & Cromwell LLP ("Sullivan"); Peter J. Weisman ("Weisman"); and Williams Securities Law ("Williams"); and a joint letter from the Securities Industry and Financial Markets Association, International Swaps and Derivatives Association, Inc. and Management Funds Association ("Financial Associations").

[31] See comment letters on the 2007 Proposing Release from the Committee on Federal Regulation of Securities of the American Bar Association (“ABA”); Feldman; Financial Associations; Fried Frank; London Forum; Richardson Patel; Roth; Sichenzia; SCSGP; Weisman; and Williams.

[32] See comment letters on the 2007 Proposing Release from the North American Securities Administrators Association, Inc. (“NASAA”) and Marc I. Steinberg (“Steinberg”).

[33] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Feldman; Financial Associations; Richardson Patel; Sichenzia; and Weisman.

[34] See comment letter on the 2007 Proposing Release from ABA.

[35] See comment letters on the 2007 Proposing Release from ABA; Bulldog Investors; and Sutherland Asbill & Brennan LLP (“Sutherland”).

[36] We are moving the statements indicating that Rule 144 is a non-exclusive safe harbor from paragraph (j) of the rule, as it existed prior to the amendments, to the Preliminary Note.

[37] Release No. 33-5223. In the original release adopting Rule 144, we stated:

In view of the objectives and policies underlying the Act, the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the rule, is part of a plan by such individual or entity to distribute or redistribute securities to the public. In such case, registration is required.

[38] Similar language can also be found in other rules such as in the Preliminary Note to Securities Act Rule 144A [17 CFR 230.144A].

[39] See the 1997 Adopting Release.

[40] These other conditions included the availability of current public information, the volume of sale limitations, the manner of sale requirements, and the filing of Form 144. See 17 CFR 230.144(c), (e), (f) and (h).

[41] See comment letters on the 1997 Proposing Release from American Society of Corporate Secretaries (“ASCS”); Association for Investment Management & Research (“AIMR”); Association of the City Bar of New York (“NY City Bar”); Baltimore Gas & Electric (“BG&E”); Investment Company Institute (“ICI”); Charles Lilienthal (“Lilienthal”); Loeb & Loeb LLP; New York State Bar Association (“NY Bar”); Schwartz Investments, LLC (“Schwartz Investments”); Sullivan; Testa, Hurwitz & Thibeault, LLP (“Testa Hurwitz”); and Willkie, Farr & Gallagher LLP (“Willkie Farr”). The comment letters on the 1997 Proposing Release are available on the Commission’s Web site at *http://www.sec.gov/rules/proposed/s7797.shtml* or in the Commission’s

Public Reference Room, 100 F Street, NE, Washington, DC 20549. Interested persons should refer to File No. S7-07-97.

[42] See comment letters on the 1997 Proposing Release from Argent Securities, Inc. (“Argent”) and The Corporate Counsel (“Corporate Counsel”).

[43] See comment letters on the 1997 Proposing Release from ABA; joint letter from Goldman Sachs & Co., JP Morgan Securities, Inc., Morgan Stanley & Co., Inc., and Salomon Brothers Inc. (“Four Brokers”); Lehman Brothers Inc. (“Lehman Brothers”); Merrill Lynch & Co., Inc. (“Merrill Lynch”); Morgan Stanley & Co., Inc. (“Morgan Stanley”); Regional Investment Bankers Association (“Regional Bankers”); Securities Industry Association (“SIA”); and Smith Barney Inc. (“Smith Barney”).

[44] See the 2007 Proposing Release at Section II.B.2.a.

[45] Under the 2007 proposals, the six-month holding period would apply to securities of an issuer that is, and has been for at least 90 days before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act.

[46] See comment letters on the 2007 Proposing Release from ABA; Feldman; Financial Associations; Fried Frank; London Forum; Richardson Patel; Roth; Sichenzia; SCSGP; Weisman; and Williams.

[47] See comment letters on the 2007 Proposing Release from Financial Associations; Pink Sheets; Richardson Patel; and Roth.

[48] See comment letter on the 2007 Proposing Release from ABA. See also letter to John W. White, Director, SEC Division of Corporation Finance, from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, ABA Section of Business Law (Mar. 22, 2007) (“the March 2007 ABA Letter”), available at *http://www.sec.gov/comments/s7-11-07/s71107.shtml*.

[49] See comment letters on the 2007 Proposing Release from Feldman and Weisman.

[50] See comment letters on the 2007 Proposing Release from NASAA and Steinberg.

[51] See amendments to Rule 144(d). The amendments do not change the Rule 144(d) requirement that, if the acquiror takes the securities by purchase, the holding period will not commence until the full purchase price is paid.

[52] See Section VI. of this release.

[53] See comment letters on the 2007 Proposing Release from ABA; Brill 1; Financial Associations; Gleicher; Weisman; and Williams.

[54] See new Rule 144(d)(1)(i). We also are making conforming amendments to paragraphs

(e)(3)(ii), (e)(3)(iii) and (e)(3)(iv) of Rule 144.

55 However, non-affiliates of non-reporting companies will no longer be subject to any other resale restrictions after meeting the one-year holding period. See Section II.B.3 below.

56 See new Rule 144(d)(1)(ii).

57 See 17 CFR 240.15c2-11.

58 See, *e.g.*, comment letters on the 2007 Proposing Release from Brill 1; Cleary Gottlieb; Pink Sheets; and Weisman.

59 See comment letters on the 2007 Proposing Release from ABA and Weisman.

60 See, *e.g.*, comment letters on the 2007 Proposing Release from ABA; BAIS; Cleary Gottlieb; Fried Frank; and SCSGP.

61 See comment letters on the 2007 Proposing Release from Argus Vickers Stock Research Corp. ("Argus"); Brill 1; and The Washington Service on the Form 144 requirement ("WS 2").

62 See comment letters on the 2007 Proposing Release from Brill 1 and WS 2.

63 See comment letters on the 2007 Proposing Release from NASAA and Steinberg.

64 Under the amendments, paragraph (k) of Rule 144 has been removed. The conditions that non-affiliates are required to meet for the sale of their securities under Rule 144 are now contained in paragraph (b)(1) of the rule.

65 Some commenters requested us to state that the Commission would not object if the restricted securities legend were removed from securities held by a non-affiliate, after all the applicable Rule 144 conditions to resale have been met. See comment letters on the 2007 Proposing Release from Cleary Gottlieb; Financial Associations; and Weisman. In the past, the staff in the Division of Corporation Finance has expressed the view that "it is not inappropriate for issuers to remove restrictive legends from securities that may be resold in reliance on Rule 144(k)." See*, e.g.*, *Toth Aluminum Corporation* (Oct. 31, 1988). Under the amendments that we are adopting, we do not object if issuers remove restrictive legends from securities held by non-affiliates after all of the applicable conditions in Rule 144 are satisfied. However, the removal of a legend is a matter solely in the discretion of the issuer of the securities. Disputes about the removal of legends are governed by state law or contractual agreements, rather than federal law.

66 Although the Rule 144(e) volume limitations will no longer apply to resales of restricted securities by non-affiliates as a result of the amendments, an affiliate pledgor, donor, or trust settlor will be required to aggregate the amount of securities sold for the

account of a pledgee, donee or trust, as applicable, even when there is no concerted action, in accordance with Rule 144(e)(3)(ii), (iii), and (iv) in order to determine the amount of securities that is permitted to be sold under Rule 144.

[67] Pink Sheets also noted in its letter that most of the abuses in transactions involving unregistered securities involve sales and purchases by affiliates of the issuers.

[68] See Section II.E.6 of this release.

[69] See Release No. 33-6862 (Apr. 23, 1990) [55 FR 17933].

[70] "Tacking" the holding period is the ability of the security holder to include, under certain circumstances, the period that securities were held by a previous owner as part of his or her own holding period for the purposes of meeting the holding period requirement in Rule 144(d). Further discussion about tacking appears in Section II.E.2 of this release.

[71] For a discussion on hedging arrangements in prior releases, see Section IV.B of the 1997 Proposing Release and Section II.A of Release No. 33-7187 (June 27, 1995) [60 FR 35645].

[72] See the 1997 Proposing Release. In that release, we proposed five different alternatives: (1) make the Rule 144 safe harbor unavailable to persons who hedge during the restricted period; (2) independently of Rule 144, promulgate a rule that would define a sale for purposes of Section 5 to include specified hedging transactions; (3) adopt a shorter holding period during which hedging could not occur without losing the safe harbor; (4) reintroduce a tolling provision in Rule 144 similar to the provision that was included prior to 1990; or (5) maintain the status quo with no specific prohibition against hedging.

[73] See comment letters on the 1997 Proposing Release from ABA; AIMR; Argent; ASCS; Constantine Katsoris; Corporate Counsel; and Schwartz Investments.

[74] See comment letters on the 1997 Proposing Release from Bear, Stearns & Co., Inc.; BG&E; Intel Corporation ("Intel"); Paine Webber Incorporated; Wilkie Farr; and XXI Securities.

[75] See comment letters on the 1997 Proposing Release from Four Brokers; NY Bar; SIA; Merrill Lynch; Citibank; and Lehman Brothers.

[76] At that time, Rule 144 provided for a two-year holding period before a security holder could sell limited amounts of restricted securities, and a three-year period before a non-affiliate security holder could sell an unlimited amount of the securities.

[77] See the 2007 Proposing Release at Section II.B.2.b.

[78] We proposed to exclude from the holding period any period in which the security

holder had a short position or had entered into a "put equivalent position," as defined by Exchange Act Rule 16a-1(h) [17 CFR 240.16a-1(h)], with respect to the same class of securities (or, in the case of nonconvertible debt, with respect to any nonconvertible debt securities of the same issuer).

[79] We proposed to amend Note (ii) to Rule 144(g)(3) [17 CFR 230.144(g)(3)] to supplement the reasonable inquiry requirement by requiring a broker to inquire into the existence and character of any short position or put equivalent position with regard to the securities held by the person for whose account the securities are to be sold, if the securities have been held for less than one year, whether such person has made inquiries into the existence and character of any short position or put equivalent position held by the previous owner of the securities, and the results of such person's inquiries.

[80] See, *e.g.*, comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Feldman; Financial Associations; Richardson Patel; Sichenzia; and Weisman.

[81] See, *e.g.*, comment letters on the 2007 Proposing Release from Feldman; Financial Associations; and Richardson Patel.

[82] See comment letter on the 2007 Proposing Release from ABA.

[83] See, *e.g.*, comment letter on the 2007 Proposing Release from Financial Associations.

[84] See comment letter on the 2007 Proposing Release from ABA.

[85] See, *e.g.*, comment letters on the 2007 Proposing Release from ABA and Financial Associations.

[86] See Release No. 33-6862.

[87] See comment letter on the 2007 Proposing Release from Financial Associations.

[88] See, *e.g.*, comment letters on the 2007 Proposing Release from Cleary Gottlieb; Financial Associations; and Sichenzia.

[89] See Release No. 33-5223 and Section I of this release.

[90] The Commission's staff has previously stated that, with respect to short sales in reliance on the safe harbor of Rule 144 where the borrower closes out using the restricted securities, all the conditions of Rule 144 must be met at the time of the short sale. See Questions 80 through 82 of Release No. 33-6099 (Aug. 2, 1979) [44 FR 46752, 46765]. In the Commission's view, the term "sale" under the Securities Act includes contract of sale. See Release No. 33-8591 (July 19, 2005) [70 FR 44722, 44765] and Release No. 34-56206 (August 6, 2007) [72 FR 45094]. The Commission has previously indicated that, in a short sale, the sale of securities occurs at the time the short position is established, rather than when shares are delivered to close out that short position, for purposes of

Section 5 of the Securities Act. See, *e.g.*, Questions 3 and 5 of Release No. 33-8107 (June 21, 2002) [67 FR 43234] and Release No. 34-56206 n. 46 (Aug. 6, 2007) [72 FR 45094, 45096].

[91] Rule 144(g) defines the term for purposes of Rule 144.

[92] 15 U.S.C. 78c(a)(38).

[93] See Section III.C of the 1997 Proposing Release.

[94] See comment letters on the 1997 Proposing Release from Corporate Counsel; Matthew Crain; Katsoris; Merrill Lynch; Regional Bankers; SIA; and Smith Barney.

[95] See comment letter on the 2007 Proposing Release from Barron.

[96] See comment letter on the 2007 Proposing Release from Sullivan.

[97] See comment letter on the 2007 Proposing Release from ABA.

[98] See, *e.g.*, comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; and Sullivan.

[99] See comment letters on the 2007 Proposing Release from ABA and Sullivan.

[100] Only affiliates are required to comply with the manner of sale requirements under the amendments that we are adopting.

[101] See Release No. 33-5979 (Sept. 19, 1978) [43 FR 43709] (Sept. 27, 1978) (the Commission amended Rule 144(f) to permit sales under the rule to be made directly to a market maker in lieu of selling through a broker).

[102] For example, in the second quarter of 2007, alternative trading systems handled approximately $1.3 trillion in volume of matched orders. (These amounts do not include orders that flow through a system, but are ultimately executed elsewhere). We obtained this data from information provided in Form ATS-R Quarterly Reports.

[103] See new Rule 144(f)(1)(iii). A “riskless principal transaction” is defined as a principal transaction where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell. See new Note to Rule 144(f)(1).

[104] See also, *e.g.*, *SEC Interpretation: Commission Guidance on the Scope of Section 28(e) of the Exchange Act*, Interpretive Release No. 34-45194 (Dec. 27, 2001) [67 FR 6]. This treatment is also consistent with NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6420(d)(3)(B).

[105] See Release No. 34-5452 (Feb. 1, 1974; amended Feb. 21, 1974). These subparagraphs, as amended, are contained in paragraphs (g)(3)(i), (g)(3)(ii), and (g)(3)(iii) of Rule 144. Under the amendments, the previous paragraph (g)(2) has been redesignated as paragraph (g)(3), and the previous paragraph (g)(3) has been redesignated as paragraph (g)(4).

[106] 17 CFR 242.300.

[107] See new Rule 144(g)(3)(iv).

[108] As noted in Section II.B.3 above, under the amendments that we are adopting in this release, the manner of sale requirements do not apply to the resale of securities of a non-affiliate under Rule 144. The manner of sale requirements also do not apply to securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate, provided that the estate or beneficiary is not an affiliate of the issuer.

[109] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Financial Associations; and Sullivan.

