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“NARROW-BASED SECURITY INDEX”: SEC AND CFTC JOINTLY ADOPT FINAL RULES UNDER THE COMMODITY FUTURES MODERNIZATION ACT OF 2000

The Commodity Futures Modernization Act of 2000 (“CFMA”), enacted on December 21, 2000, established a framework for the joint regulation by the Commodity Futures Trading Commission (the “CFTC”) and Securities and Exchange Commission (the “SEC”) (collectively, the “Commissions”) of the trading of futures on single securities and on narrow-based security indexes. To distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, and futures on broad-based security indexes, which are under the exclusive jurisdiction of the CFTC, the CFMA also amended the Commodity Exchange Act (the “CEA”) and the Securities Exchange Act of 1934 (the “Exchange Act”) by adding an objective definition of “narrow-based security index.” An SEC release dated August 20, 2001 (the “Release”), sets forth joint final rules (the “Rules”) adopted by the Commissions to implement this definition.

Background

Under the CEA and Exchange Act (as both were amended by the CFMA), a security index is a “narrow-based security index” if, subject to the exclusions discussed below, it meets any of the following four criteria:

1. It has nine or fewer component securities (“Criterion One”);

2. Any one of its component securities comprises more than 30% of its weighting (“Criterion Two”);
3. The five highest weighted component securities together comprise more than 60% of its weighting (“Criterion Three”); or
4. The lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting (“lowest weighted 25%”) have an aggregate dollar value of average daily trading volume (“ADTV Dollar Value”) of less than \$50 million (or in the case of an index with 15 or more component securities, \$30 million) (“Criterion Four”).

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A security index that does not meet any of the four criteria set forth above is, by default, a broad-based security index. Therefore, any future on such an index is not a security future under the securities laws and is subject only to the jurisdiction of the CFTC.

Even if an index meets any of the four criteria, the CEA and Exchange Act provide the following six exclusions from the definition of narrow-based security index:

1. Exclusion One, the most important exclusion, applies to any index that does not meet either Criterion One or Criterion Two, but otherwise would be a narrow-based security index by virtue of meeting either Criterion Three or Criterion Four and, with respect to such index:
 - Each of its component securities is registered under Section 12 of the Exchange Act, and
 - Each component security is one of the 750 securities with the largest market capitalization (“Market Cap Top 750”) and one of the 675 securities with the largest dollar value of ADTV (“ADTV Top 675”).
2. Exclusion Two applies to an index if, prior to enactment of the CFMA, a board of trade was designated by the CFTC as a contract market in a future on the index.
3. Under Exclusion Three, “if a future was trading on an index that was not a narrow-based security index for at least 30 days, the index is excluded from the definition of a narrow-based security index” as long as it does not “assume the characteristics” of a narrow-based security index for more than 45 business days over three consecutive calendar months. If the index assumes the characteristics of a narrow-based security index for more than 45 business days over three consecutive calendar months, the index will continue

to be treated as a broad-based security index for a three calendar month transition period.

4. Exclusion Four applies to a security index that is traded on, or subject to the rules of, a foreign board of trade and meets such requirements as are jointly established by rule or regulation by the CFTC and SEC.
5. Exclusion Five permits the offer and sale in the United States, until June 21, 2002, of security index futures “traded on or subject to the rules of foreign boards of trade that were authorized by the CFTC before the CFMA was enacted.”
6. Under Exclusion Six, an index is not a narrow-based security index if a future on the index “is traded on or subject to the rules of a board of trade,” and meets such requirements as may be established jointly by the Commissions. Exclusion Six grants to the Commissions the authority to jointly establish further exclusions.

Guidance Provided by the Final Rules

Determining the Market Capitalization of a Security

If an index contains only securities that are among the Market Cap Top 750, and if certain other conditions set forth in Exclusion One are satisfied, the index will be treated as a broad-based security index even if otherwise it would constitute a narrow-based security index.

The Rules authorize the Commissions to designate a list of the Market Cap Top 750, which are to be identified from the universe of all reported securities, as defined in Rule 11Ac1-1 of the Exchange Act, that are common stock or depositary shares.

The Rules provide that in the absence of such a list, the market capitalization for any particular day of a security that is not a depositary share is calculated by taking the sum of the market capitalizations of such security for each U.S. trading day of the preceding six full calendar months¹, and dividing this sum by the total number of such trading days. For each of the trading days in such six calendar month period, the

1. As defined in the Rules, the term “preceding six full calendar months” means, with respect to a particular day, the period of time beginning on the same day of the month six months before and ending on the day prior to such day.

