

From Texas Gulf Sulfur to Enron
(and from Kennedy to Bush 43):
The Moral and Economic Decline of
the United States

What Got Me Thinking – S.Ct. Role in Corporate Corruption

- 1933 – 2003 – 70 years of SEC Reg.
- 1934 – 2004 – 70 years of 1934 Act
- 1975 – 2005 – 30 years of S.Ct.
- 1946 – 2006 – 60 years of private suits

Not All Progress Is Good

Eliminate fixed commissions 1975- Volatility			
Date	Shares	Turnover	Trades
1925 – 1957	500M	20%	8M
1968 – 1974	3.5B	20%	8M
1982 – 1985	20B	50%	15M
1986 – 1992	40B	50%	22M
1993 – 1997	100B	60%	50M
2000 – 2003	300B	95%	500M

Speaking of Antitrust

- 1893 – Sherman Act
- Economists – Bigness not bad
- Matsushita - 1986
- Reagan

Matsushita and Easterbrook

- "The plaintiffs [in this case] maintain that for the last fifteen years or more at least ten Japanese manufacturers have sold TV sets at less than cost in order to drive United States firms out of business. Such conduct cannot possibly produce profits by harming competition, however. If the Japanese firms drive some United States firms out of business, they could not recoup. Fifteen years of losses could be made up only by very high prices for the indefinite future. (The losses are like investments, which must be recovered with compound interest.) If the defendants should try to raise prices to such a level, they would attract new competition. There are no barriers to entry into electronics, as the proliferation of computer and audio firms shows. The competition would come from resurgent United States firms, from other foreign firms (Korea and many other nations make TV sets), and from defendants themselves. In order to recoup, the Japanese firms would need to suppress competition among themselves. On plaintiffs' theory, the cartel would need to last at least thirty years, far longer than any in history, even when cartels were not illegal. None should be sanguine about the prospects of such a cartel, given each firm's incentive to shave price and expand its

Stock Options

- Relation to volatility
- Stock buy backs
- Compensation/Insider Trading
- Repricing
- Amount
- Alignment w/Shareholders

Our Economy Today & Balance of Trade

	<u>Total</u>	<u>Mexico</u>	<u>China</u>	<u>India</u>
1960's	+4B	N/A	N/A	N/A
1970 – 76	-4B	N/A	N/A	N/A
1976 – 82	-20B	N/A	N/A	N/A
1983 – 1997	-100B	--	20B	-2
2000 – 2002	-400B	-25B	83B	-7
2003 – 2004	-500B	-40B	-124B	-8

Who Said This?

“Before 1980, share buybacks were discouraged...Returns were driven by dividends. Earnings are a very dubious measure...There are so many tools a CEO can use to “craft” an earnings statement, so many ways to mislead. All asset values, after all, are just based on forecast...There’s been too much gaming of the system until it broke. Capitalism is not working!
There has been a corrupting of the system of capitalism...

Pushing the Envelope

- “[Y]our lawyers...can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone...; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice.” The difficulty which men have felt...has been rather that they wanted to go to the limit rather than they wanted to go safely.
- Hearings before Sen. Comm. On Interstate Commerce, S.Res.No.98, 62nd Cong. 1161 (1911) (statement of Louis D. Brandeis)

O'Neil p. 223-224

- If the CEO was to represent an ideal of probity, and guide all those in a company's orbit to the highest standards of decency, transparency, and disclosure, he'd have to be motivated by fear – fear of the abyss. Contemplating Greenspan's sepulchral assessments affirmed for O'Neill that the standard to trigger litigation and censure should no longer be recklessness. That was too narrow, too rare – a standard that doubtless would apply to Ken Lay when he was CEO of Enron. But Lay was one in a thousand. No, the new standard should be negligence. If you do not present to investors an accurate picture of the company you run – an illustration that a “reasonable person,” or in this case a “reasonable investor,” can understand and, thus, know to be true – you are negligent.

