ADMINISTRATIVE PROCEEDING
FILE NO. 3-6869

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

GEORGE C. KERN, JR.

(ALLIED STORES CORPORATION)

INITIAL DECISION

Washington, D.C.
November 14, 1988

Warren E. Blair
Chief Administrative Law Judge

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APPEARANCES: Thomas C. Newkirk, Mark Kreitman, Jerry A. Isenberg, Jay A. Dubow, and Julie K. Lutz, for the Division of Enforcement.

Henry L. King, L. Gordon Harriss, and J. Michael Luttig, of Davis Polk & Wardwell, of New York City,
and
Marvin Schwartz, Gandolfo V. DiBlasi, Robert A. Sacks, and Charles S. Sullivan, of Sullivan & Cromwell, of New York City, for George C. Kern, Jr.

BEFORE: Warren E. Blair, Chief Administrative Law Judge

These public proceedings were instituted by an order of the Commission dated June 29, 1987 ("Order") pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether, as alleged by the Division of Enforcement ("Division"), Allied Stores Corporation ("Allied") failed to comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder, whether George C. Kern, Jr. ("Kern") was a cause of Allied's failures to comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder, and whether the respondents should be ordered to comply or take steps to effect compliance with the requirements of Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder. [1/]

In substance the Division alleged that Allied failed to comply, and Kern caused Allied to fail to comply, with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder by failing to promptly amend a Schedule 14D-9 filed with the Commission on September 24, 1986. The alleged lack of compliance involved failure of Allied to disclose that in response to a tender offer (1) negotiations were

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1/ On July 22, 1987 the Commission, having accepted Allied's offer of settlement, issued its Findings and Order directing Allied to comply in all respects with the requirements of Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder, and terminated this proceeding as to Allied. Securities Exchange Act Release No. 24727, 38 SEC DKT 1525. Findings herein are made only as to respondent Kern and are not binding on Allied.

under way with another party relating to or which would result in a sale of a material amount of Allied's assets and a material change in Allied's capitalization or result in an extraordinary transaction such as a merger or reorganization; (2) Allied and a third party reached an agreement in principle to a merger with the third party; and (3) Allied's Board of Directors adopted a resolution directing Allied's management to execute a merger agreement with a third party.

Counsel for Kern appeared and participated throughout the hearing. As part of the post-hearing procedures, successive filing of proposed findings, conclusions, and supporting briefs were specified. Timely filings were made by the parties.

The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

RESPONDENT

Kern is a partner in Sullivan & Cromwell, a large well-known New York City law firm , and head of the firm's mergers and acquisitions group. During the relevant period covered by the Division's allegations Sullivan & Cromwell, primarily through Kern, acted as Allied's principal outside counsel on the matters involved in these proceedings. Kern was also a member of Allied's Board of Directors during this time.

ALLIED'S SCHEDULE 14D-9 2/

Allied was at all times relevant hereto a Delaware corporation with its principal executive offices located in New York City. Until December 31, 1986 Allied's common stock was registered pursuant to Section 12(b) of the Exchange Act and listed for trading on the New York Stock Exchange. On December 31, 1986 Allied became a wholly-owned subsidiary of Campeau Corporation ("Campeau"), a Canadian corporation. Since then, none of Allied's common stock has been publicly held. Allied is not now subject to the reporting requirements of Section 14(d) of the Exchange Act and Rule 14d-9 thereunder and its common stock is no longer registered with the Commission.

Campeau's efforts to acquire Allied were initiated on August 1, 1986 when Robert Campeau, Chairman and Chief Executive Officer of Campeau, met with Thomas M. Macioce ("Macioce"), his counterpart at Allied. About a month later, on September 4, Robert Campeau had a letter delivered to Macioce proposing that Campeau and Allied commence

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2/ Section 14(d)(4) of the Exchange Act requires that any solicitation or recommendation to the holders of a security to accept or reject a tender offer be made in accordance with rules and regulations to be prescribed by the Commission. Pursuant to that authority, the Commission promulgated Rule 14d-9 under the Exchange Act prohibiting a solicitation or recommendation to security holders with respect to a tender offer unless a Schedule 14D-9 has been filed as soon as practicable on the date the solicitation or recommendation is first published or sent or given to security holders.

negotiations looking toward a merger at a price of $58 per share, with Allied shareholders to receive 80 percent in cash and the remainder in securities. Allied issued a press release the same day disclosing receipt of the merger proposal. On September 11, 1986 the Allied Board of Directors met and decided to reject Campeau's proposal. Allied issued a press release disclosing the Board's action. The next day, September 12, Campeau announced the commencement of a tender offer for approximately 60 per cent of Allied's shares at $58 per share. On September 23, 1986 Allied's Board of Directors met to consider the tender offer and determined to reject it. At the meeting the Board also passed a resolution authorizing Allied to continue to explore and investigate, with the assistance of Goldman, Sachs & Co. ("Goldman Sachs"), an investment banking firm, various alternatives to Campeau's tender offer. On September 24, 1986 Allied filed a Schedule 14D-9 disclosing the Board's recommended rejection of Campeau's tender offer and setting forth the following under Item 7(a):

> At its September 23, 1986 meeting, the Board considered and reviewed the feasibility and desirability of exploring and investigating certain types of possible transactions, including without limitation, a change in the present capitalization of the Company, the public or private sale of Shares or other securities of the Company to another company or person, the acquisition by the Company of Shares by tender offer or otherwise, the acquisition by the Company of all or part of the business of another company or person, and the acquisition of the Company or of one or more of its significant business segments or of certain of its assets or a portion of its Shares by another company or person. After considerable discussion,

the Board resolved that it was desirable and in the best interests of the Company and its stockholders to continue to explore and investigate, with the assistance and advice of Goldman Sachs, such transactions, although the Board noted that the initiation or continuation of such activities may be dependent upon future actions with respect to the Offer. There can be no assurance that these activities will result in any transaction being recommended to the Board or that any transaction which may be recommended will be authorized or consummated. The proposal or consummation of any transaction of the type referred to in this Item 7 may have an impact on the Offer.

At its September 23, 1986 meeting, the Board also adopted a resolution with respect to the need for confidentiality with respect to the parties to, and possible terms of, any transactions or proposals of the type referred to in the preceding portion of this Item 7 during negotiations with respect to any such transactions.

ALLIED'S FAILURE TO AMEND SCHEDULE 14D-9 [3/]

A. The Shopping Centers

The uninvited and unexpected interest of Campeau in Allied caused Macioce to look at the options available to

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3/ Any material change in the information set forth in Schedule 14D-9 must be disclosed promptly pursuant to Rule 14d-9(b):

> (b) Amendments. If any material change occurs in the information set forth in the Schedule 14D-9 (§240.14d-101) required by this section, the person who filed such Schedule 14D-9 shall:
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> (1) File with the Commission eight copies of an amendment on Schedule 14D-9 (§240.14d-101) disclosing such change promptly . . . and
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> * * *
>
> (3) Promptly disclose and disseminate such change in a manner reasonably designed to inform security holders of such change.

forestall a Campeau takeover. During the first week of September, 1986 after receiving Robert Campeau's letter of September 4, Allied turned to Goldman Sachs for advice. Immediately representatives of Goldman Sachs began to meet with Macioce and other Allied senior officials and with lawyers from Sullivan & Cromwell. Additionally, Macioce arranged to have dinner on September 10 with Edward J. DeBartolo, Sr. ("DeBartolo"), a close business and social acquaintance of many years who was Chairman of the Board and Chief Executive Officer of Edward J. DeBartolo Corporation ("EJDC"), to discuss the Campeau offer and ascertain whether DeBartolo still had his previously indicated interest in Allied. Macioce told Kern prior to the Allied Board meeting of September 11 about his dinner with DeBartolo the night before.

After Campeau's announcement of its tender offer at $58 per share on September 12, Goldman Sachs reviewed possible defensive measures that Allied could pursue, with the primary focus being on a recapitalization of Allied. Key features of the recapitalization were a sale by Allied of six of its shopping centers and the securing of additional funds from banks to enable Allied to offer its stockholders a more attractive package than Campeau's. Various alternatives, including sale of Allied's shopping centers, were discussed at a meeting on September 17, 1986 attended by Kern and by representatives of Goldman Sachs and Allied. Kern and the Goldman Sachs people raised different

possibilities for discussion. As the meeting progressed, some form of recapitalization of Allied became the central topic of consideration.