“market capitalization” of a security equals the product of (1) the closing price (as defined in the Rules) of the security on such day multiplied by (2) the number of outstanding shares (as defined in the Rules) of the security on such day. In the case of a depositary share, the closing price is adjusted (divided by) the number of deposited securities represented by the depositary share, and the number of outstanding shares is equal to the number of deposited securities represented by the depositary share.

Determining the Dollar Value of the Average Daily Trading Volume of a Security

For purposes of the “lowest weighted 25%” test to determine whether an index is a narrow-based security index under Criterion Four, the ADTV Dollar Value of a security includes all reported transactions in the United States and in foreign jurisdictions. The ADTV Dollar value is calculated as of the preceding six full calendar months, as follows:

- For trading in the United States, the ADTV Dollar Value is calculated by adding the values of all reported transactions in such security for each U.S. trading day during the preceding six full calendar months, and dividing the resulting sum by the total number of such trading days.
- For trading in a security outside the United States, the ADTV Dollar Value is calculated by adding the values of all reported transactions in such security for each trading day in the relevant foreign jurisdiction during the preceding six full calendar months, dividing the resulting sum by the total number of such trading days, and converting the resulting value into U.S. dollars on the basis of a spot rate of exchange for each day obtained from at least one independent entity that provides or disseminates foreign exchange quotations in the ordinary course of its business.
- For the purposes of the “lowest weighted 25%” test, the Release states that if there is no group of lowest weighted securities equaling exactly 25% of the total weight of the index, then the ADTV Dollar Value of the security that would cause the aggregate

weight of the lowest weighted securities to rise from below 25% to above 25% shall not be included in the calculation of the aggregate ADTV Dollar Value of the lowest weighted securities.

For purposes of the First Exclusion, the Commissions are to designate the ADTV Top 675 securities, which are to be identified from the universe of all reported securities, as defined in Rule 11Ac1-1 of the Exchange Act, that are common stock or depositary shares. An index that would otherwise be a narrow-based security index may, subject to the satisfaction of additional requirements under Exclusion One, be considered a broad-based security index if each of its component securities is in the ADTV Top 675.

If the Commissions fail to designate the ADTV Top 675 securities, the ADTV Dollar Value of a security is calculated in the same way as it is for the purpose of performing the “lowest weighted 25%” test described above, except that only reported United States transactions are to be included to determine whether a security is in the ADTV Top 675.

Depositary Shares/Section 12 Registration

With respect to depositary shares, the Rules provide that the requirement of Exclusion One that each component security be registered under Section 12 of the Exchange Act will be satisfied if the deposited securities underlying the depositary shares are registered under Section 12 and the depositary shares are registered under the Securities Act of 1933 on Form F-6.

Broad-to-Narrow/Futures Contracts Trading for Fewer than 30 Days

Exclusion Three provides “if a future was trading on an index that was not a narrow-based security index for at least 30 days, the index is excluded from the definition of a narrow-based security index” as long as it “does not assume the characteristics” of a narrow-based security index for more than 45 business days over three consecutive calendar months. The Rules extend this exclusion under certain circumstances to index futures that have been trading for fewer than 30 days.

An index future that is trading on a designated contract market, registered derivatives transaction execution facility or foreign board of trade is not a

narrow-based security index for the first 30 days of trading, if there exists any date during the 30-day period immediately preceding the commencement of trading of such contract with respect to which, on each trading day of the six full calendar months preceding such date, such index either:

1. Would not have been a narrow-based security index;
2. Did not meet Criterion One, Criterion Two, Criterion Three or Criterion Four; or
3. Met the requirements of Exclusion One.

As under Exclusion Three, if pursuant to this Rule an index is not a narrow-based security index for the first 30 days of trading, the index will become a narrow-based security index if subsequent to the first 30 days of trading it is a narrow-based security index for more than 45 business days over three consecutive calendar months. Also under Exclusion Three, if the index becomes a narrow-based security index solely because it assumes the characteristics of a narrow-based security index for more than 45 business days over three consecutive calendar months, the index will continue to be treated as a broad-based security index for a three calendar month transition period.