[110] See comment letter on the 2007 Proposing Release from ABA stating that the definition of debt should exclude any requirement that the preferred stock have a liquidation preference in excess of par.

[111] See 17 CFR 230.144(f). As discussed above, we also are eliminating the manner of sale requirements for resales of equity and debt securities by non-affiliates.

[112] Brokers also must comply with the criteria set forth in Rule 144(g) in order to claim the "brokers' transactions" exemption under Section 4(4) of the Securities Act.

[113] We distinguish between debt and equity in the same way we distinguished debt and equity markets when we last amended Regulation S. There, we did not believe that the procedures and restrictions applicable to offerings of equity securities under Regulation S should be applicable to offerings of nonconvertible debt securities, reasoning that the nature of the trading markets for debt securities appears not to have facilitated similar abusive practices as the markets for equity securities. See *Offshore Offers and Sales*, Release No. 33-7505 (Feb. 17, 1998) [63 FR 9631].

[114] The March 2007 ABA Letter noted that debt securities generally are traded in dealer transactions in which the dealer seeks buyers for securities to fill sell orders instead of through the means prescribed in Rule 144(f).

[115] The definition of debt securities appears in amended Rule 144(a). "Non-participatory preferred stock" is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in

residual earnings or assets of the issuer.

[116] See Release No. 33-8518 (Dec. 22, 2004) [70 FR 1506].

[117] See 17 CFR 230.901 through 230.905 and Release No. 33-7505.

[118] See 17 CFR 230.144(e)(1)(i), (ii), and (iii).

[119] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; and Sullivan.

[120] The term “tranche” is also used in the definition of “distribution compliance period” in Rule 902(f) of Regulation S. 17 CFR 230.902(f).

[121] See newly revised Rule 144(e)(2).

[122] Generally, because of the absence of an active trading market in debt securities, debt holders do not rely on the average daily trading volume test to sell their securities under Rule 144.

[123] 17 CFR 230.144(h).

[124] We note, however, that in 1978, the Commission shortened the relevant time period in Rule 144(e) for calculating the amount of securities to be sold under Rule 144 from six months to three months and made conforming changes to the Form 144 filing requirement. Release No. 33-5995 (Nov. 8, 1978) [43 FR 54229].

[125] See comment letters on the 1997 Proposing Release from ABA; ASCS; AT&T Corp. (“AT&T”); BG&E; Corporate Counsel; Merrill Lynch; Morgan Stanley; NY Bar; NY City Bar; Regional Bankers; SIA; Smith Barney; and Sullivan.

[126] See comment letters on the 1997 Proposing Release from ABA; Benesch, Friedlander, Coplan & Aronoff, LLP; NY Bar; NY City Bar; and Sullivan.

[127] See comment letter on the 1997 Proposing Release from ABA.

[128] See comment letter on the 1997 Proposing Release from NY Bar.

[129] Only affiliates of the issuer are required to file a notice of proposed sale on Form 144 when relying on Rule 144 under the amendments that we are adopting.

[130] See, *e.g.*, comment letters on the 2007 Proposing Release from ABA; Financial Associations; and SCSGP.

[131] See comment letter on the 2007 Proposing Release from ABA. ABA supported elimination of Form 144 but recommended these filing thresholds, if the Commission

chose to retain it.

[132] The adjustment would be approximately $42,000 if based on the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce. In addition, if based on the Consumer Price Index, the adjustment would be approximately $50,000. To achieve a round number, we proposed to raise the filing threshold to $50,000.

[133] See, *e.g.*, comment letters on the 2007 Proposing Release from ABA; BAIS; Brill 1; Fried Frank; Pink Sheets; Sichenzia; SCSGP; and Sullivan. The comment letters from ABA, BAIS, SCSGP and Sullivan advocated that the Commission should eliminate the Form 144 filing requirement; however, to the extent that we determine to retain any items required by Form 144, they provided suggestions regarding the proposal to combine Form 144 with Form 4.

[134] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Financial Associations; Fried Frank; and Richardson Patel.

[135] See comment letter on the 2007 Proposing Release from Financial Associations.

[136] 15 U.S.C. 77d(6). Section 4(6) was included in the Securities Act pursuant to the Small Business Investment Incentive Act of 1980 [Pub. L. No. 96-477 (Oct. 21, 1980)].

[137] 17 CFR 230.144(a)(3). See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 104 (Rule 144(a)(3)), Question No. 104.03.

[138] See 15 U.S.C. 77d(6).

[139] See amendments to Rule 144(a)(3).

[140] See the Division of Corporation Finance's letter to Morgan, Olmstead, Kennedy & Gardner Capital Corporation (Jan. 8, 1988).

[141] See comment letters on the 2007 Proposing Release from Sichenzia and Sullivan.

[142] See new Rule 144(d)(3)(ix).

[143] See the Division of Corporation Finance's letter to Planning Research Corp. (Dec. 8, 1980).

[144] See the Division of Corporation Finance's letter to Morgan Stanley & Co., Inc. (June 30, 1993).

[145] See comment letter on the 2007 Proposing Release from Feldman.

[146] See comment letter on the 2007 Proposing Release from Sullivan.

[147] See amendments to Rule 144(d)(3)(ii).

[148] See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 212 (Rule 144(d)(3)), Interpretation No. 212.01.

[149] See the Division of Corporation Finance's letter to Morgan Stanley & Co., Inc. (June 30, 1993).

[150] See the Division of Corporation Finance's letters to Morgan Stanley & Co., Inc. (June 30, 1993) and Malden Trust Corporation (Feb. 21, 1989).

[151] See comment letters on the 2007 Proposing Release from Cleary Gottlieb; Feldman; and Richardson Patel.

[152] See comment letters on the 2007 Proposing Release from Cleary Gottlieb; Financial Associations; Richardson Patel; and Weisman.

[153] See comment letters on the 2007 Proposing Release from Cleary Gottlieb and Financial Associations.

[154] See comment letter on the 2007 Proposing Release from Sullivan.

[155] See new Rule 144(d)(3)(x) and related notes.

[156] See Note 2 to Rule 144(d)(3)(x).

[157] Under the amendments that we are adopting, the volume limitations in Rule 144(e) would apply only to affiliates.

[158] See the Division of Corporation Finance's Compliance and Disclosure Interpretations on Rule 144 (Updated April 2, 2007), at Section 216 (Rule 144(e)(3)), Interpretation No. 216.01. See also the Division of Corporation Finance's letter to Standard Chartered Bank (June 22, 1987).

[159] See amendments to Rule 144(e)(3)(ii).

[160] 17 CFR 230.419. The term "penny stock" is defined in Exchange Act Rule 3a51-1 [17 CFR 240.3a51-1].

[161] See Release No. 33-6932 (Apr. 28, 1992) [57 FR 18037].

[162] 17 CFR 230.419.

[163] 17 CFR 230.405.

[164] See Release No. 33-8587 (Jul. 15, 2005) [70 FR 42234].

[165] See the Division of Corporation Finance's letter to Ken Worm, NASD Regulation, Inc. (Jan. 21, 2000). In that letter, the Division stated that "transactions in blank check company securities by their promoters or affiliates ... are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) [of the Securities Act] was designed to exempt." The Division stated its view that "both before and after the business combination or transaction with an operating entity or other person, the promoters or affiliates of blank check companies, as well as their transferees, are 'underwriters' of the securities issued.... Rule 144 would not be available for resale transactions in this situation, regardless of technical compliance with that rule, because these resale transactions appear to be designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act."

[166] A "business combination related shell company" is defined in Securities Act Rule 405 as a shell company that is (1) formed by an entity that is not a shell company solely for the purpose of changing the corporate domicile of that entity solely within the United States; or (2) formed by an entity that is not a shell company solely for the purpose of completing a business combination transaction (as defined in §230.165(f)) among one or more entities other than the shell company, none of which is a shell company.

[167] See, *e.g.*, comment letters on the 2007 Proposing Release from Feldman; Financial Associations; Parsons; Pink Sheets; and Williams.

[168] See comment letter on the 2007 Proposing Release from Pink Sheets.

[169] See comment letters on the 2007 Proposing Release from Sichenzia and Williams.

[170] See comment letter on the 2007 Proposing Release from Sichenzia.

[171] See new Rule 144(i).

[172] Rule 144(i) does not prohibit the resale of securities under Rule 144 that were not initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously such a company, even when the issuer is a reporting or non-reporting shell company at the time of sale. Contrary to commenters' concerns, Rule 144(i)(1)(i) is not intended to capture a "startup company," or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe that such a company does not meet the condition of having "no or nominal operations."

[173] 17 CFR 239.16b.

[174] See Release No. 33-8587. These provisions are consistent with the Form S-8

provisions for shell companies, except that Form S-8 requires a former shell company to wait 60 days, rather than 90 days, before it is able to use the form to register securities.

[175] 17 CFR 249.210 and 17 CFR 249.220f. In another Commission release, we are rescinding Form 10-SB [17 CFR 249.210b]. See SEC Press Release No. 2007-233 (Nov. 15, 2007), available at *http://www.sec.gov/news/press/2007/2007-233.htm*.

[176] 17 CFR 249.308. Items 2.01(f) and 5.01(a)(8) of Form 8-K require a company in a transaction where the company ceases being a shell company to file a current report on Form 8-K containing the information (or identifying the previous filing in which the information is included) that would be required in a registration statement on Form 10 or Form 10-SB to register a class of securities under Section 12 of the Exchange Act.

[177] See new Rule 144(i)(2).

[178] See comment letter on the 2007 Proposing Release from Sichenzia.

[179] See new Rule 144(i)(3).

[180] See, *e.g.*, comment letters on the 2007 Proposing Release from Charles Nelson; Tom Russell; and Williams.

[181] 17 CFR 240.10b5-1.

[182] 15 U.S.C. 78j(b).

[183] 17 CFR 240.10b-5. As stated in Rule 10b5-1(a), the "manipulative and deceptive devices" prohibited by Section 10(b) and Rule 10b-5 include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

[184] See the Division of Corporation Finance's Manual of Publicly Available Telephone Interpretations, Fourth Supplement (May 30, 2001), at Rule 10b5-1; Form 144, Interpretation No. 2.

[185] See amendments to Form 144.

[197] 17 CFR 230.901 through 230.905 and Preliminary Notes.

[198] See 17 CFR 230.903.

[199] See Release No. 33-7505.

[200] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Financial Associations; Fried Frank; Herbert Smith CIS LLP ("Herbert Smith"); London Forum; Parsons; and Sullivan.

[201] See, *e.g.*, comment letters on the 2007 Proposing Release from Cleary Gottlieb; Financial Associations; and London Forum.

[202] See Release No. 33-7505.

[203] See amendments to Rule 903(b)(3) of the Securities Act.

Rule 144 as amended

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

Preliminary Note: Certain basic principles are essential to an understanding of the registration requirements in the Securities Act of 1933 (the Act or the Securities Act) and the purposes underlying Rule 144:

1. If any person sells a non-exempt security to any other person, the sale must be registered unless an exemption can be found for the transaction.

2. Section 4(1) of the Securities Act provides one such exemption for a transaction "by a person other than an issuer, underwriter, or dealer." Therefore, an understanding of the term "underwriter" is important in determining whether or not the Section 4(1) exemption from registration is available for the sale of the securities.

The term "underwriter" is broadly defined in Section 2(a)(11) of the Securities Act to mean any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates, or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. The interpretation of this definition traditionally has focused on the words "with a view to" in the phrase "purchased from an issuer with a view to * * * distribution." An investment banking firm which arranges with an issuer for the public sale of its securities is clearly an "underwriter" under that section. However, individual investors who are not professionals in the securities business also may be "underwriters" if they act as links in a chain of transactions through which securities move from an issuer to the public.

Since it is difficult to ascertain the mental state of the purchaser at the time of an acquisition of securities, prior to and since the adoption of Rule 144, subsequent acts and circumstances have been considered to determine whether the purchaser took the securities "with a view to distribution" at the time of the acquisition. Emphasis has been placed on factors such as the length of time the person held the securities and whether there has been an unforeseeable change in circumstances of the holder. Experience has shown, however, that reliance upon such factors alone has led to uncertainty in the application of the registration provisions of the Act.

The Commission adopted Rule 144 to establish specific criteria for determining whether a person is not engaged in a distribution. Rule 144 creates a safe harbor from the Section 2(a)(11) definition of "underwriter." A person satisfying the applicable conditions of the Rule 144 safe harbor is deemed not to be engaged in a distribution of the securities and therefore not an underwriter of the securities for purposes of Section 2(a)(11). Therefore, such a person is deemed not to be an underwriter when determining whether a sale is eligible for the Section 4(1) exemption for "transactions by any person other than an issuer, underwriter, or dealer." If a sale of securities complies with all of the applicable conditions of Rule 144:

1. Any affiliate or other person who sells restricted securities will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction;
2. Any person who sells restricted or other securities on behalf of an affiliate of the issuer will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction; and
3. The purchaser in such transaction will receive securities that are not restricted securities.

Rule 144 is not an exclusive safe harbor. A person who does not meet all of the applicable conditions of Rule 144 still may claim any other available exemption under the Act for the sale of the securities. The Rule 144 safe harbor is not available to any person with respect to any transaction or series of transactions that, although in technical compliance with Rule 144, is part of a plan or scheme to evade the registration requirements of the Act.

(a) *Definitions.* The following definitions shall apply for the purposes of this section.

(1) An *affiliate* of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

(2) The term *person* when used with reference to a person for whose account securities are to be sold in reliance upon this section includes, in addition to such person, all of the following persons:

(i) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;

(ii) Any trust or estate in which such person or any of the persons specified in paragraph (a)(2)(i) of this section collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and

(iii) Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in paragraph (a)(2)(i) of this section are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest.

