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Inside The Big-Boy Letter

Law360, New York (August 05, 2008) -- In 1988, the movie Wall Street depicted a culture of naked greed exemplified by insider trading.

Inspired by the high-profile indictments of Owen Morrisey, who was involved in a $20 million insider trading scandal in 1985, Dennis Levine and Ivan Boesky, among others, the protagonist, a young broker named Bud Fox, takes a short-cut on the road to success by trading on information he comes by innocently, and then less innocently, until he is actively engaged in manipulating the market and is ultimately prosecuted.

Although Bud is hazy on the morality of his actions and sanguine about his chances of having to answer for his misdeeds — "No one gets caught" — there is no doubt that what he is doing is illegal.

However, not all activities that the SEC might consider insider trading are obviously so.

Often, the purchaser or seller of securities may possess material nonpublic information or is entering into the transaction at a time when he would, in the ordinary course of business, arguably have access to such information, such as a privately-negotiated sale of a large block of publicly-traded securities or transactions where a private equity firm trades in the securities of a portfolio company or a creditor trades in the securities of a distressed issuer.

Unlike in Wall Street, the counterparty is aware of and acknowledges that the other party is in possession of or has access to such information.

If your counterparty knows you know something, who is deceived? And although there may be harm, where is the foul?

The marketplace has addressed this circumstance by memorializing this understanding in the so-called big-boy letter—meaning, the counterparty to such a trade with the possessor

of inside information is a big boy and knows what he is doing.

Big boys don't cry, after all, and the letter is intended to reduce the risk associated with litigation or criminal prosecution relating to insider trading.

The question is, what does a big boy letter say, and does a big boy letter work?

What Makes A Big Boy?

In a big-boy letter, the purchaser or seller of securities from an insider typically acknowledges that he:

(i) is aware that his counterparty may possess material, nonpublic information related to the securities and that the counterparty is not obligated to disclose such information,

(ii) has reached his own investment decision and waives any claims he may have against the counterparty for nondisclosure of the material, nonpublic information and

(iii) is a sophisticated investor and experienced in matters relating to the valuation and the purchase or sale of securities.

As a risk allocation tool, the big-boy letter has been thought to reduce the risk of private litigation under Section 10(b) and Rule 10b-5 of the Exchange Act on two fronts.

First, the counterparty agrees to waive any claims relating to the nondisclosure of the material, nonpublic information.

Second, conventional wisdom has been that in the event the waiver were to fail the counterparty would not be able to satisfy the reliance prong of a claim brought under Section 10(b) and Rule 10b-5.

While each rationale appears reasonable in theory, an examination of the underlying case law casts substantial doubt on both.

Waiver And Section 29(a) Of The Exchange Act

As noted above, a big-boy letter should purport to waive all claims against the insider that may arise in connection with the purchase or sale of the securities in question.

As a general rule, courts will stretch to enforce the terms of a contract negotiated by sophisticated parties, especially where each of the parties was represented by counsel and

consummated the transaction with their eyes wide open insofar as the allocation of risks between the parties was concerned.

The gale force wind blowing against this waiver, however, is Section 29(a) of the Exchange Act, which provides that agreements and stipulations purporting to waive compliance with the Exchange Act and the rules promulgated thereunder are void and unenforceable.[1]

As a general matter, Section 29(a) prohibits waiver of the substantive obligations imposed by the Exchange Act that weaken a party's ability to recover under the Exchange Act,[2] which may be said to be the whole point of the big-boy letter.

Although the big-boy letter's broad waiver of insider trading claims has not been litigated, analogous waivers have been considered by the courts in several jurisdictions, with conflicting results.

The First and Third Circuits have set aside analogous waivers found in stock purchase agreements as running afoul of Section 29(a).[3]

However, in the Third Circuit, while the waiver does not entitle the moving party to summary judgment as a matter of law, it is admissible as evidence of a party's non-reliance.[4]

A few courts have enforced similar waivers despite Section 29(a)'s prohibition. For example, in a line of cases addressing waivers in the context of settlement agreements, Section 29(a) has been interpreted not to prevent waivers of securities law liability so long as the party granting the waiver has knowledge of the claim and it is supported by consideration.[5]

Unfortunately, the big-boy letter does not involve an existing, ripe claim and is not given in exchange for independent consideration. Moreover, the knowledge of the claim waived necessarily dissipates as the disclosure becomes more abstract, and in the big-boy context the disclosure is entirely abstract.

