WILMER, CUTLER & PICKERING

ECOMMERCE NEWS

January 31, 2001

Defensive Strategies in a Volatile Stock Market

Stock market volatility during the past few months has created a challenging environment for management, directors, and their advisors. Here is the continuation of last month's discussion of key legal issues to consider — together with an introduction to WCP's EGroup.

What should we do if we are sued by shareholders?

Publicly traded companies are vulnerable to shareholder suits in a volatile stock market. When a company's stock drops in value, especially following a disclosure of bad news, the company may become the target of class action lawsuits — perhaps a large number of cases alleging the same or similar claims under federal and/or state securities laws. The plaintiffs in these cases often bring:

- Claims that the company's prior statements of its past performance were intentionally false and designed to inflate the value of the company's stock (under, for example, Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5);
- Similar claims against the *individuals* who made or signed any allegedly false statements;
- "Controlling persons" claims against the company's officers and directors, *whether or not* they made or signed any allegedly false statements;
- Insider trading claims against officers, directors, or employees; and
- Claims against the company's *auditors* if the alleged fraud is based on the company's SEC filings.

Shareholder lawsuits can do considerable damage to a company's image in the eyes of its customers, partners, and investors, especially when the company is young or otherwise untested.

A company sued in one of these cases immediately faces a number of strategic decisions: Should we fight the lawsuit, and how aggressively? Should we try to settle the case? If so, how soon and on what terms? These questions can only be answered after an investigation of the facts and an evaluation of the legal merits of the case. But they often turn, at least in part, on other considerations, such as how well the company can tolerate ongoing litigation. The Private Securities Litigation Reform Act of 1995 ("PSLRA") offers several attractive tactical advantages for a company that elects to pursue an early and aggressive defense:

- Every securities fraud class action must allege specific "facts giving rise to a *strong inference*" that the company knew about or ignored the alleged violations. Such facts might be difficult to ascertain at the outset of litigation.
- A district court generally must stay discovery until it rules on a motion to dismiss. A strong motion to dismiss could delay time-consuming, expensive, and potentially damaging discovery for months.
- Putative lead plaintiffs must compete with *each other* in the first months of the litigation to determine who will be in charge of the case. From the defendant company's point of view, this process helps bring order to the litigation — especially where there are multiple lawsuits — and may give the company extra time to formulate its strategy and defenses while plaintiffs litigate against one another.
- The statutory limit on damages may enhance a company's position in settlement talks.

Preventative Measures. What can a company do to guard against shareholder lawsuits in a volatile stock market? The most important point is that a plaintiff's complaint generally

will be built on a company's public statements and actions. Lawyers for shareholders who have experienced significant losses from a stock price drop will pore over the company's public statements and financial reports looking for something they can hold up as misleading. To defang future complaints, therefore, a company should (1) discourage counterfactually optimistic appraisals of its past performance, (2) ensure that appropriate accounting procedures are followed at all times, and (3) avoid actions and statements that, out of context or otherwise, may suggest that the company considers securities regulations are of secondary importance. Other things companies might do is make sure all forward-looking statements are labeled in a way that brings them within "safe harbor" provisions of the PSLRA protecting against liability, and carefully consider their list of risk factors they include in their Form 10-K disclosure (for the same reason).

What do we need to think about regarding Nasdaq listing requirements?

Financial Requirements to Remain Listed. The Nasdaq National Market and SmallCap Market each require companies to meet, among other things, specified financial requirements in order to retain their listing.

Given the current market volatility, the management of Nasdaq companies must regularly assess the company's compliance with these Nasdaq financial standards in order to avoid a potential delisting. For Nasdaq National Market companies, the NASD rules require that companies maintain: (1) net tangible assets of $4 million, a public float of 750,000 shares with a market value of at least $5 million, and a $1 minimum bid price; or if the company does not have sufficient net tangible assets, (2) a market capitalization of $50 million or total assets and total revenues of $50 million, a public float of at least 1.1 million shares with a market value of at least $15 million, and a minimum bid price of $5. For SmallCap Market companies, the NASD Rules require that companies maintain: (1) net tangible assets of $2 million, a $35 million market capitalization, or $500,000 in net income in the latest year or two of the last 3 fiscal years, plus (2) a public float of at least 500,000 shares with a market value of at least $1 million, and a minimum bid price of $1.