(3) The term *restricted securities* means:

(i) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;

(ii) Securities acquired from the issuer that are subject to the resale limitations of §230.502(d) under Regulation D or §230.701(c);

(iii) Securities acquired in a transaction or chain of transactions meeting the requirements of §230.144A;

(iv) Securities acquired from the issuer in a transaction subject to the conditions of Regulation CE (§230.1001);
(v) Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of §230.901 or §230.903 under Regulation S (§230.901 through §230.905, and Preliminary Notes);
(vi) Securities acquired in a transaction made under §230.801 to the same extent and proportion that the securities held by the security holder of the class with respect to which the rights offering was made were, as of the record date for the rights offering, "restricted securities" within the meaning of this paragraph (a)(3);
(vii) Securities acquired in a transaction made under §230.802 to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were "restricted securities" within the meaning of this paragraph (a)(3); and
(viii) Securities acquired from the issuer in a transaction subject to an exemption under section 4(6) (15 U.S.C. 77d(6)) of the Act.
(4) The term *debt securities* means:
(i) Any security other than an equity security as defined in §230.405;
(ii) Non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer; and
(iii) Asset-backed securities, as defined in §229.1101 of this chapter.
(b) *Conditions to be met* . Subject to paragraph (i) of this section, the following conditions must be met:
(1) *Non-affiliates.* (i) If the issuer of the securities is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act), any person who is not an affiliate of the issuer at the time of the sale, and has not been an affiliate during the preceding three months, who sells restricted securities of the issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of paragraphs (c)(1) and (d) of this section are met. The requirements of paragraph (c)(1) of this section shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of one year has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer.
(ii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, any person who is not an affiliate of the issuer at the time of the sale, and has not been an affiliate during the preceding three months, who sells restricted securities of the issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if the condition of paragraph (d) of this section is met.
(2) *Affiliates or persons selling on behalf of affiliates.* Any affiliate of the issuer, or any person who was an affiliate at any time during the 90 days immediately before the sale, who sells restricted securities, or any person who sells restricted or any other securities

for the account of an affiliate of the issuer of such securities, or any person who sells restricted or any other securities for the account of a person who was an affiliate at any time during the 90 days immediately before the sale, shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of this section are met.

(c) *Current public information.* Adequate current public information with respect to the issuer of the securities must be available. Such information will be deemed to be available only if the applicable condition set forth in this paragraph is met:

(1) *Reporting issuers.* The issuer is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and has filed all required reports under section 13 or 15(d) of the Exchange Act, as applicable, during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports), other than Form 8–K reports (§249.308 of this chapter); or

(2) *Non-reporting issuers.* If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, there is publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of §240.15c2–11 of this chapter, or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of the Exchange Act (15 U.S.C. 78 *l* (g)(2)(G)(i)).

Note to §230.144(c). With respect to paragraph (c)(1), the person can rely upon:

1. A statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required under section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports), other than Form 8–K reports (§249.308 of this chapter), and has been subject to such filing requirements for the past 90 days; or

2. A written statement from the issuer that it has complied with such reporting requirements.

3. Neither type of statement may be relied upon, however, if the person knows or has reason to believe that the issuer has not complied with such requirements.

(d) *Holding period for restricted securities.* If the securities sold are restricted securities, the following provisions apply:

(1) *General rule.* (i) If the issuer of the securities is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of six months must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(ii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(iii) If the acquiror takes the securities by purchase, the holding period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer.
(2) *Promissory notes, other obligations or installment contracts.* Giving the issuer or affiliate of the issuer from whom the securities were purchased a promissory note or other obligation to pay the purchase price, or entering into an installment purchase contract with such seller, shall not be deemed full payment of the purchase price unless the promissory note, obligation or contract:
(i) Provides for full recourse against the purchaser of the securities;
(ii) Is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities purchased; and
(iii) Shall have been discharged by payment in full prior to the sale of the securities.
(3) *Determination of holding period.* The following provisions shall apply for the purpose of determining the period securities have been held:
(i) *Stock dividends, splits and recapitalizations.* Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization shall be deemed to have been acquired at the same time as the securities on which the dividend or, if more than one, the initial dividend was paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitalization.
(ii) *Conversions and exchanges* . If the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.
Note to §230.144(d)(3)(ii). If the surrendered securities originally did not provide for cashless conversion or exchange by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the surrendered securities to permit cashless conversion or exchange, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the surrendered securities, so long as, in the conversion or exchange, the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer.
(iii) *Contingent issuance of securities.* Securities acquired as a contingent payment of the purchase price of an equity interest in a business, or the assets of a business, sold to the issuer or an affiliate of the issuer shall be deemed to have been acquired at the time of such sale if the issuer or affiliate was then committed to issue the securities subject only to conditions other than the payment of further consideration for such securities. An agreement entered into in connection with any such purchase to remain in the employment of, or not to compete with, the issuer or affiliate or the rendering of services pursuant to such agreement shall not be deemed to be the payment of further consideration for such securities.
(iv) *Pledged securities.* Securities which are bona-fide pledged by an affiliate of the issuer when sold by the pledgee, or by a purchaser, after a default in the obligation secured by the pledge, shall be deemed to have been acquired when they were acquired by the pledgor, except that if the securities were pledged without recourse they shall be deemed to have been acquired by the pledgee at the time of the pledge or by the purchaser at the time of purchase.

(v) *Gifts of securities.* Securities acquired from an affiliate of the issuer by gift shall be deemed to have been acquired by the donee when they were acquired by the donor.
(vi) *Trusts.* Where a trust settlor is an affiliate of the issuer, securities acquired from the settlor by the trust, or acquired from the trust by the beneficiaries thereof, shall be deemed to have been acquired when such securities were acquired by the settlor.
(vii) *Estates.* Where a deceased person was an affiliate of the issuer, securities held by the estate of such person or acquired from such estate by the estate beneficiaries shall be deemed to have been acquired when they were acquired by the deceased person, except that no holding period is required if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not such an affiliate.
Note to §230.144(d)(3)(vii). While there is no holding period or amount limitation for estates and estate beneficiaries which are not affiliates of the issuer, paragraphs (c) and (h) of this section apply to securities sold by such persons in reliance upon this section.
(viii) *Rule 145(a) transactions.* The holding period for securities acquired in a transaction specified in §230.145(a) shall be deemed to commence on the date the securities were acquired by the purchaser in such transaction, except as otherwise provided in paragraphs (d)(3)(ii) and (ix) of this section.
(ix) *Holding company formations.* Securities acquired from the issuer in a transaction effected solely for the purpose of forming a holding company shall be deemed to have been acquired at the same time as the securities of the predecessor issuer exchanged in the holding company formation where:
(A) The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
(B) Holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and
(C) Immediately following the transaction, the holding company has no significant assets other than securities of the predecessor company and its existing subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor company had before the transaction.
(x) *Cashless exercise of options and warrants.* If the securities sold were acquired from the issuer solely upon cashless exercise of options or warrants issued by the issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the exercised options or warrants, even if the options or warrants exercised originally did not provide for cashless exercise by their terms.
Note 1 to §230.144(d)(3)(x). If the options or warrants originally did not provide for cashless exercise by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the options or warrants to permit cashless exercise, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the options or warrants so long as the exercise itself was cashless.
Note 2 to §230.144(d)(3)(x). If the options or warrants are not purchased for cash or property and do not create any investment risk to the holder, as in the case of employee stock options, the newly acquired securities shall be deemed to have been acquired at the

time the options or warrants are exercised, so long as the full purchase price or other consideration for the newly acquired securities has been paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer at the time of exercise.

(e) *Limitation on amount of securities sold.* Except as hereinafter provided, the amount of securities sold for the account of an affiliate of the issuer in reliance upon this section shall be determined as follows:

(1) If any securities are sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, the amount of securities sold, together with all sales of securities of the same class sold for the account of such person within the preceding three months, shall not exceed the greatest of:

(i) One percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or

(ii) The average weekly reported volume of trading in such securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the four calendar weeks preceding the filing of notice required by paragraph (h), or if no such notice is required the date of receipt of the order to execute the transaction by the broker or the date of execution of the transaction directly with a market maker, or

(iii) The average weekly volume of trading in such securities reported pursuant to an *effective transaction reporting plan* or an *effective national market system plan* as those terms are defined in §242.600 of this chapter during the four-week period specified in paragraph (e)(1)(ii) of this section.

(2) If the securities sold are debt securities, then the amount of debt securities sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, shall not exceed the greater of the limitation set forth in paragraph (e)(1) of this section or, together with all sales of securities of the same tranche (or class when the securities are non-participatory preferred stock) sold for the account of such person within the preceding three months, ten percent of the principal amount of the tranche (or class when the securities are non-participatory preferred stock) attributable to the securities sold.

(3) *Determination of amount.* For the purpose of determining the amount of securities specified in paragraph (e)(1) of this section and, as applicable, paragraph (e)(2) of this section, the following provisions shall apply:

(i) Where both convertible securities and securities of the class into which they are convertible are sold, the amount of convertible securities sold shall be deemed to be the amount of securities of the class into which they are convertible for the purpose of determining the aggregate amount of securities of both classes sold;

(ii) The amount of securities sold for the account of a pledgee of those securities, or for the account of a purchaser of the pledged securities, during any period of three months within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after a default in the obligation secured by the pledge, and the amount of securities sold during the same three-month period for the account of the pledgor shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;

Note to §230.144(e)(3)(ii). Sales by a pledgee of securities pledged by a borrower will not be aggregated under paragraph (e)(3)(ii) with sales of the securities of the same issuer by other pledgees of such borrower in the absence of concerted action by such pledgees.
(iii) The amount of securities sold for the account of a donee of those securities during any three-month period within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after the donation, and the amount of securities sold during the same three-month period for the account of the donor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;
(iv) Where securities were acquired by a trust from the settlor of the trust, the amount of such securities sold for the account of the trust during any three-month period within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after the acquisition of the securities by the trust, and the amount of securities sold during the same three-month period for the account of the settlor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;
(v) The amount of securities sold for the account of the estate of a deceased person, or for the account of a beneficiary of such estate, during any three-month period and the amount of securities sold during the same three-month period for the account of the deceased person prior to his death shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable: *Provided,* that no limitation on amount shall apply if the estate or beneficiary of the estate is not an affiliate of the issuer;
(vi) When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the account of all such persons during any three-month period shall be aggregated for the purpose of determining the limitation on the amount of securities sold;
(vii) The following sales of securities need not be included in determining the amount of securities to be sold in reliance upon this section:
(A) Securities sold pursuant to an effective registration statement under the Act;
(B) Securities sold pursuant to an exemption provided by Regulation A (§230.251 through §230.263) under the Act;
(C) Securities sold in a transaction exempt pursuant to section 4 of the Act (15 U.S.C. 77d) and not involving any public offering; and
(D) Securities sold offshore pursuant to Regulation S (§230.901 through §230.905, and Preliminary Notes) under the Act.
(f) *Manner of sale.* (1) The securities shall be sold in one of the following manners:
(i) *Brokers' transactions* within the meaning of section 4(4) of the Act;
(ii) Transactions directly with a *market maker* , as that term is defined in section 3(a)(38) of the Exchange Act; or
(iii) *Riskless principal transactions* where:
(A) The offsetting trades must be executed at the same price (exclusive of an explicitly disclosed markup or markdown, commission equivalent, or other fee);

(B) The transaction is permitted to be reported as riskless under the rules of a self-regulatory organization; and
(C) The requirements of paragraphs (g)(2)(applicable to any markup or markdown, commission equivalent, or other fee), (g)(3), and (g)(4) of this section are met.
Note to §230.144(f)(1): For purposes of this paragraph, a *riskless principal transaction* means a principal transaction where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell.
(2) The person selling the securities shall not:
(i) Solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transaction, or
(ii) Make any payment in connection with the offer or sale of the securities to any person other than the broker or dealer who executes the order to sell the securities.
(3) Paragraph (f) of this section shall not apply to:
(i) Securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate provided the estate or estate beneficiary is not an affiliate of the issuer; or
(ii) Debt securities.
(g) *Brokers' transactions.* The term *brokers' transactions* in section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker:
(1) Does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold;
(2) Receives no more than the usual and customary broker's commission;
(3) Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; *Provided*, that the foregoing shall not preclude:
(i) Inquiries by the broker of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days;
(ii) Inquiries by the broker of his customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days;
(iii) The publication by the broker of bid and ask quotations for the security in an inter-dealer quotation system provided that such quotations are incident to the maintenance of a bona fide inter-dealer market for the security for the broker's own account and that the broker has published bona fide bid and ask quotations for the security in an inter-dealer quotation system on each of at least twelve days within the preceding thirty calendar days with no more than four business days in succession without such two-way quotations; or
(iv) The publication by the broker of bid and ask quotations for the security in an alternative trading system, as defined in §242.300 of this chapter, provided that the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last twelve business days; and
Note to §230.144(g)(3)(ii). The broker should obtain and retain in his files written evidence of indications of bona fide unsolicited interest by his customers in the securities at the time such indications are received.

(4) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer. Without limiting the foregoing, the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h) of this section.

Notes: (i) The broker, for his own protection, should obtain and retain in his files a copy of the notice required by paragraph (h) of this section.

(ii) The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

(*a*) The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should include physical inspection of the securities;

(*b*) The nature of the transaction in which the securities were acquired by such person;

(*c*) The amount of securities of the same class sold during the past 3 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

(*d*) Whether such person intends to sell additional securities of the same class through any other means;

(*e*) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

(*f*) Whether such person has made any payment to any other person in connection with the proposed sale of the securities; and

(*g*) The number of shares or other units of the class outstanding, or the relevant trading volume.

(h) *Notice of proposed sale.* (1) If the amount of securities to be sold in reliance upon this rule during any period of three months exceeds 5,000 shares or other units or has an aggregate sale price in excess of $50,000, three copies of a notice on Form 144 (§239.144 of this chapter) shall be filed with the Commission. If such securities are admitted to trading on any national securities exchange, one copy of such notice also shall be transmitted to the principal exchange on which such securities are admitted.

(2) The Form 144 shall be signed by the person for whose account the securities are to be sold and shall be transmitted for filing concurrently with either the placing with a broker of an order to execute a sale of securities in reliance upon this rule or the execution directly with a market maker of such a sale. Neither the filing of such notice nor the failure of the Commission to comment on such notice shall be deemed to preclude the Commission from taking any action that it deems necessary or appropriate with respect to the sale of the securities referred to in such notice. The person filing the notice required by this paragraph shall have a bona fide intention to sell the securities referred to in the notice within a reasonable time after the filing of such notice.