The Release also addresses the daily calculations of ADTV Dollar Values under alternatives (2) or (3), above, and of market capitalizations under alternative (3), above, for each day of the preceding six full calendar month period. The Release makes clear that, for the purpose of performing calculations under alternatives (2) and (3), only daily data should be used to make such daily calculations (as opposed to the requirement in alternative (1), above, to calculate a six month average for each day of the preceding six full calendar month period).

When a Narrow-Based Security Index Becomes Broad-Based

As discussed above, the CFMA provided a 45-day tolerance rule and a three-month transition period applicable to a future on a broad-based security index that becomes a narrow-based security index. However, the CFMA did not provide a similar provision for a future on a narrow-based security index that becomes a broad-based security index.

Under a Rule adopted only by the CFTC, if a narrow-based security index that is trading on a

national securities exchange becomes broad-based for no more than 45 business days over three consecutive calendar months, that index continues to qualify as a narrow-based security index. If the index assumes the characteristics of a broad-based security index for more than 45 business days over three consecutive calendar months, the index continues to be treated as a narrow-based security index for the following three calendar months. After this transition period, a national securities exchange may continue to trade the product only for those months that had open interest on the last day of the transition period.

Futures Contracts on Security Indexes Trading on or Subject to the Rules of a Foreign Board of Trade

The Rules provide that an index future that is “traded on, or subject to the rules of, a foreign board of trade” is not a narrow-based security index “if it would not be a narrow-based security index if a future on the same index were traded on a designated contract market or registered derivatives transaction execution facility.” The Release notes “the need to address those foreign-based security index futures that are currently trading as broad-based index futures under the exclusive jurisdiction of the CFTC” and that would be considered narrow-based index futures under the Rules. According to the Release:

The Commissions will weigh the competitive implications of treating a future on an index as a broad-based index future when traded on or subject to the rules of a foreign board of trade, but treating a future on the same index as a security future when it trades on a U.S. market.

In addition, as noted in the Release, the Exchange Act grants the Commissions joint authority to exclude any security index from the definition of narrow-based security index, and the Commissions recognize the need to consider using this authority in these cases.

Further, notwithstanding the Rules, under Exclusion Five to the CEA and the Exchange Act (as discussed above), security index futures that were traded on or subject to the rules of a foreign board of trade pursuant to a CFTC authorization issued prior to the enactment of the CFMA may continue to be offered and sold in the United States until June 21,

2002. This statutory “grandfather” provision will give both the regulators and any affected foreign boards of trade a period of time in which to attempt to work out acceptable arrangements regarding pre-CFMA security index futures that might be viewed as narrow-based indexes under the Rules.

Conclusion

The adoption of the Rules marks an important step in the process of establishing a regulatory structure for the trading of security futures in the United States. A number of additional regulatory steps, however, need to be taken by the CFTC and

the SEC before that structure will be complete. These include, for example, the adoption of rules governing the treatment of customer margin for security futures and the application of customer protection, recordkeeping and reporting requirements to accounts holding security futures. Moreover, in recent submissions to Congress, representatives of both the Securities Industry Association and the Futures Industry Association have expressed the view that any possible launch of securities futures trading prior to March 2002 is unrealistic in light of the business disruptions that the events of September 11, 2001 have imposed on the securities and futures industries. ■



COURT IN *CAIOLA* HOLDS “SYNTHETIC SECURITIES CONTRACTS” NOT “SECURITIES” FOR PURPOSES OF EXCHANGE ACT SECTION 10(b) AND EMPHASIZES IMPORTANCE OF “NO RELIANCE” REPRESENTATIONS

By Sherri Venokur¹

Overview

In *Caiola v. Citibank*, a case decided in April 2001 in the United States District Court for the Southern District of New York, plaintiff Louis Caiola (“Mr. Caiola”) claimed defendant Citibank, N.A. (“Citibank”), breached oral representations that had induced him to enter into “synthetic securities contracts” with Citibank. The synthetic securities contracts provided Mr. Caiola with the economic equivalent of a position in Philip Morris common stock without him actually buying that security.

Mr. Caiola claimed that, contrary to those alleged oral representations and without his knowledge or authorization, Citibank made investments mirroring his synthetic trading activities that had the effect of depressing the value of Philip Morris’ common stock. He sought damages of \$40 million, arguing that Citibank had violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the “Exchange Act”) through its misrepresentations and omissions and unauthorized and unsuitable

trades. Mr. Caiola also claimed Citibank’s conduct constituted fraud, breach of fiduciary duty, and breach of contract under state law.

