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DIRECTOR COMPENSATION—GRANTOR BEWARE

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Popular as an item of discussion in the financial press and subject to new disclosure rules (for CEO compensation) set to take effect January 2017, compensation for public company officers and directors will remain fertile ground for plaintiffs' lawyers. This article focuses on director compensation that, if not handled properly, can be a trap for the unwary. Indeed, after plaintiffs' initial successes, those lawsuits challenging disclosures in proxy statements regarding adoption of or amendments to companies' long-term incentive plans have become somewhat less popular recently, following a stream of court decisions rejecting those disclosure-based claims.[1]

However, a recent decision by the Delaware Chancery Court in *Calma ex rel. Citrix Sys., Inc. v. Templeton*, [2] will likely lead to an increase in challenges by plaintiffs' counsel at least to the compensation of independent directors. Unlike the first generation disclosure-based claims, these derivative claims will challenge the grant of the compensation itself as a breach of fiduciary duty and will likely only involve disclosure issues when raised as a defense by defendants based on the doctrine of shareholder ratification.

The Standard of Review

Whether director compensation will be a litigation magnet depends on a number of circumstances including: (*i*) company performance; (*ii*) nature (*i.e.*, cash or equity) and amount of the compensation; and (*iii*) proactive management of relations with institutional investors. Perhaps the most critical factor, however, is the likely standard of judicial review that might be applied to such grants in the event of a legal challenge. As the Delaware Supreme Court has recognized, "directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation."[3] While the application of that principle is generally well understood for cash compensation such as board fees (which are

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less often subject to stockholder approval) its application to stock grants made pursuant to stockholder approved equity incentive plans has been less clear.[4]

Chancellor Andre G. Bouchard's opinion in *Calma* serves as a reminder that, without appropriate procedural protections "directoral self-compensation" decisions will be reviewed under the entire fairness standard. Thus, *Calma* may serve to encourage derivative litigation not only because the Chancellor applied the entire fairness standard but also because he found demand excused.[5] While the application of entire fairness should not make it any easier for plaintiffs to overcome the exacting standards necessary to state a claim for waste,[6] application of the entire fairness standard will make it more difficult for defendants to eliminate claims for breach of fiduciary duty and unjust enrichment at least in the context of a motion to dismiss.

That, of course, opens the door in particular to plaintiffs who want to extract a settlement because corporations (many of whom may have high deductible D&O policies) may not want to incur the expense of a full-blown trial even when their director compensation falls squarely within the range of reasonableness.

The *Calma* Decision

In *Calma,* Citrix, the nominal defendant corporation, had a shareholder-approved Equity Incentive Plan.[7] The Equity Plan covered directors, officers, employees, consultants and advisors and the only limit contained in the Plan was an outside limit on grants to any individual of 1 million shares or Restricted Stock Units (RSUs) per calendar year.[8] Plaintiff challenged the grant of RSUs to the company's outside directors for a three-year period, contending that the RSUs combined with the directors' cash compensation constituted excessive compensation in comparison to the directors of certain company "peers."[9] Plaintiff contended that the compensation constituted waste, the grant of which by the Compensation Committee (comprised of less than a majority of the board) was a breach of fiduciary duty that resulted in an "unjust enrichment" of the directors. [10]

Because the Court found the directors' grant of their own compensation was an "interested transaction," it ruled that "entire fairness" was the appropriate standard of review and that the defendants,' therefore, had the burden of proving the entire fairness of the grants. [11] Accordingly, Chancellor Bouchard denied defendants' motion to dismiss Count

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One (Breach of Fiduciary Duty) and Count Three (Unjust Enrichment), while granting defendants' motion as to Count Two (Waste). [12] In so ruling, the Court agreed with the plaintiff's argument that defendants lacked business judgment protection for the grant because there were no "meaningful limits" in the Equity Plan. [13] Among other things, the Court specifically noted that the Plan (*i*) did "not specify the compensation that the Company's non-employee directors will receive annually"; and (*ii*) did not contain any "sub-limits varied by position with the Company, such as a limit for non-employee directors and a different limit for officers." [14]

The Court pointed out that the 1 million share annual limit per person meant that the Compensation Committee could have awarded $55 million worth of stock to an individual given the Company's stock price on the date of grant. [15]That defendants had not even remotely approached that number, instead awarding compensation of approximately $300,000 in 2010, $400,000 in 2011, $350,000 in 2012[16] and $375,000 in 2013 did not affect the Court's view on the issue of "meaningful limits," which the Court determined solely on the purely hypothetical extreme upper limit grant permissible under the Plan terms, however unlikely. The Court also:

- applied the test for demand fatality under the *Rales* test[17] rather than the *Aronson* test[18] because the Compensation Committee did not constitute a majority of the board and the Committee action, therefore, could not be imputed to the board as a whole; [19] and
- found demand excused as the directors could not fairly and impartially consider whether to initiate litigation challenging their own compensation without regard to the plaintiff's failure to plead the materiality of that compensation to each director on a personal level. [20]

Shareholder Ratification Defense Rejected

Chancellor Bouchard had little difficulty dispatching defendants' primary defense based on shareholder ratification. Defendants contended that, because Citrix's stockholders approved the Equity Plan in 1995, subsequent grants under that plan should be analyzed under the business judgment standard of review and not entire fairness. The Court analyzed the applicability of defendants' shareholder ratification defense by reviewing decisions spanning over half a century in which the Delaware courts addressed the defense in the context of challenges to director compensation.

The Court began its review discussing a line of cases starting in 1952 with the Delaware Supreme Court's decision in *Kerbs v. California Eastern Airways, Inc.*,[21] in which stockholders challenged the adequacy of consideration the corporation received in exchange for options awards under a stockholder-approved compensation plan. In *Kerbs*, the Supreme Court concluded that "because the plan set forth the specific options to be awarded, stockholder approval of the earlier-in-time decision of the board to adopt the plan was a ratification of the consideration and 'effective for all purposes unless the action of the directors constituted a gift of corporate assets to themselves or was *ultra vires*, illegal, or fraudulent.' "[22]

At the same time *Kerbs* was issued, the Delaware Supreme Court issued *Gottlieb v. Heyden Chemical Corp.* [23] In *Gottlieb*, the Supreme Court held that a plan that provided "for granting to seven specified officers of the company, six of whom were members of the [nine-member] board of directors"[24] the right to purchase stock options had been ratified by the stockholders because they:

> [W]ere furnished the *names* of the seven officers with whom contracts for options under the plan had already been made, the *number* of shares allocated to each, the *price* per share each of said officers was to pay, and the *schedule* of waiting and working periods specified in all seven contracts. [25]

His historical tour complete, the Chancellor then proceeded to review more recent cases starting with *Steiner v. Meyerson*,[26] in which then-Chancellor William T. Allen held that stockholders had ratified a plan which granted each non-employee director "an option to purchase 25,000 shares upon election to the Telxon board, and an additional 10,000 shares on the anniversary of his election while he remains on the board."[27] As noted by Chancellor Bouchard, critical to Chancellor Allen's decision was the fact that the plan was self-executing because it provided *specific awards* to non-employee directors. Similarly, in *Lewis v. Vogelstein*,[28] the challenged plan again set forth specific compensation information for the stockholders which supported the ratification defense.[29]

The Court then considered *In re 3COM Corp. Shareholders Litigation*, which is discussed further below, and stated that the critical distinction in that case, which allowed the court to accept the ratification defense, was that the plan had ' ' '*specific ceilings* on the awarding of options each year' " to directors.[30] Despite the plan not calling for a specific number of shares to be awarded, the *3COM* court analyzed the plan in that case stating:

> I do not see this as a case of directors independently or unilaterally granting themselves stock options, but instead a case where stock options accrued to these directors under the terms of an established option plan with sufficiently defined terms. [31]

The rationale for the Court's conclusion in *3COM*, Chancellor Bouchard noted, was that there, it "would have made little sense to have required the 3COM directors to establish the entire fairness of their compensation when the directors exercised their business judgment to grant options in amounts within the *director-specific ceilings* previously approved by stockholders." [32]

Chancellor Bouchard contrasted the *Kerbs, Gottlieb, Vogelstein* and *3COM* line of cases with the Court of Chancery's opinions in *Sample v. Morgan*[33] and *Seinfeld v. Slager*. In both of these cases, the challenged compensation grants were determined not to have been ratified by stockholders. In *Sample*, the plaintiff asserted that two non-employee directors breached their fiduciary duties by granting all 200,000 shares (the full amount authorized under the stockholder approved plan) to three employee directors.[34] The *Sample* court rejected defendants' ratification defense because the plan that the stockholders had ratified was just the general terms of an equity compensation plan and did not contain any director-specific limits on compensation. Then-Vice Chancellor Leo E. Strine, Jr. stated "the Delaware doctrine of ratification does not embrace a 'blank check' theory."[35] The fact that the stockholders had approved the general parameters of the plan, did not mean they had approved granting all 200,000 available shares to just three people.

Seinfeld, Chancellor Bouchard noted, contained facts most analogous to the facts at issue in *Calma*.[36] In that case, the plan approved by stockholders did not set forth any director-specific award amounts or director-specific ceilings. There was only a generic limit on the compensation awarded any beneficiary.[37] The court in *Seinfeld* noted that the directors had the "theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations."[38] This led the Court to hold that:

> A stockholder-approved *carte blanche* to the directors is insufficient. The more definite a plan, the more likely a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the *total* pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair. [39]

Chancellor Bouchard held that the facts in *Calma* were more consistent with the *Sample/Seinfeld* line of cases because the Equity Plan specified merely (*i*) the total shares available, (*ii*) the beneficiaries under the plan and (*iii*) the total number of shares that any beneficiary could receive in a given calendar year.[40]Because Citrix's Equity Plan essentially provided directors *carte blanche* to grant any amount, with no real ceiling, Citrix's stockholders could not have ratified the self-interested grants made to directors. The Court summed up its analysis as follows:

> In my view, Defendants have not carried their burden to establish a ratification affirmative defense at this procedural stage because Citrix stockholders were never asked to approve—and thus did not approve—any *action bearing specifically on the magnitude of compensation for the Company's non-employee directors*. Unlike in *Steiner* or *Vogelstein*, the Plan here does not set forth the specific compensation to be granted to non-employee directors. And, unlike in *3COM*, the Plan here does not set forth any director-specific "ceilings" on the compensation that could be granted to the Company's directors.[41]

Thus, the grants to directors would be reviewed under the entire fairness standard of review.