(i) *Unavailability to securities of issuers with no or nominal operations and no or nominal non-cash assets.* (1) This section is not available for the resale of securities initially issued by an issuer defined below:

(i) An issuer, other than a business combination related shell company, as defined in §230.405, or an asset-backed issuer, as defined in Item 1101(b) of Regulation AB (§229.1101(b) of this chapter), that has:

(A) No or nominal operations; and

(B) Either:
(*1*) No or nominal assets;
(*2*) Assets consisting solely of cash and cash equivalents; or
(*3*) Assets consisting of any amount of cash and cash equivalents and nominal other assets; or
(ii) An issuer that has been at any time previously an issuer described in paragraph (i)(1)(i).
(2) Notwithstanding paragraph (i)(1), if the issuer of the securities previously had been an issuer described in paragraph (i)(1)(i) but has ceased to be an issuer described in paragraph (i)(1)(i); is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act; has filed all reports and other materials required to be filed by section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials), other than Form 8-K reports (§249.308 of this chapter); and has filed current "Form 10 information" with the Commission reflecting its status as an entity that is no longer an issuer described in paragraph (i)(1)(i), then those securities may be sold subject to the requirements of this section after one year has elapsed from the date that the issuer filed "Form 10 information" with the Commission.
(3) The term "Form 10 information" means the information that is required by Form 10 or Form 20-F (§249.210 or §249.220f of this chapter), as applicable to the issuer of the securities, to register under the Exchange Act each class of securities being sold under this rule. The issuer may provide the Form 10 information in any filing of the issuer with the Commission. The Form 10 information is deemed filed when the initial filing is made with the Commission.
[37 FR 596, Jan. 14, 1972, as amended at 39 FR 6071, Feb. 19, 1974; 39 FR 8914, Mar. 7, 1974; 43 FR 43711, Sept. 27, 1978; 43 FR 54230, Nov. 21, 1978; 44 FR 15612, Mar. 14, 1979; 45 FR 12391, Feb. 28, 1980; 46 FR 12197, Feb. 12, 1981; 47 FR 11261, Mar. 16, 1982; 53 FR 12921, Apr. 20, 1988; 55 FR 17944, Apr. 30, 1990; 58 FR 67312, Dec. 21, 1993; 61 FR 21359, May 9, 1996; 62 FR 9244, Feb. 28, 1997; 63 FR 9642, Feb. 25, 1998; 64 FR 61400, Nov. 10, 1999; 69 FR 15617, Mar. 25, 2004; 70 FR 37617, June 29, 2005; 72 FR 71566, Dec. 17, 2007]

IV. CHAPTER 6, INTRODUCTION TO ACCOUNTING FOR MERGERS AND ACQUISITIONS

A. Page 347, New Sec. 6.4.C. FASB Summary of Statement No. 141 Revised (2007)

Page 347, New Sec. 6.4.C. Add before Sec. 6.5 the following:
New Sec. 6.4.C. **FASB Summary of Statement No. 141 Revised (2007)**

FASB Summary of Statement No. 141 (revised 2007)

Business Combinations
Summary
Why Is the FASB Issuing This Statement?
The objective of this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this Statement establishes principles and requirements for how the acquirer:

- Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

What Is the Scope of This Statement?
This Statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquirer), including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This Statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business
- A combination between entities or businesses under common control
- A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

How Will This Statement Improve Current Accounting Practice?
This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. Statement 141 did not define the acquirer, although it

included guidance on identifying the acquirer, as does this Statement. This Statement's scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. By applying the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses, this Statement improves the comparability of the information about business combinations provided in financial reports.

This Statement retains the guidance in Statement 141 for identifying and recognizing intangible assets separately from goodwill. The main features of this Statement and the more significant improvements it makes to how the acquisition method was applied in accordance with Statement 141 are described below.

Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces Statement 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. Statement 141's guidance resulted in not recognizing some assets and liabilities at the acquisition date, and it also resulted in measuring some assets and liabilities at amounts other than their fair values at the acquisition date. For example, Statement 141 required the acquirer to include the costs incurred to effect the acquisition (acquisition-related costs) in the cost of the acquisition that was allocated to the assets acquired and the liabilities assumed. This Statement requires those costs to be recognized separately from the acquisition. In addition, in accordance with Statement 141, restructuring costs that the acquirer expected but was not obligated to incur were recognized as if they were a liability assumed at the acquisition date. This Statement requires the acquirer to recognize those costs separately from the business combination. Therefore, this Statement improves the relevance, completeness, and representational faithfulness of the information provided in financial reports about the assets acquired and the liabilities assumed in a business combination.

This Statement also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with this Statement). In accordance with Statement 141 and related interpretative guidance, an entity that acquired another entity in a series of purchases (a step acquisition) identified the cost of each investment, the fair value of the underlying identifiable net assets acquired, and the goodwill on each step. Statement 141 did not provide guidance on measuring the noncontrolling interest's share of the consolidated subsidiary's assets and liabilities at the acquisition date. The result of applying Statement 141's guidance on recognizing and measuring assets and liabilities in a step acquisition was to measure them at a blend of historical costs and fair values—a practice that provided less relevant, representationally faithful, and comparable information than will result from applying this Statement. In addition, this Statement's requirement to measure the noncontrolling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer, which improves the completeness of the resulting information and makes it more comparable across entities.

Assets and Liabilities Arising from Contingencies

This Statement improves the completeness of the information reported about a business combination by changing the requirements for recognizing assets acquired and liabilities assumed arising from contingencies. Statement 141 permitted deferred recognition of preacquisition contingencies until the recognition criteria for FASB Statement No. 5, Accounting for Contingencies, were met. This Statement requires an acquirer to recognize assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date, measured at their acquisition-date fair values. An acquirer is required to recognize assets or liabilities arising from all other contingencies (contractual contingencies) as of the acquisition date, measured at their acquisition-date fair values, only if it is more likely than not that they meet the definition of an asset or a liability in FASB Concepts Statement No. 6, Elements of Financial Statements. If that criterion is not met at the acquisition date, the acquirer instead accounts for a noncontractual contingency in accordance with other applicable generally accepted accounting principles, including Statement 5, as appropriate.

This Statement provides specific guidance on the subsequent accounting for assets and liabilities arising from contingencies acquired or assumed in a business combination that otherwise would be in the scope of Statement 5. It requires that an acquirer continue to report an asset or a liability arising from a contingency recognized as of the acquisition date at its acquisition-date fair value absent new information about the possible outcome of the contingency. When new information is obtained, the acquirer evaluates that new information and measures a liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying Statement 5, and measures an asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount.

Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

This Statement requires the acquirer to recognize goodwill as of the acquisition date, measured as a residual, which in most types of business combinations will result in measuring goodwill as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired.

Statement 141 also required goodwill to be recognized and measured as a residual. However, as described below, this Statement improves the way in which an acquirer's obligations to make payments conditioned on the outcome of future events (often called contingent consideration) are recognized and measured, which in turn improves the measure of goodwill. This Statement also includes in the definition of contingent consideration arrangements that give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

This Statement requires the acquirer to recognize contingent consideration at the acquisition date, measured at its fair value at that date. Under Statement 141, in contrast, contingent consideration obligations usually were not recognized at the acquisition date. Rather, they usually were recognized when the contingency was resolved and consideration was issued or became issuable. In addition, the issuance of additional securities or distribution of additional cash or other assets upon resolution of contingencies based on reaching particular earnings levels was recognized as an adjustment to the accounting for the business combination, but issuance of shares or distribution of assets upon resolution of contingencies based on security prices was recognized differently. This Statement therefore improves the representational faithfulness and completeness of the information provided about an acquirer's obligations and rights under contingent consideration arrangements.

A Bargain Purchase

This Statement defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and it requires the acquirer to recognize that excess in earnings as a gain attributable to the acquirer. In contrast, Statement 141 required the "negative goodwill" amount to be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to particular assets acquired. This Statement therefore improves the representational faithfulness and completeness of the information provided about both the acquirer's earnings during the period in which it makes a bargain purchase and the measures of the assets acquired in the bargain purchase.

What Other Changes Does This Statement Make to Existing Accounting Pronouncements?

This Statement makes significant amendments to other Statements and other authoritative guidance. For example, this Statement supersedes FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, which required research and development assets acquired in a business combination that have no alternative future use to be measured at their acquisition-date fair values and then immediately charged to expense. Therefore, the acquirer will recognize separately from goodwill the acquisition-date fair values of research and development assets acquired in a business combination, which improves the representational faithfulness and completeness of the information provided in financial reports about the assets acquired in a business combination.

This Statement amends FASB Statement No. 109, Accounting for Income Taxes, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or directly in contributed capital, depending on the circumstances. (Such changes arise through the increase or reduction of the acquirer's valuation allowance on its previously existing deferred tax assets because of the business combination.) Previously, Statement 109 required a reduction of the acquirer's valuation allowance because of a business combination to be recognized through a corresponding reduction to goodwill or certain noncurrent assets or an increase in so-called negative goodwill. This Statement therefore improves the representational faithfulness of the information provided about the effect of a business combination on both the acquirer's deferred tax assets and the related valuation allowance and the goodwill and noncurrent assets acquired in the business combination.

This Statement makes various other amendments to the authoritative literature intended to provide additional guidance or to conform the guidance in that literature to that provided in this Statement. For example, this Statement amends FASB Statement No. 142, Goodwill and Other Intangible Assets, to, among other things, provide guidance on the impairment testing of acquired research and development intangible assets and assets that the acquirer intends not to use.

This Statement also eliminates many EITF issues and other interpretative guidance on accounting for business combinations and incorporates the parts of that guidance that remain pertinent. Therefore, in addition to improving the guidance provided about accounting for a business combination in the authoritative literature, this Statement makes that guidance easier to use.

What Is the Effect of This Statement on Convergence with International Reporting Standards?

This Statement, together with the IASB's IFRS 3, Business Combinations (as revised in 2007), completes a joint effort by the FASB and the IASB to improve financial reporting about business combinations and to promote the international convergence of accounting standards. Statement 141 and IFRS 3 (as issued in 2004) both required use of the acquisition method rather than the pooling-of-interests method to account for business combinations. In this Statement and the revised IFRS 3, the Boards in large part achieved their goal of reaching the same conclusions on the more significant issues involving application of the acquisition method of accounting for a business combination.

Appendix G describes the substantive differences between this Statement and IFRS 3 (as revised in 2007). One significant difference is the measurement requirements for a noncontrolling interest in an acquiree. This Statement requires an acquirer to measure a noncontrolling interest at its acquisition-date fair value. IFRS 3 (as revised in 2007) provides the acquirer a choice for each business combination to measure a noncontrolling interest either at its fair value or on the basis of its proportionate interest in the identifiable net assets of the acquiree. The Boards' requirements for recognizing at the acquisition date assets and liabilities arising from contingencies also differ, in part because the IASB decided to carry forward IFRS 3's requirements for those assets and liabilities on an interim basis, pending completion of its project to revise IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

What Is the Effective Date of This Statement?

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The effective date of this Statement is the same as that of the related FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements.

V. CHAPTER 7, MODERN VALUATION TECHNIQUES IN MERGERS AND ACQUISITIONS

A. Page 370, New Sec. 7.3.E. The Final Rule on Fairness Opinions by FINRA the Successor to the NASD

Page 370, New Sec. 7.3.E. Add before Sec. 7.4 the following:
New Sec. 7.3.E. **The Final Rule on Fairness Opinions by FINRA, the Successor to the NASD**

Financial Industry Regulatory Authority (FINRA)
Fairness Opinions
SEC Approves New NASD Rule 2290 Regarding
Fairness Opinions
Effective Date: December 8, 2007

Background and Discussion

A fairness opinion addresses, from a financial point of view, the fairness of the consideration in a transaction. Fairness opinions are routinely used by directors of companies in connection with a change of control transaction, such as a merger or sale or purchase of assets, to satisfy their fiduciary duties to act with due care and in an informed manner.

Although not required by statute or regulation, fairness opinions have become commonplace in change of control transactions following the 1985 Delaware Supreme Court case of *Smith v. Van Gorkom*,2 in which a corporate board was held to have breached its fiduciary duty of care by approving a merger without adequate information on the transaction, including information on the value of the company and the fairness of the offering price.

In addition to providing a basis for the exercise of care by the board of directors, a fairness opinion, or information about a fairness opinion, is often provided to shareholders as a part of the proxy materials relating to a change of control transaction. Fairness opinions express a conclusion as to the whether the consideration offered in a transaction is within the range of what would be considered “fair”; such opinions generally do not offer an opinion as to whether the consideration offered is the best price that could likely be attained or reach other matters, such as solvency issues, that may arise from the transaction.

Under the SEC’s proxy rules, which apply to issuers, certain disclosures about potential conflicts of interest are provided to investor-shareholders. NASD Rule 2290 is a complementary rule that requires broker-dealers that render fairness opinions to inform investor-shareholders about the potential conflicts of interest that may exist between the firm rendering the fairness opinion and the issuer. The Rule also addresses specific procedures concerning the issuance of fairness opinions.

Disclosures Required by NASD Rule 2290(a)

The Rule sets forth the parameters when the disclosures are required to be contained in a fairness opinion. If a member firm knows or has reason to know, at the time a fairness opinion is issued to a company's board, that the opinion will be provided or described to the company's public shareholders, the firm must make the enumerated disclosures in the fairness opinion. A firm will be deemed to have a reason to know that the fairness opinion will be provided or described to public shareholders, if, for example, the structure of the transaction will require a shareholder vote. The fairness opinions covered by the Rule include those issued to the board of directors, and/or any special committee or other subset or committee of the board.

Acting as Financial Advisor and Contingent Compensation

A member firm is required to disclose if the firm has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor. This requirement includes significant payments or compensation from related transactions (*e.g.*, stapled financings) if such transactions are contingent upon the completion of the transaction for which the fairness opinion was issued. This disclosure, along with the disclosures in paragraphs (a)(2) and (a)(3), requires descriptive information rather than quantitative information. In addition, FINRA notes that none of the Rule's disclosure provisions requires a member to breach any of its confidentiality obligations.

Other Significant Payment or Compensation

A member firm must disclose if it will receive any other significant payment or compensation contingent upon the successful completion of the transaction. FINRA has chosen not to establish a particular dollar or percentage figure as to what may be considered "significant" out of a concern that establishing a specific figure may become a de facto standard for such payments. Given that the nature of the provision is to inform investors of conflicts of interest, and that paragraph (a)(2) is to prevent circumvention of the provisions in paragraph (a)(1), the receipt of *de minimis* fees (such as trading fees or other small incremental fees from account assets or activity) would not be required to be disclosed. FINRA believes that a "significant" payment or contingent compensation is one that a reasonable person, who reads a fairness opinion, would have an interest in knowing about in order to assess whether the member firm authoring the fairness opinion has a potential conflict of interest.

