To Our Clients:

RECENT DEVELOPMENTS

1. Obligations of Investment Banker with Respect to Confidential Information. Two recent cases in the United States District Court for the Southern District of New York indicate that the legal responsibilities of investment bankers and brokers are still being developed on a case by case basis. In Slade v. Shearson, Hammill & Co., Inc., S.D.N.Y. 2/26/73, CCH ¶ 93,789, the court refused to grant a preliminary injunction at the request of a party who claimed that Shearson, Hammill had come into possession of material adverse information concerning Title Marine International Corp. while acting as investment banker to that corporation. Holding that the legal grounds urged by plaintiff did not give any "likelihood of ultimate success", the court stated that there were no cases that could be cited for the proposition "that a broker is required to reveal to the investing public information he has learned as an investment banker". While the court does not pass on the issue, there would appear to be no question that once the broker attempts to go into the market place to act on this information for his own benefit, he would be subject to liability.

On the other hand, in Robinson, et al. v. Penn Central Company, et al., S.D.N.Y. 2/9/73, CCH ¶ 93,772, the court refused to dismiss from a class action complaint various New York banks, brokerage houses and financial institutions charged with inside trading on "inside information" with respect to shares of Penn Central Company. The court refused to dismiss from the case William O'Neill, Inc., one of the brokerage firm defendants, which had argued that it did not execute any orders for its own account or for discretionary accounts of its customers and, therefore, even if it had been in possession of material inside information, it had no liability under Rule 10b-5 as a "tippee". The court rejected this argument, pointing out that O'Neill could still be held liable as an "aider and abettor or as a member of the alleged conspiracy" even when it did not purchase or sell securities directly for its own account or for customers with discretionary accounts.

2. The Timing of Release of a Press Release is a Matter for Exercise of Business Judgment. In Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 10th Cir., 2/20/73, CCH ¶ 93,773, the Court of Appeals reversed a judgment for plaintiff Financial Industrial Fund and ordered entry of judgment for the defendant. The case was one of the many arising from the events surrounding the June 1966 proposed underwriting of McDonnell securities by Merrill, Lynch. The plaintiff, a mutual fund, had purchased approximately 80,000 shares of McDonnell stock immediately prior to the release of the press release by McDonnell announcing a decline in its six-months earnings. Plaintiff sued McDonnell on the theory that failure to make earlier disclosure of the adverse earnings results constituted a violation of Rule 10b-5. After analyzing the processes by which management of McDonnell first learned of a possible slow-down in the aircraft manufacturing division and the steps that were taken to establish the nature of the possible adverse effect on earnings, the court concluded that the question of timing of the press release was one that was particularly appropriate for consideration under the "Business Judgment Rule". In the court's view, that rule required that "directors and officers of a corporation will not be held liable for error or mistakes in judgment, pertaining to law or fact, when they have acted on a matter calling for the exercise of their judgment or discretion when they have used such judgment and have so acted in good faith". The court held that as a matter of law, McDonnell and its executives had acted in "good faith and due diligence in the ascertainment, the verification, and the publication of the serious reversal of earnings in May".

3. No-Action Letters Under Rule 144.

(a) In Dynarad Inc. (available 1/8/73, CCH ¶ 79,232), the Staff of the Commission has apparently confirmed earlier indications that the 1% limitation under Rule 144 regarding sales of over-the-counter securities may be increased when the number of outstanding shares of the issuer has increased subsequent to the filing of a Form 144. The Commission took the view that an amended Form 144 may be filed to permit sales based on the increase in the number of outstanding shares provided that information regarding the increase has been published by the issuer.