Calma's Safe Harbor

Fortunately, Chancellor Bouchard's decision in *Calma* does not mean that all "directorial self-compensation decisions" will be subject to challenge under the entire fairness rubric. Understanding how to avoid that dilemma requires analysis of two other Chancery Court decisions involving challenges to board awards made under stockholder approved equity plans, both of which were discussed in the *Calma* opinion.

The first case, the previously mentioned *In re 3COM Corp. Shareholders Litigation*, was a 1999 decision by then-Vice Chancellor Myron Steele.[42] In that case, the Vice Chancellor was also faced with a challenge to grants made by directors to themselves under a stockholder-approved stock option plan.[43] In support of his breach of fiduciary duty and waste claims, plaintiff argued that the grants were a "self-interested transaction" that required review under the "entire fairness standard."[44] Perhaps recognizing the practical difficulties inherent in plaintiff's position (since directors will inevitably be approving their own grants) and that application of the entire fairness test to such grants could lead to prolonged litigation however reasonable such grants might be, the Court was troubled by application of that exacting standard in the context of a stockholder-approved equity plan.[45]

To resolve the tension between those two concepts, Vice Chancellor Steele described the directors approval as a "decision[] administering a shareholder approved Plan" and therefore a decision "entitled to the protection of the business judgment rule."[46] Presumably again concerned with opening the floodgates to prolonged litigation, the Court rejected plaintiff's attempt to characterize the shareholder approval distinction as "ratification," which would have shifted the burden of proof to defendants as an "affirmative defense."[47]As noted by the Court:

> Ratification, in the usual sense, involves shareholders' affirmatively sanctioning earlier *board action*, the effect of which is to validate that action. Neither the facts pleaded here nor the defendants' arguments suggest such a circumstance. These options clearly flow from a plan created by *previous* shareholder action. To suggest that this undisputed fact supports a shareholder ratification defense is absurd. . . . I do not see this as a case of directors independently or unilaterally granting themselves stock options, but instead a case where stock options accrued to these directors under the terms of an established option plan **with sufficiently defined terms.** One cannot plausibly contend that the directors structured and implemented a self-interested transaction inconsistent with the interests of the corporation and its shareholders when the shareholders knowingly set the parameters of the Plan, approved it in advance, and the directors implemented the Plan according to its terms.[48]

As becomes clear from the next case in this trilogy, *Seinfeld v. Slager*,[49] also previously mentioned, the critical phrase in *3COM* was "an established option plan with sufficiently defined terms." It is that phrase that gives rise to the business judgment safe harbor for "directorial self-compensated" decisions. In *Sein-*

feld, plaintiff challenged, among other transactions, the grant by the company's outside directors to themselves of time-vested restricted stock authorized under the stockholder-approved 2007 Stock Incentive Plan (the "Stock Plan").[50] According to plaintiff, the annual compensation award by the defendant directors to themselves "exceed[ed] the compensation of directors by *one* of the Company's peers."[51]

Defendants moved to dismiss claiming that under *3COM* the grants were subject to the presumption of the business judgment rule because the plaintiffs failed to allege the grants violated any provisions of the stockholder approved plan.[52] The Court denied the defendants' motion because it found the grants interested self-dealing transactions and that defendants had the burden of proving entire fairness.[53]

In denying defendants' motion, Vice Chancellor Sam Glassrock placed great emphasis on the "sufficiently defined terms" language employed in *3COM*.[54] The Court noted that the Stock Plan "puts few, if any, bounds on the Board's ability to set its own stock awards."[55] Indeed, the only limits were an aggregate limit of 10.5 million shares with an individual limit of 1.25 million shares a year.[56] As Chancellor Bouchard did three years later in *Calma*, Vice Chancellor Glassrock was not concerned with the grants actually awarded (either as challenged or in prior years), explaining that with 12 members, the "Board could theoretically award each director 875,000 restricted stock units. . . worth $21,691,250" at the then current stock price.[57]

This wide grant of discretion contrasted sharply with the Plan in *3COM* that not only set specific ceilings on the maximum options available for award on an annual basis but also had ceilings that differentiated between specific categories of service and board position (*e.g.* chair and lead director.)[58] Consequently, Vice Chancellor Glassrock found that the Plan before him placed "no effective limits on the total amount of pay that can be awarded" and that the "Defendant directors [were] interested in the decision."[59]

Significantly, the Court explained:

> The sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum. Though the stockholders approved this plan, there must be some *meaningful* limit imposed by stockholders on the Board for the plan to be consecrated by *3COM* and receive the blessing of the business judgment rule, else the "sufficiently defined terms" language of *3COM* is rendered toothless.[60]

Vice Chancellor Glassrock's analysis is at least an implicit endorsement of the safe harbor discussed in *3COM*. Similarly, Chancellor Bouchard's analysis of the limits, or lack thereof, of the Plan before him in *Calma*[61] also endorses the *3COM* approach, particularly when coupled with his stockholder ratification analysis that derided the "blank check theory of ratification."[62] Looking at those cases together provides some important guidelines to follow in attempting to come within the *3COM* safe harbor.

Guidance

1. Directors need to understand that decisions regarding their compensation may be found under certain circumstances to constitute an "interested transaction," whether approved by the full board or by the board's compensation committee, and are subject to review, therefore, under the entire fairness standard unless certain procedural protections are in place;

2. When approving or amending equity plans, companies should make sure that the plans contain "meaningful limits" on individual grants in a particular year while still providing sufficient flexibility for changed circumstances (for example, by allowing an appropriate range of grants) and should consider limits in terms of sub-classes since only outside director compensation is likely to be considered an "interested transaction";[63]

3. Companies should at least consider obtaining

initial shareholder approval for an appropriate range of grants to outside directors to be made on a set date so that any subsequent grant in that range is more likely to give rise to a business judgment standard of review;

4. Establish a record in connection with grants to outside directors that would help establish entire fairness such as an appropriate number of meetings to discuss and analyze the grants, consultation with appropriate advisors (*e.g.* outside counsel and independent compensation consultants) and appropriate "peer" group comparisons including differences between the company and its peers at least over a period of time; and

5. Consider the views of large institutional investors and proxy advisory firms like Institutional Shareholder Services (ISS) that has its own equity plan scorecard and a consulting arm to advise companies as to how they would likely score.

ENDNOTES:

[1]Compare *Knee v Brocade Comm. Sys., Inc.*, No. 1-12-CV-220249 (Cal. Super. April 10, 2012) with *Gordon v. Symantec Corp.*, No. 1-12-CV-231541 (Cal. Super. Oct. 7, 2012), *Noble v. AAR Corp.*, No. 12-C-7973 (N.D. Ill. Oct. 9, 2009) and *Mancuso v. The Clorox Co.*, No. RG12-651653 (Cal. Super. Nov. 13, 2012).

[2]*Calma on Behalf of Citrix Systems, Inc. v. Templeton,* 114 A.3d 563 (Del. Ch. 2015).

[3] *Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002).

[4]Compare *In re 3COM Corp*., 25 Del. J. Corp. L. 1060, 1999 WL 1009210 (Del. Ch. 1999) (grants made pursuant to stockholder-approved plan reviewed under presumption of business judgment rule), with *Seinfeld v. Slager,* 2012 WL 2501105 (Del. Ch. 2012).

[5] *Calma*, 114 A.3d at 576.

[6] *SeeCalma* at 590 ("compensation. . . so one-sided that no reasonable business person could conclude that the Company received adequate consideration").

[7] *Calma* at 568.

[8] *Calma*.

[9] *See Calma*.

[10] *See Calma* at 568-69.

[11] *See Calma* at 569.

[12] *Calma*.

[13] *See Calma*.

[14] *Calma* at 570. Like many equity or long-term incentive plans, the Plan at issue in *Calma* authorized the board's compensation committee to administer the Plan while preserving the board's ability to exercise the power assigned to the committee. *Calma* at 570-71. As is also common for such plans, the compensation committee had broad discretion under the Plan including: "complete authority, in its discretion. . . [in] making all determinations with respect to each Award to be granted by the Company under the Plan. . . ." *Calma* at 571.

[15] *Calma*.

[16] *Calma* at 572-73.

[17] *Rales v. Blasband,* 634 A.2d 927, Fed. Sec. L. Rep. (CCH) P 98821 (Del. 1993).

[18] *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984) (rejected by, *Kamen v. Kemper Financial Services, Inc.,* 908 F.2d 1338, Fed. Sec. L. Rep. (CCH) P 95363, 17 Fed. R. Serv. 3d 224 (7th Cir. 1990)) and (overruled by, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

[19] *Calma* at 574-75.

[20] *Calma* at 575-76.

[21] *Kerbs v. California Eastern Airways,* 33 Del. Ch. 69, 90 A.2d 652, 34 A.L.R.2d 839 (1952).

[22] *Calma*, 114 A.3d at 579 (citing *Kerbs*, 90 A.2d at 655). Note that the Supreme Court in *Kerbs* ultimately decided, despite ratification, to enjoin the stock option plan on the grounds of waste "because it [was] not reasonably calculated to insure that the defendant [corporation] will receive the contemplated benefits." *Kerbs*, 90 A.2d at 656.

[23] *Gottlieb v. Heyden Chemical Corp.,* 33 Del. Ch. 82, 90 A.2d 660 (1952), adhered to, 33 Del. Ch. 283, 92 A.2d 594 (1952).

[24] *Gottlieb* at 661.

[25] *Gottlieb* at 662 (emphasis added).