Material Relationships

A member firm is required to disclose any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the firm and any party to the transaction that is the subject of the fairness opinion. FINRA notes that this disclosure requirement attaches to material relationships between the member firm and all parties to the transaction, not just the party whose board of directors selected the member firm to render the fairness opinion; *e.g.*, in the case of a takeover, a member issuing a fairness opinion to the target's board of directors would also have to disclose any material relationships it had with the acquiror. As noted above, the disclosure is not required to be quantified, but each of the material relationships should be identified in the fairness opinion.

Independent Verification of Information

A member firm is required to disclose if any information that formed a substantial basis for the fairness opinion that was supplied to the firm by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the firm, and if so, a description of the information or categories of information that were verified. When no information has been verified, a blanket statement to that effect is sufficient. On the other hand, if a member firm independently verifies some or all of the information supplied to it concerning the companies that are parties to the transaction, it must describe the information or the categories of information that were verified. In those instances, FINRA notes that a firm making such a representation may also wish to explain in the fairness opinion its process or standards for independent verification.

Use of Fairness Committee

A disclosure of whether or not the fairness opinion was approved or issued by a fairness committee is required. For purposes of the Rule, the term, "fairness committee" includes any committee or group that approves a fairness opinion in accordance with the requirements of paragraph (b) regardless of whether the member firm calls it a "fairness committee."

Compensation to Insiders

Finally, member firms are required to disclose whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company. This disclosure highlights to the investor the potential conflict of interest between the member issuing the fairness opinion and the issuer receiving the opinion by requiring disclosure of whether the member did or did not take into account the amount and nature of compensation flowing to certain insiders relative to the benefits to shareholders in reaching a fairness determination.

Procedures Required by NASD Rule 2290(b)

NASD Rule 2290(b) requires that any member firm issuing a fairness opinion must have written procedures for approval of a fairness opinion. The firm must have procedures regarding the types of transactions and the circumstances in which the firm will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:

(A) the process for selecting personnel to be on the fairness committee; (B) the necessary qualifications of persons serving on the fairness committee; and (C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction.

FINRA notes that paragraph (b)(1)(C) does not require that the fairness committee be comprised entirely of persons not serving on or advising the deal team. Rather, the provision requires that the firm have procedures to promote a balanced review by including on the fairness committee persons who are not serving on the deal team. Whether a person is considered to be part of the deal team requires an analysis of the particular facts and circumstances, and will not necessarily be determined by whether a person is included on all document distributions or participated in certain meetings. The determination of whether a person is part of a deal team will depend on the nature and substance of his or her contacts and the advice rendered to the firm. Firms are also required to have a process to determine whether the valuation analyses used in the fairness opinion are appropriate.

The new rule becomes effective on December 8, 2007. An outline of the disclosure and procedural requirements under the Rule is included in Attachment B.

2290. Fairness Opinions
(a) Disclosures
If at the time a fairness opinion is issued to the board of directors of a company The member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders, the member must disclose in the fairness opinion:
(1) if the member has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor;
(2) if the member will receive any other significant payment or compensation contingent upon the successful completion of the transaction;
(3) any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion;
(4) if any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the member, and if so, a description of the information or categories of information that were verified;
(5) whether or not the fairness opinion was approved or issued by a fairness committee; and
(6) whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company.
(b) Procedures Any member issuing a fairness opinion must have written procedures for approval of a fairness opinion by the member, including: (1) the types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:
(A) the process for selecting personnel to be on the fairness committee;
(B) the necessary qualifications of persons serving on the fairness committee;
(C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction; and
(2) the process to determine whether the valuation analyses used in the fairness opinion are appropriate.
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VI. CHAPTER 13, ACQUISITION OF A PUBLICLY HELD TARGET IN A NEGOTIATED MERGER

A. Page 667, New Sec. 13.10.G. 2007 Final Amendments to Rule 145

Page 667, New Sec. 13.10.G. Add before Sec. 13.11 the following:
New Sec. 13.10.G. **2007 Final Amendments to Rule 145**

Securities Act Release No. 8869, Amendments to Rule 144 and 145
(The amended rule is at the end of this document)
December 6, 2007

ACTION: Final rule.

SUMMARY: Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. We are shortening the holding period requirement under Rule 144 for "restricted securities" of issuers that are subject to the reporting requirements of the Securities Exchange Act of 1934 to six months. Restricted securities of issuers that are not subject to the Exchange Act reporting requirements will continue to be subject to a one-year holding period prior to any public resale. The amendments also substantially reduce the restrictions applicable to the resale of securities by non-affiliates. In addition, the amendments simplify the Preliminary Note to Rule 144, amend the manner of sale requirements and eliminate them with respect to debt securities, amend the volume limitations for debt securities, increase the Form 144 filing thresholds, and codify several staff interpretive positions that relate to Rule 144. [The amendments to Rule 144 are discussed in Chapter 4.] Finally, we are eliminating the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and revising the resale requirements in Rule 145(d). We believe that the amendments will increase the liquidity of privately sold securities and decrease the cost of capital for all issuers without compromising investor protection. * * *

G. Amendments to Rule 145

Securities Act Rule 145 [186] [footnotes are at the end of the document] provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations or transfers of assets that are subject to shareholder vote constitute sales of those securities. Unless an exemption from the registration requirement is available, Rule 145(a) requires the registration of these sales. Rule 145(c) deems persons who were parties to such a transaction, other than the issuer, or affiliates of such parties to be underwriters. Rule 145(d) permits the resale, subject to specified conditions, of securities received in such transactions by persons deemed underwriters. In the 1997 Proposing Release, we proposed to eliminate the presumed underwriter and resale provisions in Rule 145(c) and (d). Many commenters supported the 1997 proposal. [187]

In the 2007 Proposing Release, we proposed amendments to Rule 145(c) and (d) that would:

- Eliminate the presumed underwriter provision in Rule 145(c), except with regard to Rule 145(a) transactions that involve a shell company (other than a business combination related shell company); [188] and

- Harmonize the requirements in Rule 145(d) with the proposed provisions in Rule 144 that would apply to securities of shell companies.

Under the proposed rule, where a party to a Rule 145(a) transaction, other than the issuer, is a shell company (other than a business combination related shell company), the party and its affiliates could resell securities acquired in connection with the transaction only in accordance with Rule 145(d).

Five commenters expressly supported the proposed changes to Rule 145. [189] Two commenters requested that we reassess the impact of the proposed Rule 145 amendments on the staff's position that stock received in a reorganization that is exempt from registration pursuant to Section 3(a)(10) of the Securities Act [190] could be publicly resold pursuant to Rule 145(d)(2). [191]

After considering the comments, we believe that it is appropriate to adopt the amendments to Rule 145, as proposed. The presumptive underwriter provision in Rule 145 is no longer necessary in most circumstances. However, based on our experience with transactions involving shell companies that have resulted in abusive sales of securities, we believe that there continues to be a need to apply the presumptive underwriter provision to reporting and non-reporting shell companies and their affiliates and promoters. We are amending Rule 145 to eliminate the presumptive underwriter provision except when a party to the Rule 145(a) transaction is a shell company. [192] Rule 145(c) now provides that any party, other than the issuer, to a Rule 145(a) transaction involving a shell company (but not a business combination related shell company), including any affiliate of such party, who publicly offers or sells securities of the issuer acquired in connection with the transaction, will continue to be deemed an underwriter. [193]

Under the amendments to Rule 145 that we are adopting, if the issuer has met the requirements of new paragraph (i)(2) of Rule 144, [194] the persons and parties deemed underwriters will be able to resell their securities subject to paragraphs (c), (e), (f), and (g) of Rule 144 after at least 90 days have elapsed since the securities were acquired in the transaction. After six months have elapsed since the securities were acquired in the Rule 145(a) transaction, the persons and parties will be permitted to resell their securities, subject only to the Rule 144(c) current public information condition, provided that the sellers are not affiliates of the issuer at the time of sale and have not been affiliates during the three months before the sale. After one year has elapsed since the securities were acquired in the transaction, the persons and parties will be permitted to resell their securities without any limitations under Rule 145(d), provided that they are non-affiliates at the time of sale and have not been affiliates during the three months before the sale.

In addition, we are adopting, as proposed, a note to paragraphs (c) and (d) of Rule 145 that paragraph (d) is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. [195] We have included a similar statement in the Preliminary Note to Rule 144. We also are adopting, as proposed, the clarification to the language in Rule 145(d) regarding the securities that were acquired in a transaction specified in Rule 145(a). [196]

186 17 CFR 230.145.

187 See comment letters on the 1997 Proposing Release from ABA; ASCS; AT&T; BG&E; Brobeck, Phleger & Harrison, LLP ("Brobeck"); Corporate Counsel; Intel; NY Bar; NY City Bar; SIA; Smith Barney; Sullivan; and Testa Hurwitz.

188 The terms "shell company" and "business combination related shell company" are defined in Securities Act Rule 405. See also Release No. 33-8587 (Jul. 15, 2005) [70 FR 42233].

189 See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Fried Frank; Financial Associations; and SCSGP.

190 15 U.S.C. 77c(a)(10).

191 See comment letters on the 2007 Proposing Release from Barron and Fried Frank.

192 With respect to a transaction that is exempt from registration pursuant to Section 3(a)(10) of the Securities Act that falls within Rule 145(a), if any party to the transaction is a shell company, then any party to the transaction, other than the issuer, and its affiliates will be permitted to resell their securities in accordance with the restrictions of Rule 145(d). Also, the staff intends to issue a revised Staff Legal Bulletin No. 3 concurrently with the effective date of the amendments that we are adopting that will address the treatment of parties to a transaction and their affiliates that have acquired securities in a transaction exempt from registration pursuant to Section 3(a)(10) of the Securities Act.

193 We are also adding the definition of "affiliate" to paragraph (e) and transferring the definition of "party" from paragraph (c) to paragraph (e).

194 The requirement in the newly added Rule 144(i)(2) that Form 10 information be filed reflecting a company's status as no longer a shell company is fulfilled with respect to a Rule 145(a) transaction through the filing of the registration statement.

195 See new Note to Rule 145(c) and (d).

196 See amendments to Rule 145(d) relating to “securities acquired in a transaction specified in paragraph (a) that was registered under the Act.”

Rule 145 Reclassification of securities, mergers, consolidations and acquisitions of assets

Preliminary Note: Rule 145 (§230.145 of this chapter) is designed to make available the protection provided by registration under the Securities Act of 1933, as amended (Act), to persons who are offered securities in a business combination of the type described in paragraphs (a) (1), (2) and (3) of the rule. The thrust of the rule is that an *offer, offer to sell, offer for sale,* or *sale* occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security. Rule 145 embodies the Commission’s determination that such transactions are subject to the registration requirements of the Act, and that the previously existing *no-sale* theory of Rule 133 is no longer consistent with the statutory purposes of the Act. *See* Release No. 33–5316 (October 6, 1972) [37 FR 23631]. Securities issued in transactions described in paragraph (a) of Rule 145 may be registered on Form S–4 or F–4 (§239.25 or §239.34 of this chapter) or Form N–14 (§239.23 of this chapter) under the Act.

Transactions for which statutory exemptions under the Act, including those contained in sections 3(a)(9), (10), (11) and 4(2), are otherwise available are not affected by Rule 145.

Note 1: Reference is made to Rule 153a (§230.153a of this chapter) describing the prospectus delivery required in a transaction of the type referred to in Rule 145.

Note 2: A reclassification of securities covered by Rule 145 would be exempt from registration pursuant to section 3(a)(9) or (11) of the Act if the conditions of either of these sections are satisfied.

(a) *Transactions within this section.* An *offer, offer to sell, offer for sale,* or *sale* shall be deemed to be involved, within the meaning of section 2(3) of the Act, so far as the security holders of a corporation or other person are concerned where, pursuant to statutory provisions of the jurisdiction under which such corporation or other person is organized, or pursuant to provisions contained in its certificate of incorporation or similar controlling instruments, or otherwise, there is submitted for the vote or consent of such security holders a plan or agreement for:

(1) *Reclassifications.* A reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security;

(2) *Mergers of consolidations.* A statutory merger or consolidation or similar plan or acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any person, unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States; or

(3) *Transfers of assets.* A transfer of assets of such corporation or other person, to another person in consideration of the issuance of securities of such other person or any of its affiliates, if:

(i) Such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or

(ii) Such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or

(iii) The board of directors or similar representatives of such corporation or other person, adopts resolutions relative to paragraph (a)(3) (i) or (ii) of this section within 1 year after the taking of such vote or consent; or

(iv) The transfer of assets is a part of a preexisting plan for distribution of such securities, notwithstanding paragraph (a)(3) (i), (ii), or (iii) of this section.

(b) *Communications before a Registration Statement is filed.* Communications made in connection with or relating to a transaction described in paragraph (a) of this section that will be registered under the Act may be made under §230.135, §230.165 or §230.166.

(c) *Persons and parties deemed to be underwriters.* For purposes of this section, if any party to a transaction specified in paragraph (a) of this section is a shell company, other than a business combination related shell company, as those terms are defined in §230.405, any party to that transaction, other than the issuer, or any person who is an affiliate of such party at the time such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(a)(11) of the Act.

(d) *Resale provisions for persons and parties deemed underwriters.* Notwithstanding the provisions of paragraph (c), a person or party specified in that paragraph shall not be deemed to be engaged in a distribution and therefore not to be an underwriter of securities acquired in a transaction specified in paragraph (a) that was registered under the Act if:

(1) The issuer has met the requirements applicable to an issuer of securities in paragraph (i)(2) of §230.144; and

(2) One of the following three conditions is met:

(i) Such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f), and (g) of §230.144 and at least 90 days have elapsed since the date the securities were acquired from the issuer in such transaction; or

(ii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and at least six months, as determined in accordance with paragraph (d) of §230.144, have elapsed since the date the securities were acquired from the issuer in such transaction, and the issuer meets the requirements of paragraph (c) of §230.144; or

(iii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and at least one year, as determined in accordance with paragraph (d) of §230.144, has elapsed since the date the securities were acquired from the issuer in such transaction.

Note to §230.145(c) and (d): Paragraph (d) is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.

(e) *Definitions.* (1) The term *affiliate* as used in paragraphs (c) and (d) of this section shall have the same meaning as the definition of that term in §230.144.

(2) The term *party* as used in paragraphs (c) and (d) of this section shall mean the corporations, business entities, or other persons, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph (a) of this section.

(3) The term *person* as used in paragraphs (c) and (d) of this section, when used in reference to a person for whose account securities are to be sold, shall have the same meaning as the definition of that term in paragraph (a)(2) of §230.144.