(b) Two recent no-action letters indicate conflicting approaches with respect to "tacking" of holding periods in connection with an exchange of securities. In International Systems & Control Corporation (available 10/16/72), the Staff took the view that where securities of an issuer are exchanged for other securities in a transaction which meets the requirements of Section 3(a)(9) of the 1933 Act, the holders of securities acquired in the exchange would be able to tack the period of time during which the original securities were held. That request concerned a proposed exchange of preferred stock. The Commission Staff took the view that persons acquiring the new preferred stock compute their holding period from the date of acquisition of the old preferred stock, pointing to subparagraph (d)(4)(A) of Rule 144, which indicates that securities acquired in connection with a "recapitalization" are deemed to have been acquired at the time of acquisition of the securities surrendered in connection with the recapitalization.

However, a request for a ruling to the same effect with respect to an exchange of subordinated notes and common stock for outstanding senior convertible subordinated debentures of an issuer in a transaction similarly structured to comply with Section 3(a)(9) of the 1933 Act was met with a negative response by the Commission Staff: Computer Response Corp. (available 1/8/73) CCH ¶ 79,228. Even though the letter of request specifically cited the International Systems & Control Corporation no-action letter, the Staff concluded that there could be no tacking of holding periods and that the securities received in exchange for the debentures would be deemed to have been acquired on the date of exchange. The Staff further indicated that Rule 155 would be applied to determining the new holding period since that Rule was in effect at the time the debentures were originally acquired, notwithstanding the fact that the Rule was repealed at the time of the adoption of Rule 144.

(c) In another examination of the "tacking" issue, the Staff of the Commission concluded that the holding period for shares acquired on conversion of a convertible security relate back to the date of acquisition of the underlying security even when the conversion price has been "sweetened" by subsequent action of the issuer in order to induce conversion.

It should be noted, however, that where the security was not originally convertible, a subsequent decision by the issuer to offer conversion probably would not result in tacking, even if otherwise qualified as a Section 3(a)(9) transaction, in view of the Computer Response Corporation ruling referred to above.

4. Use of S-7 Registration Statement and S-16 Registration Statement. In a recent no-action response, the Staff of the Commission has indicated that it will take a very narrow and restrictive reading of the instructions permitting the use of short-form registration statements. For example, a subsidiary of an issuer corporation elected to discontinue paying rent under a long-term lease and to forfeit its security deposit of $900,000, based on an economic determination that it would be to the benefit of the company to abandon the lease and forfeit the security rather than to continue to pay rent. The staff concluded that this constituted a "default" in the payment of rental under a long-term lease within the meaning of Instruction A(d) of the general rules as to the use of Form S-7, and the company would be disqualified for a period of 10 years from such default from using the short form registration statement. Furthermore, where the size of the board of directors has been increased during the past three years with the result that a majority of the existing board of directors have not served as directors for three fiscal years, there was no compliance with Instruction A(c). Finally, where the company has been late in the filing of required reports, notwithstanding good faith effort to cure such tardiness, there is no compliance with Instruction A(b). (Hyatt Corporation, available 1/22/73, CCH ¶ 79,234.)

5. Franchise Agreements as "Securities". Notwithstanding the decision of the Ninth Circuit in SEC v. Glenn W. Turner Enterprises, Inc., reported in our memorandum of February 28, 1973, the U.S. District Court for the Southern District of New York has concluded that some franchise arrangements are not securities within the meaning of the 1933 Act.

In Wieboldt v. Metz, S.D.N.Y. 2/22/73 (CCH ¶ 93,794), the court held that franchise activities which require the franchisee to undertake significant activities in order to earn profits were not "investment contracts" or otherwise securities within the classic definition of the Joiner Leasing Co. case (320 U.S. 344, 1943) and W.J. Howey & Co. case (328

U.S. 293, 1946). Even though, in the instant case, the advertising literature emphasized the limited degree of involvement required from franchisees and referred to them as "investors", the reality of the contractual arrangement was determinative and that arrangement clearly contemplated active and direct efforts by the franchisee. The court criticized the "risk capital" approach which was advocated in other cases and concluded that even where the franchisee is required to make a capital investment, the investment cannot be considered a security so long as the franchisee is required to play a meaningful role in the conduct of his individual enterprise.

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