[26] *Steiner v. Meyerson,* Fed. Sec. L. Rep. (CCH) P

98857, 1995 WL 441999 (Del. Ch. 1995).

[27] *Steiner* at *4.

[28] *Lewis v. Vogelstein,* 699 A.2d 327, 22 Employee Benefits Cas. (BNA) 1052 (Del. Ch. 1997).

[29] *Lewis* at 329.

[30] *Calma*, 114 A.3d at 582 (quoting *In re 3COM Corp.* at *3 n.9).

[31] *In re 3COM Corp.*, 25 Del. J. Corp. L. 1060, 1999 WL 1009210, at *3 (Del. Ch. 1999).

[32] *Calma*, 114 A.3d at 582 (emphasis added).

[33] *Sample v. Morgan,* 914 A.2d 647, 40 Employee Benefits Cas. (BNA) 2389 (Del. Ch. 2007).

[34] *Sample* at 650-51.

[35] *Sample* at 663. The Court went on to determine that the stockholder vote to ratify the equity plan had not been fully informed. *Sample* at 663-64.

[36] *Calma*, 114 A.3d at 584.

[37] *Calma*. (citing *Seinfeld v. Slager* at *10).

[38] *Seinfeld* at *12.

[39] *Seinfeld*.

[40] *Calma v. Templeton*, 2015 WL 1951930, at *16 (Del. Ch. 2015), published at, 114 A.3d 563 (Del. Ch. 2015).

[41] *Calma v. Templeton*, 2015 WL 1951930 (Del. Ch. 2015), published at, 114 A.3d 563, at *17 (Del. Ch. 2015).

[42] *In re 3COM Corp.,* 25 Del. J. Corp. L. 1060, 1999 WL 1009210 (Del. Ch. 1999).

[43] *See In re 3COM Corp.* at *1.

[44] *3COM* at *2.

[45] *3COM.* ("Though plaintiff correctly points out that these option grants **appear** to be self-interested transactions, he cannot overcome the indisputable fact that the directors authorized grants made within the limitations of a plan *already approved by the shareholders.*) (first emphasis added).

[46] *3COM* at *3.

[47] *3COM*.

[48] *3COM*. (third emphasis added).

[49] *Seinfeld v. Slager,* 2012 WL 2501105 (Del. Ch. 2012).

[50] *SeeSeinfeld*, 2012 WL 2501105, at *10.

[51] *Seinfeld.* (emphasis added).

[52] *Seinfeld* at *11.

[53] *Seinfeld* at *12.

[54] *See Seinfeld*.

[55] *Seinfeld* at *11.

[56] *Seinfeld*.

[57] *Seinfeld*.

[58] *See3COM,* 1999 WL 1009210, at *3 n.9.

[59] *Seinfeld*, 2012 WL 2501105, at *12.

[60] *Seinfeld*.

[61] *SeeCalma*, 2015 WL 1951930, at *3.

[62] *Calma*, 2015 WL at *13. See also *Id.* at *17 ("In my view, Defendants have not carried their burden to establish a ratification affirmative defense. . . because Citrix stockholders were never asked to approve. . . any action bearing specifically on the magnitude of compensation for the Company's non-employee directors. Unlike in *Steiner* or *Vogelstein*, the Plan here does not set forth the specific compensation to be granted non-employee directors. And, unlike in *3COM*, the Plan here does not set forth any director-specific ceilings on the compensation that could be granted to the Company's directors.")

[63] For example, in *Seinfeld,* Vice Chancellor Glassrock had no difficulty dismissing plaintiff's claim attacking board compensation for offerings as those grants were not "interested." *Steinfeld*, 2012 WL 2501105, at *14 ("The Defendant Directors. . . with respect to employee awards, are not interested in the challenged transactions.")

DOJ'S NEWEST POLICY PRONOUNCEMENT: THE HUNT FOR CORPORATE EXECUTIVES' SCALPS

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On September 9, the US Department of Justice (DOJ) issued a new policy memorandum, signed by Deputy Attorney General Sally Yates, regarding the prosecution of individuals in corporate fraud cases entitled, Individual Accountability for Corporate Wrongdoing and known colloquially as "the Yates Memorandum."

The Yates Memorandum has been heralded as a sign of a new resolve at DOJ, and follows a series of public statements made by DOJ officials indicating that they intend to adopt a more severe posture towards "flesh-and-blood" corporate criminals, not just corporate entities. Furthermore, the Yates Memorandum formalizes six guidelines that are intended "to strengthen [DOJ's] pursuit of corporate wrongdoing."

Though much of the Yates Memorandum is not entirely novel, corporations and their executives should take close note of DOJ's increasing and public focus on individual prosecutions. Additionally, both corporations and DOJ should take note of how the Yates Memorandum may carry a number of consequences—intended and unintended—with respect to cooperation with DOJ investigations.

The Genealogy of the Yates Memo

The high-profile roll-out of the Yates Memorandum—above-the-fold coverage in major newspapers and a speech by Yates at New York University—obscures the fact that DOJ leaders, at increasingly higher levels of seniority, have been making similar statements for months, even years (and ones that echo similar statements made during Eric Holder's tenure as US Attorney General).

- For instance, in a speech on September 17, 2014, Principal Deputy Assistant Attorney General for the Criminal Division Marshall Miller explained that "when [corporations] come in to discuss the results of an internal investigation to the Criminal Division. . . expect that a primary focus will be on what evidence you uncovered as to culpable individuals, what steps you took to see if individual culpability crept up the corporate ladder, how tireless your efforts were to find the people responsible."
- Similarly, in a speech on January 20, 2015, Deputy Assistant Attorney General for the Criminal Division Sung-Hee Suh stated that "corporations do not act criminally, but for the actions of individuals. . . the Criminal Division intends to prosecute those individuals, whether they are sitting on a sales desk or in a corporate suite."
- More recently, in a speech on April 17, 2015, Assistant Attorney General for the Criminal Division Leslie Caldwell stated that, for her Division, "[t]rue cooperation. . . requires identifying the individuals actually responsible for the misconduct—be they executives or others—and the provision of all available facts relating to that misconduct."

These public remarks set the stage for the Yates Memorandum, which serves as the apotheosis of these statements; together, the speeches and the Yates Memorandum reflect how goals and positions long articulated (and, in fact, pursued daily) by federal prosecutors have now been formalized in DOJ policy.

The Memo's Guidance

The Yates Memorandum—which acknowledges that many of its policies already are being followed by federal prosecutors—establishes "six key steps" intended to enhance DOJ's effort to "fully leverage its resources to identify culpable individuals at all levels in corporate cases." In brief, they are as follows:

1. To qualify for any cooperation credit whatsoever, in both criminal and civil cases, corporations under investigation must provide DOJ with all relevant facts about the individuals involved in corporate misconduct.

This is the most important guideline articulated in the Yates Memorandum, and is designed to incentivize corporations not only to cooperate with the DOJ, but also from the outset focus their investigation on individuals and share findings and conclusions regarding those individuals. It is far from clear, however, how this guideline will affect the conduct of internal investigations, or the question of whether corporations should voluntarily disclose potential issues to the DOJ, as they may have to assess whether conduct is criminal or not at a very early stage, and may be severely punished if they are perceived as not having provided "all facts related to [individual] misconduct."

In her speech accompanying the Memorandum's release, Yates called this policy a "substantial shift from prior practice" and a reflection of the "rules [having] just changed." In particular, it serves as an important revision to the fourth factor articulated in the April 2008 Principles of Federal Prosecution of Business Organizations issued by then-Deputy Attorney General Mark Filip (the Filip Memorandum)—"a corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents."

Significantly, this guideline does not stop at criminal matters. It also applies to civil matters, which often run on parallel tracks to criminal ones, and may profoundly alter how those matters are resolved. According to the Memorandum, "a company under civil investigation must provide to the Department all relevant facts about individual misconduct in order to receive any consideration in the negotiation." This includes, but is not limited to, False Claims Act matters, which are specifically highlighted in the Yates Memorandum.

Overall, this policy reflects a more draconian tone towards cooperation—instead of potentially receiving partial cooperation credit if the investigation into, or disclosures regarding, individual misconduct are incomplete, a corporation would now receive no cooperation credit at all. Of course, this leaves open the question of who at DOJ will decide if "all [relevant] facts" have been disclosed, and when such cooperation might cease. Further, consistent generally with the existing approach, any settlement document must now include a provision mandating continued cooperation with respect to any individuals engaged in wrongdoing.

In reality, corporations, through internal investigations, already and regularly identify corporate individual misconduct and, despite the implication of the Memorandum, regularly terminate or discipline employees as a result of such investigations.

2. DOJ investigations—both criminal and civil—should focus on potentially culpable individuals from the very beginning.

   This policy is directed at the DOJ itself. Acknowledging that it is difficult to build criminal cases against individuals months or years after a civil inquiry into a corporation has begun, DOJ investigations must now focus on individual wrongdoing from the outset.

   This could change the approach and temperament of federal prosecutors and civil investigators who might now require much more detail, at a much earlier stage, about specific individuals.

3. Similarly, DOJ criminal and civil attorneys are now encouraged to be in routine communication with one another.

   Accordingly, DOJ attorneys will now be required to notify the "other side of the house" about any investigation, once it is initiated. The Memorandum does not address whether or how such "routine communication" falls within the ambit of Rule 6(e) of the Federal Rules of Criminal Procedure, which constricts access to grand jury materials.

4. Only in extraordinary circumstances will a corporate resolution immunize individuals from any sort of liability.

   This policy also affects corporate resolution documents, which now cannot contain provisions immunizing individuals, or dismissing charges against them, unless there are (undefined) "extraordinary circumstances" (or if approved DOJ policy, such as the Antitrust Division's Corporate Leniency Policy, applies). Frankly, however, it is rare that current resolution agreements provide individuals with such protections.

   This guideline also increases the amount of oversight, and related bureaucracy, at DOJ. Significantly, in every matter, any release of individual liability must be vetted and approved by the relevant Assistant Attorney General or a US Attorney.