As part of a feasibility study of a recapitalization plan, Goldman Sachs, with Allied's authorization, approached several banks and advised them that Allied planned a sale of its shopping centers and certain of its operating divisions within a short time. Among the banks contacted as prospective lenders were Manufacturers Hanover Trust, Bankers Trust Company, Morgan Guarantee Bank, and Toronto-Dominion Bank.

On September 25, 1986, the day following the filing of Allied's Schedule 14D-9 disclosing the authorization of the Allied Board "to continue to explore and investigate" alternatives to the Campeau offer, Kern was at a meeting also attended by representatives of Allied and EJDC. The participants included a number of senior officers and legal advisers of the two companies as well as Kern, DeBartolo, and Macioce. The purpose of the meeting was to further discuss the possible sale of Allied's shopping centers to EJDC.

As a result of the negotiations in the lengthy morning and afternoon meetings that day, DeBartolo agreed to pay a price of $405 million dollars for the shopping centers, subject to a report on the quality of the malls based on a study to be completed within a few days, after which DeBartolo was

to make a firm offer. Macioce was prepared by the end of his meetings with DeBartolo on September 25 to recommend to Allied's Board that the shopping centers be sold for $405 million and sometime that afternoon indicated to Kern that $405 million would be acceptable to Allied.

Macioce expected and understood that Kern would make legal decisions on disclosure questions without consulting officers of Allied except as Kern saw fit. Kern recognized his responsibility in this regard and gave thought to the need to amend Allied's Schedule 14D-9 filing to disclose the shopping center negotiations. He decided, without consultation with any officer or other director of Allied, that an amendment was not required. It is concluded that the failure of Allied to amend its Schedule 14D-9 filing was a violation of Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder.

Allied was required by Rule 14d-9(b) under the Exchange Act to amend its Schedule 14D-9 to disclose promptly any material changes in the information set forth in its Schedule 14D-9. Allied's disclosure in Item 7(a) of its Schedule 14D-9 that Allied's Board had "resolved that it was desirable and in the best interests of the Company and its stockholders to continue to explore and investigate" certain types of transactions including acquisition by another company of one or more of Allied's business segments did not encompass what must be deemed negotiations for the

shopping centers that took place on September 25. Those negotiations, which culminated in an understanding between DeBartolo and Macioce that $405 million dollars would be the price tag for the shopping centers and that a firm offer by DeBartolo might be forthcoming, constituted a "material change" in Allied's Schedule 14D-9 information. Consequently, Kern's decision not to amend Schedule 14D-9 to disclose promptly that material change caused Allied to violate Rule 14d-9(b), and Kern should have known that he was contributing to Allied's failure to comply with Section 14 of the Exchange Act.

Kern attempts to defend the failure to file a Schedule 14D-9 amendment disclosing the contemplated sale of Allied's six shopping centers by arguing that there was no agreement on price and terms on September 25 and that nothing occurred in the discussions that constituted a material change in Allied's initial disclosure. The record supports Kern's argument that no agreement between the parties on price and terms came into existence on September 25, but does not with respect to his assertion that a material change in the information set forth in Allied's September 24 disclosures under Item 7 had not taken place.

While no agreement in principle fixing the price and structure for the sale of the shopping centers had eventuated on September 25, the negotiations which Kern conceded were carried on that day were of a character and nature to give rise to a material change in the situation described

under Item 7 of Allied's initial Schedule 14D-9. Kern's contention to the contrary cannot be accepted.

As of September 25 Allied stockholders and the investing public were aware by virtue of Allied's Item 7 disclosure that Allied's Board had reviewed "the feasibility and desirability of exploring and investigating certain types of possible transactions including without limitation, . . . the acquisition of the Company [Allied] or of one or more of its significant business segments or of certain of its assets . . . by another company or person," and that the Board resolved "that it was desirable and in the best interests of the Company and its stockholders to continue to explore and investigate, with the assistance and advice of Goldman Sachs, such transactions . . . ." Kern's efforts to bring the shopping center negotiations within the ambit of the phrase "to continue to explore and investigate . . . such transactions" are rejected. The disclosure in question cannot reasonably encompass the shopping center negotiations. The words "explore" and "investigate" imply efforts by Allied to locate transactions in keeping with the Board's resolution but do not suggest that a specific transaction of the magnitude of the sale of Allied's shopping centers would become the subject of on-going negotiations on September 25 and thereafter until aborted on September 29 by Campeau's raising its offer for Allied. 4/ Nor is it likely that a reasonable

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4/ Cf. Revlon, Inc., Securities Exchange Act Release No. 23320 (June 16, 1986); 35 SEC DKT 1541.

investor would construe Allied's disclosure to include such negotiations.

Having found that the shopping center negotiations were not covered in the information initially disclosed under Item 7, the next consideration is whether that change was material within the meaning of Rule 14d-9(b) so as to require the filing of an amendment to Allied's Schedule 14D-9. The controlling guidelines are found in Basic Incorporated v. Levinson [5/] in which the Supreme Court approved the use of the probability/magnitude formula enunciated in SEC v. Texas Gulf Sulphur Co., [6/] and repeated the conclusion it reached in TSC Industries, Inc. v. Northway, Inc. that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [7/]

Kern agrees that Basic's principles which were made applicable to the question of materiality in the context of Section 10(b) of the Exchange Act are equally applicable to a determination of materiality under Section 14(d) of the

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5/ ___ U.S.___, 108 S.Ct. 978 (1988).

6/ 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969). There the Second Circuit held that materiality was determined by balancing the indicated probability that an event will occur and the anticipated magnitude of the event in light of the totality of the company activity.

7/ 426 U.S. 438, 449 (1976).

Exchange Act. He contends, however, that in exercising his judgment and reaching his conclusion that an amendment to Allied's Schedule 14D-9 was unnecessary he used the very guidelines set forth in Basic.

In defense of his judgment, Kern argues that the probability of a sale of the shopping centers was too remote to require further disclosure because a sale was contingent upon a recapitalization which was as yet highly speculative, that no offer had been made for the shopping centers, that there had been no agreement that there would be a sale of the shopping centers, and that there was considerable work to be done by EJDC before it would know whether it would offer to buy the centers. Kern was also concerned that the market not be misled as to the probability of a successful recapitalization.

Kern's arguments are not persuasive. Months before the September 25 meeting Macioce knew of DeBartolo's interest in acquiring Allied's shopping malls and the September 25 discussions were directed primarily at price, not whether the centers were on the market. The understanding of the top officials of Allied and EJDC that Allied would sell and EJDC would buy if a price could be agreed upon and Macioce's and DeBartolo's luncheon understanding that $405 million would be acceptable to both companies indicate that the probability of the shopping centers being sold was not as remote as Kern insists. Further, the amount of effort by the

subordinate staff representatives of the two companies to gather the needed information to support the $405 million price points to a likely, not a remote, possibility that the sale would be consummated.[8/] Weighing all of the indicia in the record of the probability that the sale of the shopping centers would occur and the magnitude of that event, which Kern agreed would have been a material event, the balance lies heavily on the side of a finding of materiality and a need to disclose the negotiations that transpired on September 25. Moreover, where an initial Schedule 14D-9 does not, as was the situation here, state that the company was then engaged in any negotiations of the type required to be disclosed under Item 7(a), the commencement of such negotiations constitutes a "material change" in the information set forth in Schedule 14D-9 and "triggers the prompt amendment requirement of Rule 14d-9(b)."[9/]

Kern's expressed concern that an amendment to disclose the shopping center negotiations would have been misleading, particularly in light of the information filed by Allied the day before in its Schedule 14D-9, does not bolster his position. The shopping center negotiations represented a

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8/ These are factors which fall within the purview of the Supreme Court's observation in Basic regarding the proper assessment of the probability that an event will occur. (108 S.Ct., at 987).

9/ Revlon, Inc., supra, at 1552.

material change in the Schedule 14D-9 information and required disclosure. Any possibility that the market would be misled could have been readily dissipated by additional language calling attention to the contingencies involved.

B. The Merger Negotiations

Allied's plans for sale of the shopping centers and recapitalization were disrupted on September 29, 1986 by Campeau's revising its tender offer to $66 per share for 80% of Allied's stock. Although the possibility of recapitalization was not then entirely abandoned, it became clear to Allied's senior management and Kern at that time that the sale of the shopping centers and recapitalization would not suffice to counter Campeau's offer. One alternative considered was the possibility of a "white knight"[10/] merger with DeBartolo and a meeting with DeBartolo was arranged for the next day.