Therefore, reliance on the settlement authority is unlikely to prove persuasive. In the several other instances where a court has enforced a big boy-like waiver, typically where securities changed hands as part of a merger or acquisition, the party seeking to enforce the waiver had made pages of representations and the complaining party arguably had claims for the breach of those representations.[6]

Thus, the claim is more properly cast as one of buyer's remorse rather than an insider's attempt to displace the proscriptions of the Exchange Act with a regime driven primarily by the policy of caveat emptor.[7]

Although it is impossible to draw hard and fast rules in this area, several patterns emerge from the related case law.

Courts are more likely to enforce waivers borne from negotiations between sophisticated parties where the waiving party has been able to identify, to a reasonable certainty, what he is waiving and gauge the risk involved.

However, as in AES Corp., a court may find that the waiver will not entitle the insider to summary judgment as a matter of law.

As a result, the insider may be faced with incurring the costs of discovery and a trial where the battle will be waged around the issue of nonreliance.

Nonreliance

Whether an action is based on the classical or misappropriation theory of insider trading, the allegation will be that the insider failed to disclose material, nonpublic information prior to the consummation of the securities transaction when he is under a duty to either disclose such information to his counterparty or abstain from trading on the basis of such information.

Of course, market participants do not owe a general duty to one another to refrain from purchasing or selling securities on the basis of material, nonpublic information.[8]

The "disclose or abstain" duty arises when the purchaser or seller of securities owes a "fiduciary or other similar relation of trust or confidence" to his counterparty[9] or, in the case of the misappropriation theory, the source of the material, nonpublic information used by the insider in the transaction in question.[10]

If an insider is found to have such a duty, he must disclose all material, nonpublic information and in the event no disclosure is made, his counterparty is presumed to rely on the insider's silence.[11]

The big boy letter seeks to straddle the fence separating nondisclosure and full disclosure by putting the counterparty on notice that the insider may know something more than his

counterparty, but not exactly what he knows.

The thinking here has been that this general disclosure would doom a private right of action under Rule 10b-5 because the insider's counterparty would not be able to prove that he both acted on the misrepresentation and that this action was reasonable.

If the purchaser or seller has disclosed that he may know something, that something could be anything and that something could be material, or so the argument goes, the counterparty is not relying on the purchaser's and seller's silence and, moreover, what reasonable investor would purchase securities when the express terms include a wink and a nod?

There are several potential flaws with this line of reasoning. First of all, the SEC does not carry the burden of establishing justifiable reliance in an enforcement action,[12] and similarly the United States does not shoulder this burden in a criminal prosecution.[13]

As a result, the big boy letter's other primary theoretical basis — nonreliance — is simply not useful when the insider is on the wrong end of an SEC enforcement action or criminal indictment.

Moreover, the big-boy letter is not built to address the misappropriation theory of insider trading described above (a situation where a fiduciary trades on information in breach of a duty owed to the source of the information).[14]

In that case, the waiver is simply being obtained from the wrong person, as the "wronged" party is not the counterparty but the source of the information.[15]

Under this set of facts, the fiduciary must disclose to the source that he intends to trade on the information he has received as a result of his relationship with the source.[16]

The SEC echoed this view in the enforcement action it brought against Barclays Bank PLC and one of its proprietary traders last March.[17]

In that action, which ultimately settled, Barclays' proprietary trading desk was alleged to have traded in the bonds of six companies in various stages of bankruptcy proceedings on the basis of information it had learned by virtue of its membership on each company's creditors committee.[18]

Although Barclays executed big-boy letters with several of its counterparties, the SEC took

the position that only disclosure of its intent to trade to the creditors committee, issuer, federal bankruptcy court and U.S. Trustee would avoid liability for insider trading.[19]