5. Corporate cases should not be resolved unless there is a clear path to resolve related individual cases before statutes of limitations expire; further, any declinations must now be memorialized.

   This guideline seemingly implies that DOJ attorneys are prioritizing high-dollar cases against corporations while placing cases against individuals on the back burner. In our experience, federal prosecutors regularly examine the conduct of employees during corporate investigations and do not pull punches in their pursuit of individuals. As counsel for a number of individuals subject to exhaustive investigations, we disagree with the Memorandum's implied premise. The Memorandum requires DOJ attorneys to submit to their supervisors plans to investigate and bring cases against individuals to resolution if those cases have not concluded by the time of the corporate resolution. Similarly, any declinations also must be memorialized, and approved by the relevant Assistant Attorney General or a US Attorney.

6. In civil investigations, attorneys should consistently focus on individuals, and whether to bring suit against them based on considerations beyond ability to pay.

   This guideline, equally aggressive as its criminal counterparts, is intended to provide a long-term deterrent effect, by showing individual wrongdoers that lack of resources will not render one judgment-proof. In her speech, Yates called this a "broadening [of] the focus of our civil enforcement strategy."

Our Initial Views and Guidance to Clients

The Yates Memorandum, like other major policy guidelines addressing cooperation (such as the Filip Memorandum), has the real potential to affect how companies and their executives will assess cooperation and whether to provide it.

Additionally, and especially in the short-term, the Yates Memorandum is designed to place a higher premium on the prosecution (and conviction) of corporate leaders. Within DOJ, there will be increased oversight and supervision of corporate criminal matters, and line attorneys will either have to develop robust cases or investigation plans against individuals, or defend their choices to senior leaders. A more searching senior-level review of immunity applications or declinations, and newly mandated cross-DOJ cooperation seem to confirm this fact. Finally, investigations have the potential to become either more resource intensive, or much longer, as federal prosecutors and civil enforcers build multiple cases—against both corporations and individuals—simultaneously.

That said, the Yates Memorandum acknowledges, but does not address, how difficult individual prosecutions in corporate cases are—not only because of the difficulty in obtaining evidence, but also because it is profoundly difficult to determine whether any identified conduct does, in fact, violate federal laws. More unpredictable will be the effect on corporate behavior. The scale of internal investigations may increase as more intense scrutiny is focused on individuals at the outset. Vigorous investigations of this sort can negatively affect morale within companies, and employees who refuse to cooperate may cause investigations to falter or stall. Moreover, internal investigations often must deal with historical conduct—frequently in the very distant past and with former employees—and overseas activities that present a host of legal and practical challenges. The Yates Memorandum may well affect a corporation's analysis as to how vigorously or widely potential misconduct should be investigated, especially where the consequences of not being able to identify culpable individuals could be dire. As a result, it may result in an all-or-nothing approach to cooperation, with many corporations electing to take the latter path. Additionally, all of this may temper a corporation's enthusiasm to self-report potential misconduct.

Thus, corporations that decline to engage in such investigations, or—more problematically—those that are unable to find suitable evidence of individual wrongdoing despite the existence of some systemic problem (which is often the case given how action, intent and conduct can be diffused throughout a corporation), may decline to cooperate entirely. The Yates Memorandum, consequently, may have an unintended chilling effect on corporate cooperation.

IN RE DOLE FOOD CO., INC.—A GOING-PRIVATE PRIMER

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In an August 27 decision, *In re Dole Food Co., Inc.*,[1] Vice Chancellor J. Travis Laster of the Delaware Chancery Court found that David H. Murdock, the chief executive officer and president, and C. Michael Carter, the general counsel, of Dole Food Co., Inc. had breached their duty of loyalty to Dole and its stockholders in a $1.6 billion going-private acquisition of the company in November 2013, and held them personally liable for payment of $148 million in damages.

In one sense, the decision is unremarkable: The Vice Chancellor found that Murdock and Carter had committed fraud in negotiating and securing approval of the transaction, chiefly by withholding critical projected cost savings and revenue information from Dole's special board committee and stockholders. With a finding of fraud, a holding that a breach of the duty of loyalty has occurred and that damages are payable follows easily.

The broader value of the decision rests in the practical transactional advice that can be mined from it. A factual chronology, compiled from the decision, sets the stage.

Background

CEO Murdock had taken Dole private once before, in a 2003 leveraged buyout. But to deal with significant debt in the context of the 2008 financial crisis, Dole sold 41% of its shares in an October 2009 initial public offering. Murdock, who retained ownership of approximately 40% of Dole following the IPO and indisputably controlled it, had regularly considered taking Dole private again from then on, and had begun active planning for the transaction at issue by April 2012. To that end, Murdock sold significant personal assets in 2012 to enhance his liquidity, and Dole sold approximately half of its business in late 2012, enabling it to pay down substantial debt. In November 2012, Dole announced its expectation that the sale would also enable it to achieve approximately $50 million in annual savings.

In January 2013, however, Carter, the general counsel, caused Dole to announce that Dole's expected 2013 cost savings from the 2012 sale would be closer to $20 million, and Dole's stock price dropped. Three weeks later, Carter prompted another Dole press release, announcing that Dole's expected 2013 adjusted EBITDA would be at the low end of its earlier guidance range and announcing a reduction in the earlier-announced valuation of certain assets. On February 22, 2013, Dole—at Carter's instigation—announced that the performance of its fresh fruit business was continuing its declining trend. Following Dole's board's approval of a stock repurchase program on May 8, 2013, Carter had the company issue a press release on May 28, 2013, announcing an indefinite suspension of the program. Dole's stock price dropped 10% following that announcement.

Murdock, working with Deutsche Bank as his financial advisor, delivered his $12.00 per share going-private proposal to the Dole board on June 10, 2013. He conditioned the transaction on approval by an independent special committee of the board and a favorable vote of a majority of the company's unaffiliated shares, and stated that he was a buyer and not a seller. The board formed a special committee the next day. Two of the committee's four members had significant prior and continuing business dealings with Murdock. The committee enlisted Lazard Frères as its financial advisor and Sullivan & Cromwell and Richards Layton & Finger as its legal advisors.

Lazard requested an update of the December 2012 three-year financial performance projections that Dole management had prepared using its traditional "bottom-up" analysis. Carter took charge of the updating process and delivered, on July 11, 2013, projections that were significantly lower than the December 2012 projections. These projections reflected only $20 million of the earlier-projected $50 million of savings from the 2012 sale and did not forecast income from the company's continuing quest and plans to purchase fruit farms in Latin America. The next day, Carter met with Murdock's financial advisor, in a session that the committee and its advisors were not informed of, and told Murdock's advisor that the company would outperform the July 11 projections by realizing more cost savings than the July 11 projections reflected and by realizing income from the purchase of fruit farms.

The committee and its advisors, skeptical about the substance and quality of the July 11 projections, developed the committee's own projections using the December 2012 projections as a starting point. Near the end of negotiations on the merger agreement, Carter had management prepare new projections that were higher than the July 11 projections, but kept those new projections from the committee and its advisors. Murdock's acquisition entity and Dole signed the merger agreement, establishing a $13.50 per share merger price, on August 11, 2013. The Dole stockholder meeting was held on October 31, 2013, with 50.9% of the unaffiliated shares voting in favor of the transaction. The transaction closed in November 2013.

Analysis

Vice Chancellor Laster's opinion provides instructive insight into a number of conflicted-party transaction issues, including assessing controlling shareholder status; identifying the appropriate standard of judicial review; the composition and functioning of special committees; the application of the entire fairness standard to facts at hand; assigning value to contingent future events for transaction valuation and damages assessment purposes; and the distinctions between evaluating transactional fairness and individual exposure to liability.

Controlling Shareholder Status; Standard of Review

The opinion proclaimed Murdock's controlling stockholder status with dispatch, noting his 40% ownership interest; referring to him as "an old-school, my-way-or-the-highway controller"; flagging Murdock's own testimony that he "was 'the boss' "; and observing, based on documentary and testimonial evidence, that "[c]riticizing Murdock was unthinkable." Similarly, with respect to Murdock's "right-hand man" Carter, the opinion noted that "Dole's executives could not envision anyone failing to carry out Carter's instructions."

As to the standard of review, the "merger was an interested transaction [with a controlling shareholder], so entire fairness provided the baseline standard of review." Murdock had attempted to secure a business judgment rule review instead by conditioning his proposal on (*i*) approval from a board committee of disinterested and independent directors; and (*ii*) the affirmative vote of holders of a majority of the unaffiliated shares, following guidance in the late-May 2013 Chancery Court decision in *In re MFW Shareholders Litigation*.[2] Vice Chancellor Laster found, however, that allegations and evidence regarding Murdock's and Carter's activities, and the relationships between certain committee members and Murdock, created triable questions of fact regarding the committee's independence, cementing entire fairness as the controlling standard of review for the transaction.

Committee Composition and Functioning

The Vice Chancellor detailed his initial reservations about the close ties between two of the four committee members and Murdock, and Murdock's threatening behavior toward one of the two. The Vice Chancellor ultimately found, however, that the record at trial demonstrated that the committee and its advisors had carried out their tasks with integrity. But their "commendable efforts" to negotiate a fair price and terms were rendered "useless and ineffective" by Carter's fraudulent activity—"Fraud vitiates everything." In other words, even a fairly formed, well-motivated, well-advised, properly functioning committee cannot salvage a finding of entire fairness when the committee is denied the full complement of information it needs to discharge its function.

Application of the Entire Fairness Standard

Generally—The opinion's entire fairness analysis led with the familiar recitation that entire fairness comprises fair dealing and fair price, and that fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."

Fair Dealing—Vice Chancellor Laster noted that the transaction timing issue encompassed actions taken by the controller in the period leading up to the formal proposal. He found that Murdock and Carter had deliberately depressed the price of Dole's stock before the transaction by issuing misleading press releases (outlined above), and that those actions constituted unfair dealing.