Working with Nasdaq. Nasdaq closely monitors compliance with these standards, and has become increasingly aggressive in taking actions against deficient companies. The discovery of a deficiency, however, does not necessarily mean that Nasdaq will automatically delist a company. Many companies are able to work with the Nasdaq staff to avoid delisting by developing plans of compliance, obtaining exceptions to the quantitative standards, and facilitating transfers of listing to the SmallCap Market, the American Stock Exchange, and regional stock exchanges.

Initial Offerings. The volatile market is also affecting the initial Nasdaq listing applications of private companies applying for listing concurrent with an IPO and companies whose securities are listed on a non-Nasdaq market. NASD rules set forth financial criteria for initial listing applications which are more stringent than the continued listing standards enumerated above. If a company falls out of compliance with the initial listing standards before or during the application process, Nasdaq will either place the application on hold or reject it. Companies can, however, work with the Nasdaq staff to keep their applications alive while taking action to meet the initial listing standards.

What can employers in a volatile market do to attract and retain employees?

Changing Landscape. Attracting and retaining talented workers is a key challenge for companies in a volatile market. Many have relied in recent years on substantial equity compensation packages, offering stock options to key personnel and rank and file employees. Private companies now have a harder time selling the dream of a public offering to current and prospective employees, while public companies must find ways to reassure employees whose employer stock portfolios are changing on a daily basis as well as explain to persons who started around the same time why they have radically different option prices.

Repricing Options. Although options remain important, companies must now face difficult issues in providing incentives and reassuring those workers whose options have fallen far in value. Simply repricing the options can result in adverse and long lasting effects on a company's reported profit. While some employers have concluded the morale gains are worth the accounting charges, others are considering new incentives through restricted stock, performance bonuses, or even cash. Finding the right mix of compensation requires an understanding of the complicated legal framework, the psychology of the workplace, and the way the public or some potential acquirer will react to the various alternatives.

Reassuring Employees. Retention programs can provide at least a short-term bridge to keep the workforce in place. For example, a cash or stock bonus keyed to be paid in six to twelve months may provide some reassurance to nervous employees that the company is planning at least that far ahead. To the extent that the package includes cash, companies must consider whether they will have the financial resources to make the payments or must condition the payments on having such resources.

Employee Retention. In an almost perverse way, the one bright spot for companies in the present uncertainty is that the volatility dampens the urge of present employees to depart for the next larger package of stock options from some other employer. Retaining employees is thus much easier when the alternatives also look bumpy than when a volatile employer competes with companies in a market that is generally rising.

What are the responsibilities of members of the board of directors and how do they protect themselves from liability?

Members of the Board of Directors have a fiduciary responsibility to the corporation and by extension to its shareholders. They must act in the interest of the corporation and the shareholders, while subordinating their own interests. This responsibility runs not to any one shareholder in particular but to all shareholders as a group. Directors need to be aware that their fiduciary duty to the corporation will be subject to at least four different legal regimes, depending upon whether the action (i) is in the normal course of business, (ii) involves a sale of the company, (iii) involves a hostile takeover of the corporation or (iv) involves bankruptcy.

- ***Normal Course of Business and the Business Judgment Rule***. In the normal course of the business of a corporation, the actions of the directors will be judged by the well-known "business-judgment rule" — that is, a (i) business decision taken by directors who act (ii) disinterestedly and independently, (iii) with due care, and (iv) in good faith will be protected from judicial review for fairness, and the directors will be protected from liability for their actions, regardless of how these actions are viewed in hindsight.

