Spinning in a Hot IPO - Breach of Fiduciary Duty or Business as Usual?

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INTRODUCTION

I have a story to tell. A story with several lessons—some familiar, some novel. This story reflects the rapid pace of change in today's securities markets. It reflects the competitive pressures of today's securities markets and the influential power that these forces of competition wield in shaping the business practices of the participants in our modern financial world. It reflects the prevailing sense of business ethics among the participants in today's business environment. Finally, and most importantly, this story reflects the essential role that the rule of law continues to play in defining the scope of fiduciary duty imposed on individual managers operating in our modern business world. But, I get ahead of myself.

My story begins with the incredibly hot market for new issues that prevailed for a brief period in the late 1990s.1 As old-timers

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1. The IPO market of the late 1990s was a hot-issue market like none before on Wall Street. "All kinds of companies go public, but none in recent years gripped the IPO market the way technology stocks did. Their astonishing first-day gains, mostly on NASDAQ, were a hallmark of the bull market of the late 1990s and early in the year 2000." Kate Kelly, Investors Discover Gravity As IPOs Return to Earth, WALL ST. J., Mar. 7, 2001, at C1. However, the Internet-fueled IPO mania that started in 1998 came to a crashing close early in the year 2000.

New issues started the year [2000] strong, with many early-spring IPOs doubling, even tripling, their offering prices.

Then came April 4, the day the NASDAQ Composite Index and the Dow Jones Industrial Average each fell more than 500 points intra-day. There had been some weakness in technology stocks before then, but investors were really spooked by the market’s falling so far so quickly. …

Many of the companies that fell the furthest in the spring [2000] sell-off were
recall, it was in this hot new-issue market that we saw the initial public offering (IPO) of VA Linux Systems, Inc. Linux's IPO went effective at $30 a share and by the close of its first day of trading, it had surged 698% to close at a whopping $239.25, for the biggest-ever first-day gain.2 In this market, the competition to get an 

the once-hot IPOs of 1999. Investors became skeptical of IPOs in general—not just tech stocks.

Raymond Hennessey, Some Perceive A Bright Side to IPOs of 2000, WALL ST. J., Dec. 18, 2000, at C16; see also Raymond Hennessey, For Every IPO Winner, Now There Are At Least Two Losers, WALL ST. J., Dec. 4, 2000, at C1 (“By a ratio of more than 2-to-1, IPO losers are outpacing the gainers in 2000.”). Investor skepticism continued in the IPO market of 2001. See, e.g., Raymond Hennessey, IPO Market Returns To Sickbed After Kraft, WALL ST. J., June 18, 2001, at C14 (reflecting the continuing “chill” in the current IPO market, “the new-issues sector is entering the summer [of 2001] in questionable health”); Kelly, supra, at C1 (“So far this year [2001], only 13 companies have gone public, making 2001 one of the flattest IPO markets since 1991 . . .”).

2. Terzah Ewing et al., VA Linux IPO Soars a Record 698%, WALL ST. J., Dec. 10, 1999, at C1 (“Offered at $30 a share, VA Linux exploded to end the day at a 4 p.m. price of $239.25. It was the first time an IPO has ever finished the regular session at above $200 a share on the Nasdaq Stock Market.”); Kelly, supra note 1, at C1 (“VA Linux’s astounding 698% price pop set the record for first-day performance of an IPO, as its shares soared from [the offering price of] $30 to [close the day at] $239.25.”). Reflecting the heady days of the hot IPO market of 1998-2000:

Analysts called the [VA Linux IPO] stock “a runaway hit” and even “the next Microsoft.” But within three months, shares of the company, which makes hardware tailored to the free Linux operating system, had dropped 57% . . . [As of March 6, 2001], in Nasdaq Stock Market trading, shares of VA Linux [closed at] . . . $4.06. Still, more than a year after the stock’s debut on Dec. 9, 1999, the shares are off 98% from their first-day high.

Id.

Although it experienced the largest first-day gain, VA Linux was not the only technology company to go public and experience this kind of sizeable first day price “pop” in the incredibly hot market for IPOs that roared in the late 1990s. As another example, theglobe.com, which went public on November 13, 1998, closed 606% higher than its offering price; however, in February, 2001, the Wall Street Journal announced that the “Nasdaq National Market is planning to delist the company.” Steven Lipin et al., Bids and Offers: Inside the World of Corporate Finance & Wall Street, WALL ST. J., Feb. 23, 2001, at C16. Reflecting the incredible “come-down” of the IPO market, “not a single one of the top-10 gainers [in the hot IPO market of 1998-2000] is anywhere near its first-day close.” Id.

I realize that publishing on this topic in the current moribund market for IPOs is perhaps not as timely as it would have been had I published this Article at the height of the hot issue market. But my bad timing does not undermine the relevance of the morals of my story regarding the practice of spinning. Indeed, the fundamental issues raised by the practice of spinning continue to grab headlines in the financial press. E.g., John C. Coffee, Jr., The SEC’s IPO Probe, NAT'L L.J., July 9, 2001, at B8 (“Three-pronged investigation by the [SEC], the [NASD] and the U.S. Attorney’s Office for the Southern District of New York has been probing for the past year the practices of underwriters in allocating stock in ‘hot’ or oversubscribed
allocation of shares in a hot IPO was fierce owing in no small part to the widely held perception that IPOs—especially of Internet-related issuers—would yield tremendous profits to any buyer lucky enough to get the opportunity to purchase hot IPO shares from the underwriters.

In the midst of this frenzy of IPO activity, at least one individual investor made a substantial profit flipping shares allocated to him as part of a hot IPO. According to a November, 1997 article in the Wall Street Journal, Joseph Cayre, who was the CEO of a privately initial public offerings (IPOs) and regulatory action appears imminent.

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held computer software firm, GT Interactive Software, was lucky enough to receive a sizeable allocation of shares of Pixar’s hot IPO.\(^4\) Pixar’s IPO shares soared by 77% by the close of its first day of trading, and Mr. Cayre was heard to brag about the $2 million profit he made when he “flipped” (sold) his Pixar shares in the aftermarket.\(^5\)

In a market dominated by institutional players,\(^6\) one might wonder how it was that an individual investor such as Mr. Cayre was able to receive the sizeable number of Pixar shares that he was allocated by Pixar’s lead underwriter, Robertson Stephens.\(^7\) According to the *Wall Street Journal*, the allocation of Pixar shares to Mr. Cayre’s personal trading account at Robertson Stephens was apparently made in anticipation that Mr. Cayre would direct his company’s future investment banking business to Robertson Stephens.\(^8\) In fact, when GT Interactive Software went public a month later, Robertson Stephens served as the lead underwriter of the company’s IPO.

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4. Not all investors in hot IPOs were as lucky as Mr. Cayre. As in the case of Mr. Cayre, the built-in profit was there for many investors—because the shares in these oversubscribed offerings would trade at a substantial premium over the fixed IPO price—but most investors did not receive as many shares and therefore their profits were more modest as compared to Mr. Cayre’s gain.


6. E.g., THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 6.2, at 87 (Practitioner’s ed., 3d ed. Supp. 1999) (“As a result of these and other ways in which [underwriting] firms favor their larger [institutional] customers, most [individual] investors do not have access to hot issues in the new issues market.”).


8. Siconolfi, *supra* note 3, at A1 (“Many investment banks silently allocate chunks of hot new stocks to the personal brokerage accounts they hold for corporate executives and venture capitalists ... in an apparent bid for business from the executives’ firms.”).
"Spinning" is the term of art that Wall Street generally uses to refer to the decision of Robertson Stephens, as lead underwriter, to allocate shares of Pixar’s hot IPO to Mr. Cayre’s personal trading account. In turn, Mr. Cayre “flips”—that is, sells—these shares at a substantial profit and pockets the profit (here, $2 million) in his own personal trading account.\(^9\) The underwriter’s practice of

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9. The investor profits because of the substantial premium at which these new-issue shares traded in the aftermarket typical of hot IPOs of the late 1990s.

Companies continue to leave money on the table when they go public .... A criticism of initial public stock offerings has been that while shares soar, the companies themselves don’t enjoy the full benefit because their proceeds are based on the offering price, not the price the stock reaches in the market.


Corporate America has left a record $23 billion on the table from IPOs this year—but no one’s going hungry.

The number represents the staggering gain generated in the first day of trading for all initial public stock offerings this year through October. Translation: Corporate issuers could have pocketed a total of $23 billion more had their IPOs been priced to demand.

So you would think the issuers—and the Wall Street underwriters that could have earned steeper fees—would be livid.

Now, a new study shows why you would be wrong. The study, by professors Tim Loughran of the University of Notre Dame and Jay R. Ritter at the University of Florida, concludes that issuers are so thrilled by their sudden wealth that they basically don’t care.

... [Essentially], the researchers say, the company [and its insiders] will focus more on the delightful surprise that [the company] is worth more than it anticipated—rather than on the dour mathematics that it could have eked even more money out of the IPO.


The study referred to in this *Wall Street Journal* article created quite a stir and added to the continuing controversy regarding best practices for underwriters in making IPO allocations. All of this public foment resulted in a variety of investigations by state and federal securities regulators inquiring into the priorities and practices used by companies, their insiders, and their underwriters to decide how to price the offering and to allocate the shares sold in the company’s IPO. *See supra* note 2 and accompanying text (describing several of
spinning shares in hot IPOs to individual investors as the quid pro quo for future underwriting business is the focus of this Article.

Spinning is a story with a number of different dimensions. My analysis of spinning will be separated into two distinct lines of inquiry. In Part I, I analyze whether the allocation decisions of the lead underwriter in the context of an IPO violate any provisions of either the federal securities law or the rules of the NASD. Here, the story focuses on the conduct of the managing underwriter, such as Robertson Stephens, who served as lead underwriter for Pixar's hot IPO. In Part II, I shift the focus of the analysis to the conduct of the investor who receives the hot IPO allocation, regardless whether he or she flips the shares. Now the focus of the story is on individuals such as Mr. Cayre, the CEO who flipped his allocation of Pixar shares for a substantial profit, and whether this sort of conduct creates any disclosure issues under either federal or state law. In Part III, I examine the separate issue of whether this CEO may be usurping a corporate opportunity when someone such as Mr. Cayre

As captivating as this issue is, the existence of this premium, in the offering's aftermarket trading price, is an issue that lies outside the scope of this Article. Instead, this Article seeks to focus attention on an issue that has largely been ignored in the public debate so far, namely, whether Mr. Cayre breached his fiduciary duty to GT Interactive when he flipped his allocation of Pixar's hot IPO shares at a substantial premium over the offering price, without making any disclosure of this allocation to his corporation, GT Interactive Software.

10. The investor's conduct may give rise to a violation of fiduciary duty, but one that lies not just in the "flipping" of the shares into the post-distribution trading market for a substantial profit. Rather, it lies in the CEO/investor seizing these hot IPO shares and keeping this allocation for his own personal account—conduct which I believe may constitute a usurpation of a corporate opportunity in breach of the CEO's fiduciary duty to his corporation.
receives Pixar's hot IPO shares for his own account, an inquiry which may give rise to a possible breach of fiduciary duty claim against the corporate officer.

The moral of this story is set out in Part IV, where I explore the implications of my analysis of the story of spinning, focusing primarily on corporate managers, as well as the transactional lawyers who advise these business clients. By way of conclusion, this story of "spinning in a hot IPO" provides compelling evidence that the courts should continue to strongly enforce a rigorous standard of fiduciary duty as the default rule in our modern system of corporate law. Thus, the lessons learned from the story of "spinning" stand in sharp contrast to the modern law and economics view that parties should be afforded complete freedom to contract for the entire scope of fiduciary duty between owners and managers of the corporate enterprise. In this way, the story of spinning serves to emphasize the important and influential role that the law of fiduciary duty continues to play in shaping and monitoring standards of fair and ethical conduct for modern corporate managers, and, in the process, serves to reinforce the professional responsibility of modern corporate lawyers.