With reference to how the transaction was negotiated, Vice Chancellor Laster first observed that an effective special committee must be fully informed, and that a controller transacting with such a committee must disclose "all material information known to [him] except that information that relates only to [his] consideration of the price at which [he] will buy. . . and how [he] would finance a purchase. . . ." The Vice Chancellor found that Murdock and Carter had instead knowingly provided false financial projections to the committee and noted, with respect to Carter's position as a Dole officer, that "if a duly empowered committee asks for information, a corporate officer, employee, or agent has a duty to provide truthful and complete information."

Vice Chancellor Laster also detailed numerous other transaction process deficiencies in Carter's dealings with the committee. Carter (*i*) sought to restrict the committee's mandate to an up-or-down decision on Murdock's offer rather than being authorized to explore potentially superior alternatives; (*ii*) attempted to steer the committee's selection of its financial advisor and to limit the scope of the advisor's activities; (*iii*) insisted on having involvement in the confidentiality agreements being executed by the committee on Dole's behalf; (*iv*) secretly assisted Murdock in preparing a hostile tender offer to pressure the committee, if necessary; (*v*) convened a meeting of Murdock's bankers with Dole management without informing the committee, in violation of the committee's transaction process directions; (*vi*) defied the committee's instruction to suspend Murdock's bankers' access to the transaction data room; and (*vii*) secretly advised Murdock and his counsel on how to negotiate against the committee. The Vice Chancellor characterized these actions as "the antithesis of a fair process." (In addition, upon the formation of the committee, Murdock, Carter, and another director had sought to have the full board choose the committee's chairman but were outvoted by the board's majority, which also composed the committee.)

With reference to the transaction's structure and approval, the Vice Chancellor stated that Carter's fraud (primarily with respect to the financial projections) tainted both the committee's approval of the merger and the stockholder vote, and that therefore neither of those forms of approval provided evidence of the transaction's fairness. He observed that there were laudatory features of the merger agreement and that Lazard had sought other bidders diligently, but that Murdock's refusal to entertain any alternative transaction negated the salutary effect of certain of the merger agreement's features, such as a go-shop provision with a low breakup fee.

Fair Price—In focusing on the fair price element of the entire fairness analysis, Vice Chancellor Laster offered several important precepts. First, for purposes of determining fairness, the court's task is to determine whether the price falls within a range of fairness, not to pick a single number. Second, while a fair price can be the predominant consideration in an entire fairness inquiry, and has occasionally carried the day despite the absence of a fair process, "[m]ost often, the two aspects of the entire fairness standard interact." Third, assuming for the sake of argument that the $13.50 per share price fell within a range of fairness, the plaintiffs, in light of the defendants' fraud, misrepresentation, self-dealing, and gross and palpable overreaching, "are entitled. . . to a 'fairer' price" because the fraud deprived the committee of its ability to obtain a better result, prevented the committee from having the knowledge necessary potentially to say no, and foreclosed the stockholders' ability to protect themselves by voting the transaction down.

Valuation and Damages Assessment

In analyzing the fair price implications of Carter's misleading projections regarding future cost savings and planned farm purchases, the Vice Chancellor emphasized that elements of future value that are known or susceptible of proof as of the date of the merger may be considered. More directly, "when. . . the company's business plan as of the merger included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value." He characterized Dole's plans to cut costs and buy farms to improve profits as part of Dole's "operative reality" at the time of the merger. Further discussion in the opinion indicates that incremental cash flows from planned operations should not, however, be treated for valuation purposes as "just as certain" as cash generated by existing core operations.

The opinion also set forth important principles regarding damages in cases arising from a breach of the duty of loyalty. First, an award exceeding the fair value of the plaintiffs' shares may be appropriate, particularly when fraud, misrepresentation, self-dealing, or overreaching is involved. Second, the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly. Third, when a breach of duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer. And finally, in a plenary breach of fiduciary duty action, the court can award damages designed to eliminate the possibility of profit flowing to defendants from the breach—that principal "does not rest upon the narrow ground of injury or damage to the corporation."

Transactional Fairness and Individual Liability

Following his determination that the transaction was not entirely fair to the company and its stockholders, Vice Chancellor Laster observed that the entire fairness test has only a "crude" relationship to the liability that any particular fiduciary has for involvement in the transaction. He stated that when a self-dealing transaction is determined to be unfair, only the self-dealing fiduciary is subject to damages without an inquiry into his subjective state of mind. That inquiry is required, however, in order to determine whether any other director has breached his or her duty of loyalty.

Based on these premises, the Vice Chancellor found Murdock liable for breach of his duty of loyalty in both his controlling stockholder and director capacities, and found Carter liable for breach of his duty of loyalty in both his director and officer capacities. A third director, who plaintiffs contended should have advocated and voted against the transaction because he knew it undervalued the company, presented a "close call" but was exonerated because he did not know about Murdock's and Carter's specific misconduct and was entitled to rely on the committee's recommendation of the transaction. The four committee members' loyalty to the company and stockholders was not questioned.

Closing Thoughts

The *In re Dole Foods Co., Inc.* decision does not create new doctrine; rather, it applies fundamental fiduciary duty principles to an extraordinary set of facts with a high degree of clarity. While a close read of the decision leaves a few lingering questions, the decision serves as a useful guide for transaction participants on the subjects that it addresses. That same close read also suggests—though the decision does not address the proposition overtly—that a special committee and its advisors may be prudent to secure continuing direct access to the management and other company personnel who are involved in producing the information that the committee and advisors need in order to discharge their responsibilities.

ENDNOTES:

[1] *In re Dole Food Co., Inc. Stockholder Litigation*, C.A. No. 8703-VCL, (Del. Ch. August 27, 2015).

[2] *In re MFW Shareholders Litigation,* 67 A.3d 496, 502 (Del. Ch. 2013), judgment aff'd, 88 A.3d 635 (Del. 2014).

CITIZENSHIP OF LLCS AND SUBJECT MATTER JURISDICTION IN THE FEDERAL COURTS: A TRAP FOR THE UNWARY

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Nearly unheard of prior to the 1990s, the Limited Liability Company (LLC) quickly grew to become the dominant organizational form for new business ventures in the United States by a nearly two-to-one margin.[1] In Delaware, a popular venue for establishing new business entities, that margin rose to over three-to-one.[2] This rapid growth is generally attributed to the LLC's combination of favorable tax treatment, flexibility of governance structure, and limited liability for owners.[3] Indeed, the LLC has proved popular for businesses of all types and sizes, including wholly-owned subsidiaries.[4]

Amidst this meteoric growth, commentators have remarked on the lack of attention to the legal implications of the rising dominance of the LLC business form.[5] Ironically, given that the popularity is partly predicated on the belief that the LLC offers litigation-related advantages, one issue that is not widely understood is the manner in which the citizenship of an LLC is determined for federal court jurisdiction purposes. As we explain below, citizenship of an LLC will ultimately turn on the citizenship of each of its members. Thus, in extreme cases, large, multi-member LLCs may not be able to establish the complete diversity of citizenship that is often necessary to file a case in, or remove it to, federal court regardless of the citizenship of the opposing party. Moreover, to establish diversity jurisdiction, an LLC must be prepared to disclose the citizenship of each of its members. This could be unattractive or impossible for confidentiality or other business reasons.

Diversity Jurisdiction Requires Consideration of Every Member of an LLC

As first-year law students learn, federal courts are courts of limited jurisdiction permitted to hear cases only if authorized by the Constitution and federal law. With respect to common business litigation including contract and tort disputes arising solely from state law, the basis for federal court jurisdiction arises under so-called "diversity jurisdiction." Diversity jurisdiction confers federal jurisdiction in cases between citizens of different states.[6] Congress has further restricted this jurisdiction, as is its right, to "civil actions where the matter in controversy exceeds the sum or value of $75,000, exclusive of interest and costs, and is *between. . . [c]itizens of different States*."[7]

Thus, assuming that the amount-in-controversy threshold is met, federal jurisdiction turns on the citizenship of the parties. While a relatively straightforward proposition for natural persons, it becomes more complicated when dealing with entities such as corporations and LLCs. Indeed, more than 200 years ago, the Supreme Court initially concluded that the citizenship of a corporation turned on "the character of the individuals who compose the corporation" (*i.e.,* the citizenship of the president, directors and shareholders).[8] Later, the Court reconsidered this approach and held that corporations doing business in their state of incorporation would be deemed citizens of that state regardless of where the individuals making up the entity resided.[9] This issue was only firmly resolved in 1958 by amendment to § 1332(c), which established that "a corporation shall be deemed to be a citizen of every State and foreign state by which it has been incorporated and of the State or foreign state where it has its principal place of business."

In 1990, the Supreme Court held in *Carden v. Arkoma Associates* that a general partnership is a citizen of each of the states in which one of its member is a citizen.[10] Thus, in a suit between an Arizona-organized partnership and citizens of Louisiana, the federal court in Louisiana lacked subject matter jurisdiction over the case because one of the limited partners of the plaintiff partnership was also a citizen of Louisiana.[11] The Court's reasoning made clear that this analysis would extend to all unincorporated entities regardless of how much their structure resembled that of a corporation.[12] Nearly every federal court of appeals has subsequently applied the *Carden* reasoning to LLCs.[13] Thus, at this point it is clear that that citizenship of an LLC is determined by the citizenship of each of its members.

Failure to Recognize this Rule can be Costly

Despite the clarity of the jurisprudence, litigants regularly predicate diversity jurisdiction on an LLC's state of organization as they would a corporation under § 1332(c). This may well be due to the perceived similarities between LLCs and corporations. In any event, this mistaken basis for jurisdiction has led to numerous costly situations in which a case proceeds in federal court without either the parties or the judge realizing that the federal courts are not competent to hear the dispute. In many instances, this realization does not occur until the case has reached the court of appeals, sometimes after the parties have tried the case to a verdict.