As discussed more fully below, the court held the synthetic securities contracts between Mr. Caiola and Citibank were not “securities” for purposes of Section 10(b) of the Exchange Act because they were not: (1) investments, (2) loans, or (3) securities options. The court also ruled that the representations made by Citibank were either not material or were overridden by the “no reliance” representations included in the written confirmation of each transaction (“Confirmation”) provided by Citibank to Mr. Caiola. For this reason, the court also dismissed Mr. Caiola’s state law claims.

The court noted that the Commodity Futures Modernization Act of 2000 (the “CFMA”) amended Section 10(b) to include within its coverage “security-based swap agreements,” and determined that the types of transactions entered into between Mr. Caiola and Citibank would constitute “security-based swap

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agreements” under the new law. Thus, according to the *Caiola* court, “amended Section 10(b) would indisputably cover the transactions at issue in this case” had they been entered into after the law was amended. Nevertheless, the court dismissed Mr. Caiola’s federal claims because his transactions with Citibank were entered into prior to the CFMA’s enactment – when there did not yet exist any authority to pursue a Section 10(b) fraud claim in connection with “security-based swap agreements.”

Assuming the decision is upheld on appeal, it is important for two reasons. First, it supports the position that transactions such as the “synthetic securities contracts” were not, prior to enactment of the CFMA, securities for purposes of the U.S. securities laws. It also supports an expansive interpretation of the “no reliance” representations customarily included in swap documentation subsequent to the action by Procter & Gamble Co. against Bankers Trust claiming, among other things, fraud and breach of fiduciary obligations in connection with swap transactions between the two companies.

The Synthetic Trading Strategy

In 1994, Citibank proposed to Mr. Caiola the strategy of trading synthetic securities contracts. Under this strategy, the two parties would enter into contracts structured to provide Mr. Caiola with the economic benefits and risks of owning a position in a given security without actually purchasing that security. Citibank allegedly represented orally to Mr. Caiola that synthetic trading would permit him to accumulate large positions in securities without taking the attendant risks of having to meet margin requirements, of affecting the stock’s market price (by making a large trade), of being unable to find a seller or buyer when needed in order to establish or unwind a large position, or of having to finance the purchase of actual stock.

The court used the following example to illustrate the synthetic securities trading relationship between Mr. Caiola and Citibank:

If Philip Morris stock were trading on the New York Stock Exchange for \$50 per share, then rather than purchase 100 shares of Philip Morris, Caiola might enter into a contract with Citibank to approximate such a position. Rather than Caiola paying Citibank the \$5000 purchase price of the stock, Citibank

would treat it as a \$5000 loan to Caiola, for which Caiola would pay interest. Under this contract (commonly known as an “equity swap” or a “total return swap”), Citibank would pay Caiola the amount of any gains on his synthetic position, and Caiola would pay Citibank the amount of any losses. Also, Citibank would pay to Caiola the amount of any dividends that he would have received if he had actually owned the 100 shares.

Mr. Caiola’s “No Reliance” Representations in the Confirmations

In March 1994, prior to their first synthetic transaction (“Transaction”), Citibank and Mr. Caiola entered into a standard form International Swaps and Derivatives Association Master Agreement (“ISDA Agreement”), including a negotiated Schedule. As is customary, Citibank provided Mr. Caiola with a written Confirmation of each Transaction. In addition to setting forth the economic terms of the deal, each Confirmation included representations and acknowledgements by each party that:

1. It was not relying on any written or oral “advice, statements or recommendations” of the other party regarding the transaction, other than express, written representations made by the other party in the ISDA Agreement and or the Confirmation “in respect of such Transaction;”
2. It was entering into the Transaction as principal and not as an agent for any other party; and
3. The other party was not “acting as a fiduciary or advisor to it in connection with [the] Transaction.”

In addition, the Confirmations included representations by Mr. Caiola to Citibank that he understood that (1) Citibank had “no obligation or intention to register [the] Transaction under the Securities Act of 1933 or other applicable federal securities law;” (2) the Transactions were “subject to complex risks” that could “arise without warning;” and (3) “losses may occur quickly and in unanticipated magnitude,” and that he was willing to accept such

terms and conditions “and assume (financially and otherwise) such risks.”