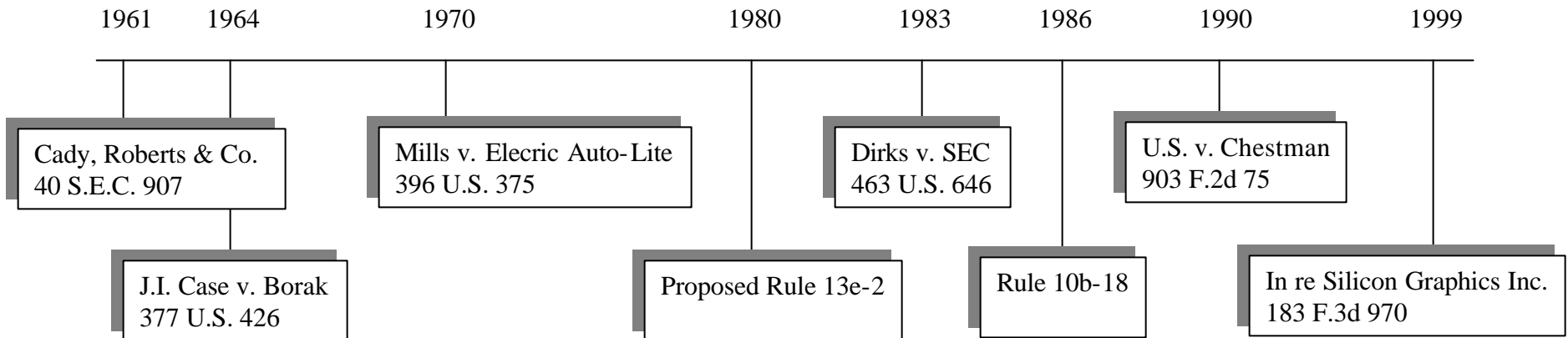
Greenspan 222 - 223

- Over the next pages, Greenspan took O’Neill’s concept and bolstered it with supporting analysis, noting that boards of directors are mostly selected from slates provided by the CEO; that auditors are selected by the CEO; and that the business strategy of a company, set by the CEO, “strongly influences the choice of accounting practices that measure the ongoing degree of success or failure of that strategy.
- “Thus,” he wrote, “the markets have no alternative but to depend on the CEO to ensure an objective evaluation of the prospects of a corporation.”
- Greenspan then ran through a litany of commissions and omissions perpetrated of late, under the CEO-dominated model, by various parties from securities analysts (who, research shows, “have been persistently overly optimistic”) to CEOs (who, “under increasing pressure from the investment community to meet elevated expectations,” have been “drawn to accounting devices whose sole purpose is to obscure potential adverse results”).

O'Neil 229

- “We need CEOs to certify financial statements, and that will create a system of internal controls,” he said – an idea whose clarity, coming from the only one in the room who’d ever run a large company, cut off a host of escape routes. Then he went a step further. The key, as with so much else, was creating a process of constant improvement. You could do that only by setting a standard of “best practice” and then grading how close a firm goes to the optimal. This must be added to the architecture of thresholds and sanctions – a path to self-improvement. “Every investor should know, is the company following best practice? Auditors must disclose to a company’s audit committee must certify and disclose if best practice is not being met – and, if not, why not. This gives a context to the standard of negligence, a set of parameters for that discussion. I am going to brief the President in preparation for a speech he’s giving in a few weeks. These ideas will be at the centerpiece of that briefing.

Changing Attitudes in the Law



1961

Cady, Roberts & Co.

“There is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an ‘insider’ should not have the same protection afforded by disclosure of special information as persons who sell stock to them. **Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.**”