I. SPINNING BY THE LEAD UNDERWRITER

By way of general background, the lead underwriter is a broker-dealer firm that is subject to regulation by both the SEC and the NASD. The issuer hires the lead underwriter to manage a company's IPO. As a matter of generally accepted practice today, underwriters offer investors—both individuals and institutions—the opportunity to invest in hot IPOs. In recent years, institutional investors have dominated the market for IPOs. In the hot equity


12. Siconolfi, supra note 3, at A1 ("It is no news that underwriters make most of the shares in hot IPOs available not to the little-guy investor but to institutions, such as mutual-fund companies and pension funds, that provide a lot of trading commissions and other business."). The reasons for this dominance of institutional investors lie outside the focus of
market of the late 1990s, however, individual investors increasingly demanded the opportunity to invest in hot IPOs and their voice did not go unnoticed. With some important assistance from recent developments in Internet-based technologies, the securities markets responded by increasing the direct participation of individuals as retail consumers of shares of hot IPOs.\textsuperscript{13} The focus of this section, therefore, is on the allocation of shares made by the lead underwriters in a hot IPO,\textsuperscript{14} with the primary emphasis on the decision to allocate hot IPO shares directly to the trading accounts of certain types of individual investors.

Under the 1934 Act,\textsuperscript{15} the NASD has been delegated considerable authority to regulate the lead underwriter and its practice of allocating IPO investment opportunities, subject to SEC oversight. The SEC reviews both the promulgation of the NASD’s substantive rules, as well as the enforcement of these NASD rules.\textsuperscript{16} In addition, the registration statement that the issuer files with the SEC must include detailed disclosures regarding the underwriter’s plan of distribution for the corporate issuer’s IPO.\textsuperscript{17} This section first examines various aspects of the SEC’s disclosure requirements as they apply to the underwriter’s decisions regarding allocating shares in an IPO. More importantly, however, the remainder of this section analyzes the various NASD rules that regulate the lead

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  \item[13.] For a more detailed description of the impact of the Internet, and specifically the growth and continuing development of online underwriting by e-bankers who appear to have targeted individual investors as the primary market for their services see generally Witt Capital Corp., SEC No-Action Letter, 1999 WL 498545 (July 14, 1999); Terzah Ewing & Joshua Harris Prager, Many are Finding IPOs Still Out of Reach, WALL ST. J., Feb. 28, 2000, at C21.
  \item[14.] See generally RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 89-95 (6th ed. 1998) (describing the lead underwriter’s allocation authority over the “retail pot”).
  \item[16.] Id. §§ 19, 78s; JENNINGS ET AL., supra note 14, at 104-07.
  \item[17.] That portion of the prospectus describing the plan of distribution for securities sold in an IPO is usually drafted by the underwriters and their counsel. John S. D’Alimonte & Linda G. Schechter, Underwriting Documents: Their Purpose and Content, in MECHANICS OF UNDERWRITING 1995, at 213 (PLI Corporate Law & Practice Course, Handbook Series No. B-879, 1995); see also infra notes 20-24 and accompanying text (describing in more detail certain disclosures required under Regulation S-K as to the plan of distribution).
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underwriter’s decision as to how to allocate shares in an IPO transaction.

A. Disclosure of the Underwriter’s Allocation Decisions Under Federal Securities Laws

In general, the lead underwriter’s decision as to how to allocate the shares of an IPO is not subject to substantive regulation under the terms of either the 1933 or the 1934 Acts. This means that the lead underwriter, acting pursuant to the authority delegated to it by the other members of the underwriting syndicate, has broad discretion in deciding how to allocate the shares in an IPO.

18. Gasparino et al., supra note 2, at C1 (noting that underwriters “currently have broad discretion as to how, and to whom, they allocate IPO shares. Put another way: Wall Street can dole out IPOs basically any way it sees fit,” and that “IPO allocation is generally an area in which the SEC may have limited authority to act.”); Deborah R. Meshulam, Taking Stock: Spin Cycle: How to Allocate Shares of “Hot Issues,” THE RECORDER, Mar. 26, 1998, at 4 (“No specific SEC rules govern the process of allocating shares in a securities offering.”).

19. One of the standard provisions included in the Agreement Among Underwriters for a firm commitment underwriting of a fixed price offering—the type of underwriting arrangement customarily used in a hot IPO—is a clause whereby all syndicate members delegate broad discretionary authority to the lead underwriter to make final decisions as to the allocation of shares in the IPO for retail distribution to syndicate members as well as to any selling group members who might be recruited to participate in the IPO process. See generally 3B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW §§ 8:1, 8:7, 12:42 (2001); HAROLD S. BLOOMENTHAL, GOING PUBLIC HANDBOOK 262-69 (2001); Siconolfi, supra note 3, at A1 (stating that underwriters “offer most of the [IPO] shares to big institutional client companies. A small number, known as the ‘retail pot,’ are set aside for individuals, and spin shares typically come from this pot.”). A registered public offering will be a fixed price offering, which is to say that all shares sold in the offering will be sold to the investing public at the same price. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 236 (2d ed. 1997) (“The cornerstone of the underwriting syndicate is that all members must sell the offered security to the public at a fixed price that is stated in the registration statement and accompanying prospectus.”) (emphasis added); JENNINGS ET AL., supra note 14, at 97 (“The typical underwriting agreement requires all the underwriters and selling group members to adhere to the public offering price as stated in the prospectus.”). The distribution of shares in an IPO to the investing public will usually involve use of an underwriting syndicate and a selling group:

For business reasons, basically relating to the volatility of securities prices, underwriters in a firm commitment underwriting [who purchase the stock from the issuer] wish to dispose of [that is, resell] an entire issue almost immediately.

… To accomplish that quick sale, the underwriters often sell a portion of the securities—at a discount from the [fixed] public offering price—to other securities firms [i.e., selling group members], which in turn attempt to resell them to the [investing] public.
However, the failure to disclose the practices used by the lead underwriter, acting on behalf of the syndicate, to make its decision as to the allocation of IPO shares may give rise to several different types of potential disclosure violations under federal securities law. Let me illustrate these potential disclosure issues in the context of the lead underwriter’s decision to spin out shares of Pixar’s hot IPO to the personal discretionary trading account maintained by Mr. Cayre with Pixar’s lead underwriter, Robertson Stephens.

Item 508 of Regulation S-K (regarding the issuer’s plan of distribution) generally requires disclosure of the underwriter’s plan for the distribution of the registered public offering. In the context of the IPO for GT Interactive Software, this would be the plan for distribution of the common stock of GT Interactive Software.

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Soderquist & Gabaldon, supra note 11, at 29.

Members of the selling group—often referred to as “participating dealers”—are broker-dealers who for one reason or another (such as financial inability or a conscious desire not to commit the necessary funds) are not members of the underwriting syndicate but who nonetheless deem it in their financial interests to become a “participant” in the offering. Hence, they purchase from underwriters an allocated number of shares offered and resell them to their customers, their profit being the difference between the purchase price from the underwriters [and the fixed offering price paid by] their customers.


As used in Wall Street parlance, the “gross spread” usually refers to the difference between the fixed offering price paid by the investors and the amount received by the issuer. The gross spread “normally is composed of three parts: (i) the management fee for the managing [or lead] underwriter, (ii) the underwriting compensation received by the underwriters, and (iii) the ‘selling concession’... [paid to the broker-dealer participating (as either a selling group member or underwriter) who actually sells the securities to the investor].” Cox et al., supra, at 213. Finally, in the case of IPOs and other public offerings, the NASD reviews the underwriters' compensation arrangements “to assure that member broker-dealers do not receive unfair or unreasonable compensation for their underwriting activities.” Id. at 235. In addition to this mandatory NASD review, issuers increasingly have been insisting that “some of their Wall Street underwriters work harder for their pay.” Randall Smith, Dear IPO Co-Underwriter: Work Harder, Wall St. J., Apr. 24, 2000, at C1 (describing issuers' complaints about paying management fees to co-managing underwriters on the theory that co-managers often do not perform sufficient services to justify payment of what often amounts to extravagant fees.)

20. “In examining whether a broker-dealer, investment advisor or other regulated entity improperly favors certain investor accounts when allocating ‘hot issues,’ the SEC has focused on whether the firm’s allocation practices require disclosure, and if so, whether the [broker-dealer] firm and those associated with it have adequately disclosed those practices.” Meshulam, supra note 18, at 4.
Specifically, Item 508(a) requires disclosure of any material relationship between the issuer, GT Interactive, and the company's underwriter, Robertson Stephens. As a threshold matter, Item 508(a) requires a determination whether Robertson Stephens's prior allocation of Pixar shares to Mr. Cayre's personal trading account gives rise to a material relationship between the underwriter and the registrant. Since Item 508(a) does not directly focus on the relationship between the company's officers and the lead underwriter, this seems to be a fairly attenuated analysis. It would seem that disclosure would be required only if there is some suggestion that the prior allocation was made under circumstances that—either explicitly or implicitly—obligated Mr. Cayre to use the services of Robertson Stephens. "Absent such an agreement, it would seem difficult to establish that there is a 'relationship' requiring disclosure." Most securities lawyers would probably conclude that disclosure of prior spinning activity is not directly called for under the terms of Item 508.

In addition, Item 508(c)(2) of Regulation S-K generally requires disclosure of the plan of distribution for an offering, including "the terms of any agreement, arrangement, or understanding entered into with broker(s) or dealer(s) prior to the effective date" of the issuer's public offering. Applying the terms of Item 508(c)(2) to a situation such as Mr. Cayre's prior receipt of shares of Pixar's hot IPO, the question to be decided is whether Robertson Stephens' prior allocation to Mr. Cayre gives rise to an "arrangement or understanding" between the issuer, GT Interactive in this case, and its lead underwriter, Robertson Stephens, that was entered into


22. Id.


24. Id. at 5 ("The receipt of IPO shares from an underwriter by an executive of a company, absent other factors suggesting a quid pro quo relationship, would not seem to be a material relationship for purposes of Item 508(a)."; Gasparino et al., supra note 2, at C1-C2 ("It can be difficult to prove a clear quid pro quo in establishing wrongdoing. Because underwriters have such wide discretion, 'the basic practice [of IPO allocation] is bulletproof,' asserts John Carroll, a former federal prosecutor who is a defense attorney with the New York firm of Rogers & Wells.").

prior to the effectiveness of GT Interactive's IPO. In other words, does the allocation of Pixar hot IPO shares to the personal trading account of Mr. Cayre—as a person who is presumably in a position to direct GT Interactive's future underwriting business to Robertson Stephens—give rise to the type of "agreement or understanding" that requires disclosure under Item 508(c)(2)? In the face of little concrete guidance on this issue, most securities lawyers seem to believe that this relationship is too attenuated to give rise to the kind of material relationship that would require disclosure in the prospectus for GT Interactive's IPO. 26 Indeed, as a general proposition, "[t]he reason an underwriter might allocate shares to any particular person has not been viewed as required disclosure" under Item 508. 27

This very well may be a sound conclusion from the underwriter's perspective, for a number of different reasons, not the least of which involves the difficult issues of proving up the motivation of the investment banker who spins shares out to the personal account of a corporate manager, such as Mr. Cayre. In order to establish the existence of a "material relationship" as a result of such spinning activity, it may require proof that the underwriter's allocation was made as a quid pro quo for the CEO's exercise of his decision-making authority to direct his company's future underwriting business to the lead underwriter who decided to spin out hot IPO shares (of other issuers) to this CEO. 28 In light of these difficulties,

26. Even assuming that these facts would create the basis for finding a relationship between a Mr. Cayre and a Robertson Stephens, there is still the separate issue of whether this relationship is "material" and therefore qualifies as a required item of disclosure under the terms of Regulation S-K. See Michael Siconolfi, SEC Broadens "Spinning" Probe To Corporations, WALL ST. J., Dec. 24, 1997, at C1 ("As part of a broader inquiry, the SEC is examining whether such IPO allocations should have been publicly disclosed by corporations as 'material' events involving their choice of a particular investment bank to do business with, the person familiar with the matter said."); Michael Siconolfi, SEC, NASD Begin Probes of IPO "Spin" Accounts, WALL ST. J., Nov. 13, 1997, at A3 (reporting observation of William McLucas, the SEC's enforcement chief, that "there may well be facts and circumstances where [IPO allocations] cross the threshold of material transactions and certainly ought to be disclosed' to investors").

27. Cross & Roberts, supra note 23, at 599.

28. Furthermore, the expectation of a quid pro quo would seem to be the most that the investment banking firm could realistically expect of the company's CEO, in light of the limited authority of the CEO to decide which investment banking firm will serve as the company's lead underwriter. This is usually the kind of decision that requires the approval
we may well decide that Item 508 does not mandate disclosure of the underwriter’s decision to recruit future business from GT Interactive by allocating shares of a hot IPO to the personal trading account of an influential manager of that firm,29 such as the company’s CEO, Mr. Cayre.

of the company’s board directors. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 301, reporter’s note (1994):

In general, questions concerning the authority of senior executives are normally special issues of agency law, and, as in agency law, the major relevant concepts are those of actual and apparent authority .... [T]he accepted modern rule is that ... the president [CEO] has apparent authority by virtue of that position to take actions in the ordinary course of business, but not extraordinary actions. The difficulty, of course, lies in drawing a line between what is ordinary and what is extraordinary.