Citibank’s Alleged Oral Representations

According to Mr. Caiola, notwithstanding its representations in the Confirmation, Citibank orally represented to him that (1) Citibank’s “fiduciary umbrella” would constitute the “cornerstone” of its trading relationship with Mr. Caiola; (2) Citibank would hedge its own market risk to achieve “delta neutrality,” *i.e.*, Citibank would enter into off-setting trades to hedge its potential obligations to Mr. Caiola under the Transactions; (3) Citibank could achieve delta neutrality by purchasing “only a fraction of the securities” underlying the Transactions; and (4) Citibank would continually monitor the performance of the Transactions “in order to maintain delta neutrality.”

Based on these assurances, Mr. Caiola designed and entered into synthetic securities contracts in Phillip Morris stock and options totaling nearly \$350 million in notional value. In the fall of 1998, Caiola’s \$40 million synthetic investment in Philip Morris was hedged so that his potential losses were limited to approximately \$2 million.

Following the October 1998 merger of Citibank’s parent company with Travelers Group, Inc. (“Travelers”), responsibility for handling Mr. Caiola’s synthetic trades shifted to Salomon Smith Barney (“Salomon”), a subsidiary of Travelers. Nonetheless, according to Mr. Caiola, Citibank assured him it would “oversee his synthetic trading relationship on exactly the same basis as it had prior to the merger.” Mr. Caiola claimed he was relying on these assurances when, during the period from November 30, 1998 to March 1999, he entered into additional Transactions involving large unhedged positions in Philip Morris stock that exposed him to substantial risk. Then, contrary to those alleged assurances, Citibank abandoned its “delta hedging” strategy and, instead, mirrored Mr. Caiola’s synthetic investments by purchasing Philip Morris securities in the securities markets. Mr. Caiola claimed Citibank’s unauthorized and undisclosed purchases and sales of Philip Morris securities “had the effect of depressing the price of Philip Morris stock,” thereby causing him to suffer “tens of millions of dollars” in losses.

The Caiola Decision

The Synthetic Securities Contracts were not “Securities” Under the Exchange Act

According to the opinion in *Caiola*, no court previously had addressed whether “synthetic securities contracts” such as the Transactions were securities for purposes of the Exchange Act (although in *Procter & Gamble Co. v. Bankers Trust Co.*, the District Court had held certain interest rate swap contracts were not securities). Section 3(a)(10) of the Exchange Act defines a “security” as:

. . . any note, stock, treasury stock, bond, debenture, . . . investment contract . . . put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) . . . or, in general, any instrument commonly known as a security.

While the *Caiola* opinion includes a detailed discussion of the definition of “security” in Section 3(a)(10), its analysis of why the Transactions did not constitute “investment contracts” has the most relevance for institutional market participants and their counterparties, and is discussed below.

The Synthetic Securities Transactions were not “Investment Contracts”

Even though the value of the Transactions derived from the performance of the Philip Morris equity securities, the court ruled the Transactions were not “investment contracts.” The court began its analysis with the seminal case on this issue, *SEC v. W.J. Howey Co.* (S.Ct. 1946), which states that in order for a transaction to be an investment contract, it must contain three elements:

- (i) an investment of money (ii) in a common enterprise (iii) with profits to be derived solely from the efforts of others.

A “common enterprise,” the court explained, may be proven by showing that the fortunes of each individual investor are tied to the fortunes of the other investors through “the pooling of assets, usually combined with the pro-rata distribution of profits.” This describes the so-called horizontal

commonality test. The court noted Mr. Caiola did not argue that the other test of a common enterprise — vertical commonality — was present.

Mr. Caiola argued the Transactions were investment contracts because his synthetic trading relationship with Citibank involved a common enterprise between Mr. Caiola and the buyers and sellers of Philip Morris securities who took the other side of Citibank's hedging trades. Mr. Caiola, however, did not pool his money and share profits with these buyers and sellers of Philip Morris stock, and he did not participate with them in a "single business venture."

Since the *Caiola* court found that the Transactions did not meet the "common enterprise" prong of the "investment contract" test, it was not necessary to analyze whether Mr. Caiola's profits, if any, would derive "solely from the efforts of others." The facts of the case, however, suggest that the Transactions would have failed this prong of the test as well. Although on one level, Mr. Caiola was a synthetic investor in Philip Morris securities by virtue of the Transactions, his profits and losses resulted from his own expertise in determining the amounts and timing of his trades, including the extent to which he would leave them unhedged.