[37 FR 23636, Nov. 7, 1972, as amended at 49 FR 5921, Feb. 16, 1984; 50 FR 19016, May 6, 1985; 50 FR 48382, Nov. 25, 1985; 55 FR 17944, Apr. 30, 1990; 62 FR 9245, Feb. 28, 1997; 64 FR 61449, Nov. 10, 1999; 72 FR 71570, Dec. 17, 2007]

VII. CHAPTER 23, TARGET'S DEFENSIVE TACTICS

A. Page 998, New Sec. 23.11.B. Delaware Court's View on Change of Control Provision of Debt Instrument--Amylin

Page 998, New Sec. 23.11.B. Add before Sec. 23.12 the following:
New Sec. 23.11.B. **Delaware Court's View on Change of Control Provision of Debt Instrument--*Amylin***

San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc
C.A. No. 4446-VCL
COURT OF CHANCERY OF DELAWARE
2009 Del. Ch. LEXIS 83

MEMORANDUM OPINION AND ORDER

LAMB, Vice Chancellor.

The principal issue addressed in this opinion is whether a commonplace provision found in a trust indenture governing publicly traded notes prevents the issuer's board of directors from "approving" as "continuing directors" persons nominated by stockholders in opposition to the slate nominated by the incumbent directors. Both the corporation and its stockholders take the position that it does not and that, instead, the board of directors has the power to give its approval to any nominee, whether or not nominated by the incumbent directors. The indenture trustee takes the opposite position, arguing that the incumbent directors cannot "approve" as a "continuing director" any person whose election the incumbent directors publicly oppose. The issue is consequential because if a majority of the board at any time are not "continuing directors," holders of the notes gain the right to put their notes to the corporation at face value. Because the notes are trading on a deeply discounted basis, any event threatening to trigger this provision poses a substantial economic problem for the corporation and its stockholders.

Noting that provisions of this kind can operate as improper entrenchment devices that coerce stockholders into voting only for persons approved by the incumbent board to serve as continuing directors, the court holds that the indenture provision cannot be read as narrowly as urged by the indenture trustee. Instead, construed in accordance with generally applied standards, the provision is properly understood to permit the incumbent directors to approve as a continuing director any person, whether nominated by the board or a stockholder, as long as the directors take such action in conformity with the implied covenant of good faith and fair dealing and in accordance with their normal fiduciary duties.

I.

A. The Parties

Plaintiff San Antonio Fire & Police Pension Fund is a public pension fund for police officers and fire fighters in the city of San Antonio, Texas. The plaintiff is, and has been at all relevant times, a record and/or beneficial owner of Amylin common stock.

Defendant Amylin Pharmaceuticals, Inc. is a publicly traded Delaware corporation with its principal place of business in San Diego, California. Amylin is a biopharmaceutical company engaged in the discovery, development, and commercialization of drug candidates for the treatment of diabetes, obesity, and other diseases.

The individual defendants are all of the directors of Amylin.

Defendant Bank of America, N.A. ("BANA") is the Administrative Agent for Amylin's senior secured credit agreement dated December 21, 2007 (the "Credit Agreement"), and is also the Collateral Agent, L/C Issuer, [1] and a lender thereunder.

FOOTNOTES

1 As L/C Issuer, BANA is responsible for issuing letters of credit under the letter of credit facility included as part of the Credit Agreement.

Defendant The Bank of New York Mellon Trust Company, N.A. (formerly, The Bank of New York Trust Company, N.A.) is the "Trustee" under the trust indenture dated June 8, 2007 (the "Indenture") for Amylin's 3.00% convertible senior notes due 2014 (the "2007 Notes").

B. Facts

Because there are no issues of material fact, the following is drawn mainly from the statement of undisputed facts contained in the Joint Pretrial Stipulation and Order filed May 1, 2009.

1. The History Of The Debt Instruments

At a meeting on or about May 22, 2007, Amylin's board adopted resolutions authorizing certain members of the company's senior management to negotiate the terms and conditions of the 2007 Notes. The board also designated the Finance Committee of the Amylin board as the "Pricing Committee" for the 2007 Notes, and delegated full board authority to the Pricing Committee to negotiate and issue the 2007 Notes. The Pricing Committee ultimately approved the issuance of the 2007 Notes.

This lawsuit arises out of a change of control covenant in the Indenture for the 2007 Notes. Section 11.01 of the Indenture gives the noteholders the right to demand redemption of any or all of their notes at face value upon the occurrence of certain events,

including a Fundamental Change, as defined in the Indenture. [2] A “Fundamental Change” is defined in Section 1.01 of the Indenture to have occurred if, *inter alia*, “at any time the Continuing Directors do not constitute a majority of the Company’s Board of Directors . . . .” The Indenture defines “Continuing Directors” as:
(i) individuals who on the Issue Date constituted the Board of Directors and (ii) any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the Issue Date or whose election or nomination for election was previously so approved. [3]
At present, the Amylin board consists of 12 persons, each of whom is a Continuing Director.

FOOTNOTES

2 *See* Fourth Am. Compl. Ex. A (hereinafter “Indenture”) § 11.01.

3 Indenture § 1.01.

The drafting history of the Indenture reveals little regarding the parties’ intentions surrounding the Continuing Directors provision. On June 1, 2007, counsel for Goldman Sachs and Morgan Stanley, the lead underwriters in the offering of the 2007 Notes, circulated a first draft of the description of the notes, which included a Continuing Directors provision. Amylin’s outside counsel, Cooley Godward, circulated a markup of the draft description of the notes the next day. The markup did not contain any proposed change of the Continuing Directors provision. On June 5, 2007, the underwriters’ counsel sent Cooley Godward an initial draft of the Indenture. The initial draft of the Indenture contained a Continuing Directors provision substantially the same as the one contained in the draft description of the notes. The final version of the Continuing Directors provision is unchanged from that contained in the initial draft Indenture.

Before authorizing the issuance of the 2007 Notes, the Pricing Committee discussed certain terms of the notes with the company’s outside counsel. During the course of that discussion, the Continuing Directors provision was neither brought to the attention of, nor discussed by, the Amylin directors. [4]

FOOTNOTES

4 The Pricing Committee engaged in extensive discussions with its legal advisors, management, and underwriters with regard to the best way to structure the notes. Once the final terms had been negotiated, the Pricing Committee asked its outside counsel, whom, with input from Amylin management and internal counsel, had acted as agents for the company in the process of negotiating the terms of the Indenture with the underwriters, whether the notes were subject to any terms which counsel saw as “unusual or not customary.” Bradbury Dep. Tr. 77. Amylin’s outside counsel responded that there

were not. The Pricing Committee then authorized the issuance and sale of the notes. Amylin's officers and its outside counsel were of the opinion at the time that the financial terms of the offering were very favorable to the company.

Amylin's senior secured credit facility also contains a form of continuing director provision, the history of which is useful in considering the parallel provision in the Indenture. In July 2006, almost a year before the 2007 Notes were issued, the Finance Committee authorized the officers of Amylin to enter into a senior secured debt facility of up to $ 100 million on terms and conditions as those officers determined to be necessary and appropriate. In November 2006, the Finance Committee increased its authorization for the credit facility to $ 125 million. Almost a year later, in October 2007, Amylin signed a term sheet for a $ 105 million credit facility and $ 15 million revolving line of credit. On December 21, 2007, Amylin entered into the definitive senior secured Credit Agreement with BANA, providing for a $ 125 million term credit facility and a $ 15 million revolving credit facility.

The Continuing Directors provision in the Credit Agreement is more explicitly confining than the one in the Indenture. Under the Credit Agreement, the occurrence of a Change of Control constitutes an Event of Default which, if not waived, would have the effect of accelerating the debt due under the agreement. [5] A Change of Control is defined in the Credit Agreement as including:

an event or series of events by which . . . (b) during any period of 24 consecutive months, a majority of the members of the board of directors or other equivalent governing body of the Company cease to be composed of individuals

(i) who were members of that board or equivalent governing body on the first day of such period,

(ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body, or

(iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body (excluding, in the case of both clause (ii) and clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors). [6]

This Change of Control definition was the subject of some negotiation between counsel for BANA and counsel for Amylin. Amylin's counsel suggested that the language of the Credit Agreement defining Change of Control be changed to conform to the definition in the Indenture. BANA's counsel rejected that suggestion, instead insisting on the form found in Bank of America's Model Syndicated Credit Agreement. It is that model clause, as set forth above, that appears in the final Credit Agreement.

FOOTNOTES

5 *See* Fourth Am. Compl. Ex. B [hereinafter "Credit Agreement"] §§ 8.01(k), 8.02.

6 *Id.* at § 1.01.

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2. The Proxy Contest

On January 28, 2009, Icahn Partners LP and affiliates ("Icahn"), an approximately 8.8% stockholder, notified Amylin of its intention to nominate a slate of five directors to Amylin's 12-person board. The next day, Eastbourne Capital Management, L.L.C., a 12.5% stockholder, notified Amylin of its intention to nominate its own five-person slate. On February 1, 2009, Eastbourne sent a letter asking the Amylin board to take action to prevent the adverse consequences that would befall the corporation if the Continuing Directors provision of the Indenture were triggered. Specifically, Eastbourne asked the board to assemble an approved slate of directors that included a significant number of the nominees from each of Eastbourne's and Icahn's slates.

On February 27, 2009, Amylin filed its annual report on Form 10-K for the year ended December 31, 2008. In its Form 10-K, Amylin highlighted the potential adverse consequences if the Continuing Directors provisions of its outstanding debt instruments were triggered. [7]

FOOTNOTES

7 Amylin stated in its annual report:
If as a result of this potential proxy contest a majority of our Board of Directors ceases to be composed of the existing directors or other individuals approved by a majority of the existing directors, then a "change of control" under the Term Loan and a "fundamental change" under the indenture for 2007 Notes will be triggered. If triggered, the lenders under the Term Loan may terminate their commitments and accelerate our outstanding debt and the holders of our 2007 Notes may require us to repurchase the notes. We may not have the liquidity or financial resources to do so at the times required or at all.

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If a proxy contest results from one or both notices received from the Icahn Group or Eastbourne announcing their intent to each nominate five individuals for election to our Board of Directors at the 2009 annual meeting . . . our business could be adversely

affected because . . . if a majority of our Board of Directors ceases to be composed of the existing directors or other individuals approved by a majority of the existing directors, we may be required to repay $ 575 million under our 2007 Notes, $ 125 million under our Term Loan and any amounts that may be outstanding under our $ 15 million revolving credit facility, and if a cross-default is triggered, $200 million under our 2004 Notes . . .
(Amylin Pharmaceuticals, Inc., Annual Report (Form 10-K), at 37, 39-40 (Feb. 27, 2009)).

Thus, if the Continuing Directors provisions of both the Credit Agreement and the 2007 Notes were triggered, and the 2004 Notes cross-defaulted as a result, the company would be required to immediately pay back as much as $ 915 million. As of December 31, 2008, Amylin had approximately $ 817 million in cash, cash equivalents, and short term investments. *Id.* at 59.

On March 9, 2009, Eastbourne sent a letter to the Amylin board questioning the legitimacy of the Continuing Directors provisions of the Indenture and the Credit Agreement and calling upon the board to use its power to remove any obstacle to the operation of the stockholder franchise, including “approving” the dissident slates for purposes of the 2007 Notes and obtaining any necessary consents or waivers from the lenders under the Credit Agreement.

On March 17, 2009, Amylin stated publicly that the tentative date for its 2009 annual meeting was May 27, 2009.

C. The Litigation

On March 24, 2009, the plaintiff filed its original purported class action complaint against Amylin and its individual directors. That complaint alleged (1) breaches of the fiduciary duties of care and loyalty by the board of Amylin in the adoption of the Credit Agreement and the Indenture, insofar as they both contained Continuing Directors provisions, (2) breaches of the fiduciary duties of care and loyalty by Amylin’s board in failing to approve the dissident nominees in order to defuse the Continuing Directors provision of the Indenture, and (3) breaches of the fiduciary duties of care and loyalty in the allegedly misleading and coercive manner in which Amylin’s board chose to disclose the risks presented by the Continuing Directors provisions in the company’s Form 10-K. The relief requested was in the form of declaratory and injunctive relief. Specifically, the plaintiff sought declarations that the directors had breached their fiduciary duties and that the Continuing Directors provisions were unenforceable. The plaintiff also sought a mandatory injunction requiring the directors to approve the stockholder nominees. After a telephonic hearing, the court ordered expedited proceedings. [8]

FOOTNOTES

[8] On March 26, 2009, the plaintiff filed a motion for expedited proceedings. On March 27, 2009, the plaintiff filed an amended complaint adding a count alleging that the directors violated Section 141(a) of the Delaware General Corporation Law in adopting the Continuing Directors provision in the Credit Agreement, and that such allegedly *ultra vires* act renders the provision unenforceable as a matter of law.

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On March 30, 2009, Amylin filed its preliminary proxy statement, stating its belief that the board possesses the contractual right under the Indenture to approve the stockholder nominees "at any time up to the election."[9] On April 2, 2009, Amylin released a proxy "fight letter," stating:

While we believe that the Board has the ability to approve any nominees proposed by Icahn or Eastbourne at any time up to the election in order to nullify the debt acceleration provision, we cannot ensure that our bondholders will concur with that view. In fact, we requested confirmation of our view from the trustee of the 2014 notes and the trustee has refused to confirm our view. To protect the company and its shareholders, this issue will need to be resolved in court.[10]

FOOTNOTES

[9] Amylin stated: "The Company believes that its current Board of Directors has the ability to approve any nominees proposed for election by Icahn or Eastbourne at any time up to the election and avoid the occurrence of a 'fundamental change' under the indenture for the [2007 Notes] in the event six or more of those nominees are ultimately elected. However, approval of those nominees by the current Board of Directors cannot avoid the occurrence of a 'change of control' under the credit agreement in the event six or more of them are elected." Amylin Pharmaceuticals, Inc., Preliminary Proxy Statement (Schedule 14A), at 18 (Mar. 30, 2009).

[10] Amylin Pharmaceuticals, Inc., Proxy Solicitation Materials (Form DEFA14A), Ex 99.1 at 2 (Apr. 2, 2009).

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Early in April, the plaintiff filed second and third amended complaints, adding BANA and the Trustee as necessary defendants. The third amended complaint also added a new count seeking a declaration that Amylin's board has the sole right and power to approve the stockholder nominees for the purpose of the Continuing Directors provision of the Indenture.