DeBartolo, Paul Bilzerian ("Bilzerian"), who was associated with EJDC in its efforts to acquire Allied,[11/] and other representatives of EJDC met on September 30 in

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10/ In Wall St. parlance a "white knight" is a company that a take-over candidate hopes will thwart the plans of a hostile bidder and be a more friendly acquirer. Prior to September 29, 1986 Macioce had informed DeBartolo, in response to the latter's merger overtures, that Allied desired to remain independent.

11/ ASC Acquisition Corp. ("ASC"), a Delaware corporation, was formed by EJDC for the purpose of making a tender offer for Allied. Bilzerian, a private investor, owned 10% of ASC.

Macioce's office with Macioce, Kern, and other representatives of Allied. In the course of that meeting the Campeau offer was discussed and analyzed and consideration was given to the mechanics and timing of a competing offer by EJDC. Before the conclusion of the meeting DeBartolo and Bilzerian indicated to Macioce that they were going to make an all-cash offer for Allied stock at a price of $66 to $67 per share. They also said that they had been talking to investment counsel about the matter. Additionally, the need to be very careful to guard against leaks and to keep information confidential was brought up at the meeting as was the need for EJDC to have access to non-public information about Allied. After some hesitancy Allied agreed to allow the EJDC group to meet with Goldman Sachs and go through Goldman Sach's materials on condition that EJDC sign a confidentiality agreement. The confidentiality agreement was signed and late that night or the next morning of October 1, 1986 EJDC began receiving the non-public information about Allied.

In a series of private meetings on October 1 and 2, Bilzerian continued negotiations on behalf of EJDC with Macioce. In the evening hours of October 2 Macioce accepted an offer by Bilzerian of $67 all-cash for all of Allied's shares and a break-up fee of a dollar a share plus expenses to be paid EJDC in the event a third party

acquired Allied, subject only to Goldman Sachs convincing EJDC that Allied stock was worth $67 per share. Macioce assured Bilzerian that Goldman Sachs could do so, and they shook hands on the deal.

During the four-day period from Tuesday, September 30 until and including Friday, October 3, 1986 a series of meetings in which Kern also participated took place. In those meetings consideration was given by the Allied and EJDC representatives to the all-cash requirement, coverage of the merger to all Allied outstanding shares, timing of the various steps in the proposed merger, maintenance of Allied's employee pension and profit-sharing plans, and payment of a break-up fee for EJDC if the deal collapsed. In that same period Sullivan & Cromwell and the law firm of Wilkie Farr and Gallagher, respectively outside counsel for Allied and EJDC, worked on drafting a merger agreement. By October 1 drafts of the agreement were available for review before a meeting of the parties on Thursday, October 2.

Separately from the negotiations on the terms of the merger, EJDC representatives went to work on September 30 with representatives of Goldman Sachs and Citibank to firm up financing for the prospective merger. EJDC felt that a meeting of the minds with Citibank relative to the financial arrangements had been reached by October 1, but because

Citibank unexpectedly introduced an unacceptable provision for indemnification of Citibank, EJDC broke off the proposed financing through Citibank and turned to Chemical Bank which had earlier indicated an interest in participating in the financing. A meeting of the representatives of Chemical Bank and EJDC was arranged for the evening of October 2. The meeting, which extended into the morning hours of October 3, ended with a written commitment from Chemical and that commitment was immediately delivered to DeBartolo.

Continuing to exercise the legal discretion vested in him by Macioce, Kern, without consultation with any officer or other director of Allied, decided that no amendment to Allied's Schedule 14D-9 disclosing the merger negotiations with DeBartolo and Bilzerian during the period September 29 through October 3, 1986 would be filed. It appears from the record that Kern's decision not to file such amendment was erroneous and that as a result Allied failed to comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder. It also appears that Kern was a cause of Allied's failure to comply and knew or should have known that the omission to amend Allied's Schedule 14D-9 would contribute to the failure to comply.

Without attempting to pinpoint the precise moment when Allied's merger negotiations reached the stage where its disclosure in the Schedule 14D-9 of September 24 no longer sufficed to cover the material change in Allied's situation with respect to EJDC's proposed merger, it is clear that by the close of October 2, 1986 a material change in the information previously disclosed had occurred and that the new developments would have been of significant interest to Allied shareholders.[12/] That new information should have been made known to them by way of an amendment to Allied's Schedule 14D-9. Bearing in mind the Supreme Court's approval in its recent Basic Inc. v. Levinson decision[13/] of the concept expressed in S.E.C. v. Texas Gulf Sulphur Co.[14/] that materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity,"[15/] there is little in the record to justify Kern's position that an amendment to disclose Allied's merger negotitions was not required. As the

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12/ Cf. Revlon, Inc., supra, at 1550.

13/ Supra.

14/ Supra, at 849.

15/ Frequently referred to as "the probability/magnitude balancing test."

Division points out, by October 2 Allied and EJDC negotiators had drafts of a merger agreement in their hands and Allied and EJDC negotiators had reached an agreement on price and other terms of the contemplated merger. Contrary to Kern's position, it is concluded that as of October 2 the probability of EJDC's competing tender offer going forward was strong and the probable effect of the negotiations was close to being of the first magnitude. Nor can there be any question that the emergence of a competing bid against Campeau's hostile tender offer was information defined as "material" within the terms of Rule 12b-2 under the Exchange Act. 16/ If disclosed fully and accurately the negotiations and the understandings of the parties would have undoubtedly "assumed actual significance in the deliberations of the reasonable shareholder," and there would have been "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." 17/

16/ For purposes of the reporting requirements under Regulation 14D, Rule 14d-1(b) provides that the meaning of "material" will be the same as in Rule 12b-2. In turn, the definition of "material" under Rule 12b-2 is:

> The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.

17/ TSC Industries, Inc. v. Northway, Inc., supra.

Kern argues that a critical aspect of the evidence concerning the events of September 30 to October 3 was that Allied and its advisors were pursuing and engaging in negotiations concerning two mutually exclusive alternatives. One was a recapitalization that would have left Allied independent and the alternative was a merger with DeBartolo. In his testimony at the hearing Kern characterized the merger discussions as "contingent negotiations" because negotiations were being carried on simultaneously with respect to each of the possibilities.

The record, however, reflects that with Campeau's revised tender offer of September 29, Kern and the Allied advisers had almost entirely discounted the feasibility of going forward with a recapitalization plan. Kern's investigative testimony was that when Campeau raised its offer "the recapitalization plan wouldn't work," and that "[w]e at least were not able to figure out a recapitalization mechanism that would produce to the stockholders the kind of return that Campo [sic] was then reportedly offering." 18/

But even if Campeau's offer had not changed the picture regarding recapitalization, there appears to have been

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18/ Division Exhibit 114, at 36.

no reason to withhold information concerning the merger negotiations which by October 3 had reached a stage that completely overshadowed the alternate recapitalization plan. Under the circumstances, any "contingency negotiations" looking toward a recapitalization would have had a negligible effect upon the degree of probability that a merger with EJDC would occur, and reasonably should not have been a factor in determining whether an amendment to Allied's Schedule 14D-9 was required.

The second critical aspect of the negotiations which Kern relies upon in support of his decision not to amend Schedule 14D-9 to disclose the negotiations is that no merger agreement with DeBartolo would exist unless and until DeBartolo had firm financing commitments in hand. As Kern points out, DeBartolo did not have a firm commitment during the period of the discussions in question.

Kern's reliance upon the absence of firm financing to justify a decision not to amend is misplaced, for he is saying in effect that Allied was not required to amend unless and until there was certainty that a merger agreement would be executed. That is not a standard that can be accepted. The degree of probability, not certainty, is to be balanced against the anticipated magnitude of the event.[19/] Here it is uncontroverted that the negotiations were being carried on at the highest corporate levels

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19/ See *SEC* v. *Texas Gulf Sulphur*, *supra*, at 849.

of Allied and EJDC, supplemented by private discussions between the head of Allied and an EJDC control person, and that investment bankers and advisers for both companies were busily engaged in the attempts of EJDC to obtain the necessary financing. The agreements reached during the discussions and the activities and status of the negotiators, when considered in the light of the magnitude of the corporate event under consideration and the potential premium of about $3 per share over existing market value that DeBartolo was willing to offer for Allied stock, are sufficient to dispel any doubt that the negotiations were material.[20/]

The language of the Allied initial filing under Item 7(a) of Schedule 14D-9 that the Board had resolved "to continue to explore and investigate" certain types of possible transactions including the acquisition of Allied by another company cannot reasonably be construed to have conveyed to Allied stockholders or to public investors the information that Allied would agree to a merger at a price of $67 if the bidding "white knight" could secure financing. There can be little doubt that within the meaning of Rule 14d-9 under the Exchange Act the negotiations of September 30

20/ See Basic Inc. v. Levinson, supra, at 987.

to October 3 resulted in a material change in the information set forth under Item 7(a) of Schedule 14D-9 and were required to be disclosed by the filing of an amendment to that item.