1964

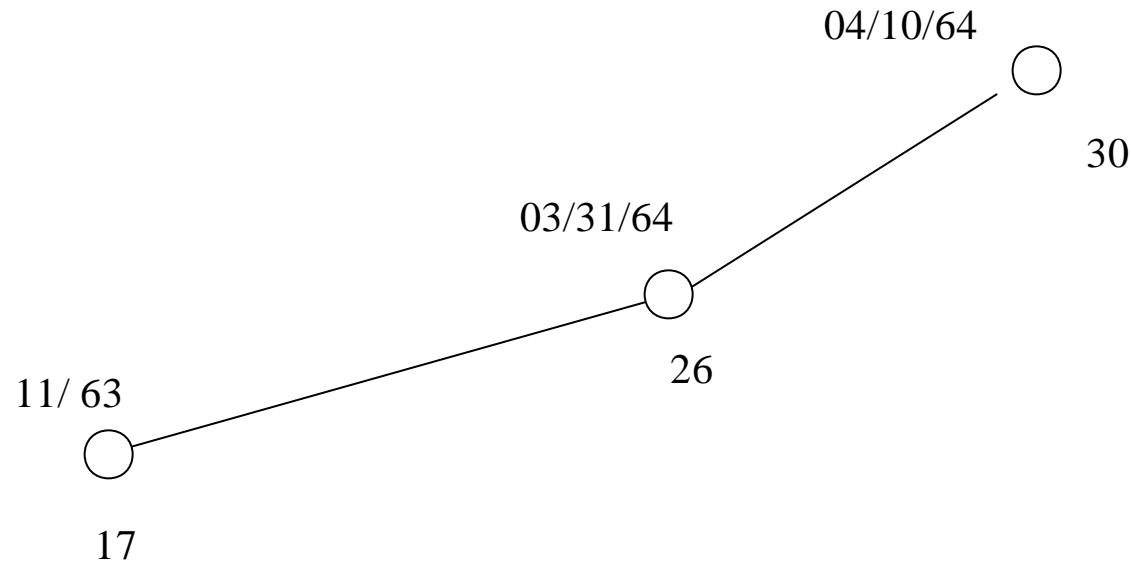
J.I. Case Company v. Borak

“Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought. These broad remedial purposes are evidenced in the language of the section which makes it ‘unlawful for any person*** to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security*** registered on any national securities exchange in contravention of such rules and regulations as **the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.**’ While this language makes no specific reference to a private right of action, among its chief purposes is ‘**the protection of investors,**’ which certainly implies the availability of judicial relief where necessary to achieve that result. ”

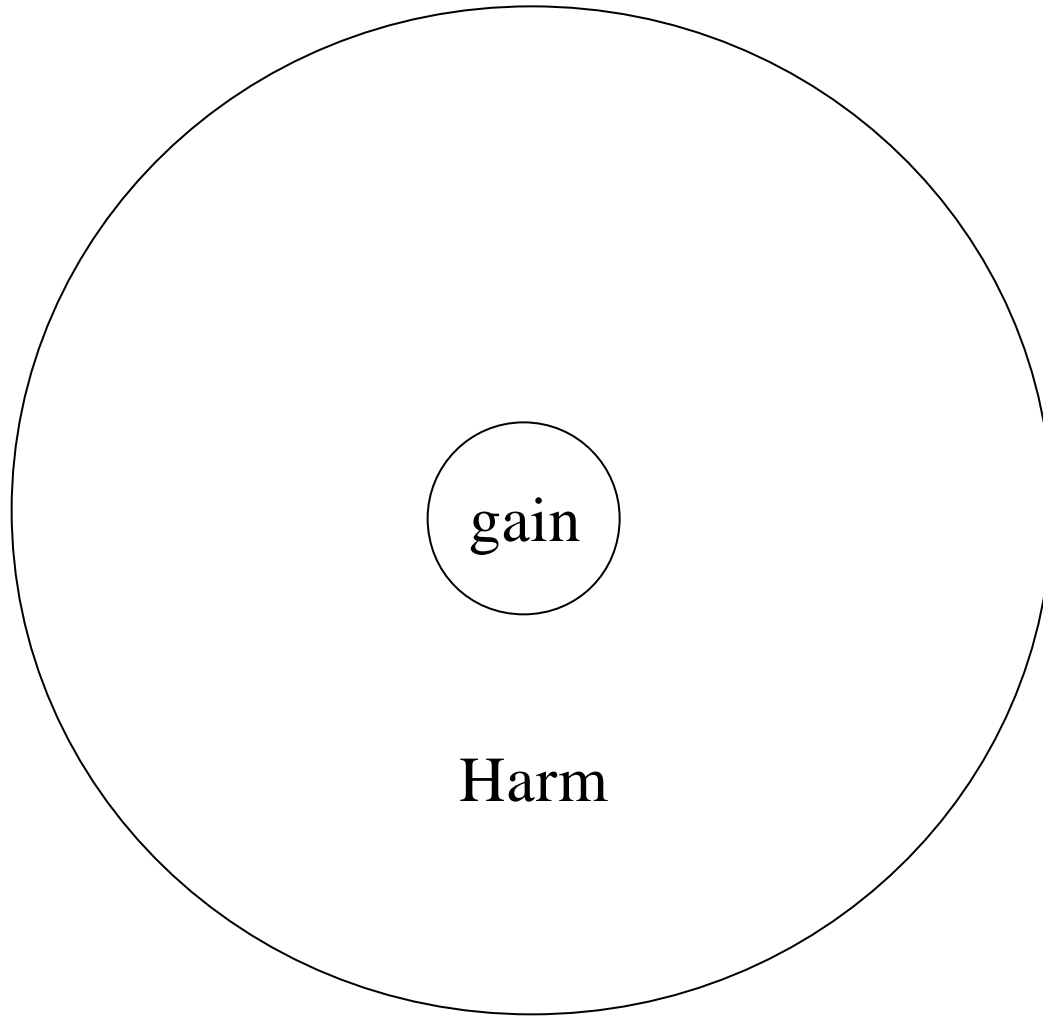
1970 Mills v. Electric Auto-Lite Company