- ***Duty of Care***. Directors must exercise their duty of care by keeping themselves informed of all aspects of the transaction, and reading all transaction materials carefully. Also, in fulfilling their fiduciary duties, directors can rely in good faith on the advice of professionals such as investment bankers and attorneys, and will be fully protected under the business judgment rule where they reasonably rely on the advice of such advisors, as long as they do not substitute their advisors' judgment for their own.

- ***Duty of Loyalty***. Directors must exercise their duty of loyalty by making sure to disclose conflicts of interest to other board members and shareholders and to abstain from voting on matters where they are conflicted, or protect themselves by delegating the decision to an independent and disinterested committee of the board.

- If a decision fails the business judgment rule, the action in question will be judged by the "entire fairness" standard — was the action with respect to company fair in all respects, including the standards of "fair dealing" and "fair price." It is up to the party challenging the transaction to overcome the presumption in favor of the directors of the business judgment rule. Once that presumption is overcome, it is up to the directors to defend their actions.

Sale of the Company. In the context of the sale of the company, the so-called "Revlon Doctrine," named after the *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* case, dictates that once the directors decide to sell the company, their fiduciary duty is no longer to do what is best for the company, but rather is to maximize value for the shareholders as part of such sale. The Revlon Doctrine applies when there is a change of corporate control (e.g., a sale to a controlling or strategic shareholder), or a break-up of the corporate entity. Directors and management need to consider whether any binding agreement or term sheet with a "deal protection mechanism," such as a "no shop" provision or "break-up fees" would violate this fiduciary duty. Additionally, the board should always seriously consider obtaining a "fairness opinion" from a reputable investment bank.

Hostile Takeover of the Company. In the context of a hostile takeover, the directors are held to a higher standard. Under the so-called "Unocal Doctrine," named after the *Unocal Corp. v. Mesa Petroleum Co.* case, the directors must justify any defensive action taken to counter a takeover as being in the best interests of the company and the shareholders. Directors must show that they had reasonable grounds for believing that a danger to the corporation existed, and then that the measures taken were proportionate to the danger posed. Once these factors are shown, directors will again enjoy the protection of the business judgment rule.

Bankruptcy or Insolvency. If the company becomes insolvent (i.e., unable to pay its debts in full) the directors' fiduciary duty runs to the creditors because the decisions of the board will have a direct effect on the extent of their recovery. In this situation, the creditors effectively become the "owners" of the insolvent company, and the board must give priority to the creditors' interests, even if they conflict with the interests of shareholders. The fiduciary duty becomes one of maximizing the value of the company and its assets (and thus its ability to pay back creditors). In situations where the company is using up its cash reserves with no realistic prospect of becoming profitable within the foreseeable future, maximizing the company's value may mean shutting it down and distributing the remaining cash to creditors even though the shareholders would recover nothing. Furthermore, it is not necessary for the company to actually be in bankruptcy for this duty to creditors to arise. Accordingly, directors must exercise great care when a company is operating in the vicinity of insolvency.

Meet the EGroup

WCP has a comprehensive cross-disciplinary ecommerce practice led by partner David R. Johnson, former Director of the Aspen Institute Internet Policy Project, former

Chairman of Counsel Connect, and founder and co-director of the Cyberspace Law Institute.

David Johnson has been involved in online issues since long before there was a World Wide Web — he helped to write the Electronic Communications Privacy Act, was involved in discussions leading to the Framework for Global Electronic Commerce, and was involved with very early online projects. (including The Source, ANS, and Prodigy). His work on the legal issues posed by cyberspace has been profiled in the *Wall Street Journal* and *New York Times*.

Basic construction of the practice: The EGroup meets every Monday morning for breakfast to discuss developments and listen to client visitors. By drawing on lawyers across the firm's practice, we are able to very quickly put together cross-disciplinary teams to assist ecommerce clients.