C. The Agreement in Principle and Board Resolution

Allied and EJDC reached an agreement in principle in the merger negotiations on October 3, 1986, with EJDC agreeing to offer $67 per share in cash for Allied stock and accepting a break-up fee of $1 per share plus expenses if the deal were not consummated. The only unresolved contingency was whether EJDC could raise the financing needed to carry out the tender offer. As of the morning of October 3 Kern assumed, on the basis of DeBartolo's assurances, that the necessary funds would become available.

The Allied Board meeting convened at 2:00 P.M. on October 3 and Kern acquainted the Board with DeBartolo's merger proposal. The minutes of that meeting reflect that:

> Mr. Kern, at Mr. Macioce's invitation, described the general framework and essential components of a proposal by The Edward J. DeBartolo Corporation ("DeBartolo") which would provide for the execution of a merger agreement by the Corporation and two affiliates of DeBartolo (upon DeBartolo's securing of necessary financing commitments) calling for the making of an all-cash tender offer at a price of $67 per share for all the common stock of the Corporation, to be followed by a merger providing for an all-cash payment of an equal per share price for all shares not previously tendered. Mr. Kern noted that, as contrasted with the Campeau offer, there would be no conditions, other than standard ones, attached to the DeBartolo offer.

> He also noted that the proposed merger agreement would make no provision for a "lock up" or special options or other deterrent to third parties from entering competing bids or to the Corporation from entertaining competing bids; would provide for retention of employee benefit plans and for the cashing out of outstanding options, restricted stock and phantom stock; would make no provision for any arrangement solely for the benefit of the management of the Corporation; would not give management any equity interest in the surviving corporation; would not prevent Allied from giving information to Campeau or anyone else in connection with a competing transaction; would provide for a break-up fee of $1 per share payable to, and reimbursement of expenses incurred by, the DeBartolo organization if the proposed transaction did not come to fruition either as a result of the Corporation's default or of a higher offer by a third party.

The minutes also reflect other presentations relating to efforts to maximize value for Allied stockholders, Macioce's recommendation of acceptance of the DeBartolo offer, and adoption of the following resolution:

> RESOLVED, that, considering this Corporation's business, financial condition and prospects, the terms and conditions of the proposed Agreement and Plan of Merger (the "Merger Agreement") among this Corporation, ASC Acquisition Corp., a Delaware corporation ("ASAC"), and a wholly owned subsidiary of ASAC and of an offer (the "ASAC Offer") by ASAC pursuant to the Merger Agreement for all Shares at a price of $67 per share payable in cash, and other matters, including presentations by this Corporation's legal and financial advisors at this meeting, this Board of Directors conclude, and it does hereby conclude, that the proposed terms of the Merger Agreement and the ASAC Offer are fair to and in the best interests of this Corporation and its stockholders and that, subject to ASAC's obtaining of the financial commitments contemplated by the Merger Agreement (the "Financing Condition"), it approve and recommend, and it does hereby approve and recommend, the ASAC Offer for acceptance by this Corporation's stockholders with the further recommendation that such stockholders tender all their

> Shares pursuant to the ASAC Offer, and that the proper officers of this Corporation be, and each of them hereby is, authorized to execute and deliver or make such filings, consents, documents or other instruments, including, without limitation, the filing of a Solicitation/Recommendation Statement on Schedule 14D-9 pursuant to the 1934 Act, and any supplements or amendments, in such form as the acting officer may approve, in response to the ASAC Offer as may be necessary or appropriate to comply with applicable legal requirements, the approval of such acting officer and of this Board of Directors to be evidenced conclusively by such execution....

As of the evening of Friday, October 3, EJDC did not have the necessary financing to consummate a merger agreement and to commence a tender offer for Allied shares, but continued its efforts to obtain that financing during the weekend. Meetings involving EJDC and various banks were held Saturday and Sunday, October 4 and 5, 1986 and by the end of the weekend EJDC had a commitment letter from Citibank and a strong indication that Bankers Trust would act as co-lead in the financing of the tender offer. A final answer from Bankers Trust was to await the outcome of a meeting to be held at seven o'clock in the morning, Monday, October 6. Kern was told on Sunday that prior to the market opening the next day the bank commitments would be firm.

Kern was confident enough about the financing that on Monday, October 6 he requested the New York Stock Exchange to delay the opening of trading in Allied stock because he anticipated that an Allied announcement of the

merger agreement with EJDC was in the immediate offing. Later that morning, after Allied learned that the financing had collapsed, trading in Allied stock opened with no news announcement being made by Allied.

Throughout October 6 and 7, 1986 EJDC had further discussions with certain banks which culminated in EJDC receiving financing commitments sufficient to enable it to enter into a merger agreement and commence a tender offer for Allied stock. During the evening of October 7 Allied entered into a merger agreement with two subsidiaries of EJDC and the execution of that agreement was publicly disclosed before the opening of the market on Wednesday, October 8, 1986. On October 8 Allied filed with the Commission Amendment No. 1 to its Schedule 14D-9 which described, pursuant to Item 7, the approval and execution of the merger agreement.

Allied's filing of Amendment No. 1 was days late to effect compliance with Rule 14d-9(b) which required Allied's prompt disclosure of any material change in the information set forth in its Schedule 14D-9. That failure to comply constituted a violation of Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder. Kern was well aware of the developments leading up to and including the reaching of the agreement in principle between Allied and EJDC on the price and terms of their contemplated merger and of the passing of the Allied Board Resolution on

October 3. Because he assumed sole responsibility for determining when an amendment to Allied's Schedule 14D-9 would be filed, Kern must be found to have caused Allied's violation. It must also be concluded that within the meaning of Section 15(c)(4) of the Exchange Act Kern knew or should have known that he was contributing to Allied's failure to comply.

Kern insists that Allied was under no obligation to file an amendment disclosing the "agreement in principle" or the merger resolution because he did not believe an "agreement in principle" was ever reached, and that by October 6 the Board Resolution of October 3 became a "non-event" when Allied learned that no financing was available. Those contentions are not persuasive.

The term "agreement in principle" does not lend itself to a precise legal definition but for purposes of Schedule 14D-9 the best approach to defining the term is that of the Third Circuit which indicated that "agreement in principle" is reached when would-be merger partners have agreed on the price and structure of the transaction.[21/] Here, the top-level officers and representatives of the intended merger partner had reached agreement in the morning of October 3 not only upon price

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21/ See Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (3d Cir. 1984), cert. denied 469 U.S. 1215 (1985).

and structure but upon all substantive terms affecting the merger subject to EJDC obtaining financing. Kern steadfastly insists that there was no agreement on anything unless there was financing and that obtaining financing was a condition precedent before the terms agreed upon by the parties could come into existence. His position simply cannot bear up under scrutiny. If accepted, the entire concept of disclosure of an "agreement in principle" in a Schedule 14D-9 filing would be frustrated by the simple expedient of parties reaching agreement on each and every term of a merger and then evading disclosure requirements by subjecting the agreement to some condition precedent purporting to negate the existence of the agreement. The parties could thereby defer disclosure until such time as the "agreement in principle" became a _fait accompli_ merger agreement which would then be disclosed. The latter is what happened here on October 8 when, by the filing of Allied's Amendment No. 1 to its Schedule 14D-1, the first public knowledge regarding the terms of the merger of Allied and EJDC came to light. Those terms which were embodied in the "agreement in principle" constituted material information and a material change in the information initially filed in Allied's Schedule 14D-9. That material change could and should have been disclosed by amendment on October 3

and, regardless of the availability of financing, no later than October 6. The condition precedent to the actual effectuation of a merger between Allied and EJDC could have been readily disclosed, satisfying both Kern's concern about possibly misleading the market and the requirements of the Commission's disclosure regulations.