“Where there has been a finding of materiality [regarding a misstatement or omission in a proxy statement], a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, **by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions.**”

Texas Gulf Sulfur – Act I



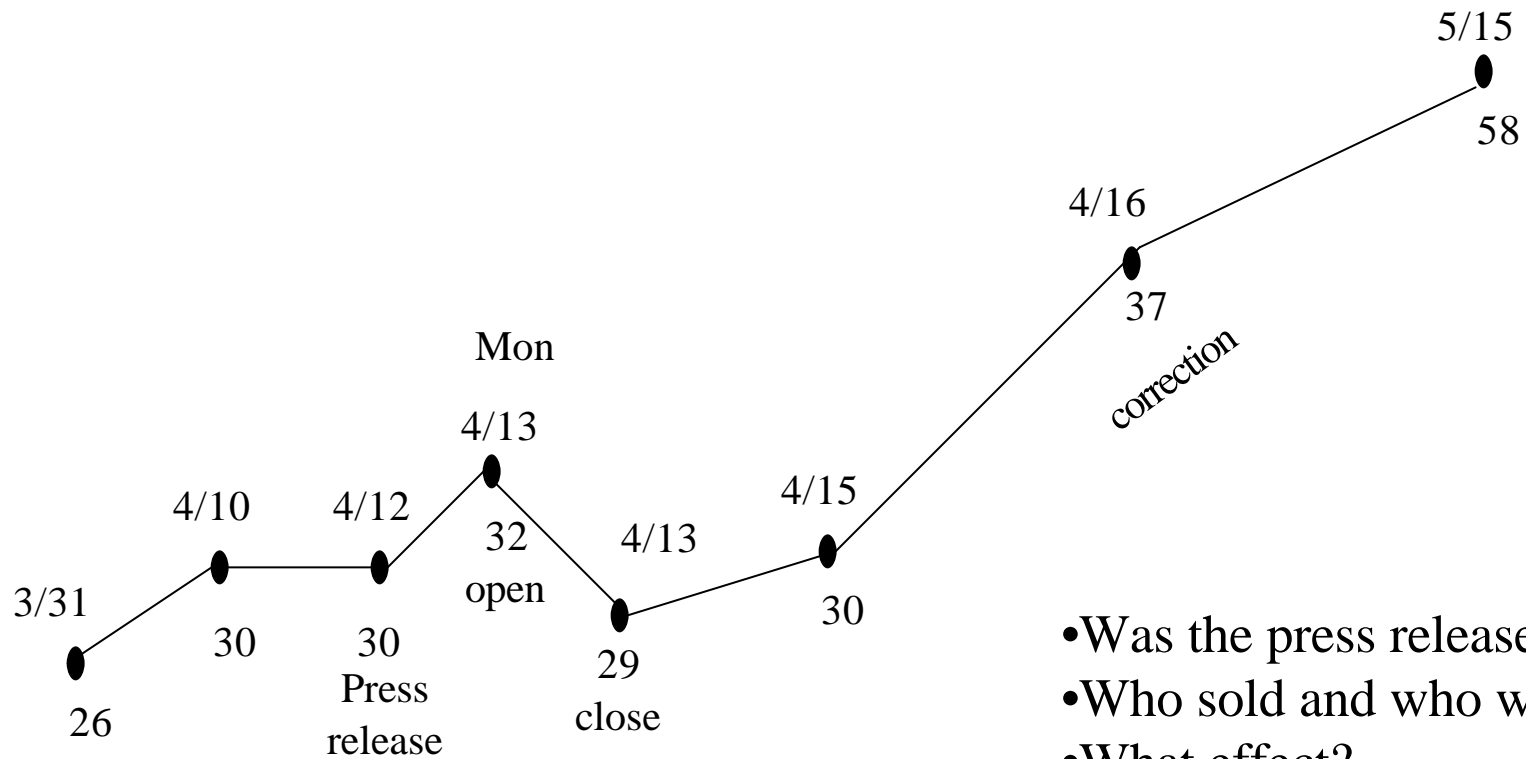
- 11/12/63 drilling completed and stopped
- What happened from November to April
- Who did what
- What was the sin
- Quere: materiality, scienter
- Who is hurt; who gains? how much?