Thus, as a general proposition, the CEO usually will not have sufficient inherent authority by virtue of his office to create the apparent authority necessary to enter into this kind of relationship with an investment banking firm (that is, to select the firm who will serve as lead underwriter for the company’s IPO). This is because within most corporations this decision is likely to be viewed as “extraordinary” and not within the company’s “ordinary course of business.” As such, the investment banking firm could not reasonably expect that the CEO could make this selection on his own authority and consequently, there would be no basis for establishing apparent authority on the part of the CEO to unilaterally decide who will serve as the lead underwriter for the company’s IPO. All of which means that the underwriter who spins shares out to the CEO is left in the much more attenuated position of hoping for a return of the favor—the expectation of a quid pro quo—in other words, the mere hope that the CEO will use his influence to steer the Board to select this investment banker as the company’s lead underwriter. Under these circumstances, it would seem very difficult to establish a “relationship” of the type that would trigger disclosure under Item 508 of Regulation S-K. Indeed, this conclusion seems to have been borne out by the failure of the government to bring any fraud or other enforcement action against any underwriter, notwithstanding reports of SEC investigations into the practice of spinning. As the Wall Street Journal reports:

After the Journal’s “spinning” disclosures, for instance, the SEC’s enforcement division, both in Washington and in the New York office, launched full-blown investigations into the matter. But after reviewing a number of potential cases, the SEC realized how difficult it would be to prove a violation of federal securities law, according to people familiar with the matter.... The SEC, as is its custom, declines to discuss specific cases. And it’s rare for the agency to formally close cases, so it’s impossible to predict what future enforcement actions, if any, it is likely to make.

Gasparino et al., supra note 2, at C1.

29. This analysis should be essentially the same for both corporate officers and directors and therefore, in this Article, the term “managers” will be used to refer to both corporate officers and directors. Rutherford B. Campbell, Jr., A Positive Analysis of the Common Law of Corporate Fiduciary Duties, 84 Ky. L.J. 455, 456 n.2 (1996) (“[S]ome cases make distinctions between the fiduciary duties of officers and directors. ... Nonetheless, the basic principles applied to actions by officers and directors are the same, and thus the two groups are treated as one.”).
This may be a sound conclusion for the further reason that the underwriter's allocation practice may be regarded as a generally accepted business practice within the investment banking industry, similar to a Robertson Stephens paying for the CEO's greens fee when the investment banker invites the company's managers to go golfing. Although no one has ever suggested that the underwriter's prior payment of the CEO's greens fee gives rise to a "material relationship" that must be disclosed in the company's prospectus, the practice of spinning, on the other hand, does seem to rest on quite different footing. For many observers, spinning activity is seen as tantamount to "corporate bribery."\(^3\) This differing perception is further reflected in the fact that the NASD ultimately responded to the publicity surrounding press reports of spinning activity by proposing a rulemaking initiative,\(^3\) whereas, to the best of my knowledge, the payment of greens fees has not prompted any rulemaking initiative on the part of the NASD. The NASD's proposed rulemaking to deal with the practice of spinning is discussed in the next section.

B. Does Spinning Violate the NASD's Withholding and Free-Riding Rules?

In response to certain well-publicized events of spinning, such as Mr. Cayre's flipping of Pixar's hot IPO shares, the NASD proposed to amend its Rules of Fair Practice as they relate to hot IPOs.\(^3\) As will be demonstrated in this section, the NASD's current

\(^{30}\) See infra notes 61-64 and accompanying text (discussing the NASD's pending rulemaking proposal to address the practice of spinning).
rulemaking proposal suggests that the underwriters’ practice of spinning raises a set of concerns that are significantly and qualitatively different than the situation where the underwriter has merely paid the greens fee of the CEO while on a golfing outing. Indeed, the practice of spinning seems to conjure up unpleasant images that, at the very least, imply that underwriters harbor expectations of a quid pro quo from corporate managers who personally benefit from the underwriter’s spinning practices. All of this seems to have led the NASD to become concerned as to whether the lead underwriter is fulfilling its obligations of fair dealing and fair practice under the NASD Rules when it engages in spinning activity. To understand the nature of the NASD’s

33. As the NASD has seen fit to address the practice of spinning by announcing rulemaking activity to amend its Rules of Fair Practice, it seems fair to conclude that spinning by underwriters smacks of a certain kind of unseemliness that is suggestive of such a quid pro quo. See infra notes 34, 46-48 and accompanying text. But it seems to me that all this rulemaking activity ignores the more fundamental question of why this spinning activity violates our sensibilities in such a way as to demand the intervention of the NASD. I believe the more fundamental problem is one of business ethics, including the ethics of corporate managers. Most disturbing is that this issue has tended (so far at least) to be ignored, with public debate focusing on the underwriter’s allocation decisions and NASD efforts to curb the practice of spinning, thereby avoiding altogether any discussion of the unseemliness of the manager’s conduct and whether his conduct violates standards of business ethics as developed under modern fiduciary duty law. “In the three months since The Wall Street Journal first gave a name to the common but unpublicized practice, all attention regarding spinning has been on the investment banks. . . . However, the CEOs who take the bait have caught far less flack than the [investment] banks.” Lashinsky, supra note 30, at 1E.

34. This line of inquiry also raises issues of materiality. In other words, the underwriter’s payment of the CEO/manager’s greens fee may be widely viewed as a generally accepted business practice, and therefore, it does not give rise to an “arrangement or understanding” within the meaning of Item 508(c)(2) of Regulation S-K. A different result might be reached, however, if the facts were to show that, instead of paying a greens fee, the underwriter had paid to host an all-expense paid one-week trip for the CEO/manager to visit Paris, France. The materiality of the CEO’s/manager’s decision to accept an all-expense paid trip to Paris seems much clearer to me. Why? Because the quid pro quo seems self-evident—otherwise why else would the investment banker bestow such a lavish gift on this CEO/manager? But again, this discussion seems to overlook another equally important aspect, which is the business ethics of the CEO/manager who accepts the underwriter’s payment of the greens fee versus the CEO/manager who accepts the underwriter’s payment of an all-expense paid trip to visit Paris versus the CEO/manager who accepts the allocation of shares that the underwriter decides to spin out to the personal trading account of the CEO/manager. The notion that there is—or might be—a difference between paying the greens fee of a CEO/manager who accompanies the investment banker on a golf outing, on the one hand, and the underwriter’s practice of spinning, on the other hand, seems rather obvious. But this difference is not nearly so obvious to others. So, for example, “Cristina Morgan, Hambrecht & Quist’s managing
concerns regarding spinning, this section first offers a brief overview of the terms of the NASD's existing Free-Riding Rule and the underlying policy premise for this rule. This section then analyzes how the NASD currently interprets its existing Free-Riding Rule as applied to the practice of spinning. Finally, this section closes by briefly examining the terms of the NASD's pending proposal to amend its Free-Riding Rule in light of recent spinning activity.

1. General Background Regarding the NASD Free-Riding Rule

By way of general background, what are known as the NASD Free-Riding and Withholding Rules serve to regulate the sale of “hot issues” — generally defined as IPOs that immediately trade at a premium when the shares open for trading in the secondary market. The Free-Riding Rule emanates from Rule 2110 of the NASD (Conduct) Rules of Fair Practices, which operates in the form of a general exhortation to NASD members, demanding that they "observe high standards of commercial honor and just and equitable principles of trade." Immediately following this provision is the NASD interpretation of how this general standard applies to the distribution of public offerings. In applying its Free-Riding Rule, the NASD starts from the basic premise “that members have an obligation to make a bona fide public distribution at the public offering price of securities which trade at a premium in the secondary market.” In effect, the NASD assumes that a member's failure to make a bona fide offering may be viewed as an attempt to

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35. See 3B BROKENTHAL & WOLFF, supra note 19, § 8:59.


37. Id. at IM-2110-(a)(2). This NASD interpretation is referred to as the “Free-Riding Rule,” although it is not technically an NASD rule.

38. Id. at IM-2110-1(a)(1).
manipulate the market price for the issuer’s securities. Accordingly, free riding is viewed by the NASD as “inconsistent with high standards of commercial honor and just and equitable principles of trade.” On these grounds, the NASD has interpreted the general standard of Rule 2110 to prohibit free riding in order to protect “public confidence in the fairness of the investment banking and securities business.”

Generally speaking, the NASD Free-Riding Rule regulates the sale of shares of a “hot issue,” which the NASD has determined to be a new issue where “after completion of the distribution, the stock commences trading at a premium above its offering price.” Under long-standing NASD interpretation, this rule has been applied to regulate broker-dealer selling practices in the context of a “hot IPO” regardless of whether the broker-dealer is acting as an underwriter or as a selling group member in the offering process. Consequently and not surprisingly, the NASD Free-Riding Rule has always prohibited the sale of “hot issue” shares to the personal account of the employees, officers, directors, partners, or agents of the NASD member serving as an underwriter of the hot issue.

39. Id.
40. Id. at IM-2110-1(b).
41. Id. at IM-2110-1(a)(1). As a leading commentator has observed, an NASD member serving as lead underwriter for a hot IPO and coming into possession of material, nonpublic information regarding the extent to which a public offering is oversubscribed finds itself in essentially the same position as “a stock exchange specialist who knows that there is an imbalance between buy and sell orders reaching its post, and so both are restricted in their ability to trade on such information.” Coffee, supra note 7, at 5. As such, the NASD member who is participating in a public offering “should not be able to exploit the information it possesses that the offering is oversubscribed (and hence the aftermarket price will rise).” Id.
42. 3B BLOOMENTHAL & WOLFF, supra note 19, § 8:59. As to an offering that is greatly in demand, it is often necessary to restrict allotments to less than the number of shares members of the selling and underwriting groups are willing to purchase. In such event, the security is likely to trade at a substantial premium above the offering price on the first day of trading which is frequently the offering date. Issues that trade at a premium are characterized as “hot issues,” and in certain market periods, speculative frenzy and the very prospect of new issues trading at a premium create a new-issue market which is essentially a hot-issue market.

43. See infra notes 164-66 and accompanying text.
44. 3B BLOOMENTHAL & WOLFF, supra note 19, § 8:60 (citing prior NASD enforcement cases finding underwriter violations of the Free-Riding Rule).
45. Although the NASD Free-Riding Rule casts a wide net, it does not speak to another
In addition, the NASD member is likewise restricted in the sale of "hot issue" shares to similar categories of persons who are persons associated with any other NASD member. The clear premise underlying this restriction is the familiar problem of "mutual back-scratching." In other words, the NASD is concerned that norms of reciprocity might otherwise develop: "You give me an allocation in your hot issues, and I will do the same for you in mine." Thus, the long-standing concern of the NASD—and the concern that clearly animates its Free-Riding Rule—is firmly rooted in the NASD's continuing efforts to regulate the business ethics of its members by discouraging practices that might lead to an overt expectation of a quid pro quo.

practice prevalent among underwriters in today's IPO market, namely, the increasing use of "lock-ups."

Under the "lockup" period, typically lasting six months, so-called insiders are barred from immediately selling shares in a newly public company. ... Lockup agreements, made between Wall Street underwriters and company insiders, are designed to attract and protect IPO investors by stabilizing stock prices following the [IPO] offering through a more orderly sale of [insiders'] shares. (When lockup periods expire, insiders often rush to sell [their] shares and realize their profits, which can pressure stock prices.).

Cassell Bryan-Low, Some IPO "Lockups" Worked as Intended, WALL ST. J., Apr. 25, 2001, at C1. The use of lockups is a fairly recent Wall Street innovation that only really came into its own in the heyday of the hot IPO market of the late 1990s. "Lockups aren't mandated by law. Rather, underwriters use them to reassure other [IPO] investors that the people who know a particular company best won't be selling out as soon as [the company] is public." Raymond Hennessey, Longer Lockups May Not Avert Sell-Offs by Anxious Investors, WALL ST. J., Nov. 27, 2000, at C19. How do these agreements work so as to provide some measure of reassurance to investors who buy the company's stock in an IPO? "Before a company holds an IPO, insiders, such as company executives and venture capitalists, typically sign lockup agreements saying they won't sell their shares until a certain period after the offering, usually 180 days." Id. In this way, investors in an IPO gain some comfort that insiders are not simply going to "cash in" their shares by immediately selling their holdings into the aftermarket, a particular danger if the offering is a hot IPO that immediately doubles or triples over the offering price. One investment organization explained:

This is bad news for corporate insiders, but not for investors. That's because the restrictions are intended to be an incentive for executives "to create value for the long run, rather than profiting from a quick pop after the IPO," says Patrick McGurn, vice president of Institutional Shareholder Services of Rockville, Md., which advises institutional investors on proxy issues.