Similarly, Kern cannot justify Allied's failure to file an amendment on Monday, October 6, disclosing the October 3 Board Resolution. That resolution approved an agreement, with the exception of the amount of the "break-up fee," subject to DeBartolo's obtaining the necessary financing commitments. The offer, with that exception and condition, for all Allied shares at $67 per share payable in cash did not, as suggested by Kern, become a "non-event" or relate to a "dead transaction"[22/] by reason of DeBartolo's inability to find financing over the weekend. Kern knew on October 6 that EJDC was continuing its attempts to raise the necessary funds which the banks finally committed on October 7. Further proof of the viability of the October 3 resolution and its continuing efficacy need go no further than that Kern did not seek and the Allied Board did not adopt a further resolution approving a merger with EJDC before Allied entered into the merger agreement with EJDC's subsidiaries on the

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22/ Post-Hearing Brief of Respondent George C. Kern, Jr., August 12, 1988, at 81.

evening of October 7.[23/] Quite clearly the October 3 Board Resolution was a continuing one which constituted a material change in the information under Item 7 of Allied's Schedule 14D-9 and should have been promptly disclosed by an amendment. Again any concern that Kern might have had about misleading the market could have been dispelled by language alerting Allied shareholders and public investors to the problems encountered by EJDC in obtaining the necessary financing.

EXPERT TESTIMONY

A. Market Experts

In support of its allegations the Division introduced the expert testimony of an economist specializing in the effects of information disclosures on the operation of financial markets. Based upon his study and analysis, he concluded:

> Within the framework of the literature and within the framework of the kinds of analyses

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23/ The Allied Board did hold a special meeting which was convened at 5:00 P.M. on October 7, but the minutes of that meeting reflect that Macioce "advised that the meeting had been called to update the Board on the status of the proposed tender offer..." and that thereafter Kern advised that upon receipt of the banks' commitment letters a public announcement of the DeBartolo tender offer would be made. Kern next reviewed for the Board's benefit a derivative action commenced against Allied and its directors after which the Board adjourned without action being taken on any matter. (See Respondent Exhibit E.)

> that we conduct, I would regard each of those events, restructuring negotiations, merger negotiations, and board resolution, and agreement in principle as significant changes in the status of the target firm, and therefore as events that would convey information to the market that would be important to shareholders in assessing what the correct value of Allied shares is, and therefore what their best decision was in the face of the Campeau offer. 24/

Kern claims that the testimony of the Division's expert is irrelevant given the Supreme Court's holding in Basic that an assessment of materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company's activity." 25/ Kern's further argument is that even if relevant the economist's opinion is flawed by being a product of an analysis divorced from the facts in this matter. He also asserts that the opinion was also contradicted by Kern's financial expert whose expertise includes investment banking as related to mergers and acquisitions.

But the Supreme Court's discussion of materiality in Basic did not end with the quotation relied upon by Kern, but went on to point out:

> As we clarify today, materiality depends on the significance the reasonable investor

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24/ Tr., at 501.

25/ Basic Inc. v. Levinson, supra, at 987.

would place on the withheld or misrepresented information. 18 . . . .

> 18. We find no authority in the statute, the legislative history, or our previous decisions, for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited. See, e.g., Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1231 (CA 1 1984) ("A fact does not become more material to the shareholder's decision because it is withheld by an insider, or because the insider might profit by withholding it"); cf. Aaron v. S.E.C., 446 U.S. 680, 691, 100 S.Ct. 1945, 1953, 64 L.Ed.2d 611 (1980) ("scienter is an element of a violation of §10(b) and Rule 10b-5, regardless of the identity of the plantiff or the nature of the relief sought").
>
> We recognize that trading (and profit making) by insiders can serve as an indication of materiality, see S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d at 851; General Portland, Inc. v. LaFarge Coppee S.A., CCH Fed. Sec. L. Rep. (1982-1983 Transfer Binder) ¶99,148, p. 95,544 (ND Tex. 1981) [Available on WESTLAW, 1981 WL 1408]. We are not prepared to agree, however, that "[i]n cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in a publicly disseminated press release." S.E.C. v. Geon Industries, Inc., 531 F.2d 39, 48 (CA2 1976). Devising two different standards of materiality, one for situations where insiders have traded in abrogation of their duty to disclose or abstain (or for that matter when any disclosure duty has been breached), and another covering affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead), would effectively collapse the materiality requirement into the analysis of defendant's disclosure duties. 26/

26/ Id., at 988.

By footnote 18, the Supreme Court appears to signal that materiality must be construed uniformly in the application of that term to any disclosure requirements under the Exchange Act. That being the case, trading and profit making by a reasonable investor can serve as an indication of materiality. To that extent, testimony of the Division's expert that disclosure of the events in question would have conveyed information to the marketplace that would have significantly raised the price of Allied stock and would have been important to shareholders in assessing the correct value of Allied shares has been taken into consideration in determining the materiality of those events.

Kern's complaint that the analysis of the Division's expert was "divorced" from the facts of this case is ill-founded. Although he could not, of course, precisely assess the market impact of Allied's required disclosures since those disclosures were not made, he could and did, by finding reasonably analagous situations where disclosures had been made of events similar to those at issue, come to conclusions that shed light upon the materiality of Allied's undisclosed events. His conclusions are deserving of consideration in determining whether a reasonable investor would place significance upon the information withheld by Allied and how the market would have reacted if Allied had made the disclosures in question.

Kern called as one of his expert witnesses an investment banker with nearly twenty years experience as an investment banker specializing in the field of mergers and acquisitions. The expert did not testify as a witness having knowledge of the record in this matter except for information gleaned from his review of Allied's September 24 Schedule 14D-9, the stipulation of facts entered into by the Division and Kern, and a summary of Allied's stock prices during the relevant period. From the sparse information he had regarding the details of the negotiations and relevant events that took place between September 24 and October 8, 1986, he ventured the opinion that had the disclosures in question been made there would have been no impact upon the market price of Allied stock.

Kern's expert dismissed the idea that disclosures concerning the shopping center negotiations might have provided additional information to shareholders by telling them that negotiations had in fact commenced, saying he would have "read that type of discussion into the 14D-9 as it was originally filed." 27/ The importance of the negotiations of September 30 to October 3, 1986 leading toward a possible merger of Allied and EJDC was also downplayed by the expert because he read Allied's Schedule 14D-9 "to say that basically they are exploring a lot of

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27/ Tr., at 684.

different alternatives, they don't know what they are going to do, and included among those would be white knight discussions." 28/ Regarding the agreement in principle and the Allied Board Resolution of October 3, the expert believed that a disclosure on the morning of October 6 revealing the contingencies attached would have been "saying, in effect, if we had a deal, but we don't have a deal -- you'd be telling the market that we have a non-deal." 29/

While the qualifications of Kern's expert regarding banking and his extensive experience in mergers and acquisitions and the financial markets command respect, the opinions he expressed contradicting those offered by the Division's expert cannot be accepted. If the market would have construed the September 24 Schedule 14D disclosures as Kern's expert did, there would be no question but that the market would not have responded to the further disclosures about the negotiations for the shopping centers and ensuing merger negotiations and the October 3 Board Resolution. However, his interpretations of the September 24 disclosures are, as Kern asserts his were at the time of the events in question, too inclusive to be given credence as representative of information conveyed to professional market traders. Certainly it is

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28/ Tr., at 709.

29/ Tr., at 675.

more reasonable to conclude that if the generalities of the September 23 Board Resolution had been supplemented by specifics as events unfolded during the relevant period, there would have been less speculation in the market about Allied's situation which would have led to an increase in the market price of Allied stock as projected in the Division expert's study. Another factor that has been considered in weighing the conflicting opinions of the two experts is whether personal bias intruded upon their analyses. In the case of the Division's expert, none was perceived, but Kern's expert made no effort to conceal his partisanship. His testimony in response to the Division's inquiry as to how he came to be involved in this case was:

> Well, after the matter was publicly announced in the newspapers that the SEC was bringing an action again[st] the Allied situation and George Kern, I called George Kern myself and said that I was very disturbed on what I read in the newspapers, very troubled, and if there was any way in which I could be helpful to him as a witness, expert witness or whatever, I would be happy to do so because I have very strong professional regard for George. 30/

B. Legal Experts

As part of his defense, Kern called four of the leading practitioners and scholars in the field of securities law, all of whom testified that in their opinions

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30/ Tr., at 743-44.