Who bought how much

Purchase Calls				Shares	
Date	Purchaser	Number	Price	Number	
•					
• Hole K-55-1 Completed November 12, 1963					
•					
• 1963					
Nov.	12	Fogarty		300	17 3/4
	15	Clayton		200	17 3/4
	15	Fogarty		700	17 5/8
	15	Mollison		100	17 7/8
	19	Fogarty		500	18 1/8
	26	Fogarty		200	17 3/4
	29	Holyk (Mrs.)		50	18
•					
• Chemical Assays of Drill Core of K-55-1 Received					19
December 9-13, 1963					

TGS – Act II



- Was the press release “fraud”?
- Who sold and who would hold?
- What effect?

The Press Release

- 'During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.
-
- 'The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals--lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.
-
- 'Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

Press Release cont

- 'Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.'
-
- 'The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project.'

1970s: Corp. Responsibility [BCA 8.85 Stakeholders]

- § 8.85. In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best long term and short term interests of the corporation, consider the effects of any action (including without limitation, action which may involve or relate to a change or potential change in control of the corporation) upon employees, suppliers and customers of the corporation or its subsidiaries, communities in which offices or other establishments of the corporation or its subsidiaries are located, and all other pertinent factors.

1980

Proposed Rule 13e-2 Regulation of Issuer Repurchases

“The regulatory predicate that underlies the Commission’s proposed Rule 13e-2 is **the need for a scheme of regulation that limits the ability of an issuer and persons whose purchases are closely related to those of the issuer to control the price of the issuer’s securities.** That predicate stems in part from the unique incentives that an issuer and those related persons have to control the price of the issuers securities. It stems also from the fact that the anti-fraud and anti-manipulative provisions of the Act are very general in language and may not provide adequate guidance. **A rule such as Rule 13e-2 can curb the opportunity for abuse.”**

1983

Dirks v. SEC

“Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in Cady, Roberts: a purpose of the securities laws was to eliminate “use of inside information for personal advantage.” Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”

1986 Rule 10b-18 "Safe Harbor" for Issuer Repurchases

“The Commission has recognized that issuer repurchase programs are seldom undertaken with improper intent, may frequently be of substantial economic benefit to investors, and, that, in any event, undue restriction of these programs is not in the interest of investors, issuers, or the marketplace. Issuers generally engage in repurchase programs for legitimate business reasons and any rule in this area must not be overly intrusive.”

“In light of these considerations, and based on the extensive public files developed in this proceeding, the Commission has determined that it is not necessary to adopt a mandatory rule to regulate issuer repurchases.”