On April 7, 2009, the individual defendants and Amylin filed their answer. That answer contains a cross-claim by Amylin against the Trustee, seeking declaratory relief that the board has the right under the Indenture to approve the election of any or all of the stockholder nominees at any time up to their election. The plaintiff then moved for partial summary judgment that the Continuing Directors provision of the Credit Agreement is unenforceable as a matter of law and that the board has the right and power to approve the stockholder nominees for the purpose of the Indenture.

D. The Partial Settlement

On April 13, 2009, the plaintiff and Amylin announced that they had entered into a partial settlement. Under the terms of the settlement, the plaintiff agreed to amend its complaint to remove any allegations of breaches of the duty of loyalty (or allegations of lack of good faith by the board), agreed not to seek damages against Amylin or the board, and agreed to dismiss without prejudice its claim against the board relating to the allegedly coercive disclosure in the company's Form 10-K. The plaintiff also agreed to dismiss its claim against the board for breach of fiduciary duty in failing to act to approve the stockholder nominees and drop its related demand for injunctive relief. In exchange for dropping this claim, the board issued a public statement that:

the Board has determined, subject only to the entry of a final, non-appealable order prior to May 27, 2009 declaring that the Board possesses the contractual right to do so, that the Board will "approve" the Icahn Capital LP and Eastbourne Capital Management L.L.C. nominees for [the purpose of the Continuing Directors provision of the Indenture]. [11]

That same day, Amylin moved for partial summary judgment on its cross-claim against the Trustee.

FOOTNOTES

[11] Amylin Pharmaceuticals, Inc., Current Report (Form 8-K), at 2 (Apr. 15, 2009).

On April 16, 2009, the plaintiff filed its fourth amended complaint implementing the terms of the partial settlement between the plaintiff and Amylin. On April 23, 2009, BANA filed its answering brief with respect to the plaintiff's motion for partial summary judgment and made its own cross-motion for summary judgment with respect to the claims against it.

E. The Claims Against BANA Are Mooted

During the pretrial conference on May 1, 2009, counsel for Amylin, together with counsel for BANA, informed the court that the parties were close to reaching an agreement on a consent and waiver under the Credit Agreement which would moot the related claims. The court thus agreed, with the consent of the parties, to hold the claims arising out of the Credit Agreement in abeyance for the purposes of the May 4 trial. Later that day, Amylin and BANA entered into a consent and waiver agreement (the "BANA Consent Agreement") as anticipated. Under the BANA Consent Agreement, the lenders would agree to waive any event of default resulting from the 2009 Amylin director elections triggering the Continuing Directors provision of the Credit Agreement. [12] In exchange, Amylin agreed to pay a 50 basis point fee on any outstanding balance under the Credit Agreement to the lenders, should the Continuing Directors provision be triggered by the 2009 director elections. [13]

FOOTNOTES

12 The lenders' consent is conditioned on the delivery to BANA of a copy of one of the following, providing that the election of any or all of the stockholder nominees will not result in a Fundamental Change under the Indenture: (1) a final judgment by a court of competent jurisdiction, (2) a settlement agreement approved by the court, or (3) an opinion of counsel to the Trustee.

13 Amylin also agreed to pay a 25 basis point fee to BANA for attempting to solicit the consent to the BANA Consent Agreement of the required percentage of the lenders under the Credit Agreement (the "Required Lenders").

The resolution with BANA did not affect the claims relating to the Indenture. Thus, on May 4, 2009, trial was held and oral arguments were heard on all outstanding motions for summary judgment regarding the Indenture, and all outstanding claims relating to the Indenture were submitted to the court for final adjudication on the record. [14]

FOOTNOTES

14 On May 6, 2009, BANA notified the court that the Required Lenders consented to the BANA Consent Agreement. Count II of the fourth amended complaint, which seeks a declaration of the invalidity and unenforceability of the Continuing Directors provision of the Credit Agreement, has thus been rendered moot.

F. Post-trial Changes In The Proxy Contest

On May 6, 2009, two days after the close of the record, the court received a letter from counsel for Amylin, setting forth recent developments in the plans of the insurgent parties. On May 4, 2009, Eastbourne filed its definitive proxy statement, in which it reduced the number of candidates it was nominating to the Amylin board from five to three. [15] On May 6, 2009, Icahn filed its definitive proxy statement, in which it reduced the number of candidates it was nominating to the Amylin board from five to two. [16] As a consequence of these changes, no more than five stockholder-nominated directors will be elected to the 12 member Amylin board at the 2009 annual stockholder meeting. The Trustee has, in response, renewed its objection to proceeding at this point, on the basis that the issues are not ripe for determination. The plaintiff and Amylin both respond that the court should proceed because, if elected, whether or not the stockholder-nominated directors constitute Continuing Directors may have a significant effect on next year's annual stockholder meeting.

FOOTNOTES

15 Amylin Pharmaceuticals, Inc., Definitive Proxy Statement of Eastbourne Capital Management, L.L.C. et al. (Form DEFC14A), at 1-4 (May 4, 2009).

16 Amylin Pharmaceuticals, Inc., Definitive Proxy Statement of Carl C. Icahn et al. (Form DEFC14A), at 2 (May 6, 2009).

II.

The Amylin board has already agreed to approve the dissident slates if this court determines that it is entitled to do so. Thus, the central issue in this case is whether or not the Amylin board has both the power and the right under the Indenture to approve the stockholder nominees.

Because the Indenture constitutes a contract between Amylin and the Trustee, determination of this question is one of contract interpretation. [17] Interpretation of the Indenture is controlled by New York law pursuant to a choice of law provision contained therein. [18] “Under New York law, as in Delaware, the construction and interpretation of an unambiguous written contract is an issue of law within the province of the court.” [19] “Included in this initial interpretation is the threshold question of whether the terms of the contract are ambiguous.” [20] “Contractual language whose meaning is otherwise plain is not ambiguous merely because the parties urge different interpretations in the litigation.” [21] “Contract language is unambiguous if it has ‘a definite and precise meaning, unattended by danger of misconception in the purport of the [contract] itself, and concerning which there is no reasonable basis for a difference of opinion.’“ [22] “Where the [contract’s] language is free from ambiguity, its meaning may be determined as a matter of law on the basis of the writing alone without resort to extrinsic evidence.” [23]

FOOTNOTES

17 *See Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1049 (2d Cir. 1982) (stating that under New York law “[i]nterpretation of indenture provisions is a matter of basic contract law”).

18 *See* Indenture § 1.12.

19 *Law Debenture Trust Co. v. Petrohawk Energy Corp.*, 2007 Del. Ch. LEXIS 113, 2007 WL 2248150, at *5 (Del. Ch.), *aff’d mem.*, 947 A.2d 1121 (Del. 2008); *see also K. Bell & Assocs., Inc. v. Lloyd’s Underwriters,* 97 F.3d 632, 637 (2d Cir. 1996).

20 *Alexander & Alexander Servs. v. These Certain Underwriters at Lloyd’s, London,* 136 F.3d 82, 86 (2d Cir. 1998).

[21] *First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y*, 164 F. Supp. 2d 383, 393 (S.D.N.Y. 2001) (citing *U.S. Trust Co. of New York v. Jenner*, 168 F.3d 630, 632 (2d Cir. 1999)).

[22] *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 906 F.2d 884, 889 (2d Cir. 1990) (quoting *Breed v. Ins. Co. of N. Am.*, 46 N.Y.2d 351, 385 N.E.2d 1280, 413 N.Y.S.2d 352, 355 (App. Div. 1978)).

[23] *Master-Built Constr. Co. v. Thorne*, 22 A.D.3d 535, 802 N.Y.S.2d 713, 714 (App. Div. 2005).

"In interpreting contract language, New York contract law instructs courts ordinarily to give the words and phrases employed their plain and commonly-accepted meanings." [24] Thus:

The parties' rights under an unambiguous contract should be fathomed from the terms expressed in the instrument itself rather than from extrinsic evidence as to terms that were not expressed or judicial views as to what terms might be preferable. In its efforts to preserve the parties' rights and the status quo, the court must be careful not to alter the terms of the agreement. The parties having agreed upon their own terms and conditions, "the courts cannot change them and must not permit them to be violated or disregarded." [25]

Moreover, when interpreting quasi-standardized contracts such as indentures, "[b]oilerplate provisions are . . . not the consequence of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture." [26] Finally, "[i]ndentures are to be read strictly and to the extent they do not expressly restrict the rights of the issuer, the issuer is left with the freedom to act, subject only to the boundaries of other positive law." [27]

FOOTNOTES

[24] *Petrohawk,* 2007 Del. Ch. LEXIS 113, 2007 WL 2248150, at *6; *accord Laba v. Carey*, 29 N.Y.2d 302, 277 N.E.2d 641, 644, 327 N.Y.S.2d 613 (N.Y. 1971).

[25] *Metro Life Ins.*, 906 F.2d at 889 (some internal citations and quotations omitted) (quoting *Whiteside v. N. Am. Accident Ins. Co.*, 200 N.Y. 320, 93 N.E. 948, 950 (N.Y, 1911)).

[26] *Sharon Steel*, 691 F.2d at 1048.

[27] *In re Loral Space & Commc'ns Inc. Consol. Litig.*, 2008 Del. Ch. LEXIS 136, 2008 WL 4293781, at *35 (Del. Ch.).

A. The Power To Approve

The Trustee contends that, for the purpose of the Continuing Directors provision of the Indenture, that the word "approve" is synonymous with "endorse or recommend." The Trustee argues:

[t]he Board's determination not to recommend the election of any of the Dissident Nominees, to recommend its own competing slate, and that the election of the Dissident Nominees would not be in the best interests of the Company--determinations that have not changed as a result of the Partial Settlement--simply cannot be reconciled with the plain meaning of the term "approval." To the contrary, such determinations by the Board clearly indicate *disapproval.* [28]

As the Trustee would have the court read the Indenture, then, the board could never approve a stockholder-nominated slate for the purposes of the Indenture and yet, simultaneously, run its own slate in opposition.

FOOTNOTES

28 Trustee's Br. in Opp'n to Pl.'s and Amylin's Mot. for Summ. J. 31-32 (emphasis in original).

In contrast, cross-claim plaintiff Amylin contends, citing *Black's Law Dictionary*, that "to approve" means "to give formal sanction to; to confirm authoritatively." [29] Thus, Amylin argues, while endorsement or recommendation may necessarily imply approval, the reverse is not true. By Amylin's reading, therefore, the board may approve a slate of nominees for the purposes of the Indenture (thus sanctioning their nomination for election) without endorsing them, and may simultaneously recommend and endorse its own slate instead.

FOOTNOTES

29 BLACK'S LAW DICTIONARY 111 (8th ed. 2004).

Amylin's reading of the Indenture is the correct one. To read the provision as the Trustee suggests would mean that any election of stockholder nominees resulting from a contested election, even over insubstantial matters, would bar the board from approving the dissident slate for the purposes of the Indenture. Unlike the Credit Agreement with its two-year sliding-window lookback, under the Indenture a non-Continuing Director remains so for the life of the notes. The Trustee's reading would therefore render the Continuing Directors provision of the Indenture, as a possible entrenchment mechanism, to be far more restrictive than the parallel provision in the Credit Agreement. This would be a surprising result given the facially more restrictive language in the Credit Agreement. [30] Read that way, the Indenture would prohibit *any* change in the majority of the board as a result of any number of contested elections, for the entire life of the notes.

FOOTNOTES

30 In light of the fact that when Amylin's outside counsel attempted to convince BANA, during the negotiation of the Credit Agreement, to replace BANA's own model Continuing Directors provision with the one from the Indenture, BANA refused and insisted on its own provision, it seems reasonable to conclude that BANA, as an objective third party, read the Indenture provision to be less restrictive than its own model covenant and desired the greater restriction its own model provision provided. Such restrictive provisions are somewhat less concerning in syndicated lending agreements than they are in public debt instruments because of the relative ease with which consents or waivers are obtained in bank lending than in public debt instruments. Witness the consent and waiver agreement obtained from BANA and the Required Lenders on May 6, compared to the understandable lack of any attempt by Amylin to obtain an amendment from the noteholders.

A provision in an indenture with such an eviscerating effect on the stockholder franchise would raise grave concerns. In the first instance, those concerns would relate to the exercise of the board's fiduciary duties in agreeing to such a provision. The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting such a provision, it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it. [31] Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy. [32]

FOOTNOTES

31 This is arguably a lesser burden than would be applied if the record showed that the board had specifically included such a provision for the primary purpose of interfering with or frustrating the stockholder franchise. *See Blasius Indus., Inc. v. Atlas Corp.,* 564 A.2d 651, 659-60, 662 (Del. Ch. 1988).

32 A provision so strongly in derogation of the stockholders' franchise rights would likely put the trustee and noteholders on constructive notice of the possibility of its ultimate unenforceability.

B. The Right To Approve

Having determined that the board has, in the abstract, the power to approve a stockholder-nominated slate and still engage in a proxy contest against that slate, the court now turns to the question of whether the Amylin board has properly exercised the *right* to do so in this case. The key question is whether approval by the board, under the given circumstances, comports with the company's implied duty of good faith and fair dealing which inheres in all contracts, including the Indenture.

This court considered the contours of that duty in a similar context in *Hills Stores Company v. Bozic*. [33] In that case, the board of directors of Hills Stores Company entered into an employment agreement with three of its executives, which agreement included the right to a significant severance payment should there be a change in control of the board not approved by the pre-existing board for the purposes of the agreement. A dissident stockholder ultimately took control of the board in a proxy contest with promises of a rich sale transaction. [34] The Hills Stores board, over the dissident's protests, refused to approve the change in control, and the executives resigned and took their severance payments. The dissident, now in control of Hills Stores, then caused the company to sue the former directors for allegedly breaching their duty of loyalty by failing to approve the change in control.

FOOTNOTES

33 769 A.2d 88 (Del. Ch. 2000).

34 The board, in considering the dissident's offer the financing for which was uncommitted, had earlier determined that the dissident's offer and a change in control in his favor represented a threat to the corporation and its stockholders. *Id.* at 108.