Bryan-Low, supra, at C1.


47. Coffee, supra note 7, at 5.

48. See Michael Siconolfi, NASD Warns on "Spinning" IPO Shares, WALL ST. J., Nov. 24, 1997, at C1 ("The purpose of the [Free-Riding Rule] is to ensure that investment banks don't
In addition to restricting sales to certain persons associated with the underwriter or with any other NASD members, the NASD has also construed its Free-Riding Rule to prohibit the sale of shares of a "hot issue" to "any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional account (including, but not limited to, hedge funds, investment partnerships ... [and] investment clubs)."^{49} By extending the prohibition of its use hot IPO shares to reward people who are in a position to direct future business to the investment bank. The NASD ... wants 'to make sure that hot issues are sold genuinely as bona-fide public offerings,' says Elisse Walter, chief operating officer of NASD's regulatory arm.

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49. Free-Riding Rule, in NASD MANUAL supra note 36, at IM-2110-1(b)(4). By way of general summary, the existing NASD Free-Riding Rule prohibits the sale of shares in a "hot issue" to the following categories of persons:

(i) persons associated with the [participating NASD] member or another broker-dealer or their family members,(ii) persons who were finders with respect to the public offering, (iii) persons acting in a fiduciary capacity (such as underwriter's counsel) to the managing underwriter, and (iv) senior officers of [institutional] entities such as banks, investment companies [i.e., mutual funds], investment advisory firms or other institutional types of accounts, and/or others who are involved in or influence the buying and selling of securities for those types of entities. Exceptions to the prohibitions require that the NASD member be prepared to show that the securities were sold to the restricted person in accordance with the restricted person's normal investment practice as a customer of the [NASD] member, in insubstantial amounts and in amounts not disproportionate to sales to members of the public.

Meshulam, supra note 18, at 4. The application of the last category of the NASD rule—subpart (iv) above—was illustrated in a recent SEC administrative decision that grew out of a controversy closely related to the practice of spinning, even though the dispute centered on facts that predate the hot IPO frenzy of the late 1990s. In Monetta Financial Services, Inc., Admin. Proc. File No. 3-9546, 32 Sec. Reg. & L. Rep. (BNA) No. 32, at 434, 2000 WL 320457 (SEC 2000), Chief Administrative Law Judge Brenda P. Murray held that "an advisor, portfolio manager, [mutual] fund director and [mutual] fund trustee committed fraud when the portfolio manager allocated IPO shares to the director's and trustee's personal accounts without making proper disclosures." Dixie L. Johnson et al., Hot IPOs: The Dangers of Both Giving and Receiving, in PLI Corporate Law & Practice Course, Handbook Series No. B0-009A, 509, 511 (2000). Based on this spinning activity, Chief Judge Murray ruled that "[t]he only reasonable conclusion to be drawn from the evidence" was that these allocations had been made to the personal trading accounts of these mutual fund insiders "because these [insiders] could further the business interests" of the portfolio manager making the allocations, thereby implying the finding of a quid pro quo. Monetta Financial, supra; see also Johnson et al., supra, at 511 (discussing Monetta Financial). The decision, the "first enforcement case to address spinning since press reports first published in 1997 focused attention on this practice," id., is not directly related to the spinning practices that are discussed in this Article since Monetta Financial involved decisions that were made in the mutual fund context as to how to allocate hot IPO shares that had been received in fifty-one
Free-Riding Rule to these other persons, the NASD is reflecting its concern "that hot issue stock could be used as a commercial bribe to induce such persons to cause the entity they serve [such as a mutual fund, pension fund, etc.] to buy securities in weaker offerings from the same underwriter."\(^{50}\) I should point out, though, that sales by an NASD member to these other persons—who are related to an "institutional type account"—are only conditionally restricted under the current NASD interpretation of its Free-Riding Rule. Shares of a hot IPO may therefore be sold to such persons if the NASD member is prepared to demonstrate that the securities were sold to such persons in accordance with their normal investment practice, that the aggregate of the securities sold is insubstantial and not disproportionate in amount as compared to sales to members of the public and that the amount sold to any one of such persons is insubstantial in amount.\(^{51}\)

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IPOs over an eight-month period in 1993. The ALJ found that these shares had been allocated "to the personal accounts of" several mutual fund directors and flipped in first day trading for repeated quick profits, id. at 512, giving rise to numerous violations of the federal securities laws, including violations of the 1933 Act, the 1934 Act, and the Investment Advisors Act. See also Michael Siconolfi & Robert McGough, SEC Case Against Fund Firm May Influence "Spinning" Probe, WALL ST. J., Mar. 2, 1998, at C1. In light of the provisions of federal securities laws, fund "directors are, by law, supposed to look out for the fiduciary interests of fund investors .... Given these roles, [fund] directors aren't supposed to have 'material business relationships that would impair their independence,' said Julie Allecta, a partner at the San Francisco office of law firm Paul, Hastings, Janofsky & Walker." Id. at C27. It is worth emphasizing that this lawyer, Ms. Allecta, could only reach this conclusion if she were confident that the courts would continue to vigorously enforce fiduciary duty law. Of course, in the Monetta Financial case, this concern has been virtually eliminated because Congress has mandated certain fiduciary standards for fund directors by express provision in the Investment Advisor Act.

What is most interesting for purposes of my story regarding spinning activity is that Monetta Financial "can fairly be read ... to find violations of law not in the allocations, or the acceptances, but in the failure to disclose them." Johnson et al., supra, at 511 (emphasis added). This conclusion has particular relevance to the underwriters' practice of spinning out shares to corporate executives such as Mr. Cayre. See infra notes 85-188 and accompanying text (discussing potential violations of federal securities law as well as violations of state common law of fiduciary duty as a result of the failure to disclose underwriters' practice of spinning out shares to corporate executives).

50. Coffee, supra note 7, at 38.
Later in the interpretation, the NASD defines the terms "normal investment practice" and "disproportionate amount." The NASD defines "normal investment practice" to refer to similar sized purchases in a public offering made by one of these conditionally restricted persons within the prior year. In addition, the NASD suggests a ten-percent guideline as the standard for determining whether a "disproportionate" allocation is being made to the account of a conditionally restricted person.

2. Applying the NASD Free-Riding Rule to the Practice of Spinning

It is in this context that one must consider the NASD's first public response to the controversy over spinning, which was issued in December 1997, a scant month after publication of the Wall Street Journal article detailing Mr. Cayre's relationship with Robertson Stephens. The NASD's first response took the form of a notice to its members reminding them of their obligations under the existing NASD Free-Riding Rule and the NASD's longstanding interpretations thereunder. As part of its Notice, the NASD indicated that members could be subject to sanctions for allocating shares of hot IPOs to the personal brokerage accounts of fund managers of "institutional type" accounts, such as individual managers of venture capital firms. The Notice did not suggest, however, that the NASD Free-Riding Rule would apply to the allocation of shares to executives of private companies who are in a position to influence the selection of an underwriter for the forthcoming IPO at their respective companies, such as Mr. Cayre of GT Interactive Software.

In its Free-Riding Policy, the NASD clearly reflects its concern that its members might be tempted to use hot IPO allocations to recruit future business from persons in the financial services industry. This concern is particularly apparent in the NASD warning that investment banks could be subject to sanctions for allocating shares of IPOs to the personal brokerage accounts of

52. Id. at IM-2110-1(b)(4).
53. Id. at IM-2110-1(b)(9)(A).
venture capitalists. The NASD's long-standing concern over problems of "mutual back-scratching" apparently now extends to include individuals associated with the venture capital industry, another segment of the financial services industry. So, in its December 1997 Notice, the NASD put its members on notice that the NASD was worried that members, when serving as underwriters, might allocate hot IPO shares to the personal accounts of venture capitalists "in the hope that the venture capitalists would be in a position to influence the companies in which they held interests to use the brokerage firm for an IPO if the companies decided to go public." The NASD Notice, however,

56. Cross & Roberts, supra note 23, at 598. On the other hand, it would appear that current NASD policy would allow for allocations of "hot IPO" shares to the personal accounts of individuals associated with these venture capital firms if the allocations were not "disproportionate" and otherwise complied with NASD criteria for "normal investment practice." See supra notes 51-53 and accompanying text (discussing these defined terms).

57. Cross & Roberts, supra note 23, at 598. As a largely unregulated element of the financial services industry, the venture-capitalist community quickly moved to lobby their members to avoid the practice of "spinning" and the appearance of impropriety that it thereby created. According to a 1997 article published in the Wall Street Journal:

Venture capitalists who accept hot initial public stock offerings and quickly sell them for a profit could be skating on thin regulatory ice.

That's the conclusion of a memorandum prepared for the National Venture Capital Association, an Arlington, Va., trade group, by an outside law firm.

The memo, written last year but previously unpublished, underscores the broad concern outside Wall Street with investment banks allocating "directed shares" of hot IPOs to the personal accounts of corporate executives and venture capitalists—and selling the shares on the day of the IPO for fast profits—in an apparent bid for business from the executives' firms. . . .

"At a minimum," the memo said, receiving such shares "would be tainted with the appearance of impropriety."

[In an apparent reaction to these concerns], some venture-capital firms have stopped accepting such IPO shares in the memo's wake, including [the well-known venture capital firm] Sequoia Partners in Menlo Park, Calif.


This informal lobbying effort can be seen as a shrewd move on the part of the venture-capital industry, which presumably feared that continued publicity of spinning practices—at least insofar as they involved allocation to venture capitalists—might invite more scrutiny, which ultimately might lead to greater regulation of the venture capital industry, by either the NASD, the SEC, or both. This concern is reflected in the observations made in the same Wall Street Journal article:

Not to mention a black eye for the venture-capital community, one of corporate America's biggest success stories of the 1990s. "If it became a prevalent industry practice and were to draw the attention of the limited partner community or
financial press, trading in and flipping of 'directed shares' by venture capitalists could create a public relations issue for the industry," the memo warned.

The memo's message for venture capitalists: "Times are good. Let's all not get greedy, and remember an ounce of prevention is worth a pound of cure," Carl Thoma, Chairman of the trade group, said in an interview.

At issue, among other things, is the [NASD] "Free-Riding and Withholding Rule." The purpose of the rule is to ensure that investment banks don't use hot IPO shares to reward people who are in a position to direct future business to the investment bank.

"A conservative, literal reading" of the rule would "appear to preclude an NASD member from allocating any 'directed shares' in a hot issue to any venture capitalists," the memo said. Though the [Free-Riding] rule essentially applies to the underwriter, "prudence dictates that the venture industry avoid the appearance of any conflict or impropriety," the memo said.

Here's the specific concern for venture capitalists: If an executive [of a venture capital firm] accepted IPO shares in his personal account from an underwriter, the memo said, "with the express or implied understanding that the 'quid pro quo' for such purchase opportunity would be to place such underwriter on a 'short list'" of candidates to receive future business from the venture capitalist's [portfolio] firm, there could be a problem.

[What's more, w]hen the venture capitalist flips those IPO shares for a quick profit, he "has improperly used his position of influence within his firm for personal gain," the memo said. "It is possible as well that he has breached the terms of his partnership agreement."

James F. Morgan, former Chairman of the trade group's standards committee, said in a note to members accompanying the memo: Accepting such IPO shares creates "the potential of regulatory or cosmetic conflicts of interests."

Id.