And although disclosure to the source of information may foreclose liability under federal securities law, the insider may still be subject to liability under state law for breach of duty.[20]

Of course, the situation could have been avoided entirely had Barclays instituted internal firewalls and controls similar to those outlined in Rule 10b5-1(c)(2).[21]

Second, although the Supreme Court has not remotely, much less squarely, addressed a big boy letter's insider trading disclaimer and any oral disclosures surrounding a challenged securities transaction, it has cast the duty of disclosure as requiring "a corporate insider ... [to] abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him",[22] and that, at least when writing in the context of the misappropriation theory, it is "full disclosure [that] forecloses liability".[23]

Thus, the utility of the big boy letter's disclosure and any related and documented disclosures turns on whether the insider has disclosed all material information.

Sadly, no court has directly addressed the adequacy of a big boy letter and any materiality determination is by and large a factual inquiry.[24]

There are, however, a few decisions that test the sufficiency of disclosures made in connection with a purchase and sale of securities which provide some guidance.

For example, in McCormick v. Fund American Companies Inc.,[25] an acknowledgement signed by a former officer in connection with the sale of his shares and options to the parent corporation of his former employer was found to foreclose 10b-5 liability because the company had disclosed all material information – that the company was engaged in preliminary discussions to sell the company to a foreign entity, the consummation of the transaction could result in a significant premium to shareholders and that this premium could be well in excess of the price they were offering McMormick for his shares.[26]

Similarly, in Jensen v. Kimble,[27] the purchaser of securities was found not to have breached his disclosure duty where he told the seller a "prospective deal" was afoot and that the deal might fall apart if the seller did not tender his shares as asked.[28]

The disclosures made in the above cases would suggest that the more specific and tailored the disclosure of material information in the big-boy letter to the transaction at hand the better.

Moreover, in each of the cases, the courts were presented with sophisticated parties, each of whom presumably considered the cautionary disclosure they received and other market whispers as they weighed the investment opportunity they had been presented.

Importantly, although not expressly cited by the courts, McMormick and Jensen were themselves quasi-insiders and had access to the issuer of the securities and could have pressed for more answers had their minds been plagued with material questions unanswered.[29]

Essentially, McMormick and Jensen were given an opportunity to ask questions and gauge the official's responses and demeanor as part of the diligence process.

Conclusion

As a threshold matter, it is vital to apprehend the limited purpose of the big boy letter – to shield an insider from federal securities law liability in limited circumstances.

It will necessarily not offer any protection against enforcement actions by the SEC or criminal prosecution, or against a suit brought by the source of information to whom a fiduciary duty is owed.

However, within its intended purpose — to protect against an action by a trading counterparty — it is essential to remember that the big boy letter is ultimately about information, and, as Gordon Gekko advises Bud Fox: "I know of no more valuable commodity than information."

The case law suggests that the provision of adequate information is a significant measure of the big boy letter's likely effectiveness.

To the extent the insider is not bound by confidentiality, meaningful and detailed disclosure makes the counterparty appear less like a victim of insider trading and more like the victim of buyer's remorse.

Allowing the counterparty to conduct the diligence process and freely ask and pursue lines of inquiry further establishes their investment decision as fully informed, and the insider can

encourage this substantive diligence and disclosure in the trading process.

However, the party at the informational disadvantage may have reason to shun such information and prefer the big boy letter's elusive disclosure, as greater disclosure might make the counterparty an insider, and require the counterparty to consider its own disclosure obligations to its trading partners.

This may impact the marketability of the securities or even remove the counterparty from the marketplace of the issuer's securities.

Moreover, it will also be impossible for the counterparty to evaluate, ex ante, the risks and advantages of more detailed disclosure, or indeed any disclosure at all.

In practice, the big-boy letter offers comfort to the extent it contaminates the counterparty.

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[1] 15 U.S.C.A. § 78cc(a).

[2] See Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 229-30 (1987).