For example, the jurisdictional defect in Belleville Catering Co. v. Champaign Market Place, LLC[14] was not discovered until after trial and a jury award of $220,000 in favor of the defendant/ counter-claimant.[15] The appeals court, recognizing that the complaint improperly failed to disclose the identity and citizenship of the members of the defendant LLC, sua sponte ordered jurisdictional briefing that revealed that the plaintiff was incorporated in Illinois and the defendant LLC was composed of Illinois members, thereby destroying diversity and any basis for jurisdiction in federal court. The court, decrying the "litigants' insouciance towards the requirements of federal jurisdiction," ordered the case dismissed and both parties' counsel to perform any additional services necessary to bring the dispute to resolution at no charge to their clients.[16]

Additional Considerations Complicate the Analysis

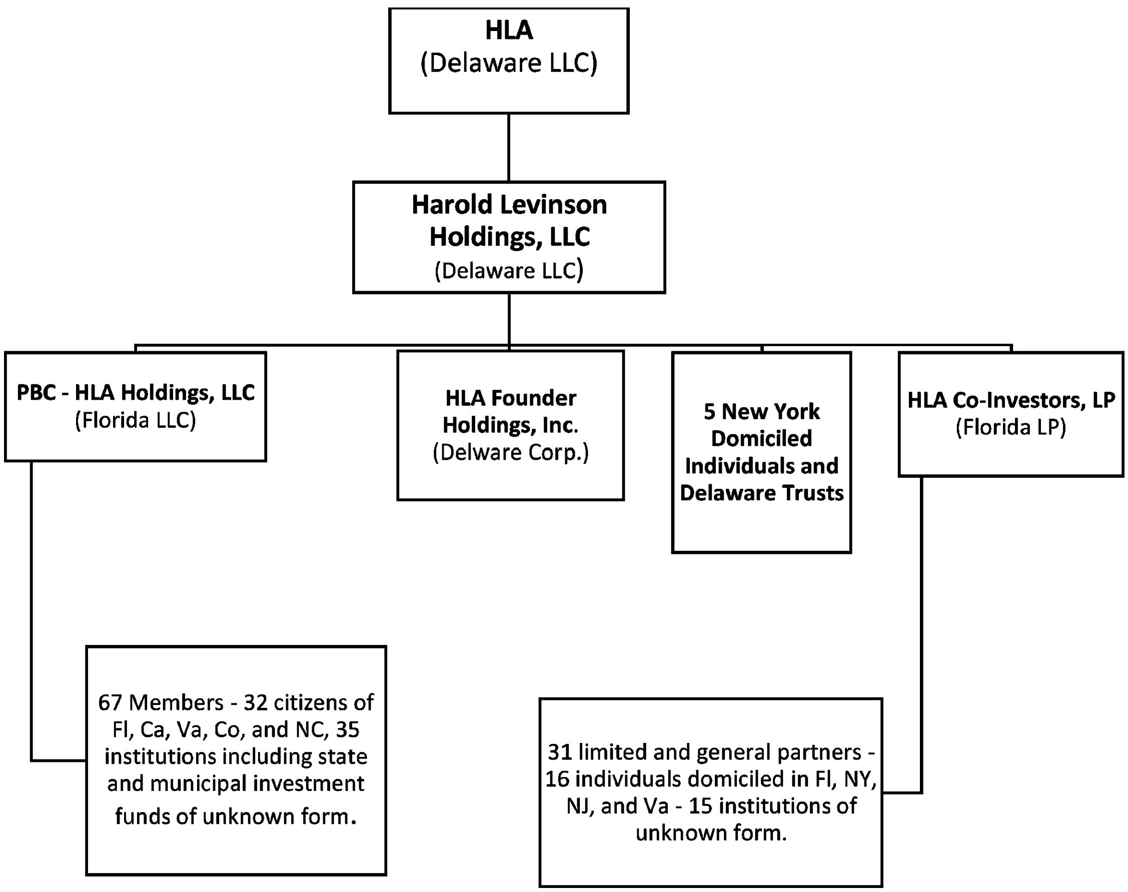
Understanding the jurisdictional treatment of LLCs does not end with recalling that citizenship cannot be established on the basis of the state of organization. Rather, two additional factors add to the complexity of adequately establishing subject matter jurisdiction in cases involving LLCs: (*i*) the citizenship rules are "iterative"; and (*ii*) a party must affirmatively establish its citizenship.

The citizenship rules for unincorporated entities are "iterative" in that where a member of an LLC is itself an LLC, LLP or partnership, citizenship for that entity is also determined by the citizenship of *its* members.[17] For example, in *Hart v. Terminex International*,[18] the Illinois-domiciled plaintiffs filed a product liability action against Dow Chemical and Terminix International Company LP. Dow removed the action to federal court on the basis of diversity, claiming that Terminix was a Delaware limited partnership and neither of the partners were citizens of Illinois. The case proceeded in litigation for seven years before it reached the U.S. Court of Appeals for the Seventh Circuit. On appeal, the Seventh Circuit demanded a complete statement of citizenship for Terminix and discovered that the chain of membership of that entity included Illinois corporations. Thus, after more than eight years of litigation, it was finally revealed that the parties were not completely diverse, and the court was forced to dismiss the action for want of jurisdiction.

Moreover, because diversity affects a federal court's power to hear a case, the citizenship of the parties must be affirmatively established; it cannot be assumed, it cannot be stated in the negative, and any failure to identify citizenship precludes federal court jurisdiction.[19] In *D.B. Zwirn*, the U.S. Court of Appeals for the First Circuit, recognizing an insufficient jurisdictional statement for the first time at oral argument, instructed the plaintiff LLC investment fund[20] to file an affidavit identifying its members. In response, the fund stated that according to its records "there were no members of the limited liability company who were citizens of" the defendant's home state. The First Circuit held this response insufficient, noting that the Supreme Court's 1888 decision in *Cameron v. Hodges*[21] held that citizenship must be affirmatively established for jurisdictional purposes. The court explained that because certain persons are deemed "stateless" and invariably destroy diversity, statements of citizenship must affirmatively identify the citizenship of all parties.[22] In light of the prior insufficient statement, the court gave the parties 15 days to file an adequate response. The parties settled the case before any such statement was filed.[23]

In Extreme Cases, LLCs May Never Satisfy Diversity Jurisdiction

The two difficulties identified above came together in a recent case in the District of Massachusetts, Garber Brothers Inc. v. Louis Troilo & Harold Levinson & Associates, LLC.[24] A suit was filed in state court solely against defendant Troilo and removed to the District of Massachusetts. The Massachusetts-incorporated plaintiff then amended the complaint to add Harold Levinson and Associates, LLC (HLA) as an additional defendant, describing it as "a New York limited liability company with a principal place of business" in New York.[25] The district court raised the jurisdictional issue sua sponte and ordered HLA to identify the citizenship of each of its members. HLA submitted an affidavit describing the following organization structure:[26]



HLA's structure consisted of at least four organizational tiers, each containing some LLCs or LPs. Fatally for HLA, although each of the entities it could identify was diverse from the Massachusetts plaintiff (*i.e.,* was a citizen of some state other than Massachusetts), HLA was unable to determine the citizenship of more than 40 of its members. Nor was this due to counsel's lack of effort in ascertaining the factual bases for jurisdiction. According to an affidavit from HLA's Executive Vice President, the institutional entities were either unwilling or restricted by contract from disclosing the identities of their investor partners.[27] Based on HLA's inability to affirmatively identify the citizenship of all of its members, the court, concluding that it lacked subject matter jurisdiction, remanded the case to state court.[28]

Practice Tips When Dealing with Jurisdiction over LLCs

The Supreme Court's decision in *Carden* makes clear that regardless of how much LLCs may resemble or operate like corporations, the courts will continue to resolve citizenship questions by looking at each of the members of the entity.[29] One solution to this lack of access to the federal courts would be to amend 28 U.S.C. § 1332(c) to simplify the citizenship analysis of an LLC perhaps by adopting, in whole or in part, the rules applicable to a corporation, which is deemed a citizen of its state of organization and principal place of business. *Carden* suggests that the Court would deem such a statutory revision adequate notwithstanding the constitutional dimensions of the jurisdiction issue.[30]

Absent congressional action, however, federal jurisdiction for LLCs will remain a trap for the unwary. This is particularly true for large, multi-member LLCs, such as investment vehicles, that are likely to have many layers of artificial entities as members and value the confidentiality of the identity of those members. It may be true that some LLCs are established by sophisticated parties and counsel with the expectation that they may never satisfy diversity jurisdiction in federal court.[31] However, for the practitioner who would like to preserve the option to litigate in federal court based on diversity of citizenship, we can offer a number of suggestions.

First, when initially drafting the LLC operating agreement, an attorney could consider using language that would require all members to identify their residency and that of their own members if required to establish citizenship for litigation purposes. There is authority supporting the view that such a disclosure to a court may be made under seal[32] to alleviate any potential privacy concerns on the part of the LLC's members.

Second, when drafting a jurisdictional statement either in a complaint or a notice of removal, counsel must take reasonable steps to attempt to ascertain the citizenship of an LLC (whether the opposing party or one's own client). Counsel should budget adequate time and resources for this research and should consider looking at secretary of state filings, UCC filings, corporate reports and disclosures, and filings in other litigation involving the entity in question. Unlike for corporations, documents necessary to establish the jurisdiction of an LLC are often difficult to find publicly and, in many cases, are unobtainable by third parties. Nevertheless, failure to adequately investigate jurisdictional facts has been characterized as a violation of a party's obligations under Federal Rule of Civil Procedure 11,[33] which requires a party to conduct a reasonable inquiry into the truth of its factual contentions.[34]

If taken to its logical conclusion, court enforcement of this approach could deprive a party of its right to litigate in federal court simply because the facts underlying its opponent's citizenship are nonpublic, preventing it from adequately alleging diversity jurisdiction.[35] However, where a party has taken reasonable steps, such as those outlined above, and is still unable to determine the citizenship of the adverse parties, all may not be lost. Two recent appeals court decisions in the Third and Ninth Circuits have held that in this situation, a party may comply with its Rule 11 obligations and survive a motion to dismiss by identifying the steps it took to ascertain jurisdiction and then alleging, "on information and belief," that the adverse parties are citizens of different states.[36] Noting that it would be transparently unfair to deny jurisdiction based on facts solely within an opponent's possession, both courts held that in the event the opponent then challenges jurisdiction, the district court would be permitted to order limited jurisdictional discovery.[37] The Third Circuit noted that this discovery should be relatively straightforward to accomplish: "in determining the membership of an LLC or other unincorporated association, a few responses to interrogatories will often suffice."[38] While this approach is practical and logically compelling, it has only been adopted in two circuits[39] and only very recently; counsel should be cautious in relying upon it in other jurisdictions.