Historical development of the practice: Lawyers across the firm have been working on technology issues for many years. (Indeed, WCP was one of the first firms in the country to have a PC on every lawyer's desk.) The EGroup was formalized in August 1998 with David Johnson's return to the firm from Counsel Connect (an online service for lawyers). ECommerce News has been published monthly by the EGroup since December 1998.

Meet the Members of the EGroup:

Maya Alexandri (litigation) - Washington, D.C.
Brandon Becker (securities) - Washington, D.C.
Christopher Bowers (tax) - Washington, D.C.
Joshua Brady (tax) - Washington, D.C.
Jerome Broche (antitrust) - Brussels
Russ Bruemmer (corporate) - Washington, D.C.
Becky Burr (corporate) - Washington, D.C.
Megan Carlyle (corporate) - Washington, D.C.
Patrick Carome (litigation) - Washington, D.C.
Kevin Carroll (corporate) - Baltimore
Mike Carroll (IP) - Washington, D.C.
Gerry Cater (corporate) - London
Matt Chambers (securities) - Washington, D.C.
Lynn Charytan (communications) - Washington, D.C.
Louis Cohen (litigation) - Washington, D.C.
Susan Crawford (ecommerce) - Washington, D.C.
Meredith Cross (corporate) - Washington, D.C.
Mark Dewire (corporate) - Baltimore
Steve Doyle (corporate) - Washington, D.C.
Jennifer Drogula (corporate) - Washington, D.C.
Steve Dunne (litigation) - Washington, D.C.
Christian Duvernoy (communications) - Brussels
Greg Ewald (corporate) - Washington, D.C.
Brett Frischmann (communications) - Washington, D.C.
Daniel Gallagher (securities) - Washington, D.C.
Ron Greene (financial institutions) - Washington, D.C.
Marc Hansen (communications) - Brussels
Russ Hanser (communications) - Washington, D.C.
Franca Harris Gutierrez (financial institutions) - Washington, D.C.
Andrew Herman (corporate) - Washington, D.C.
Thomas Hicks (corporate) - Washington, D.C.
Matthew Huggins (corporate) - Washington, D.C.
Samir Jain (communications) - Washington, D.C.
Joerg Karenfort (antitrust/corporate) - Berlin
Glynn Key (corporate) - Washington, D.C.
Scott Kilgore (coporate) - Washington, D.C.
Satish Kini (financial institutions) - Washington, D.C.
Chuck Levy (trade) - Washington, D.C.
Scott Llewellyn (litigation) - Washington, D.C.
Natalie Luebben (communications) - Berlin
David Luigs (financial institutions) - Washington, D.C.
Eric Markus (corporate) - Washington, D.C.
Patrick Marotta (communications) - Washington, D.C.
Jeff McFadden (securities) - Washington, D.C.
Jeremy McKown (corporate) - Washington, D.C.
Christopher McWhinney (corporate) - Washington, D.C.
Brian Menkes (tax) - Washington, D.C.
P.J. Mode (litigation) - Washington, D.C.
Thomas Olson (litigation) - Washington, D.C.
John Payton (litigation) - Washington, D.C.
Matthew Phillips (corporate) - Washington, D.C.
Daniel Phythyon (communications) - Washington, D.C.
John Pierce (litigation) - New York
Matthew Previn (litigation) - New York
Joseph Profaizer (litigation) - Washington, D.C.
Tonya Robinson (litigation) - Washington, D.C.
Colin Rushing (litigation) - Washington, D.C.
John Ryan (corporate) - Washington, D.C.
Robert-Paul Sagner (communications) - Washington, D.C.
Paul Tiao (litigation) - Washington, D.C.
Paul von Hehn (corporate) - Brussels
Philipp von Hoyenberg (communications) - Berlin
Jay Watkins (corporate) - Baltimore
Thomas White (corporate) - Washington, D.C.
Jim Wrathall (litigation) - Washington, D.C.
Soo Yim (securities) - Washington, D.C.