The Synthetic Securities Transactions were not "Options on Securities"

The opinion also addresses the question whether the Transactions were options on securities. Citing *Procter & Gamble*, the court held that the Transactions were not options on securities because "they did not give either counterparty the right to exercise an option or to take possession of any security."

Therefore, the court rejected Mr. Caiola's reliance on *In the Matter of BT Securities Corporation*, Nos. 33-7124, 34-35136 (Dec. 22, 1994), in which the SEC concluded that under the federal securities laws, treasury-linked swaps and knock-out call options were securities. The SEC had characterized the transactions at issue in that case as "cash-settled put and call options," respectively, and options clearly fell within the Section 3(a)(10) definition of a "security."

Applicability of Section 301 of the Commodity Futures Modernization Act

The court also relied on Section 301 of the then-recently enacted CFMA to support its holding that the Transactions were not securities. Section 301

provides that transactions of the type entered into between Mr. Caiola and Citibank are "security-based swap agreements." According to the CFMA's legislative history, Section 10(b) of the Exchange Act was amended to apply to "security-based swap agreements" because such transactions had been expressly excluded by the CFMA from the amended definition of "securities" under the Exchange Act.

Based on that legislative history, the court concluded that Section 10(b) of the Exchange Act, as amended, would have covered the Transactions had they been entered into after December 21, 2000 (the effective date of the CFMA), because they were "security-based swap agreements." Nevertheless, Mr. Caiola's federal claims had to be dismissed because his Transactions with Citibank were entered into prior to the CFMA's enactment — when there did not yet exist any authority to pursue a Section 10(b) fraud claim in connection with "security-based swap agreements."

The Caiola Court Interpreted the Representations in the Confirmations Broadly

The "No Reliance" Representations

As noted above, Citibank provided Mr. Caiola with a written Confirmation of each Transaction entered into between them. In addition to setting forth the relevant deal terms, each Confirmation included standard bilateral "no reliance" representations. Among other things, Mr. Caiola represented to Citibank that he was not relying on "any advice, statements or recommendations (whether written or oral)" of Citibank regarding the transaction, other than express, written representations made by Citibank in the ISDA Agreement and in the Confirmation "in respect of such Transaction."

The court held that Mr. Caiola could not meet the "reasonable reliance" component of a fraud claim because the oral misrepresentations allegedly made by Citibank directly conflicted with "the unambiguous language of the Confirmation." Therefore, the language in the Confirmation controlled and the misrepresentations alleged in the complaint could be disregarded.

Caiola Decision Expands Protection Offered by General "No Reliance" Representations

It is well established that an investor who makes

representations such as those made by Mr. Caiola assumes the risks inherent in the relevant transaction. For example, if Mr. Caiola had chosen not to hedge the speculative trades he entered into between November 1998 and March 1999, and had lost money due to changes in market direction and volatility unrelated to Citibank's hedging strategy, the general "no reliance" representations in the Confirmation would have precluded him from complaining to Citibank that he did not understand the risks of the trade or that the trade was not consistent with his investment goals. The more difficult question, and the one at issue in *Caiola*, is whether Mr. Caiola also assumed the risk that Citibank would mislead him intentionally and act in a way completely inconsistent with its oral assurances to him.

Because *Caiola v. Citibank* was decided on a motion to dismiss the complaint, all factual allegations made by Mr. Caiola were treated as true. Looking at the facts from this perspective, in November 1998, Mr. Caiola sought and was given assurances by Citibank that he could continue his investment strategy because Citibank would oversee his synthetic trading relationship "on exactly the same basis" as it had prior to the merger with Travelers Group, Inc. Mr. Caiola relied on these assurances and entered into new speculative positions that "exposed his portfolio to substantial risk."

Then, contrary to its oral assurances, Citibank changed its hedging strategy from "delta hedging" its positions with Mr. Caiola – a strategy Citibank claimed would have a smaller effect on the price of the Philip Morris securities or, by extension, the profitability of Mr. Caiola's trades – to mirroring Mr. Caiola's synthetic positions through actual purchases and sales of Philip Morris securities. This change in strategy had the effect of depressing the price of Philip Morris stock. Citibank exacerbated the situation by terminating its synthetic trading relationship with Mr. Caiola, making it substantially more difficult for him to enter into offsetting trades that could have reduced his risk and mitigated his losses.