[3] See, e.g., AES Corp. v. Dow Chemical Co., 325 F.3d 174 (3d Cir. 2003); Rogen v. Ilikon, 361 F.2d 260 (1st Cir. 1966).

[4] See AES Corp., at 181. As the dissent noted, this is essentially the same argument as the waiver bar, but in different clothing. Id. at 184.

[5] See, e.g., Hamilton v. Harrington, 807 F.2d 102 (7th Cir. 1986).

[6] See, e.g., Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996).

[7] In fact, while the Harsco Court found that the waiver at hand did not offend Section 29 (a), it explained that "[i]n different circumstances (e.g., if there were but one vague seller's representation) a 'no other representations' clause might be toothless and run afoul of Section 29(a)." Id. at 344.

[8] See Chiarella v. United States, 445 U.S. 219, 230 (1980).

[9] Id. at 226.

[10] See United States v. O'Hagan, 521 U.S. 642, 653 (1997).

[11] See Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

[12] See, e.g., SEC v. Hasho, 784 F.Supp. 1059 (S.D.N.Y. 1992).

[13] See, e.g., United States v. Haddy, 134 F.3d 542 (3d Cir. 1998).

[14] Nor will the big-boy letter cleanse insider trading in the context of a tender offer, where the material, nonpublic information must be publicly disclosed prior to the purchase or sale of the securities. See 17 C.F.R. § 240.14e-3.

[15] Although feigning fidelity to the principal while surreptitiously profiting from information entrusted to the insider by virtue of his position of trust or confidence is the deceptive device that brings the conduct within the purview of Rule 10b-5, the source of the information could not satisfy Rule 10b-5's standing requirement because it is neither purchasing nor selling securities.

[16] See United States v. O'Hagan, 521 U.S. 642, 657 (1997).

[17] SEC v. Barclays Bank PLC and Steven J. Landzberg, 07-CV-04427 (S.D.N.Y. May 30, 2007).

[18] Id. at ¶ 4.

[19] Id. at ¶ 18. Oddly, the complaint also highlighted that the defendants did not, notwithstanding the big-boy letters, disclose the material nonpublic information to their counterparties. Id.

Moreover, it is doubtful Barclays could have disclosed the material, nonpublic information to its counterparties without violating the terms of the confidentiality agreements it signed to join the creditors committees.

Arguably, such disclosure could also have exposed Barclays' counterparties to liability as a tippee in connection with any resales to the extent the counterparty knew or should have known Barclays was passing along such information in breach of a duty of trust or confidence.

[20] See, e.g., Diamond v. Oreamuno, 24 N.Y.2d 494 (1969). At the time of Diamond, Rule 10b-5's insider trading jurisprudence was in its infancy and the purchases and sales in

question fell outside Section 16(b)'s short-swing period. As a result, the Diamond plaintiff instituted a derivative action seeking disgorgement of profits several officers had reaped through trading on material, nonpublic information.

[21] 17 C.F.R. § 240.10b5-1(c)(2).

[22] See Chiarella v. United States, 445 U.S. 219 (1980) (characterizing the SEC's decision in Cady, Roberts & Co.) (emphasis added).

[23] See O'Hagan, 521 U.S. 642, 657 (1997) (emphasis added).

[24] See McCormick v. Fund American Companies, Inc., 26 F.3d 869, (9th Cir. 1994) (noting that the court "must examine the alleged omissions and misrepresentations one by one and cumulatively, in order to determine whether singly or together they were both misleading and material.")

[25] 26 F.3d 869 (9th Cir. 1994).

[26] Id. at 874-75.

[27] 1 F.3d 1073 (10th Cir. 1993).

[28] Id. at 1075.

[29] McCormick was the former CEO of the Fund American Companies ("FAC") subsidiary up for sale and buttonholed both the FAC CEO and chairman of the board, as well as the executive vice president who had been running the discussions with the foreign buyer in an attempt to solicit further details.

Jensen's father-in-law was a member of the Sage Court board, the issuer of the securities sold by Jensen, though Jensen never once sought his father-in-law's counsel during the period in question.

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