Kern's disclosure decisions here in issue were reasonable exercises of his professional judgment. One went further during cross-examination by the Division by testifying:

> Q. Is it your view that Mr. Kern's decisions concerning disclosure in this case were correct, as a matter of law?
>
> A. Based upon my knowledge of the record and the facts, which may or may not have included all the nuances of the situation, but just based on my knowledge of the record, I think his decisions were correct. 31/

Expert testimony was also elicited to the effect that in hostile take-over situations corporations very frequently delegate responsibility for making decisions on disclosures to outside counsel and that very frequently the outside counsel makes a decision that no amendment to a previously filed Schedule 14D-9 is required.

Although the opinions of these highly regarded experts are contrary to conclusions reached herein regarding the reasonableness of Kern's decisions not to file an amendment to Allied's Schedule 14D-9 until October 8, 1986, those opinions were taken into consideration. Their expert testimony not only contributed to clarification of factual issues but has been taken into account in the determination of the appropriate

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31/ Tr., at 914-15.

order to enter in these proceedings.

The Division persists in its objection to the introduction of the testimony of the legal experts, arguing that Kern's liability is to be judged by objective determinations by the trier of the facts and that the subjective views of Kern and his witnesses should be irrelevant. The Division's contentions are in conflict with current authorities which tend to leave the question of admission of opinions and expert testimony on factual issues to the discretion of the trial judge. For example, in Marx & Co., Inc. v. Diners' Club, Inc., which the Division relies upon, the Second Circuit noted with approval that the lawyer who was qualified as an expert in securities regulation had given testimony concerning the practice of lawyers and others engaged in the securities business, stating:

> Testimony concerning the ordinary practices of those engaged in the securities business is admissible under the same theory as testimony concerning the ordinary practices of physicians or concerning other trade customers. . . . 32/

Rules 702-04 of the Federal Rules of Evidence also reflect the relaxation of the formerly strict rules relating to admissibility of expert testimony.

32/ 550 F.2d 505, 509 (2d Cir. 1977).

SECTION 15(c)(4) OF THE EXCHANGE ACT [33/]

Standard of Culpability

Under Section 15(c)(4) the Commission may issue an order requiring any person who was a cause of a failure to comply with Section 14 of the Exchange Act "due to an act or omission the person knew or should have known would contribute to the failure to comply," to comply, or to take steps to effect compliance. Kern claims that before the Division can establish that he "knew or should have known" that he was contributing to a violation of Rule 14d-9 the Division must prove that Kern knowingly or consciously counseled a course of illegality. Kern further asserts that even assuming Section 15(c)(4) requires the lesser standard of negligence, the Division must prove that Kern did not take the care that a

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33/ Section 15(c)(4) of the Exchange Act provides:

> If the Commission finds, after notice and opportunity for a hearing, that any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15 of this title or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or to take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

reasonable lawyer would have taken under the circumstances and that the Division's failure to introduce expert testimony that Kern's judgment was unreasonable is fatal to its case. The Division contends that the phrase "knew or should have known" describes a range of mental intent from actual knowledge to negligence and includes reckless conduct and argues that Kern's conduct was reckless or at least negligent.

Taking into consideration the intent and purpose of the addition of Section 15(c)(4) to the Exchange Act in 1964 and of the amendment of Section 15(c)(4) in the 1984 Insider Trading Sanctions Act ("ITSA") and finding no case law or Commission authority to the contrary,[34/] it is concluded that a showing of negligence by a person contributing to a failure to comply is sufficient to satisfy the phrase "should have known" in Section 15(c)(4). This conclusion is based upon the perception that although Section 15(c)(4) can be looked upon as an enforcement tool of the Commission, it was enacted to provide an expeditious procedure for the resolution of accounting and technical questions involving disclosure provisions under

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34/ All prior proceedings under Section 15(c)(4) have been disposed of by consent order except for Oppenheimer & Co., Inc., 20 SEC DKT 58 (May 19, 1980) which was instituted prior to the 1984 ITSA amendment and did not charge that an individual was a "cause" of a violation.

Sections 12, 13, or 15(d) of the Exchange Act and a means of apprising investors of materially false and misleading filings concerning their securities. 35/ The 1984 amendments to Section 15(c)(4) widened the Commission's reach to include Section 14 within the purview of Section 15(c)(4). The addition was deemed desirable to remedy a need that became apparent after the tender offer reporting provisions under Section 14 were added to the Exchange Act in 1968 36/ and did not affect its over-all purpose. Quite obviously, construing the language of Section 15(c)(4) to require a showing greater than negligence as a preliminary to ordering compliance by a person contributing to a violation of Section 14 would conflict with the intent to provide the Commission with a quick means to obtain disclosures mandated by the Exchange Act. Not only would investigations into suspected violations be far more protracted, but also the time required to present evidence to establish violations in administrative hearings would be substantially extended.

Kern chooses to ignore the disclosure philosophy behind Section 15(c)(4) and to concentrate upon its enforcement potential in his argument that the phrase

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35/ S. Rep. No. 379, 88th Cong., 1st Sess. 25-26 (1963).

36/ H.R. 98-355, 98th Cong., First Sess. 8 (1983).

"knew or should have known" has been interpreted to require knowing or, at the very least, reckless conduct. In support of his position he cites several cases in which courts have decided the standard of proof required to sustain allegations of violation of Section 10b-5 of the Exchange Act and whether scienter is established by a showing of recklessness.[37/] Kern suggests that the interpretation of "knew or should have known" in his cited cases should also govern in construing the language of Section 15(c)(4) and argues that the cases cited by the Division in which the phrase was equated to a showing of negligence are not in point because they did not arise under the federal securities laws.[38/] He further argues that in Heit v. Weitzen,[39/] also cited by the Division, the Second Circuit in the pre-Hochfelder era[40/] did not

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37/ E.g. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978), cert. denied 439 U.S. 1039 (1978); Spiekerman v. Whittaker Corp., 598 F.Supp. 1 (E.D.N.Y. 1978); and Stern v. American Bankshares Corp., 429 F.Supp. 818 (E.D. Wisc. 1977).

38/ Levine v. CMP Publications, 738 F.2d 660 (5th Cir. 1984), a defamation case; Wisener v. Air Express International Corp., 583 F.2d 579 (2d Cir. 1978), involving indemnification of a corporate official.

39/ 402 F.2d 909 (2d Cir. 1968).

40/ In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court held that proof of scienter was required before a violation of Section 10(b) of the Exchange Act and Rule 10b-5 could be found.

decide the appropriate standard of culpability in passing upon the sufficiency of a pleading under Section 10(b) of the Exchange Act.

The cases relied upon by Kern are insufficient to carry his argument and his objections to the cited Division's cases are rejected. No authority has been cited or found declaring that the meaning to be ascribed to the phrase "knew or should have known" must be the same under every enforcement provision of the Exchange Act. To the contrary, the Division's cited cases and other court rulings [41/] indicate that the meaning of "knew or should have known" is flexible, varying with the context in which the question arises.

Also rejected is Kern's view that it is "unseemly" for the Division to now contend that a different meaning should be given to the language of Section 15(c)(4) than the one presented to the Commission in an open meeting by the Division staff which drafted the proposed amendment. In that meeting the then Director of the Division, in response to a commissioner's question, indicated that the standard of culpability was at least as high as required to establish aiding and abetting liability. As now pointed

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41/ Cf. McIntyre v. United States, 789 F.2d 1408 (9th Cir. 1986); Amoco Production Co. v. United States, 619 F.2d 1383 (10th Cir. 1980).

out by the Division, there is no showing that any participant in the meeting spoke for the Commission. Further, Kern has failed to establish that the views expressed by the Division staff at the meeting were made known to Congress or that Congress was in accord with the then Division Director's thinking. Certainly if Congress wanted to impose the strict standard advocated by Kern it could readily have used language similar to that found in Section 15(b)(4)(E) of the Exchange Act where the words "willfully aided, abetted, counseled, commanded, induced or procured the violation by any other persons . . . ." leave no doubt as to Congressional intent.

Because it appears that the words "should have known" in Section 15(c)(4) import a test of reasonableness, Kern's conduct in question has been judged by the standard of negligence. Under that measure the Division was not required to prove that Kern acted with knowledge or awareness that he was counseling a violation of Rule 14d-9 by Allied, and it is concluded that the due care required of Kern to comply with the disclosure requirements of the Exchange Act was not accorded.