The *Hills Stores* court, in considering whether the board was justified in not approving the change in control, recognized that the measure of whether the approval was in good faith was whether the board believed that the dissident slate posed a danger to the interests of the corporation and its stockholders. [35] The court stated:
[T]he board's decision . . . to take a consistent approach to the issue of whether to approve the Dickstein Change in Control was a reasonable response in the circumstances presented. Because the board had determined, for many sufficient reasons, that the Dickstein Change in Control was harmful to the company, it would have exercised bad faith under the Employment Agreements if it had voted to approve the Change in Control simply so as to avoid triggering the Covered Executives' right to severance. [36]
The underlying rule is the same here. Thus, the board may approve the stockholder nominees if the board determines in good faith that the election of one or more of the dissident nominees would not be materially adverse to the interests of the corporation or its stockholders. [37]

FOOTNOTES

35 *Id.* at 108-09.

36 *Id.*

37 In other words, if passing control would not constitute a breach of the directors' duty of loyalty to the corporation and its stockholders. It is important to recognize here that the directors are under absolutely *no* obligation to consider the interests of the noteholders in making this determination.

The application of this rule here is problematic. [38] The court has been presented with no evidence regarding the board's deliberation with respect to the decision to approve the stockholder-nominated slate. No party has placed into the record any board minutes, resolutions, or other evidence that would indicate how the board came to its decision. Rather, before the court are two less than helpful sets of circumstances.

FOOTNOTES

38 Because Amylin seeks a declaratory judgment as to its right to approve, it bears the burden of proof here. *See Those Certain Underwriters at Lloyd's, London v. Nat'l Installment Ins. Servs., Inc.*, 2008 Del. Ch. LEXIS 57, 2007 WL 4554453 (Del. Ch.).

First are the negative public statements made by the board in various fight letters with respect to the dissident nominees. [39] While, if taken at face value, these statements would suggest that the board has concluded that the dissidents would be harmful to the company, such a reading would be inappropriate. Election "puffery" in the context of a fight letter is hardly the same as a determination by the board, in the exercise of its power to approve Continuing Directors, that the election of one or more of the stockholder nominees would be harmful to the corporation or the interests of its stockholders.

FOOTNOTES

39 *See, e.g.*, Amylin Pharmaceuticals, Inc., Additional Definitive Proxy Solicitation Material (Form DEFA14A), at 3 (Apr. 24, 2009). The board stated:
Over the course of our conversations with Mr. Icahn and Eastbourne, it has become abundantly clear that their goal is the sale of Amylin. We strongly believe that this agenda is not in the best interests of Amylin's shareholders. Your Board and management believe that a sale of the Company in the near-term would undervalue the return on investment we believe shareholders will realize as a result of the approval and launch of exenatide once weekly.

Consistent with his history in several recent and current proxy fights, Mr. Icahn wants to employ a "cookie-cutter" approach to slashing costs, without any regard to the specific nature of Amylin's business. His one-size-fits-all methodology is exemplified by his identifying insurance and logistics as potential areas for additional savings, neither of which are significant components of Amylin's cost structure. His actions would undermine our efforts to prepare for and launch exenatide once weekly.

Mr. Icahn and Eastbourne show a serious lack of understanding of Amylin's business and the value-enhancing opportunities that the Company has created in the marketplace. The Company's future opportunity is tied directly to the FDA approval for and successful launch of exenatide once weekly. Their desire to disrupt the Company's operations and focus in the middle of the FDA process could potentially derail the launch preparations for exenatide once weekly. This demonstrates that both Mr. Icahn and Eastbourne fail to appreciate the sensitivities and potential shareholder value that we expect will result from the successful execution of this process.

At the upcoming annual meeting, you have a clear choice: vote for your Board's plan, which is close to achieving its strategic objectives to build value for all shareholders, or take your chances with the Icahn and Eastbourne platform, which demonstrates a disregard for the fundamental drivers of our business.

Neither Mr. Icahn nor Eastbourne has offered any constructive ideas as to how they would lead Amylin differently.

Second is the posture in which the board appears to have made its decision to approve. On March 9, 2009, the plaintiff asked the board to act to approve the stockholder nominees. The board did not do so until April 13, 2009, and then only in exchange for a partial settlement with the plaintiff in which the plaintiff agreed to amend its complaint to remove any allegations of breach of the duty of loyalty by the individual defendants, and not to seek money damages against them. These circumstances at least raise a question whether the board's decision to approve was made in a good faith exercise of its considered business judgment, or instead taken simply to avoid facing a suit for money damages against themselves personally. [40]

FOOTNOTES

40 The court by no means concludes that this is, in fact, what motivated the board's decision. But absent any facts about the board's decision-making process, the court cannot rule it out.

Given the underdeveloped state of the record, any judgment about the propriety of the Amylin board's decision to "approve" the insurgent nominees would appear to risk prejudicing the rights of one of the parties to this case. Alternately, the court can treat the issue as unripe and leave it to be determined at such later time as the record can be more fully developed. In light of the fact that the dissident parties have reduced the size of their respective slates so that even if both slates are elected a majority of the board will remain Continuing Directors, regardless of the board's approval or lack thereof of the stockholder nominees, the latter course is preferable. If the dissident nominees are successful in fostering a sale of the company, the issue of Continuing Directors may become irrelevant long before next year's annual stockholder meeting. Alternately, the plaintiff or Amylin is free after the 2009 annual meeting to replead its case that the stockholder nominees, if they are in fact elected, are Continuing Directors by virtue of Amylin's "approval," whatever form that approval may ultimately take. [41] At that point, the relevant facts will be frozen, and the parties will have ample time for fact discovery to develop a complete record for the court to consider, in light of today's ruling. The court recognizes the potential diseconomy of requiring the parties to re-litigate the issue at a later time. However, the risk of prejudice to either the Amylin stockholders or the noteholders of an improvident decision made in a factual vacuum, at a time when there is no urgent need for decision, outweighs the potential costs of future litigation.

FOOTNOTES

41 Because there is no chance that a default or acceleration obligation will result from any choice the stockholders might make in the 2009 Amylin director elections, there is no reason to suspect that the Continuing Directors provisions should have a significant influence on the outcome of the election, even without a ruling by the court that the stockholder nominees are Continuing Directors.

III.

In addition to its claims sounding in contract, the plaintiff alleges that the board of Amylin breached its duty of care in the adoption of the Indenture for the 2007 Notes, insofar as the Indenture contained the Continuing Directors provisions. The plaintiff bases its claim largely on the fact that the Pricing Committee never discovered during its approval process that the proposed Indenture contained a Continuing Directors provision.[42]

FOOTNOTES

42 Moreover, the plaintiff points out, Amylin's CEO and its CFO both admit that they had no idea of the existence of the Continuing Directors provisions until they read about them on February 2, 2009. This may, on the surface, seem compelling for its "shock value." But because the CFO is not a director, and there is nothing in the record to indicate whether the CEO, who is a director, was a member of the Pricing Committee, this information does little if anything to support the plaintiff's claim.

The duty of care requires that:

in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent . . . . [T]he standard for judging the informational component of the directors' decisionmaking does not mean that the Board must be informed of *every* fact. The Board is responsible for considering only *material* facts that are reasonably available, not those that are immaterial or out of the Board's reasonable reach. [43]

Thus, the question is squarely framed: was the board of Amylin (or its delegate, the Pricing Committee) grossly negligent in failing to learn of the existence of the Continuing Directors provisions?

FOOTNOTES

43 *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

The answer must be no. The board [44] retained highly-qualified counsel. It sought advice from Amylin's management and investment bankers as to the terms of the agreement. It asked its counsel if there was anything "unusual or not customary" in the terms of the Notes, and it was told there was not. Only then did the board approve the issuance of the Notes under the Indenture. This is not the sort of conduct generally imagined when considering the concept of gross negligence, typically defined as a substantial deviation from the standard of care.

FOOTNOTES

44 For the purposes of the discussion of the due care claim, references to the board encompass acts taken by the Pricing Committee on behalf of the board.

The plaintiff argues that the board's questioning if there was anything "unusual or not customary" in the Indenture was insufficient. But the way in which the board inquired into the material terms of the Indenture cannot be equated with gross negligence in failing to inform itself. [45] Certainly, no one suggests that the directors' duty of care required them to review, discuss, and comprehend every word of the 98-page Indenture.

FOOTNOTES

45 The fact that a term is customary is not proof that it is, in fact, either permissible or justifiable under the specific circumstances faced by the board. *See La. Muni. Police Employees' Retirement Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

This case does highlight the troubling reality that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise. In the context of the negotiation of a debt instrument, this is particularly troubling, for two reasons. First, as a matter of course, there are few events which have the potential to be more catastrophic for a corporation than the triggering of an event of default under one of its debt agreements. Second, the board, when negotiating with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise), must be especially solicitous to its duties both to the corporation and to its stockholders. This is never more true than when negotiating with debtholders, whose interests at times may be directly adverse to those of the stockholders. Outside counsel advising a board in such circumstances should be especially mindful of the board's continuing duties to the stockholders to protect their interests. Specifically, terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment.

IV.

For the reasons set forth above, as to Count I (alleged breach of the duty of care by the defendant directors), judgment is entered for the defendants. Count II, seeking a declaration of the invalidity and unenforceability of the Continuing Directors provision of the Credit Agreement, has been rendered moot by the parties and is DISMISSED. Count III, seeking a declaration that the board of Amylin is entitled to approve the dissident nominees for the purposes of the Indenture, together with Amylin's substantially similar cross-claim against the Trustee are GRANTED to the extent described in this opinion, and are otherwise held to be unripe for adjudication at this time and therefore DISMISSED WITHOUT PREJUDICE. IT IS SO ORDERED.

VIII. CHAPTER 30, ACQUISITIONS OF BANKRUPT CORPORATIONS

A. Page 1232, New Sec. 30.6. Bankruptcy Sale of Investment Banking Assets of Lehman Brothers

Page 1232, New Sec. 30.6. Add at the bottom of the page the following:
New Sec. 30.6. **Bankruptcy Sale of Investment Banking Assets of Lehman Brothers**

Form 8-K, Lehman Brothers Holdings, Inc.
September 22, 2008

Item 2.01. <u>Completion of Acquisition or Disposition of Assets</u>.

On September 22, 2008, the Registrant, Lehman Brothers Inc. ("LBI") and LB 745 LLC completed the sale of Lehman's United States and Canadian investment banking and capital markets business, including the fixed income and equities cash trading, brokerage, dealing, trading and advisory businesses, investment banking operations, LBI's business as a futures commission merchant and LBI's commodities business, government securities trading operations and mortgage-backed securities trading operations of LBI, and its private investment management business (collectively, the "Business") to Barclays Capital Inc. ("Barclays"). In addition, Barclays acquired certain securities of LBI held as part of its securities trading operations, equity in certain of the Registrant's subsidiaries, and Lehman's headquarters in New York and two data centers in New Jersey. In connection with its acquisition of the Business, Barclays also assumed certain liabilities relating to the Business.

Pursuant to the terms of the Asset Purchase Agreement, dated as of September 16, 2008, as amended by the First Amendment to Asset Purchase Agreement, dated as of September 19, 2008 and the Letter Agreement, dated as of September 20, 2008 (as so amended, the "Asset Purchase Agreement"), the purchase price for the assets sold to Barclays was $250 million in cash and Assumed Liabilities (as defined in the Asset Purchase Agreement) and $1.29 billion in cash (subject to certain holdbacks in order to effectuate the prorations contemplated by Section 12.2 of the Asset Purchase Agreement) for Lehman's headquarters and two data centers. In connection with the Barclays transaction, Barclays has offered employment to approximately 10,000 employees of Lehman associated with the Business. Among those employees are certain officers of the Registrant who participated in the negotiation and preparation of the Asset Purchase Agreement. The amount and form of the consideration paid by Barclays for the Business (which consideration included the assumption of the Assumed Liabilities) was determined based on a variety of factors, including, but not limited to, Lehman's financial condition in the period leading up to and following the bankruptcy filing and available appraisal information regarding Lehman's headquarters and two data centers sold in the transaction. The transaction, including the consideration, was approved by the Registrant's board of directors and the Bankruptcy Court (as defined below).

Because the Asset Purchase Agreement was signed by the Registrant as a debtor-in-possession, the sale was conducted under the provisions of Section 363 of Chapter 11 of Title 11 of the United States Code, and was subject to approval by the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), which the Bankruptcy Court granted on September 20, 2008. The Asset Purchase Agreement contemplated the sale of LBI's assets in connection with a case commenced under the Securities Investor Protection Act of 1970, as amended ("SIPA"). In this regard, on September 19, 2008, the Securities Investor Protection Corporation commenced a case under SIPA with respect to LBI in the United States District Court for the Southern District of New York (the "District Court"). James W. Giddens was appointed by the District Court as the trustee for LBI's estate (the "LBI Trustee"), and further proceedings in the case were referred in accordance with SIPA to the Bankruptcy Court, which approved the sale of certain of LBI's business pursuant to the Asset Purchase Agreement.

In accordance with a Letter Agreement, dated September 22, 2008 (the "DTCC Letter Agreement"), among Barclays, The Depository Trust & Clearing Corporation ("DTCC") (on behalf of itself, the Fixed Income Clearing Corporation and the National Securities Clearing Corporation (collectively, the "Clearing Agency Subsidiaries")) and the LBI Trustee, LBI and Barclays agreed that $250 million of the purchase price paid by Barclays for the Business would be paid by Barclays to DTCC to provide collateral against any losses, claims, damages and expenses of DTCC and each of the Clearing Agency Subsidiaries and their respective officers, directors, employee, owners, agents and representatives. If any portion of this deposited amount remains following the closeout of the accounts and the satisfaction of all obligations in accordance with the rules and procedures of the Clearing Agency Subsidiaries, such remaining amount will be remitted to the LBI Trustee.

In addition, in connection with the sale, the Registrant entered into a $450 million Senior Secured Superpriority Debtor-In-Possession Credit Agreement, dated as of September 17, 2008 (the "DIP Credit Agreement"), among the Registrant and Barclays Bank PLC, as Administrative Agent, Collateral Agent and a Lender, and a Transition Services Agreement, dated September 22, 2008 (the "Transition Services Agreement" and, together with the Asset Purchase Agreement, the DTCC Letter Agreement and the DIP Credit Agreement, the "Agreements") between the Registrant and Barclays.

The Agreements were the subject of, and were filed as exhibits to, the Registrant's Current Report on Form 8-K dated September 22, 2008. This item of this Report hereby incorporates by reference the descriptions of the Agreements and their respective transactions contained in Item 1.01 of such report, except to the extent the information in this Report may supersede any portion of such prior descriptions.