What is most important about this memo's warning to venture capitalists is its clear acknowledgement of the potential conflict-of-interest problem inherent in the practice of spinning along with the memo's passing reference to the "limited partner community." As developed more fully in Part III, the practice of spinning gives rise to a potential claim for breach of fiduciary duty on the part of corporate managers, which is the focus of this Article. But, interestingly enough, the venture capital community apparently realized the potential for this type of conflict-of-interest claim long before the story of spinning became "the subject of recent articles in the Wall Street Journal." Id. Part of the concern about attracting the attention of the limited partner community would appear to stem from the notion that these limited partners may well view the venture capitalist's receipt of hot IPO shares as an improper use of their (fiduciary) position within the firm in order to gain personal financial advantage. This sounds like the venture capitalists anticipate that their investors—"the limited partner community"—may well view this practice as disappointing the expectations that these limited partner investors have with respect to the kind of fair and ethical practices they expect as to the conduct of corporate managers who find themselves in a position similar to Mr. Cayre. It seems fair to assume that the trade association anticipates that these investors may well take action to hold venture capitalists who accept hot IPO allocations responsible for this type of abuse of position within the firm. This memo arguably reflects the tacit acknowledgement that there may very well be grounds for finding a breach of fiduciary duty as a result of spinning activity—which is, after all, the point of this Article. See infra,
does not suggest that the [Free-Riding] rule would apply to the allocation of shares to executives of private companies who are in a position to select an underwriter for an upcoming IPO (assuming that the executive is not otherwise in the category of persons subject to the Free-Riding and Withholding Rule), even though the same problem of "mutual back-scratching" would seem to be equally present in this situation as well.58

Despite what appears at first blush to be a gaping loophole in the scheme of NASD regulation of hot IPOs, "this does not mean that anything goes."59 The NASD Free-Riding Rule also prohibits "withholding" shares of a hot IPO, a practice that is closely related to "spinning." Withholding refers to the underwriter practice of allocating shares in a hot IPO to the personal account of a favored client, such as Mr. Cayre of GT Interactive, after secondary trading in the shares has commenced. Like spinning, withholding is seen as an inherently deceptive practice because the trading price in the secondary market is based on the assumption that the public float consists of all the shares registered in the offering, when in fact some portion has been "withheld" from the public offering process. Thus, to the extent that Mr. Cayre was allocated shares of Pixar's hot IPO after trading in Pixar's shares had commenced, for example, the underwriter probably would have violated the NASD's interpretation of Rule 2110 by virtue of "withholding" the hot IPO shares in order to allocate these shares at the IPO price "to a preferred customer when the aftermarket price [was] already higher."60

notes 105-88 and accompanying text (for further development of the idea that spinning inherently involves a breach of fiduciary duty because it violates investors' reasonable expectations as to standards of fair and ethical business practices in today's business environment).

58. Cross & Roberts, supra note 23, at 598.
59. Coffee, supra note 7, at 5 (emphasis added).
60. Id. The expectation of a quid pro quo in this setting seems particularly self-evident, unlike some other cases involving spinning out hot IPO allocations as part of the IPO distribution process. Where the allocation is made after secondary trading in the security has commenced and the stock is already trading at a premium over its fixed offering price in the IPO, the spinning activity seems to be nothing short of a tacit "commercial bribe." The NASD Free-Riding Rule "probably does reach and preclude the most egregious abuse in the current 'spinning' investigation: namely, the allocation of shares at the initial offering price to a preferred customer when the aftermarket price is already higher." Id.; see also Randall Smith
In response to the controversy over the practice of spinning, the NASD proposed to amend its Free-Riding Rule as applied to "hot issues." In October 1999, the NASD filed a proposal with the SEC to adopt a new rule, Rule 2790, which, if adopted, would replace the existing NASD interpretation of its Free-Riding Rule as applied to hot IPOs. This rule proposal has been amended twice, and the most recent amendment, which took place in January 2000, addressed concerns raised by NASD members as part of the public comment to proposed Rule 2790.

In this most recent rulemaking proposal, the NASD indicated that its primary concern is the impact that "spinning" has on the integrity of the public offering system:

The [Free-Riding Rule] is designed to protect the integrity of the public offering process by ensuring that [NASD] member firms make a bona fide public offering of securities at the public offering price and that none are withheld for the firms benefit or to reward individuals in the position to direct future business to the [NASD] firm.

Thus, the concern that led the NASD to propose its new Free-Riding Rule remains essentially the same as originally led it to promulgate its policy in this area. Its efforts, however, to stretch the language of its original formulation of its policy to embrace the myriad set of concerns that had been raised as a result of the recent spinning controversy ultimately led the NASD to formalize its policy into a

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& Susan Pulliam, SEC Seeks Wall Street Firms' Records on Stock Purchases as Part of IPO Probe, WALL ST. J., Apr. 30, 2001, at C1 ("The after-market order inquiry is an out-growth of an active IPO investigation by the SEC, as well as the U.S. Attorney in Manhattan and the regulatory unit of the [NASD], according to people familiar with that probe.") (emphasis added).


new free-standing rule of more comprehensive scope than its pre-existing Free-Riding interpretation.

Most significant for purposes of this Article’s discussion of spinning is that proposed Rule 2790, as amended, would eliminate the term “hot issue” or “hot IPO” and instead apply the restrictions of the Free-Riding Rule to all initial public offerings of equity securities. By extending the proposed Free-Riding Rule to all IPOs, the NASD eliminates the difficulties traditionally associated with defining the term “hot issue.” Under the current Free-Riding Rule, a difficult threshold issue lies in determining whether a particular public offering constitutes a “hot issue” that is subject to the NASD Free-Riding Rule. In practice, the NASD Compliance Department usually has the responsibility of reviewing aftermarket quotations to determine whether a particular security is a “hot issue.” As revised, proposed Rule 2790 eliminates the requirement that the stock trade at a “premium” in the aftermarket, thereby eliminating the threshold determination whether a particular public offering is a “hot IPO.” Thus, a stock that sold at a fixed offering price of $15 in the IPO that begins trading at $15 1/32 in the aftermarket is a hot issue that is subject to the free-riding restrictions of proposed Rule 2790.65

Proposed Rule 2790 clarifies many of the ambiguities under the existing free-riding interpretation, particularly as to IPO allocations made to accounts of individuals who are currently treated as “conditionally restricted persons.”66 The NASD’s proposed rule, however, continues existing policy in that it does not address sales

65. See 3B BLOOMENTHAL & WOLFF, supra note 19, §§ 8:60.1 to :60.2.
66. Proposed Rule 2790

... is designed to eliminate confusion over whether certain investors are restricted from receiving shares in hot stock deals, Gary Goldscholle, assistant
general counsel at NASD Regulation, said. 

If the proposed new rule takes effect, individuals responsible for managing other people’s money would be barred from getting shares in a hot stock issue, according to the NASD. That would prohibit hedge-fund managers, investment advisers and some venture-capital managers from receiving shares from such deals in their personal brokerage accounts, the NASD said. Most venture capitalists won’t be restricted under the new rule, because they don’t manage pools of money from outside investors. Ewing, supra note 32, at C20.
made to individuals who are not related to the financial services industry, such as a Mr. Cayre, but who clearly fall within the policy rationale that underlies Rule 2790 and its predecessor Free-Riding Rule—that is, the concern that an allocation to a Mr. Cayre might be used as a quid pro quo to influence the CEO/manager to direct their company's underwriting business to that NASD member.

In the face of what some consider to be a gaping loophole, at least one commentator has suggested that the most simple and most expedient way to eliminate the pernicious practice of spinning hot IPO shares out to individuals, such as Mr. Cayre, would be to further regulate the underwriter, as the gatekeeper for this practice. Thus, the suggestion has been made that the NASD Free-Riding Rule should reach more broadly—to restrict allocations to officers, directors, and agents of significant clients of the underwriter. Under this suggestion, corporate managers, such as Mr. Cayre, apparently would be treated by underwriters in essentially the same way as individuals associated with a venture capital firm are currently treated under the existing NASD Free-Riding Rule. Thus, allocations of hot IPOs presumably could be made to the personal accounts of these corporate managers provided that such allocations were consistent with the individual's "normal investment practice."

One criticism of this approach is that it continues the practice of relying on the broker-dealer community to police their clients, extending it now to include monitoring the business ethics of those brokerage clients who also happen to be corporate fiduciaries. At a minimum, if we decide to pursue this approach in order to address potential abuses arising out of the practice of spinning, this effort should not eliminate the possibility of holding the corporate

67. E.g., Coffee, supra note 7. For a fuller analysis of the "gatekeeper" function see Peter C. Kostant, Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice, 84 MINN. L. REV. 1213 (2000) (analyzing the gatekeeper function by extending it to the role of corporate lawyers in the transactional setting); Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. ECON. & ORG. 53 (1986) (making the case for lawyers and accountants, among others, serving as "gatekeepers," that is, serving as reputational intermediaries in third-party enforcement regimes).

68. Coffee, supra note 7. Professor Coffee rejects the notion of a prophylactic rule that would completely prohibit such allocations on the grounds that it "does not seem necessary." Id.

69. Id.; see also supra notes 51-53 and accompanying text.
manager liable for breaching their fiduciary duty to their corporation when they accept hot IPO shares spun out to personal accounts by a broker who is acting as an underwriter for a particular "hot IPO." In this way, the corporate manager can be held accountable as a corporate fiduciary. Just as the NASD member firm can defend its allocation decision to this CEO as consistent with the CEO's "normal investment practice," the CEO may be able to defend against a breach of fiduciary duty claim by demonstrating that the hot IPO shares were allocated to them personally as part of their established investment practices with that broker-dealer firm and therefore did not constitute a corporate opportunity. To do otherwise is to dilute the fiduciary duty standard that applies to the CEO's conduct. This is not to say that the NASD Free-Riding Policy should not extend to underwriter's decisions to allocate hot IPO shares to individuals such as Mr. Cayre. Any effort, however, to extend the NASD Free-Riding Policy to corporate managers should not eliminate—or even reduce in the slightest—the scope of the manager's fiduciary duty to his or her corporation.

Many market participants believe that spinning has been around for a long time; but there can be no doubt that it received heightened scrutiny in the face of an unprecedented wave of hot IPO activity in the late 1990s. In a market where individual investors were routinely denied access to hot IPOs, it is not surprising that broker-dealer allocation practices became the object of a more intense public scrutiny not generally seen before. Beginning with the Wall Street Journal article in November 1997, describing the spinning of Pixar shares to Mr. Cayre, and continuing with intermittent coverage by the Wall Street Journal and other publications in the financial press, these broker-dealer practices were critically examined not only by regulators but by investors as well. Notwithstanding all this controversy surrounding "spinning" of hot IPO shares out to corporate managers, the NASD's proposed

70. See infra notes 157-64 and accompanying text.
71. "Spinning got going in the 1980s and exploded during the 1990s bull market, as underwriters began competing fiercely to handle initial offerings." Siconolfi, supra note 3, at A4.
72. For a description of regulators' investigations, at the SEC, the NASD, and the state level by NASAA and other state securities officials, criminal investigations rumored to be undertaken at both the federal level by the U.S. Attorney's office and by local prosecutors in Manhattan, see supra note 2 and accompanying text.
rule amendments do not specifically address decisions by the underwriter to allocate shares of hot IPOs to executives of companies that are themselves future IPO candidates. 73

In an interesting turn of events, however, many broker-dealer firms moved to adopt policies formalizing the firm’s decision-making practices for allocating shares in a hot IPO where the firm serves as the lead underwriter. Indeed, within a week after the Wall Street Journal published its story describing the Robertson Stephens allocation of Pixar’s hot IPO shares to Mr. Cayre, Robertson Stephens announced that it was taking steps to prevent potential abuses in how it allocates hot new stocks to corporate executives and venture capitalists. . . .

[On Tuesday, November 18, 1997, it] adopted a new policy requiring that IPO shares be doled out based on a client’s brokerage activity with the firm during the preceding 18 months, according to an internal memo by Michael McCaffery, president and chief executive officer . . . .

The move comes as the [SEC] and [NASD] scrutinize the practice of [spinning] . . . .

The memo says: “Specifically, the syndicate department will allocate IPO shares based on a numerical formula and analysis of a client’s brokerage with the firm, excluding the prior allocation of IPO shares.” Previously the investment bank had no policy on how it allocated IPO shares to individual brokerage accounts. 74

Robertson Stephens, however, was not alone in its reform efforts. In the wake of this heightened scrutiny of Wall Street allocation

73. The SEC has yet to act on the NASD rule-making proposal. But even if it were to be approved, the NASD Free-Riding Rule would not prohibit the lead underwriter from spinning hot IPO shares to a corporate manager’s personal trading account, such as Robertson Stephens did when it acted as lead underwriter for Pixar’s IPO and spun out shares to Mr. Cayre of GT Interactive. So the potential for corporate bribery through this form of transaction continues, unless the conduct of the corporate manager—GT Interactive’s CEO, Mr. Cayre in this example—is subject to scrutiny for a potential breach of their fiduciary duty to his or her corporation. This topic is taken up in Part III, see infra notes 105-88 and accompanying text.