Kern further argues that even assuming a negligence standard there is no evidence of negligence on his part because the Division failed to introduce expert testimony "on whether the advice given was reasonable or whether a

lawyer in a similar situation would have acted "differently."42/ In support of that argument Kern calls upon a number of civil legal malpractice cases which have required that a plaintiff carry the burden of proving a lawyer's negligence by introducing expert testimony regarding the level of care ordinarily exercised under the circumstances.43/ The law appears well-established with respect to the need for expert testimony to prove legal malpractice, but malpractice cases are not acceptable precedent for use in a Commission proceeding under Section 15(c)(4). The ultimate purpose of this proceeding is to determine what action, if any, the Commission should take to protect investors. That contrasts sharply with the money damages sought in a private malpractice suit where the plaintiff is charging that a lawyer failed to exercise the reasonable care owed to him as a client and thereby caused monetary damage. Courts have recognized this distinction in Commission injunctive actions44/ and no

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42/ Post-Hearing Brief of Kern, supra, at 58.

43/ E.g. Wagenmann v. Adams, 829 F.2d 196, 218-20 (1st Cir. 1987); Reis v. Morrison, 807 F.2d 112, 113 (7th Cir. 1986); Helmich v. Kennedy, 796 F.2d 1441, 1442-43 (11th Cir. 1986).

44/ SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975); SEC v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973); SEC v. Texas Gulf Sulphur Co., supra, at 854-55.

perceptible reason appears that would preclude the same distinction being made between a private malpractice action which subjects a practitioner to potentially heavy civil money damages and a Commission proceeding which subjects a lawyer to remedial action by the Commission. Further, as the Division observes, expert testimony regarding accepted standards of legal practice at the private securities bar is not the issue here, but rather whether under all the circumstances Kern knew or should have known that he would contribute to a violation of Section 15(c)(4) by Allied.

It appears from the record that during the relevant period Kern found himself in the center of a complex and fast-changing series of negotiations which required him to exercise his authority to have Allied comply with the disclosure requirements of Rule 14d-9. In the usual relationship of lawyer and client Kern would have had only the responsibility of giving legal advice to Macioce or other officers of Allied who in turn would have made the decisions whether amendments to Allied's Schedule 14D-9 were required. When Kern accepted discretionary authority to make those decisions he also accepted the responsibility the Allied officers had for compliance with Rule 14d-9 and cannot be heard now to complain that his legal judgments are being second-guessed in these proceedings.

Were the law otherwise, corporate officials could find a safe harbor from accountability by giving discretionary authority to discharge their responsibility for compliance with disclosure requirements to a lawyer who in turn would be immune from action under Section 15(c)(4) unless his misconduct were so egregious as to also warrant disciplinary action under Rule 2(e) of the Commission's Rules of Practice. Delegation of authority by corporate officers to counsel to comply with Sections 12, 13, 14 or 15(d) of the Exchange Act would be encouraged, with Section 15(c)(4) becoming an ineffectual enforcement tool. Moreover, if a "cause" happens to be a person who is also counsel to the person out of compliance, adoption of Kern's approach to responsibility would create a two-tiered standard for enforcement of Section 15(c)(4), one for the "cause," who happens to be a lawyer, the other for a non-lawyer "cause." Such distinction would be at odds with the statutory language of Section 15(c)(4) which calls to account any person, not just a non-lawyer, who is a "cause."

It appears that in devoting himself and his attention to the interest of his client Kern neglected to give due care and consideration to the need for amendment of Allied's Schedule 14D-9 as material changes occurred in the information in that schedule during the relevant period. The Revlon decision, even though issued in a consent matter, should have alerted Kern to the disclosure

philosophy of the Commission and to the need for securities practitioners to be aware that the Commission favors a liberal interpretation of Rule 14d-9.

SCOPE OF COMMISSION AUTHORITY UNDER SECTION 15(c)(4) OF THE EXCHANGE ACT

The remedy sought by the Division in this matter is an order pursuant to Section 15(c)(4) directing future compliance by Kern with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder. Kern protests against issuance of any order for future compliance asserting that the Commission has no authority to use Section 15(c)(4) to direct generalized prospective relief. Under the circumstances of this case where Kern has no power or authority to make or correct any filing on behalf of Allied, it is concluded that Section 15(c)(4) does not authorize the issuance of an order directing future compliance by Kern with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder.

As originally enacted in 1964, Section 15(c)(4) authorized administrative proceedings to compel compliance with the provisions of Section 12, 13, or 15(d) of the Exchange Act. In 1984 Section 15(c)(4) was amended by Congress to include Section 14 of the Exchange Act and to authorize the Commission to issue an order requiring "any person who was a cause of the failure to comply. . ., to comply or to take steps to effect compliance. . . ."

It appears from the testimony of Kern's legal experts that the authority of the Commission under Section 15(c)(4) to isue an order "to comply" with the provisions of Section 12, 13, 14, or 15(d) can be reasonably construed to limit such order for future compliance to correcting a previous defective filing or, in case of a failure to file, to rectifying that failure by filing the required information. A more liberal and also reasonable view of the breadth of the Commission's authority is that in addition to correcting past filings or requiring filings to be made the term "to comply" also enables the Commission to order future compliance in the sense advocated by the Division. The Division cites a number of consent orders issued by the Commission since at least 1981 which directed future compliance by respondents, [45/] but it otherwise looks to the legislative history of the 1984 amendments for support.

There being a latent ambiguity in the language and no case law construing Section 15(c)(4), it is appropriate

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45/ The consent orders are not considered to have precedential value in determining the proper interpretation of the Section 15(c)(4) language in question since there is no indication in those cases whether the Commission considered if it had the authority to impose a requirement of future compliance as a matter of law.

to look to the legislative history of that section.[46/] The House Report ("H. Rep.") which, as the Division states, was the only Congressional Report on the 1984 ITSA amendment referred to the then current enforcement remedies available to the Commission to deal with insider trading and other fraudulent or unlawful activities. With respect to Section 15(c)(4), the following was included:

> The Commission is also authorized to bring an administrative proceeding under section 15(c)(4) to require compliance with the reporting requirements under sections 12, 13, and 15(d) of the Exchange Act. The Commission's order may require any person subject to those requirements to correct public filings in order to make fair and complete disclosure to shareholders, direct future compliance and obtain additional relief as part of the terms and conditions of the order. However, although an administrative order under section 15(c)(4) may resemble a civil injunction, it does not carry with it certain consequences of an injunction, such as the threat of criminal contempt proceedings or certain disqualifications under the securities laws. 47/

In explaining the application of Section 15(c)(4) of the Exchange Act to violations of Section 14, the H. Rep. stated:

> The legislation gives the Commission authority to bring administrative preceedings [sic] under section 15(c)(4) of the Exchange Act to remedy violations of section 14. Under the legislation, if

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46/ Ernst & Ernst v. Hochfelder, supra, at 197-201 (1976); Fairport R. Co. v. Meredith, 292 U.S. 589, 594-95 (1934); Russell Motor Car Co. v. United States, 261 U.S. 514, 519 (1923).

47/ H. Rep. 98-355, 98th Cong., First Sess. 7 (1983).

> the Commission finds, after notice and a hearing, that any person subject to section 14 has failed to comply with that section, or any rule or regulation, the Commission may publish its findings and issue an order requiring compliance.
>
> This new authority is in addition to the Commission's current authority under section 15(c)(4) to issue orders requiring compliance with the periodic reporting provisions under sections 12, 13 and 15(d) of the Exchange Act.
>
> The Committee believes that the option of obtaining administrative correction of proxy and tender offer documents should be available to the Commission, just as it is with respect to other filed reports. The more far-reaching remedy of an injunction, and the costs attendant to civil litigation, are not appropriate in some cases of inaccurate filings. These situations are as likely to occur in connection with documents filed pursuant to section 14 as in those materials filed pursuant to section 12, 13, and 15(d). The Committee believes that the addition of section 14 will allow the Commission greater flexibility in dealing with abuses in the tender offer and proxy area. 48/

The H. Rep., scant as it may be on the subject of Section 15(c)(4), does by the reference to the Commission's authority to "direct future compliance," lend support to the Division's position that the Commission is not limited to orders requiring corrective disclosure. Logic also dictates a conclusion favoring a broad interpretation, for otherwise the Commission would be faced with a situation where it would have to expend its resources on successive administrative proceedings to deal with an issuer or other person who repeatedly violated Section 12, 13, 14, or 15(d). For the Commission to be required to cope with

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48/ *Id.*, at 12.

that kind of administrative burden cannot be reconciled with the purposes behind the enactment of Section 15(c)(4).