Conclusion

The LLC form of business organization has been widely embraced by lawyers and business people, but it can be highly disadvantageous if the organization is seeking diversity-based jurisdiction in the federal courts. Conversely of course, it can help defeat federal diversity jurisdiction if the LLC prefers to be in state court. Thus, if federal diversity jurisdiction is an important right that the business wishes to retain, careful consideration must be given at the time the entity is established as to whether the LLC is the best form for organizing the business.

For the LLC involved in a dispute, litigation counsel should be aware that the test for determining the citizenship of these entities involves an unintuitive and often cumbersome inquiry into the citizenship of every member of the LLC. Diligent counsel must be aware of these rules at the outset of litigation to avoid potentially wasting significant time (and their client's money) in federal court only to discover that jurisdiction was lacking all along.

ENDNOTES:

[1]*See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. & Fin. L. 459, 460 (2010).

[2]*Id.* at n.4.

[3]Howard M. Friedman, *The Silent LLC Revolution-The Social Cost of Academic Neglect*, 38 Creighton L. Rev. 35, 36-40 (2004).

[4]*Id.* at 44.

[5]*See* John Tyler, et. al, *Producing Better Mileage: Advancing the Design and Usefulness of Hybrid Vehicles for Social Business Ventures,* 33 Quinnipiac L. Rev. 235, 271-72 (2015) (noting that "many practitioners and law professors bemoaned the 'dearth' of case law" early in the development of the form).

[6]U.S. Const. art. III, § 2, cl. 1.

[7]28 U.S.C. § 1332(a) (emphasis added). Note that § 1332 governs "original jurisdiction" of federal courts for civil actions. That is, actions originally filed by a plaintiff in federal court. Actions originally filed in state court but removed to federal court are governed by the federal removal statute, 28 U.S.C. § 1441. This statute permits removal for cases that could have been brought in federal court under "original jurisdiction" including under § 1332.

[8]*Bank of U.S. v. Deveaux*, 9 U.S. 61, 92 (1809).

[9]*Louisville, C. & C.R. Co. v. Letson,* 43 U.S. 497,558, 2 How. 497, 11 L. Ed. 353, 1844 WL 5963 (1844).

[10]*Carden v. Arkoma Assocs.*, 494 U.S. 185, 195-96 (1990).

[11]*Id.* at 186.

[12]*Id.* at 193-96.

[13]*See, e.g.*, *D.B. Zwirn Special Opportunities Fund, LP v. Mehrotra*, 661 F.3d 124, 125 (1st Cir. 2011); *Johnson v. Smithkline Beecham Corp.*, 724 F.3d 337, 348 (3d Cir. 2013); *Intec USA, LLC v. Engle*, 467 F.3d 1038, 1041-42 (7th Cir. 2006); *GMAC Commercial Credit LLC v. Dillard Dep't Stores, Inc.*, 357 F.3d 827, 829 (8th Cir. 2004); *Segundo Suenos, LLC v. Jones,* 494 Fed. Appx. 732 (9th Cir. 2012); *Siloam Springs Hotel, L.L.C. v. Century Sur. Co.*, 781 F.3d 1233, 1234 (10th Cir. 2015).

[14]Belleville Catering Co. v. Champaign Market Place, L.L.C., 350 F.3d 691 (7th Cir. 2003).

[15]See also GMAC Commercial Credit LLC, 357 F.3d at 829 (jurisdictional defect identified post-trial;

appeals court remanded for jurisdictional discovery).

[16]*Id*. at 692.

[17]*D.B. Zwirn Special Opportunities Fund, LP*, 661 F.3d at 126-27.

[18]*Hart v. Terminex Intern.,* 336 F.3d 541 (7th Cir. 2003).

[19]*D.B. Zwirn Special Opportunities Fund, LP*, 661 F.3d at 126.

[20]While the caption of the case indicates that D.B. Zwirn Special Opportunities Fund, L.P. was a limited partnership, at the time of removal it had become a limited liability company. *See* 661 F.3d at 125 n.2.

[21]*Cameron v. Hodges,* 127 U.S. 322, 8 S. Ct. 1154, 32 L. Ed. 132 (1888).

[22]*D.B. Zwirn*, 661 F.3d at 126 (identifying United States citizens domiciled abroad, Indian tribes, and U.S. states as examples of entities that destroy diversity under 28 U.S.C. § 1332).

[23]*See D.B. Zwirn Special Opportunities Fund, LP v. Mehrotra*, No. 11-1172, Document No. 0011630219 (1st Cir. Dec. 9, 2011).

[24]Garber Brothers Inc. v. Louis Troilo & Harold Levinson & Associates, LLC, No. 1:15-cv-10148-IT, slip op. (D. Mass., June 25, 2015).

[25]Am. Compl. at ¶ 5, Garber Brothers Inc. v. Louis Troilo & Harold Levinson & Associates, No. 1:15-cv010148 (D. Mass. Jan. 30, 2015).

[26]Affidavit of Barry Feldman at 2-3, Garber Brothers Inc. v. Louis Troilo & Harold Levinson & Associates, No. 1:15-cv010148 (D. Mass. June 4, 2015).

[27]*Id*.

[28]*Garber Brothers Inc. v. Louis Troilo & Harold Levinson & Associates*, No. 1:15-cv010148, slip op. at 8 (D. Mass. June 25, 2015).

[29]*Carden* at 195-96.

[30]*Id.* at 196 ("Congress has not been idle. In 1958 it revised the rule established in *Letson*, providing that a corporation shall be deemed a citizen not only of its State of incorporation but also 'of the State where it has its principal place of business.' " (quoting 28 U.S.C. § 1332(c)).

[31]Moreover, regardless of the structure of the LLC, certain *types* of actions essentially preclude diversity jurisdiction when they involve LLCs. These include: suits between the LLC and one of its members; suits between members of an LLC in which the LLC is an indispensable party; and derivative suits brought on behalf of the LLC. *See* Carter G. Bishop and Daniel S. Kleinberger, *Diversity Jurisdiction for LLCs? Basically, forget about it,* Business Law Today (Sept./Oct. 2004).

[32]*D.B. Zwirn Special Opportunities Fund, L.P. v. Mehrotra*, 661 F.3d 124, 125 (1st Cir. 2011).

[33]*Belleville Catering Co. v. Champaign Market Place, L.L.C.*, 350 F.3d 691, 692-93 (7th Cir. 2003).

[34]Fed. R. Civ. P. 11(b).

[35]Of course there is nothing illegitimate about an LLC keeping that information confidential; there are many reasons why LLC members may wish not to disclose their identity and, indeed, such protections are one of the attractions of using an LLC structure.

[36]*Lincoln Benefit Life Co. v. AEI Life, LLC*, No. 14-2660, 2015 U.S. App. LEXIS 15576 (3d Cir. Sept. 2, 2015); *Carolina Cas. Ins. Co. v. Team Equipment, Inc.,* 741 F.3d 1082 (9th Cir. 2014).

[37]The Third Circuit's decision in *Lincoln Benefit Life Co.* contains a "concurrence" joined by all three panel judges in which the court, noting Congress's inaction, urges the Supreme Court to abandon its *Carden* jurisprudence and treat LLCs as citizens of the state in which they are organized. *Lincoln Benefit Life Co.*, 2015 U.S. App. LEXIS 15576, at *23 (Ambro, J., concurring).

[38]*Lincoln Benefit Life Co.,* 2015 U.S. App. LEXIS 15576, at *18; *see also Carolina Cas. Ins. Co.,* 741 F.3d at 1088 ("If the defendants deny that the court has jurisdiction, the district court should evaluate the record created by the parties to determine its jurisdiction. Jurisdictional discovery may be appropriate." (internal citations omitted)).

[39]*See also Medical Assur. Co., Inc. v. Hellman,* 610 F.3d 371,376 (7th Cir. 2010) (permitting plaintiff to alleged the citizenship of natural persons on information and belief).

SEC/SRO UPDATE: FCPA ENFORCEMENT REMAINS A HIGH PRIORITY AREA FOR THE SEC; RECENT ACADEMIC STUDY SUGGESTS INSIDERS PROFIT DURING "8-K TRADING GAP"; SEC APPROVES TWO-YEAR EXTENSION OF ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES

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FCPA Enforcement Remains a High Priority Area for the SEC

In August, the Securities and Exchange Commission (SEC) continued its recent focus on the enforcement actions relating to the U.S. federal Foreign Corrupt Practices Act of 1977, as amended (FCPA) by announcing two settled cases, bringing the total for the calendar year to seven cases. FCPA prohibits certain companies from making any payment or giving anything of value to a "foreign official" for the purpose of either influencing any decision made by the official or inducing the official to use his influence with a government to affect any act of such government.[1] Below is a brief summary of the August cases and two additional recent cases during 2015:

- ***BNY Mellon:***[2] In August, and without admitting or denying the findings, global investment company BNY Mellon agreed to pay $14.8 million to settle SEC charges that it violated the FCPA by providing valuable student internships to family members of foreign government officials associated with a Middle Eastern sovereign wealth fund in order to win or preserve contracts to manage and service the assets of the fund. According to the press release, the SEC investigation found that BNY Mellon failed to evaluate the family members through its highly competitive internship programs that have rigorous hiring standards. The SEC also found that the family members did not meet the stringent criteria, yet were hired. The SEC order found that Mellon lacked sufficient internal controls to prevent and detect the improper hiring practices. BNY Mellon agreed to pay $8.3 million in disgorgement, $1.5 million in prejudgment interest, and a $5 million penalty. According to the press release, the SEC considered the company's remedial acts and its cooperation with the investigation when determining the settlement.