74. Michael Siconolfi & Anita Raghavan, Robertson Stephens Tries to Stop “Spinning” of Shares of Hot IPOs, WALL ST. J., Nov. 18, 1997, at C1. According to Mr. McCaffery, “exact allocations will depend on, among other things, the size and demand for the IPO, as well as the amount of commissions generated in the brokerage account.” Id. at C24.
practices in hot IPOs, other firms also announced plans to evaluate their internal policies and procedures for allocating shares of hot IPOs. These efforts presumably were undertaken in order to eliminate the basis for any perception of a conflict of interest, one otherwise inherent in the practice of spinning, and to thereby eliminate the basis for any further public criticism of those firms that had engaged in such practices. Some commentators have even speculated that the embarrassment resulting from all this media attention very well may have eliminated any further need for NASD rulemaking in this area.

75. Id.; see also id. at C1 (“Several [other] investment banks said they either were re-examining their practices of allocating IPOs or restating their policies; these [firms] included Hambrecht & Quist LLC, NationsBank Corp.’s Nationsbanc Montgomery Securities Inc., Bankers Trust New York Corp.’s BT Alex. Brown and Morgan Stanley, Dean Witter Discover & Co.”).

76. Concern over the ethics of its prior spinning activity appears to be the driving force that ultimately led Robertson Stephens to formalize its policy for allocating shares in hot IPOs. “What we want to avoid is having even the appearance of a conflict of interest,” Mr. McCaffery said in an interview.” Id. at C1. I elaborate further on the ethical implications of the story of spinning in Part IV of this Article. See infra notes 189-202 and accompanying text.

77. Indeed, regulators have said their investigations of future spinning activity could be limited because the practice has waned in the wake of the [Wall Street] Journal’s scrutiny of the matter. “The focus on spinning has had perhaps the greatest impact” on stamping out the practice, said Richard Walker, the SEC’s general counsel who recently was tapped to be the [SEC’s] new enforcement chief. Siconolfi, SEC Broadens, supra note 26, at C15; see also Gasparino et al., supra note 2, at C1: [E]xposing abusive practices has been a remedy in itself, [securities] regulators say. They assert that the media can have a tremendous impact. For example, the Wall Street Journal disclosed the prevalence of spinning, and the SEC’s Mr. Levitt says the “embarrassment” caused by the disclosure caused “the practice [of spinning] to disappear almost overnight.”

On the other hand, the “disappearance” of the practice of spinning may be just a reflection of the deteriorating market for IPO activity since early February 2000. The general “melt down” of the IPO market has been widely reported for some time now. See, e.g., Suzanne McGee et al., Cold Springs: Doing an Internet IPO In This Climate Takes Grit, Loudcloud Learns, WALL ST. J., Apr. 6, 2001, at A1 ("In 1999, nearly a quarter of IPOs doubled or better on their first day. A few rose six and sevenfold. Now, as stocks struggle and Internet highflyers fade, the IPO market is a cold place."); Riva Richmond, Former IPO Fans Change Their Tune, Vowing Not to Buy in Lackluster Market, WALL ST. J., Nov. 29, 2000, at C22 ("[T]he once-hot market in IPOs has iced over as the U.S. stock market has turned treacherous. IPO issuance has tailed off... "). If the current softness in the market for new issues is the real explanation for the failure of spinning to continue to grab headlines in the financial press, then the need for NASD intervention in the form of proposed Rule 2790 may still be very real, allowing regulatory action to be taken in anticipation of the inevitable rebound in the IPO market.
C. Does Spinning Constitute Payment of a “Gratuity” in Violation of NASD Rule 3060?

As a final possibility, some have questioned whether the underwriter practice of spinning might violate existing NASD Rule 3060, another of the NASD Rules of Fair Practice. The terms of NASD Rule 3060 speak very broadly, purporting to prohibit any payment or gratuity of more than $100 where such payment is given "in relation to the business of the employer of the recipient of the payment."

At some intuitive level, it would be easy to treat our example of Pixar shares spun out to Mr. Cayre's personal trading account as the payment of an illegal gratuity. It would seem, however, that, in order to establish that spinning constitutes a violation of NASD Rule 3060, there would need to be some evidence that Mr. Cayre received this allocation of Pixar shares as a quid pro quo for directing the underwriting business of his corporation to Pixar's lead underwriter, Robertson Stephens. This would seem to place the NASD regulators back into the difficult predicament of proving the underwriter's motivation for making specific allocation decisions. In any case, the NASD, at least so far, "has not applied Rule 3060 to

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78. Influencing or Rewarding Employees of Others, in NASD MANUAL, supra note 36, at 3060.
79. Id. As an example of the kind of facts that give rise to an alleged violation of this rule, the Wall Street Journal recently reported:

Federal securities regulators have launched an inquiry into whether a Salomon Smith Barney broker bribed officials of San Bernardino County, Calif., in exchange for fees and excessive commissions on more than $7.5 billion of investments for the county.

The investigation by the [SEC] comes on the heels of a lawsuit filed last month by the county against the firm [Salomon Smith Barney]. . . . The suit alleges that the broker, Peter Morrison, bribed county officials with cash, trips to foreign hot spots [which allegedly included trips to Paris and Greece], entertainment and dinners . . . .

Wall Street firms have long taken clients from investment firms to dinners and ballgames, and at times shower them with gifts. But the value of the gifts can't total more than $100 in a year, and the handouts must not influence the decision of the investors or municipalities, according to securities regulations.

sanction [broker-dealer] firms reported to be involved in spinning activities.**80**

Despite the NASD's failure to treat spinning as payment of a prohibited gratuity, this line of analysis has sparked some concern as to whether spinning is analogous to the "pay-to-play" practices that were prevalent in the municipal securities industry until the MSRB promulgated Rule G-37 in 1994.81 "Pay-to-play" refers to the practice of local public officials receiving (as a quid pro quo?) political contributions from securities firms competing for the municipal bond underwriting business to be handed out by these local politicians.82

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The "pay-to-play" practices proscribed by Rule G-37 are to be distinguished from another more recent practice engaged in by Wall Street underwriting firms that also is referred to as "paying to play." As one commentator explains:

Indeed, "paying to play" is becoming an increasingly common phenomenon in capital markets. It is happening as commercial banks that have acquired Wall Street investment banks try to use their lending operations, once considered a low profit-margin business for the risks involved, as a way to win higher-margin deals of all other kinds, such as underwriting. That, industry participants say, is a logical step for banks promoting a "one-stop shopping" concept.


82. For general background regarding the MSRB and SEC oversight of its rulemaking activities see generally COX ET AL., supra note 19, at 543-60. As a general overview of the scope of Rule G-37, a leading treatise has summarized what is probably among the most controversial of the SEC's recent regulatory efforts in this area as follows:

To address concerns over campaign contributions by broker-dealers to public officials who award underwriting business, the [MSRB] adopted Rule G-37, which restricts "pay to play" practices. The Rule became effective in 1994, following SEC approval. It prohibits a securities firm from engaging in municipal securities business with an issuer if the firm, any municipal finance professional associated with the firm, or any political action committee controlled by the firm has made political contributions to an official of the issuer within the previous two years. The Rule has withstood an early constitutional challenge launched by William Blount, the chairman of the Alabama Democratic
Some legal commentators have questioned whether spinning is a form of corporate bribery that should be outlawed in the same way that Rule G-37 eliminated pay-to-play practices in the municipal securities industry. Others believe that the proposed reform of the NASD Free-Riding Rule, now pending before the SEC, adequately addresses the current public policy concerns raised by broker-dealers' spinning practices, thereby obviating any need to adopt a rule that would prohibit completely the practice of spinning. If any such prohibition were to be adopted, however, it would serve only to regulate the practices of NASD members, including those broker-dealers serving as lead underwriters of hot IPOs, but would not apply to regulate the conduct of corporate managers such as Mr. Cayre of GT Interactive Software. Is a Mr. Cayre, however, any

Party and a municipal securities dealer. See Blount v. SEC, 61 F.3d 938 (D.C. Cir. 1995).

Id. at 545-46.

83. Coffee, supra note 7; Cross & Roberts, supra note 23.

84. At the federal level, the SEC may not have much of an alternative in the context of "spinning activity" other than to regulate the practices of securities broker-dealers. The SEC's authority to regulate securities broker-dealers is clear. See Securities Exchange Act of 1934 §§ 15-15A, 15 U.S.C. §§ 780, 780-03 (2000). The conduct of managers, however, is an area traditionally the province of state corporate law to regulate, and it may be virtually impossible, or certainly very difficult, for the SEC to directly regulate spinning practices as they implicate corporate CEO conduct. The SEC, however, may be tempted in this context, as it has been in others, to do indirectly that which may be impossible, or at least very difficult, for the agency to do directly. As but one example, the SEC has used this strategy in the context of regulating the municipal securities industry.

[In 1989, [the SEC] adopted rule 15c2-12, which requires underwriters participating in municipal offerings of over $10 million to obtain and review the issuer's disclosure documents and distribute them to investors. Although this obligation was imposed on underwriters, not issuers, it indirectly requires issuers to prepare a mandatory disclosure document. . . . These developments illustrate a familiar pattern in securities regulation: through its enforcement and anti-fraud powers, the SEC can accomplish by the back door what it cannot achieve by the front door—namely, the gradual institutionalization of a mandatory disclosure system within a particular market. . . .

[The SEC's] strategy is evident here: placing a regulatory burden on the broker or dealer (who is subject to SEC regulation) to compel a change in behavior by the municipality (who is largely not).

JENNINGS ET AL., supra note 14, at 15 (emphasis added) (footnote omitted).

The SEC could monitor the conduct of the broker-dealer community to insures that fair and ethical business practices are used to distribute securities in the public offering process. This would include the regulation of the distribution of securities to individuals such as Mr. Cayre, where the SEC is concerned that sales to such persons may lead to potential conflicts of interest that might impair the integrity of corporate management. The SEC may decide to
less culpable in his conduct than the broker who spins hot IPO shares out to such a corporate manager’s personal trading account as the quid pro quo for that manager using his or her influence to direct future underwriting business to this broker’s firm?

In the next section, the focus of my story, and this Article, shifts from the underwriter’s conduct to that of the individual CEO receiving the hot IPO allocation. Part II will analyze whether the conduct of the corporate manager—who accepts an allocation of hot IPO shares and then flips these shares, earning a quick profit for his or her own personal trading account—gives rise to any disclosure issues. Later, Part III analyzes whether this conduct gives rise to a breach of fiduciary duty.

II. THE CONDUCT OF THE CORPORATE MANAGER WHO RECEIVES HOT IPO ALLOCATIONS—DISCLOSURE ISSUES

Analysis of the obligations imposed on broker-dealer firms as members of the securities business, itself a regulated industry, puts into sharper focus certain issues with regard to spinning that have received far less attention to date. The public debate over the practice of spinning has virtually ignored the question of the culpability of those corporate managers who profit personally from these practices. The central focus of this section is to analyze whether the conduct of the manager, in receiving an allocation of shares in another company’s hot IPO, creates disclosure obligations under federal securities laws or under relevant state law principles, either at the time of receiving the shares or at some later date. Part III addresses the heart of the inquiry into the culpability of the corporate manager by considering whether the manager’s conduct constitutes the usurpation of a corporate opportunity in breach of his or her fiduciary duty to the corporation.85

promulgate rules that impose a regulatory burden on the underwriter—who is subject to SEC regulation—in order to compel a change in the behavior of corporate management—who is not directly subject to SEC regulation. Even if this type of federal regulation were to be adopted, however, it does not eliminate the need to monitor corporate managers to insure that these individuals abide by standards of fair and ethical conduct under relevant state law fiduciary principles. Such federal regulation of the broker-dealer community should not operate to eliminate the traditional authority of states to establish standards of fairness required to satisfy fiduciary duty obligations of corporate managers.

85. See infra notes 201-02 and accompanying text (describing the impact of the current
A. Disclosure Requirements Under Federal Securities Laws

The last section, as an example case, focused on whether Item 508 of Regulation S-K requires that the prospectus for GT Interactive's IPO include disclosure that the company's CEO, Mr. Cayre, personally received an allocation of shares in another company's hot IPO that was underwritten by Robertson Stephens, the same investment banking firm now serving as the lead underwriter for GT Interactive's IPO. This earlier discussion, however, focused on this disclosure issue primarily from the lead underwriter perspective. Not surprisingly, when the issue is examined from the company's perspective—as the registrant of the securities to be sold in the IPO—the analysis under Item 508 yields essentially the same conclusion. That is to say, the line item disclosure of Regulation S-K emphasizes the pre-existing relationship between the company and the investment bank chosen to serve as the lead underwriter for its IPO. As applied to GT Interactive's IPO, Item 508 focuses on any financial advice or underwriting services previously rendered by Robertson Stephens to the company. Because spinning activity does not directly implicate the company's interests, Mr. Cayre's prior dealings with his broker, Robertson Stephens, presumably would not fall directly within the (line item) disclosure mandated by Item 508.

legal framework regarding spinning practices on the professional responsibilities of transactional lawyers when advising corporate managers in this context).