Revlon: Maximize Shareholder Value

- However, when Pantry Pride increased its offer to \$50 per share, and then to \$53, it became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

1990

United States v. Chestman

In Chestman, a man's wife informed him of an impending tender offer on the family business even though she had been sworn to secrecy. The man then told his broker that he had some "definite" and "accurate" information that the company's stock was being sold at a "substantially higher price." Chestman, the broker, then proceeded to buy the stock for himself and his discretionary accounts. The court, however, held:

“Evidence that Keith Loeb revealed the critical information in breach of a duty of trust and confidence known to Chestman is essential to the imposition of liability upon Chestman as aider/abettor or as tippee. Such evidence is lacking here”

“because Keith owed neither Susan nor the Waldbaum family a fiduciary duty or its functional equivalent, he did not defraud them by disclosing news of the pending tender offer to Chestman. Absent a predicate act of fraud by Keith Loeb, the alleged misappropriator, Chestman could not be derivatively liable as Loeb's tippee or as an aider and abettor.”

Central Bank of Denver (S.Ct. 1994)

- In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (Authority) issued a total of \$26 million in bonds to finance public improvements at Stetson Hills, a planned residential and commercial development in Colorado Springs. Petitioner Central Bank of Denver served as indenture trustee for the bond issues.

The security for the bonds

- The bonds were secured by landowner assessment liens, which covered about 250 acres for the 1986 bond issue and about 272 acres for the 1988 bond issue. The bond covenants required that the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest. The covenants required AmWest Development, the developer of Stetson Hills, to give Central Bank an annual report containing evidence that the 160% test was met.

Notice to the Bank of possible default

- In January 1988, AmWest provided Central Bank with an updated appraisal of the land securing the 1986 bonds and of the land proposed to secure the 1988 bonds. The 1988 appraisal showed land values almost unchanged from the 1986 appraisal. Soon afterwards, Central Bank received a letter from the senior underwriter for the 1986 bonds. Noting that property values were declining in Colorado Springs and that Central Bank was operating on an appraisal over 16 months old, the underwriter expressed concern that the 160% test was not being met.

Was this aiding and abetting?

- Central Bank asked its in-house appraiser to review the updated 1988 appraisal. The in-house appraiser decided that the values listed in the appraisal appeared optimistic considering the local real estate market. He suggested that *168 Central Bank retain an outside appraiser to conduct an independent review of the 1988 appraisal. After an exchange of letters between Central Bank and AmWest in early 1988, Central Bank agreed to delay independent review of the appraisal until the end of the year, six months after the June 1988 closing on the bond issue. Before the independent review was complete, however, the Authority defaulted on the 1988 bonds.

Aiding and abetting rejected

- Because the text of § 10(b) does not prohibit aiding and abetting, we hold that a private plaintiff may not maintain an aiding and abetting suit under § 10(b).

PLSRA, 15 USC s 78u-4(b)(2)

- (2) Required state of mind-
- In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

§ 78u-5(c)(1) safe harbor for forward-looking statements

Except as provided in subsection (b) of this section, in any private action arising under this chapter that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) of this section shall not be liable with respect to any forward-looking statement, whether written or oral, if and to the extent that--

- **(A)** the forward-looking statement is--
- **(i)** identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
- **(ii)** immaterial; or

- **(B)** the plaintiff fails to prove that the forward-looking statement--
- **(i)** if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
- **(ii)** if made by a business entity; [\[FN1\]](#) was--
- **(I)** made by or with the approval of an executive officer of that entity; and
- **(II)** made or approved by such officer with actual knowledge by that officer that the statement was false or misleading.***
- (d) Duty to update
- Nothing in this section shall impose upon any person a duty to update a forward-looking statement.

Silicon graphics facts

- On October 19, 1995, SGI announced that its revenue had grown just 33% during the first quarter of FY96, well below the projected growth of 40%. The disappointing first quarter performance, according to Brody, caused SGI's officers to fear another drop in the value of SGI stock [now at 30].. To prevent such a drop, Brody asserts that SGI's officers allegedly conspired to restore investor confidence by downplaying SGI's problems. In furtherance of their alleged "conspiracy," SGI's officers made the following statements which were intended to artificially inflate the value of SGI stock:

Management's statements

- October 19, 1995: SGI issued a press release reporting that the Indigo2 was shipping in volume.
- October 19, 1995: In a conference call, McCracken and other officers told securities analysts and institutional investors that SGI's sales force reorganization had been successful. The officers attributed the shortcoming in first quarter growth to a "temporary pause" in OEM sales, and a brief drop in demand from the U.S. Government and French businesses. SGI assured investors that (1) there were no manufacturing problems with or supply constraints on the Indigo2; (2) demand was strong for the workstation, and it was being shipped in volume; (3) the Indigo2 upgrade was on schedule and would be introduced in January 1996 as planned; and (4) the goal of 40% revenue growth for FY96 would be achieved.