- ***Former SAP SE Executive:***[3] In August, the SEC charged a former SAP SE executive with violating the FCPA by bribing Panamanian government officials, through a third party, to obtain software license sales and received approximately $86,000 in kickbacks. According to the SEC order, the executive evaded SAP's internal controls by submitting various approval forms to SAP with falsified information. The executive consented to the entry of a cease-and-desist order and agreed to pay disgorgement of $85,965, which is the total amount of kickbacks he received, plus prejudgment interest of $6,430 for a total of $92,395. In connection with the SEC case, in August, the U.S. Department of Justice (DOJ) announced a criminal action against the executive.

- ***Mead Johnson Nutrition:***[4] In July, and without admitting or denying the findings, Mead Johnson Nutrition agreed to pay $12 million to settle the SEC's FCPA violation charges alleging that the company's Chinese subsidiary made improper payments to health care professionals at Chinese government-owned hospitals to endorse the company's infant formula product to patients who were new or expectant mothers. According to the Chief of the SEC Enforcement Division's FCPA Unit, "Mead Johnson Nutrition's lax internal control environment enabled its subsidiary to use off-the-books slush funds to pay doctors and other health care professionals in China to recommend its baby formula and give the company marketing access to mothers." The company agreed to pay $7.77 million in disgorgement, $1.26 million in prejudgment interest, and a $3 million penalty.

- ***BHP Billiton:***[5] In May, and without admitting or denying the findings, global resources company BHP Billiton agreed to pay a $25 million penalty to settle SEC FCPA violation charges that it sponsored the attendance of foreign government officials at the 2008 Summer Olympic Games in Beijing. According to the press release, the SEC investigation found that sponsored guests received three- to four-day hospitality packages valued at $12,000 to $16,000 per package that included event tickets, hotel accommodations and sightseeing excursions. According to a Director of the SEC's Divisions of Enforcement, "BHP Billiton recognized that inviting government officials to the Olympics created a heightened risk of violating anti-corruption laws, yet the company failed to implement sufficient internal controls to address that heightened risk."

Although the basic concepts underlying the FCPA are simple, the law can directly affect every day business relationships with foreign governments and can have far reaching effects, as illustrated by the foregoing broad variety of recent SEC enforcement actions. These recent actions also signify the SEC's continued emphasis on the necessity for companies to create and maintain robust internal controls to prevent and detect these types of violations.

Recent Academic Study Suggests Insiders Profit during "8-K Trading Gap"

A recent study[6] conducted by researchers at Columbia University and Harvard University concluded that corporate insiders earn "meaningful" profits when trading during the four-day period when information is known by insiders but before a Form 8-K is filed (referred to in the study as the "8-K trading gap").

Under SEC rules, public companies have four business days after a material event occurs to file a Form 8-K disclosing such event. As noted in an article in *The Wall Street Journal*,[7] which first reported the study, according to Columbia researcher Robert Jackson, "to leave open a gap like that is an invitation to insider trading."

The study ultimately analyzed 42,820 insider transactions reported by companies during the 8-K trading gap, between 2004 and 2014. The results showed that, on average, insiders netted approximately 0.4 percentage points over a broad market index during the 8-K gap. Even better, when insiders made direct stock purchases (rather than exercising derivative securities), insiders gained approximately 1.6 percentage points over the index. The study further showed that when companies used the full four-day window to file Form 8-Ks, the average gain was approximately 1.95 percentage points. According to Jackson, "the consistency of the profits suggests insiders benefit from proprietary knowledge of their business when making trades."[8]

The results of the study raise questions over whether legislators and regulators may consider changes to U.S. securities laws disclosure rules, such as potentially shortening the gap (to two days as proposed by the SEC in 2002,[9] before adopting the current four-day period in 2004[10]), or as suggested by the study, to consider whether the underlying nature of the information (*i.e.* type of Form 8-K event) should shape the disclosure timing. The study also suggests companies should consider expanding their "blackout periods" to include a broader group of events, including those required by 8-K filings.

The *WSJ* article also reported that, U.S. Rep. Carolyn Maloney, (D-NY), a member of the House Financial Services Committee, reviewed the study's findings and characterized them as "troubling" and said she was preparing legislation to address the issue.[11] Although it is very early to discuss the eventual implications of the study's findings, one wonders if it will follow a path similar to that of the options backdating study conducted in 2006 by researchers at Indiana University and the University of Iowa that led to significant enforcement and regulatory reform.[12]

SEC Approves Two-Year Extension of Advisory Committee on Small and Emerging Companies

On September 23, the SEC announced[13]that it approved the renewal of its Advisory Committee on Small and Emerging Companies (Committee).[14] According to the SEC, the Committee will continue to focus on interests and priorities of small businesses and smaller public companies.[15]

The advisory committee provides a formal mechanism for the SEC to receive advice and recommendations on privately held small businesses and publicly traded companies with a market capitalization of less than $250 million.[16] Since October 2011, when the Committee was formed, it has provided recommendations to the SEC regarding policies related to these companies.

ENDNOTES:

[1]*See* 15 USC § 78dd-1(a).

[2]*See* SEC Press Rel. No. 2015-170 (August 18, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-170.html and SEC Ad. Proc. No 3-16762 *In re The Bank of New York Mellon Corp.* (August 18, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-75720.pdf.

[3]*See* SEC Press Rel. No. 2015-165 (August 12, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-165.html and SEC Ad. Proc. No 3-16750 *In re Vicente E. Garcia* (August 12, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-75684.pdf.

[4]*See* SEC Press Rel. No. 2015-154 (July 28, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-154.html and SEC Ad. Proc. No 3-16704 *In re Mead Johnson Nutrition Company* (July 28, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-75532.pdf.

[5]*See* SEC Press Rel. No. 2015-93 (May 20, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-93.html and SEC Ad. Proc. No 3-16546 *In re BHP Billiton Ltd.* (May 20, 2015), *available at* http://www.sec.gov/litigation/admin/2015/34-74998.pdf.

[6]*See* Paper: The 8-K Trading Gap (September 7, 2015) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract__id=2657877.

[7]*See* The Wall Street Journal, "Insiders Beat Market Before Event Disclosure: Study" (September 14, 2015).

[8]The Wall Street Journal, "Insiders Beat Market Before Event Disclosure: Study."

[9]*See* SEC Rel. No. 33-8106 (June 17, 2002) (proposing release).

[10]*See* SEC Rel. No. 33-8400 (Mar. 16, 2004) (adopting release).

[11]The Wall Street Journal, "Insiders Beat Market Before Event Disclosure: Study."

[12]*See* Paper: Does backdating explain the stock price pattern around executive stock option grants? (January 2006) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract__id=877889.

[13]*See* SEC Press Rel. No. 2015-206 (September 23, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-206.html.

[14]*See* http://www.sec.gov/info/smallbus/acsec.shtml.

[15]*See* SEC Press Rel. No. 2015-206 (September 23, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-206.html.

[16]*See* SEC Press. Rel. No. 2015-197 (Sept. 18, 2015) *available at* http://www.sec.gov/news/pressrelease/2015-197.html.

FROM THE EDITORS

Stung by Criticism, SEC Proposes Changes to its Administrative Proceedings

As this issue of *Wall Street Lawyer* was going to press, the Securities and Exchange Commission (SEC) announced it was proposing changes to its administrative proceedings in an attempt to update the rules.

"The proposed amendments seek to modernize our rules of practice for administrative proceedings, including provisions for additional time and prescribed discovery for the parties," said SEC Chair Mary Jo White in announcing the proposals.

While no doubt the proposed amendments will do that—and such a result would be heartily welcomed—it's obvious the SEC is also attempting to quell growing controversy over what critics are calling its overuse of administrative proceedings run by SEC-appointed administrative law judges (ALJs) rather than rolling the dice in federal court. (The SEC gained the authority to expand the use of administrative proceedings in the 2010 Dodd Frank Act. An analysis by *The Wall Street Journal* showed that the SEC has won 90% of the time when using its own ALJs since October 2010, compared to a 69% success rating in court.) And while once the SEC's use of administrative proceedings was traditionally for cases involving regulated brokers and investment advisers where the SEC has specialized experience and direct regulatory responsibility, the agency, with Dodd-Frank's blessing, has now gone to ALJs for such complex matters as pursuing alleged insider trading, disclosure and other violations by corporate officers and directors and unregulated companies.

A recent report from Wolters Kluwer noted that respondents in 10 administrative proceedings brought by the SEC within the last year have sued the agency, claiming the process violates the US Constitution. "Some of the cases reference news reports that the SEC's home-field advantage is aided by the alleged bias of its ALJs for the agency's enforcement division," the report stated.

Indeed, the SEC's proposed amendments' three main points seem aimed directly at stemming some of the complaints from the defense side about addressing matters before an ALJ. The proposals include:

- adjusting the time of the proceedings to allow for more preparation time before a hearing is held;
- allowing up to five witnesses to be deposed as part of the overall discovery process; and
- requiring parties to use electronic communications for filing and serving documents, and allowing certain personal information to be redacted from those filings.

It is unlikely that these changes will satisfy all critics, in that in any complex matter the limit on number of depositions, limited document discovery, and the fact that the Commission itself can overturn any ALJ decision, will continue to provide defendants with second-class due process compared to a district court proceeding.

Given the win-rate of the SEC in cases brought before ALJs, it's unlikely these changes came about altruistically. Rather, the SEC may have sensed it overplayed its hand with the use of these proceedings.

The SEC said it will solicit public comment on the proposed rule amendments for 60 days following publication in the Federal Register. Thus, the changes could be adopted as early as later this year.

—John F. Olson & Gregg Wirth

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