By concluding that Citibank's alleged oral misrepresentations were parol evidence that was directly contradicted by unambiguous language in the Confirmation, the court was able to disregard Mr. Caiola's allegations as inadmissible, based on longstanding precedent that "parol evidence is

inadmissible as a matter of law to contradict the terms of an unambiguous agreement." As to its conclusion that the "no reliance" language unambiguously contradicted the alleged oral misrepresentations, the court may have been influenced by a general concern that parol evidence is unreliable, or a particular concern based on the facts of this case. The court may have deemed material that Mr. Caiola:

- Was a sophisticated investor who determined the tenor, frequency and size of his Transactions with Citibank and understood how to manage his risk by hedging;
- Understood that large outright purchases of stock may affect the price at which the securities trade; and
- Had prompted Citibank's alleged oral assurances by expressing his concern to Citibank that its hedging activities might affect his synthetic positions.

Although Citibank's oral assurances presumably would have held great importance for Mr. Caiola, there is no indication in the court's opinion that he ever asked Citibank to memorialize them in writing, or that he ever questioned Citibank about the effect on Citibank's alleged oral assurances of the "no reliance" representations that were present in each Confirmation for each Transaction. The court may have deemed the absence of such requests and questions to have significant probative value.

Conclusion

Caiola v. Citibank is currently on appeal to the Second Circuit. If affirmed, there will no longer be any question, at least in the Second Circuit, that prior to enactment of the CFMA, transactions such as the "synthetic securities contracts" were not securities. Affirmance by the Second Circuit also could have the effect of confirming the expanded scope of "no reliance" representations in derivatives transactions. Such a result would highlight the importance to institutional market participants of broad "no-reliance" representations in derivatives documentation and would put their counterparties on notice that significant representations or assurances must be in writing. ■



DELAWARE SUPREME COURT ALLOWS TARGET SHAREHOLDERS IN A MERGER TO PROCEED WITH NON-SECURITIES LAW CONTRACT CLAIMS AGAINST ACQUIRER

By Dean Kloner¹

Background

When the mergers of Paramount Communications, Inc. (“Paramount”) and Blockbuster Entertainment, Inc. (“Blockbuster”) were consummated in 1994, the Paramount shareholders received securities known as Contingent Value Rights (“CVRs”) and the Blockbuster shareholders received, as part of their compensation for approving the merger and delivering their shares to Viacom, securities known as Variable Common Rights (“VCRs”). For the sake of brevity, this article discusses only the CVRs, though as noted by the Delaware Supreme Court in *Rossdeutscher v. Viacom, Inc.*², the principles in its decision apply to the VCR holders as well.

The CVR derivative securities were intended to provide, for a period of time after the mergers, protection against a decline in the value of the Viacom Class B common stock (the “Class B Common”) received by the former Paramount shareholders. In essence, the CVRs constituted a “put spread” on the Class B Common held by the former Paramount shareholders. Subject to adjustment under certain circumstances, Viacom was obligated to make a payment (the “Payment”) to holders of the CVRs equal to the amount by which \$48 exceeded the greater of (a) the median average closing price of the Class B Common during a valuation period (the “Valuation Period”) immediately preceding the maturity date of the CVRs, and (b) the \$36 “Minimum Price.” Viacom was permitted to make the Payment in cash, or in the equivalent value of other registered securities of Viacom, including Class B Common.

In effect, the Minimum Price capped the maximum exposure of Viacom at \$12 per CVR, so former Paramount shareholders still were exposed to risk if the average median closing price of Class B Common during the Valuation Period declined below \$36. The higher the median average closing price of Class B Common during the Valuation

Period, the smaller the Payment to which holders of CVRs were entitled on redemption. If the average median closing price exceeded \$48, the Payment would be zero – regardless of how low the price of Class B Common fell following the Valuation Period.

Because the price of Class B Common spiked during the Valuation Period (to as high as \$54), the Payment was only a fraction of Viacom’s potential exposure under the CVRs. Unfortunately for the CVR holders, the price began to drop almost immediately after the redemption and settlement of the CVRs (and the expiration of the protection afforded the former Paramount shareholders).