The Reality

- Soon thereafter, SGI began to publicly confirm the negative rumors about its performance. On January 2, 1996, the company announced its disappointing second quarter results and acknowledged that revenue growth for the year would be much lower than expected. The next day, SGI's stock fell to \$21 1/8. On January 17, 1996, SGI's officers admitted to securities analysts that SGI had been unable to fill Indigo2 orders because of a shortage of ASIC chips and other primary components. They also acknowledged that OEM, North American, and European sales had all been down.

Silicon Graphics

<u>Name</u>	Sold per Court	Proceeds	Sales per Holdings	Residual Holdings
McCracken	60,000/2,305,382	\$2,186,000	60,000/358,000	298,716
Kelly	20,000/45,790	\$743,000	20,000/20,815	815
Sekimoto	7,600/110,811	\$266,988	7,600/10,667	3,067
Baskett	30,000/390,577	\$1,097,500	30,000/37,620	7,620
Ramsay	20,000/489,978	\$746,071	20,000/50,309	30,309
Burgess	250,588/332,746	\$8,761,294		

The Ann Taylor Litigation

- The plaintiffs' specific allegations focus on AnnTaylor's so-called "Box and Hold" practice, whereby a substantial and growing quantity of out-of-date inventory was stored in several warehouses during the Class Period without being marked down. Internal Company documents ("Weekly Reports")--distributed at regular Monday morning merchandise meetings in which the AnnTaylor defendants participated--distinguished between regular inventory and "Box and Hold" inventory. According to the complaint, these reports demonstrated that: (1) much of the "Box and Hold" inventory was several years old and thus unlikely to be sold at full price, if at all; and (2) the levels of such inventory grew significantly during the Class Period, from about 10% to about 34% of total inventory.

What Mgmt Told the Public

- However, AnnTaylor's public financial statements did not distinguish between types of inventory, nor did AnnTaylor write off any of the "Box and Hold" inventory during the Class Period, allegedly in violation of Generally Accepted Accounting Principles ("GAAP") that required markdowns under these circumstances. Instead, the defendants made or caused to be made a series of positive statements to the public about the status of AnnTaylor's inventories, describing them at various points during the Class Period as "under control," "in good shape," and at "reasonable" or "expected" levels; stating that "no major or unusual markdowns were anticipated"; and attributing rising levels of inventory to growth, expansion, and planned future sales.

1999

In re Silicon Graphics Inc.

In Silicon Graphics, investors filed a securities fraud class action, alleging that the corporation and six of its top officers made a series of **misleading statements** to inflate the value of the company's stock while they engaged in massive **insider trading**, however, the court held:

With respect to the complaint alleging misstatements and asserting the belief that More substantial evidentiary support would exist after a reasonable opportunity for Discovery the court held:

“In this case Brody’s complaint does not include adequate corroborating details.* we would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability.”**

Question: How is a plaintiff supposed to obtain these facts before discovery?

1999

In re Silicon Graphics Inc.

With respect to the insider trading, the court held:

“Brody alleges that six individual officers engaged in massive insider trading during the fifteen-week class period, collectively selling 388,188 shares of stock totaling \$13,821,053 in proceeds. **The district court determined that although two of the individual defendants’ sales were suspicious, the allegations overall failed to raise a strong inference of deliberate recklessness. We agree that the allegations fail to raise the required strong inference.**”

“Although “unusual” or “suspicious” stock sales by corporate insiders may constitute circumstantial evidence of scienter, **insider trading is suspicious only when it is “dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information.”**”

1999

In re Silicon Graphics Inc.

Also with respect to the insider trading, the court held:

“All but two of the officers in this case sold a relatively small portion of their total holdings and traded in a manner consistent with prior practice. Collectively, the officers - even including the two who sold the greatest percentage of their holdings - retained 90 percent of their available holdings. ”

Question: What is the court including in “available holdings”?

Silicon Graphics

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