86. See supra notes 22-31 and accompanying text (discussing disclosure requirements of Item 508 as applied to distribution practices in Pixar's prospectus for its IPO).

87. The earlier discussion of Item 508 focused on the prospectus disclosure required (primarily of the underwriter) to provide a description of the plan of distribution for the securities to be sold in the issuer's IPO. This presents a different set of concerns than are present when one analyzes the scope of disclosure required by Item 508 from the perspective of holding managers accountable to the company's investors. See infra notes 90, 100-02 and accompanying text.

88. In considering these potential disclosure issues, one is reminded of similar issues that arose in connection with the savings and loan crisis in the 1980s that ultimately led Judge Sporkin to exclaim, "Where were the lawyers?" Sporkin focused attention on the professional responsibilities of those transactional lawyers who advised S&L clients amidst some of the more egregious scandals that arose in the S&L crisis of the 1980s. Likewise, in the context of spinning, it is important that practicing lawyers do not overlook that spinning practices may give rise to disclosure issues that go beyond the line-item disclosures required by the terms of Regulation S-K. See infra notes 201-02 and accompanying text (discussing
The line item disclosures called for by Regulation S-K do raise a further line of inquiry as to the scope of disclosure required of the company and of its managers in the company’s prospectus for its IPO. Though not mandated by the terms of Regulation S-K, one professional responsibilities of lawyers).

89. “Spinning” is a term of art that usually refers to the allocation practices of investment banking firms that serve as underwriters of hot equity offerings. This is not to be confused with issuer-sponsored programs generally known as “Directed Share Programs” or “Friends and Family Programs.” In these programs, the investment banks, at the request of the issuer, allocate a portion of the registered offering to persons whom the issuer may wish to provide the opportunity to participate in the offering, such as the issuer’s business partners, employees and their families or friends. Although directed-share programs may seem to resemble spinning in that both involve decisions as to how to allocate stock in an IPO, directed-share programs are issuer-sponsored and, as such, are not initiated by the underwriters, whose involvement is generally limited to administering the directed-share program. The registration statement typically contains disclosure in the Plan of Distribution regarding the existence of such programs, including the number of shares of the offering that are subject to the directed-share program, the nature of the participants (e.g., the issuer’s suppliers), and whether the directed-share participants are subject to lock-up agreements.

In recent years, another type of issuer-sponsored IPO allocation practice has evolved. Investors, particularly venture capital firms investing in start-ups, have increasingly bargained for the right to purchase shares in the IPOs of their portfolio companies “as sweeteners in consideration for their investment in [this portfolio] company.” See Michael E. Lubowitz and Erika L. Weinberg, IPO Participation Rights, INSIGHTS, July 2000, at 7. The right to purchase stock in the company’s IPO is generally referred to as “IPO participation rights.” In general, these rights may take the form of a firm option (similar to a preemptive right) or a best efforts undertaking by the issuer to make available to the venture capitalist investor shares offered in a future initial public offering. This arrangement usually is evidenced in a written agreement signed at the time of the venture capitalist’s investment. Often these shares are delivered to the venture capitalist investor through a directed share program established at the time of the initial public offering.

At first blush, IPO participation rights may also seem to resemble spinning. Much like directed-share programs, however, it is the issuers, not the underwriters, who usually grant IPO participation rights. These types of transactions trigger obligations under the federal securities laws in that the SEC “staff . . . regards any agreement under which these [IPO participation] rights are granted by an issuer within one year of the issuer’s IPO . . . as an ‘offer’ of a security within the meaning of Section 2(3) of the Securities Act.” Id. This means that the issuer must find an exemption for the earlier grant of the IPO participation rights or run the risk that it will have violated the registration obligation of section 5 of the Securities Act. Id.; see also Kevin P. Kennedy, Section 5 Issues Relating to IPO Participation Rights, 32 ANNUAL INST. ON SEC. REG. 343 (PLI Corporate Law & Practice Course Handbook Series No. B1212 2000). The SEC’s principal concern with respect to IPO participation rights has been enforcing the registration and prospectus delivery obligations of the Securities Act, and therefore, any further discussion of IPO participation rights lies outside the scope of this Article.
may be prompted to ask whether the company's investors, or, for that matter, even the Board members themselves, have a right to know that their CEO has received spun shares from the broker-dealer firm that (not coincidentally) is later selected or recommended to serve as the company's lead underwriter for its own IPO. Analysis of any other such disclosure obligations, however, will turn on application of state law fiduciary duty principles, not the requirements of the federal securities laws. These state-level disclosure obligations are the topic of the next section.

B. Disclosure Obligations at the State Level

Quite apart from the corporation's prospectus disclosure obligations under federal securities law, there is the separate question of whether principles of state corporate law impose any disclosure obligations—on the company or its managers—as to the spinning activities engaged in by the company's managers. Analysis of this disclosure issue presumably would depend on the scope of the manager's fiduciary duty, including both the duty of care and the duty of loyalty. With respect to the duty of loyalty inquiry, spinning practices clearly implicate the corporate opportunity doctrine, which will be discussed in the next section.91

90. Current SEC disclosure policy regarding management integrity raises a separate line of inquiry as to whether disclosure of spinning activity might be required under a "materiality" analysis. Though disclosure is not specifically required by the terms of Regulation S-K, an investor could argue that disclosure is nonetheless required so that the statements made in the company's prospectus are not rendered misleading. Do modern qualitative theories of materiality support this line of reasoning? To the extent that the SEC's modern theories of materiality require disclosures that bear on management integrity, there is some support for this view. Bevis Longstreth, SEC Disclosure Policy Regarding Management Integrity, 38 BUS. LAW. 1413 (1983); In the Matter of Franchard Corp., 42 S.E.C. 163 (1964). This inquiry into materiality is generally used to compel disclosure of information that is omitted from the line-item disclosures that are otherwise required to be made part of the company's prospectus. If no line-item disclosure is required as to the practice of spinning, it may be more difficult to conclude that the company's failure to disclose spinning activity resulted in the omission of a material fact, and thereby a misleading disclosure. This line of reasoning instead seems to run dangerously close to the argument that failed in Santa Fe Industries, wherein the Supreme Court cautioned against using federal securities laws to convert what amounts to a breach of fiduciary duty claim under state law into a disclosure violation under the federal securities laws. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

91. See infra notes 105-88 and accompanying text (discussing corporate opportunity doctrine).
Under a duty of care analysis, there arises the interesting question of whether the Board of Directors, or the company's senior executive officers for that matter, are subject to any obligation to disclose the nature of prior dealings between the company's CEO/manager and a prospective underwriter. Specifically, do modern corporate fiduciary duty principles require disclosure by either the company's CEO, or its Board of Directors, as part of the duty of care owed to the corporation and its shareholders? This Article will first consider this disclosure obligation as of the time at which the Board of Directors of GT Interactive begins the process of selecting the firm that will serve as the lead underwriter for the GT Interactive IPO. To analyze the disclosure issues that might arise at this time, some general observations about the nature of the Board of Directors' decision-making process for an IPO are in order.

Once the company makes the decision to sell its stock in a public offering, the general practice today is for companies to interview usually at least three investment banking firms for the position of lead underwriter. As part of this interview process, the Board will take into account the recommendation of the company's CEO. The nature of this process poses the question of whether a Mr. Cayre, as CEO and presumably a member of the company's Board of Directors, owes any duty to disclose to fellow board members the existence of a prior relationship with Robertson Stephens, one of the candidates being considered for the position of lead underwriter for the company's IPO. It would seem that the existence of such a relationship should, at a minimum, affect the credibility and weight to be given by the Board to the CEO's recommendation. But precisely which rule or legal doctrine serves as the source of a duty to compel the CEO to disclose this information to the Board—before the Board makes its decision as to the selection of the lead

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92. Although this Article separates analysis of spinning into distinct lines of inquiry under the duty of care and then under the duty of loyalty, this distinction is somewhat artificial in the context of real-world decision making, where the obligations imposed by a manager's duty of loyalty often shade into his duty of care.

93. See generally 3 B BLOOMENTHAL & WOLFF, supra note 19, § 8.1 (describing the role of the underwriter).

94. For a detailed description of the IPO process see generally COX ET. AL., supra note 19, at 211-314; SODERQUIST & GABALDON, supra note 11, at 29-32; MARC STEINBERG, UNDERSTANDING SECURITIES LAW (3d ed. 2001).
This Article posits that, at the very minimum, the CEO's fiduciary duty obligates him or her to disclose any prior spinning activity to the Board before it finalizes its selection of the lead underwriter for the company's IPO.

The law and economics scholars of corporate law would most likely respond to what they probably view as my rather quaint view of fiduciary duty by saying that we should rely on the reputation market for managers and directors, as well as other market forces, to compel this type of disclosure, rather than extending fiduciary duty law to mandate disclosure of spinning activity. The entire reason for telling the story of spinning is because the lessons learned from this story lead inexorably to exactly the opposite conclusion. Indeed, the story of spinning only serves to underscore the continuing need for fiduciary duty law to fill this residual role by providing the basis for imposing on managers a duty to disclose information that bears directly on the credibility of their decisions.

It is at this point in the analysis of fiduciary duty obligations, moreover, that the response of the investment community takes on enormous significance in delineating the proper scope of the fiduciary duties of corporate officers and directors. Press accounts

95. It would seem to go without saying that no Board member wants to be embarrassed by disclosure of the CEO's prior spinning activity with the investment banker who is ultimately chosen by the Board to serve as the company's lead underwriter after the Board has decided to hire this particular investment banking firm.

96. This disclosure obligation is reinforced by the recent decision of the Delaware Supreme Court in Malone v. Brincat, 722 A.2d 5 (Del. 1998); see also Faith Stevelman Kahn, Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure, 34 GA. L. REV. 505 (2000). The essential importance of the Delaware Supreme Court's decision in Malone is that it reaffirms the fiduciary duty of candor that some thought was eroding. Malone's holding is not directly relevant to the practice of spinning because in the case of spinning activity the shareholders are not being asked to take any action. The importance of Malone lies in the court's rationale for its holding, which underscores the traditional view of fiduciary duty law. Malone, 722 A.2d at 9-12. Just as importantly, the need for managers to make disclosure of their prior spinning activity—as part of their fiduciary obligation—is more than amply supported by the outraged reaction of the investing public to press accounts describing underwriters' practices for allocating hot IPO shares in the unprecedented equity market of the late 1990s. See supra notes 30, 33, 57, 59, 75-77 and accompanying text (describing this investor outrage and the reform measures that were voluntarily undertaken by Wall Street firms in response).

97. Under this perspective, corporations and their managers would presumably have complete freedom of contract to define the entire scope of management's responsibilities to the company. For a general overview as to the scope contractual freedom in this context, see generally Symposium, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395 (1989).
of investors' responses clearly indicate that investors have expectations that are quite contrary to the views espoused by many law and economics scholars. Investors' palpable disappointment in those corporate managers who have engaged in spinning activity suggests that they expected that those managers would behave very differently. By rigorously enforcing principles of fiduciary duty, the courts are reinforcing the legitimate expectations of investors (and others) who deal with corporate managers as to acceptable standards of business ethics.

This Article does not suggest that we should not rely on market forces, including the reputation market, to curb unethical practices. Market forces do exert a disciplining influence on the conduct of managers. The reputation market and other market forces, however, are not enough in and of themselves. The story of spinning shows that a CEO will often be faced with a contingency, such as the opportunity to receive an allocation of hot IPO shares, that is not directly dealt with by the terms of his agreement with the company. Under these circumstances, a manager who knows that the courts will rigorously enforce the default rule of fiduciary duty law is more likely to deal with this unforeseen contingency in a fair and ethical way. Thus, in the case of spinning, rigorous enforcement of the CEO's fiduciary duty should obligate him to come forward and disclose this relationship (i.e., his prior receipt of spun shares) to the Board before the Board makes the decision to retain the lead underwriter. Moreover, relying on the reputation market to deal with these potential conflict-of-interest situations abdicates any further responsibility of the rule of law to monitor the conduct of business managers and to determine, at least at the margins, what constitutes fair, or ethical, business practices. This Article posits that the courts should not relinquish their traditional role of

98. Indeed, my own rather cynical view is that the reform measures voluntarily undertaken by Wall Street's investment banking firms clearly reflect these forces at work. See Siconolfi, supra note 3, at A14 ("Recently, however, Wall Street has seen a bit of a backlash. The National Venture Capital Association, a trade group, has cautioned [its] members that taking such IPOs could lead to regulation of the venture-capital community.").