The plaintiff in *Rossdeutscher* alleged the price spike occurred because Viacom deliberately released false and misleading earnings reports and growth projections, leading to undeserved favorable coverage by analysts. According to the complaint, Viacom improperly deferred certain amortization charges and the purchase of inventory to “sweeten” its earnings picture, while at the same time touting significant growth expectations to the analyst community, only to announce significant write-downs, increased inventory expenses and lowered earnings expectations shortly after the redemption and settlement of the CVRs. The complaint asserted two counts of liability against Viacom for breach of contract under New York law (which governed the CVRs): Count I, for breach by Viacom of the implied covenant of good faith and fair dealing, and Count II, for restitution for unjust enrichment. There was no reference to securities law claims.

Viacom moved to dismiss on the grounds that plaintiff sought to prosecute “time-barred securities law claims.” The trial court agreed, dismissing the action as time-barred, holding that the shorter statute of limitations under the Securities Exchange Act of 1934 (the “Exchange Act”), applied because plaintiff “was entitled to timely file suit for securities fraud under section 10 and Rule 10b-5” and could not “breath life into a dead securities

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² *Rossdeutscher v. Viacom, Inc.* (Del. No. 444, 1999, 3/9/01 [revised 4/2/01])

action by the complaint recasting it as a breach-of-implied covenant contract claim.”

The Exchange Act Does Not Preempt Common Law Contract Claims

On appeal, the Delaware Supreme Court reversed the trial court, holding that even if plaintiff’s allegations constituted a cause of action under the federal securities laws, the federal securities laws do not preempt the bringing of a breach of contract action under state law. In reaching its conclusion, the Court cited Section 28(a) of the Exchange Act, which provides that “the rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity.”

To hold otherwise, explained the Court, would transform all state common law fraud actions involving the purchase or sale of a security into federal securities fraud actions. Such a result, the Court noted, would be “antithetical” to the savings clause provided by Section 28(a), would “ignore material differences in the elements and remedies of the claims,” and would “effectively result in preemption of common law claims by federal securities laws.” The Court concluded that federal and common law claims can proceed independently, subject to the limitation that a plaintiff may not receive “overlapping or duplicate damages for the same act.”

Court Rejects Alternative Grounds for Dismissal

The Delaware Supreme Court also rejected two alternative grounds advanced by Viacom for affirming the trial court’s decision. The first of these was based on the “pre-existing legal duty rule,” which holds that a promise to perform a pre-existing legal or contractual obligation is insufficient, by itself, to constitute consideration necessary to establish a valid contract. Viacom argued that because Viacom had a pre-existing legal obligation to comply with the federal securities laws, it could not have contractual liability for breaching that obligation. Therefore, plaintiff’s claim based on the breach of the implied covenant of good faith and fair dealing was barred because the implied covenant “was co-extensive with the duty not to violate the federal securities laws.”

The Court rejected Viacom’s argument, noting

that under New York case law, the implied duty of good faith and fair dealing:

encompasses any promises which a reasonable person in the position of the promisee would be justified in understanding were included. . . . The implied covenant is breached when one party seeks to prevent the contract’s performance or withhold its benefits.

The Court reasoned that the CVR holders were not attempting to enforce a promise by Viacom to comply with the federal securities laws, but rather were seeking to obtain the protection promised by Viacom against a decline in the value of the Class B Common. The complaint alleged that Viacom’s actions “rendered this bargained-for-protection meaningless.” Plaintiff’s common law claim was, according to the Court, “independent of federal securities law.” That Viacom’s conduct might also violate the federal securities laws was “beside the point.”

Viacom also argued that because plaintiff failed to comply with the “no-action” clause in the CVR agreement, he had no standing to sue. Among other things, the no-action clause provided that no CVR holder could commence any action “under or with respect to this [CVR] Agreement,” unless written notice had been provided to the CVR trustee and the trustee refused to sue despite having received a demand to do so from at least 25% of the CVR holders.

The Court held that compliance was not required once the CVRs had been redeemed, explaining that no-action clauses are designed to protect CVR holders as well as Viacom from frivolous or otherwise ill-advised actions that would be detrimental to Viacom and therefore not in the collective best interest of the CVR holders. However, once the CVRs had been redeemed there no longer were any CVR holders, and consequently they no longer needed the protection provided by the no-action clause.

In upholding the trial court’s dismissal of Plaintiff’s unjust enrichment claim, the Court noted that Plaintiff’s rights were governed by an enforceable contract between the parties that clearly governed the subject matter of the dispute. Plaintiff’s rights were “clearly set forth in the contract, and any recovery would likewise be premised on what he should have received under the pricing formulas set forth in the contract had there not been the alleged artificial inflation of the Viacom stock.” ■



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