The language adding the "cause" provision to Section 15(c)(4) was not considered in the H. Rep. but taken up later in a Congressional hearing on H.R. 4574.[49/] The Hearing on H.R. 4574 reflects that an oversight hearing on the activities and policies of the Commission was being held and that testimony would be heard on H.R. 4574, a bill drafted by the Commission at the request of the Subcommittee during hearings in 1983 in order to clarify the statutes under which the Commission operates.[50/] At the hearing the prepared statement of then Commission Chairman Shad referred to new enforcement remedies the Commission was recommending. One of the recommendations was for expansion of the Commission's authority under Section 15(c)(4) to add persons subject to Section 14 and "to clarify the Commission's authority to name, as respondents, in Section 15(c)(4) proceedings, individuals who cause failures to comply with Sections 12, 13, 14, or 15(d)."[51/] Included as part of the Hearing on H.R. 4574 was a

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49/ Hearing Before a Subcomm. of the Comm. on Energy and Commerce on H.R. 4574, 98th Cong. Second Sess. (1984). ("Hearing on H.R. 4574").

50/ *Id.*, at 2.

51/ *Id.*, at 51.

letter from Chairman Shad to the Chairman of the Subcommittee holding the hearing which was in response to the latter's request to be advised of the results of a Commission staff review of the adequacy of Commission enforcement sanctions and remedies. 52/ Attachment A to Chairman Shad's letter set forth the results of that review with the portion captioned "Expansion of Section 15(c)(4) to Authorize the Commission to Name Individuals Who Cause Violations as Respondents" reading:

> Section 15(c)(4) authorizes the Commission to publish its findings and issue an order with respect to any person subject to Sections 12, 13, 14 or 15(d) of the Securities Exchange Act, or the rules or regulations thereunder, who has failed to comply with such section, rule or regulation "in any material respect." The attached legislative proposal, which the Commission recommends and supports, also would clarify the Commission's authority to name individuals as respondents if it appears that they have caused a failure to comply on the part of a subject person. If the Commission should find that an individual was "a cause of the failure to comply," the legislation would authorize the Commission to issue an order directing the individual "to comply, or take steps to effect compliance."
>
> An individual could be found to be "a cause" if he or she engaged in an act, or failed to act, under circumstances where the individual knew or should have known that such act or omission would contribute to a failure to comply. This test would establish two litations on the scope of individual liability. First, there would have to be a nexus between an individual's act or omission and a particular failure to comply. Second, an individual would be culpable only when he or she knew or should have known that the act or omission would contribute to such failure to comply.

52/ Id., at 341.

> This approach would allow the Commission to proceed against officers or directors or other individuals who cause a failure to comply with Sections 12, 13, 14 or 15(d), or the rules promulgated thereunder, whether or not they fall within the definition of a "controlling person" under Section 20 of the Securities Exchange Act. This would include, for example, the officer who, while not directly participating in the preparation of a report, is responsible for the underlying transaction which required that the report be filed and for providing relevant information to those who do prepare the report. For example, should an officer either provide materially false and misleading information or fail to correct materially false and misleading information, where he knew or should have known of it falsity, the Commission could proceed under Section 15(c)(4) to redress a violation of the reporting requirements. In addition, the officer who prepares or assists in the preparation of materially false or misleading disclosure documents, when he knew or should have known they were false, could be made the subject of a Section 15(c)(4) proceeding. The Commission also would be authorized to direct such a person to take steps necessary to effect compliance on the part of the issuer involved. [Emphasis supplied].
>
> The legislation would clarify the Commission's authority to proceed against individuals in a Section 15(c)(4) proceeding. It would eliminate the potential bifurcation of proceedings inherent in the cases where a Section 15(c)(4) proceeding provides an appropriate forum for dealing with violations on the part of an issuer, and it also is appropriate to take enforcement action against the individuals responsible for that violation. 53/

The Hearing on H.R. 4574 makes clear that the Commission's purpose in recommending and supporting the "cause" amendment to Section 15(c)(4) was to remove any doubt that it could proceed administratively against

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53/ *Id.*, at 345-46.

persons indirectly participating in the preparation of a report as well as against those responsible for preparing a report in order to redress a violation. But it is also clear from the Commission's stated position that the "cause" amendment it was recommending was intended only to authorize the Commission "to direct such a person to take steps necessary to effect compliance on the part of the issuer involved." 54/ The Commission's statement leaves no ambiguity regarding the nexus that must exist between the issuer involved and the "cause" named insofar as any order of compliance is concerned.

It follows then that in these proceedings the Commission has the authority under Section 15(c)(4) to issue, if appropriate, an order of future compliance requiring Kern to take steps necessary to effect compliance on the part of Allied. There is no authority, however, for the Commission to issue an order under Section 15(c)(4) that Kern comply generally or to take steps necessary to effect compliance with Sections 12, 13, 14, or 15(d) by any other issuer Kern might represent or become associated with in the future.

As to the appropriateness of any order of compliance directed against Kern with respect to Allied, the record establishes that Kern no longer has power or authority to require Allied to make any corrective filing and cannot control its future compliance. Under the circumstances,

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54/ Id.

the issuance of an order to Kern to take steps to effect compliance by Allied with Section 14 would be a futile gesture, and an order of general future compliance would be beyond the scope of Section 15(c)(4). Accordingly no order will be issued against Kern and, since no other relief is sought or appears necessary pursuant to Section 15(c)(4), these proceedings will be discontinued with the publication of the Commission's findings in this matter.

DUE PROCESS

From the outset of these proceedings Kern has insisted that he is not being accorded his constitutional right to a fair hearing. His assertions in that regard are based upon his belief that the Commission's findings that Allied had violated Section 14(d) and Rule 14d-9 by failing to make the amendments to its Schedule 14D-9 as alleged by the Division [55/] constitute prejudgment of one of the essential elements of the Division's allegations against him.

There can be no quarrel with the established principles found in the cases cited by Kern [56/] to the effect that a fair trial in a fair tribunal is basic to due

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55/ Securities Exchange Act Release No. 24727, 38 SEC DKT 1525.

56/ Cinderella Career & Finishing School, Inc. v. F.T.C., 425 F.2d 583 (D.C. Cir. 1970; American Cyanamid Co. v. F.T.C., 363 F.2d 757 (6th Cir. 1966).

process and that a respondent in an administrative proceedings is entitled to a hearing before an agency that has not prejudged the issues. But neither of the cases relied upon by Kern involved a challenge of a decisional authority on grounds that an earlier decision handed down in discharge of quasi-judicial duties constituted prejudgment of the same or similar issues in a succeeding proceeding. The apposite Supreme Court ruling on the due process issue raised here is expressed in F.T.C. v. Cement Institute 57/ where the Court, after consideration of its earlier decision in Tumey v. Ohio, 58/ concluded:

> Neither the Tumey decision nor any other decision of this Court would require us to hold that it would be a violation of procedural due process for a judge to sit in a case after he had expressed an opinion as to whether certain types of conduct were prohibited by law. In fact, judges frequently try the same case more than once and decide identical issues each time, although these issues involve questions both of law and fact. Certainly, the Federal Trade Commission cannot possibly be under stronger constitutional compulsions in this respect than a court. [Footnote omitted]. 59/

No showing having been made by Kern that the Commission's Allied findings constitute impermissible prejudgment by the Commission of the allegations against Kern, 60/ it is concluded that Kern's claim that this proceeding violates his

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57/ 333 U.S. 683 (1948).

58/ 273 U.S. 510 (1927).

59/ F.T.C. v. Cement Institute, supra, at 702-03.

60/ Kern's claim of unconstitutional prejudgment does not involve a challenge to the fairness of the hearing. See Post-Hearing Brief of Respondent George C. Kern, Jr., at 111, n.

constitutional right to a fair hearing is without merit.[61/]

O R D E R

IT IS ORDERED that these proceedings are discontinued as to George C. Kern, Jr., and that the findings herein be published.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Rules of Practice.

Pursuant to Rule 17(f) of the Rules of Practice, this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for

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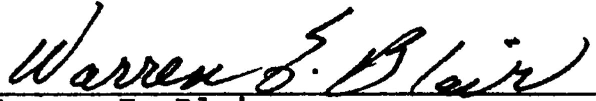
61/ All proposed findings and conclusions submitted by the parties have been considered, as have their contentions. To the extent such proposals and contentions are consistent with this initial decision, they are accepted.

review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Warren E. Blair
Chief Administrative Law Judge

Washington, D.C.
November 14, 1988