99. If this rule of law is rigorously enforced, the lawyer advising the CEO, the Board, or both, will stand on firm ground in advising that the CEO is obligated to make this type of disclosure. See infra notes 174-80, 201-02 and accompanying text; see also Kostant, supra note 67.
enforcing fiduciary duty law to regulate ethical standards of conduct for corporate managers.\(^{100}\)

As yet another alternative, some have suggested that the SEC should amend Regulation S-K to require disclosure of a CEO's prior spinning activity. This approach would clarify certain issues, though it also suffers from several fundamental drawbacks. On a going-forward basis, this kind of line-item disclosure of prior spinning activity by a company's directors and/or senior executive officers would resolve the immediate question that this Article raises—whether this information is material; that is to say, whether investors would find this information important in evaluating the totality of the company's required disclosure as to the terms of its IPO and the plan of distribution to be carried out by the company's lead underwriter. Mandating disclosure of this information also has the great virtue (no pun intended) of eliminating any need for either lawyers or their clients to consider whether the CEO's fiduciary duty obligates him to make such disclosure. Finally, line-item disclosure eliminates the other issue that the Article struggles with in this section—whether the company, or its directors or senior executive officers, are subject to a fiduciary duty to disclose their prior spinning activity.\(^{101}\)

The fundamental drawback of this suggestion is that this type of line-item disclosure operates only to solve the immediate problem, that is, whether disclosure is required of the practice of spinning. It does not cover future situations of conduct that are not presently

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100. If managers and others know that the courts will rigorously enforce fiduciary duty standards then it creates incentives for the parties to disclose unforeseen contingencies and to bargain for an appropriate allocation of rights and responsibilities in light of these unforeseen developments. See infra notes 194-202 and accompanying text (discussing contractual limitations on the scope of corporate opportunity doctrine). For all these reasons, the story of spinning provides compelling support for the courts to continue rigorously enforcing fiduciary duty as the default rule. See also Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 261-65 (1999).

101. If the SEC were to mandate disclosure by amending Regulation S-K, this approach would have the commendable virtue of resolving any uncertainty in the future as to whether disclosure of managers' spinning activity is required, and, if so, what kind of disclosure is sufficient. This kind of predictability is generally desirable, but promulgating rules requiring disclosure of spinning activities does not help to clarify the threshold issues of materiality and duty on which this Article focuses attention. This Article seeks to clarify the scope of a manager's fiduciary duty and the responsibilities of those corporate lawyers advising their business clients as to appropriate disclosure and other related matters in this setting.
addressed by the terms of Regulation S-K. It is in the face of this type of uncertainty—this type of unanticipated contingency—where the rule of law may continue to play an important role. If the courts continue to impose rigorous standards of fiduciary duty as the default rule that is to guide the conduct of corporate managers, then the next unanticipated situation that gives rise to a potential conflict of interest will be governed by the fiduciary duty principles advocated in this Article. In this way, the rule of law, in the form of the law of fiduciary duty, will continue to shape the standards of ethical behavior that can be reasonably expected of corporate managers operating in the modern business setting.\(^{102}\)

As a final matter to consider regarding disclosure, there is the question of whether the CEO has any disclosure obligation at the time the underwriter originally spins shares out to the CEO's personal trading account. In other words, at the time that Mr. Cayre received the allocation of shares as part of the distribution of Pixar's hot IPO, did Mr. Cayre incur any duty to disclose his receipt of these shares? The most obvious source of a disclosure obligation at this time is the manager's fiduciary duties under state law, most importantly the corporate manager's duty of loyalty.\(^{103}\) Here, the analysis of the scope of the manager's disclosure obligations will turn on whether the manager's receipt of these hot IPO shares constitutes the usurpation of a business opportunity in potential breach of the CEO's fiduciary duty to his or her corporation. This issue is the focus of the next section.\(^{104}\)

\(^{102}\) This kind of line-item disclosure responds directly to those critics, particularly critics of the corporate opportunity doctrine, who complain that the uncertain scope of fiduciary duty of modern corporate managers makes it hazardous to predict in specific situations whether a particular opportunity is a corporate opportunity. See infra note 117 and accompanying text.

\(^{103}\) See infra Part III.

\(^{104}\) If, following such disclosure, the Board were to decide (on the merits) to stand by its original business decision to retain the services of that same investment banker as its lead underwriter, it would seem likely that many Board members nonetheless would feel that their trust in the CEO had been betrayed by his failure to disclose the spinning activity before the Board made its decision as to the lead underwriter for the company's IPO. Although the story of spinning does seem to have significant implications on the role of trust in the context of fiduciary relationships, nonetheless any discussion of these implications lies outside the scope of this Article; they are, in effect, a story for another day. See generally Therese H. Maynard, Law Matters, Lawyers Matter, 76 TUL. L. REV. (forthcoming Spring 2002).
III. SPINNING AS A BREACH OF THE CORPORATE MANAGER'S FIDUCIARY DUTY: THE DUTY OF LOYALTY AND THE CORPORATE OPPORTUNITY DOCTRINE

When the underwriter spins out shares to the CEO, the fiduciary duty issue that the individual CEO must resolve is whether this investment opportunity constitutes a business opportunity that properly belongs to the corporation. This section examines whether the CEO's decision to accept the hot IPO shares constitutes a breach of fiduciary duty on the grounds that the purchase of these shares is a usurpation of a corporate opportunity. The section begins with a brief overview of the existing common law framework for determining the scope of modern corporate opportunity doctrine, focusing primarily on the law of Delaware.\(^\text{105}\) The remainder of this section is devoted to applying modern principles of the common law doctrine of corporate opportunity to the typical situation of spinning activity, as reflected in the Wall Street Journal account of Mr. Cayre's decision to keep the shares allocated to him in Pixar's hot IPO by Robertson Stephens.\(^\text{106}\)

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105. The primary focus is on Delaware law, as it is widely recognized today—by legal scholars, practicing lawyers, and corporate managers—to be the leading jurisdiction for corporate law. See, e.g., Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061 (2000); Mark J. Lowenstein, Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic, 71 U. COLO. L. REV. 497, 501-07 (2000); Andrew G.T. Moore, II & Bayless Manning, State Competition: Panel Response, 8 CARDOZO L. REV. 779, 785-86 (1987); Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 FORDHAM L. REV. 843, 848-50 (1993). While "[e]fforts to explain the success of Delaware [corporate law] have become virtually a cottage industry for corporate theorists," ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 226 (7th ed. 2001), there can be no doubt about the attractiveness of Delaware as the state of first choice for incorporation of both new and established businesses. "As of early 2001, almost 50% of New York Stock Exchange [companies] and 50% of the Fortune 500 companies are incorporated in Delaware. The number of new incorporations in Delaware are in the range of 45,000 per year." Id.; see also Steven Lipin, Firms Incorporated in Delaware Are Valued More by Investors, WALL ST. J., Feb. 28, 2000, at C21 ("Most companies doing initial public stock offerings [IPOs] choose to be based in Delaware."). Moreover, "a significant number of corporate opportunity cases arise in Delaware." HAMILTON, supra, at 900.

A. General Background Regarding the Common Law Doctrine of Corporate Opportunity

The common law doctrine\textsuperscript{107} of corporate opportunity rests on the fundamental principle that a corporation's fiduciaries—its officers and directors—are not allowed to personally take advantage of a business opportunity that rightfully belongs to the corporation.\textsuperscript{108} Over the years, the inherent difficulty in applying this doctrine has arisen primarily in deciding whether a particular business opportunity is a corporate opportunity. This threshold determination is crucial because if a particular business opportunity is not found to be a corporate opportunity, then the individual officer or director may take advantage of the opportunity for personal profit.\textsuperscript{109}

\textsuperscript{107} Traditionally, this issue has not been addressed by statute, and so is governed primarily by case law. That may be changing, however, as reflected in Delaware's recent amendments to section 122 of its General Corporation Law. \textit{See DEL. CODE ANN. tit. 8, § 122 (2000).}

\textsuperscript{108} "A moment's reflection should reveal that the corporate opportunity doctrine is of central importance in assuring the integrity of a business." \textit{HAMILTON, supra} note 105, at 898. In light of the established purpose of the corporate opportunity doctrine, a disclaimer is in order here. I am not writing this Article to dispute the wisdom of continuing the common law tradition of enforcing fiduciary duty standards of fairness through the corporate opportunity doctrine. Rather, my analysis starts from the premise that the corporate opportunity doctrine is an established part of the fiduciary duty obligations imposed by operation of law on modern corporate managers. The discussion in this section, therefore, is intended to provide the reader with a concise overview of the case law that has established the current framework for analyzing modern principles of the corporate opportunity doctrine. For a fuller discussion of the theoretical underpinnings of this doctrine see generally Victor Brudney & Robert Charles Clark, \textit{A New Look at Corporate Opportunities}, 94 \textit{HARV. L. REV.} 997 (1981); Eric Talley, \textit{Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine}, 108 \textit{YALE L.J.} 277 (1998); David J. Brown, \textit{Note, When Opportunity Knocks: An Analysis of the Brudney & Clark and ALI Principles of Corporate Governance Proposals for Deciding Corporate Opportunity Claims}, 11 \textit{J. CORP. L.} 255 (1986).

\textsuperscript{109} "At common law, courts developed a host of factors for determining whether a [corporate manager's] fiduciary duty requires her to pass up a business opportunity, or whether, instead, she is free to take it for herself." Michael Begert, \textit{The Corporate Opportunity Doctrine and Outside Business Interests}, 56 \textit{U. CHI. L. REV.} 827, 829 (1989) (footnotes omitted). On the other hand, if it does constitute a corporate opportunity, the modern view nonetheless allows the director to take advantage of the opportunity if he first proceeds to remove the corporate opportunity taint. "Therefore, if the [corporate manager] first offers the opportunity to the corporation with full disclosure and the disinterested board members reject the opportunity, then the director may take advantage of it. Such a formal rejection always constitutes a defense." \textit{Id.} at 836-37. This point is also made clear in the most recent efforts to formulate the scope of corporate opportunity doctrine. \textit{See infra} notes 122-35 and accompanying text.
this is very much a high-stakes poker game, if you will, because if the corporate fiduciary guesses wrong and personally takes advantage of a business opportunity that is later determined to be a corporate opportunity, then the traditional remedy calls for the court to impose a constructive trust. Under this remedy, all of the profit gained by the wrongdoing fiduciary must be turned over to the corporation.

Over the years, the courts have struggled to craft a workable definition of what constitutes a "corporate opportunity." The earliest formulation was the "interest or expectancy test," which generally confined the corporate opportunity doctrine to "property wherein the corporation has an interest already existing, or in which it has an expectancy growing out of an existing right, or to cases where the [managers'] interference will in some degree balk the corporation in effecting the purpose of its creation." In recent years, this narrow, property-oriented test has evolved into what has come to be known as the "line of business test." Originally articulated in what remains the leading case, Guth v. Loft, the Delaware Supreme Court framed the relevant inquiry as follows:

[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.

Under this formulation of the corporate opportunity doctrine, the focus is on the factual question of "the closeness of fit between the

110. "Where there has been a usurpation of a corporate opportunity, the corporation may elect to claim the benefits of the transaction. The property that the officer or director has acquired in violation of his fiduciary duty is held in constructive trust for the corporation." COX ET AL., supra note 19, at 245 (footnote omitted).
111. Id.
113. 5 A.2d 503 (Del. 1939).
114. Id. at 511.
opportunity and the corporation's business." Therefore, "[u]nlike the 'interest or expectancy' test, the Guth test does not require that the corporation has previously done something to establish its rights in the opportunity."

But therein lies the inherent difficulty in applying the corporate opportunity doctrine. Traditionally, this doctrine has required corporate managers to wrestle with difficult factual questions as to whether a particular investment opportunity involves a corporate opportunity because of the "closeness of the fit" between the nature of the business opportunity and the company's line of business. In determining the closeness of this fit, the courts since Guth have generally required that this analysis include not only the company's existing line of business, but also take into account any closely related lines of business, as well as any potential plans for expansion of the company's line of business. The scope of the factual inquiry under the modern line of business approach is obviously fraught with great complexity and ultimately yields great uncertainty as to the proper scope of a company's "line of business." Not surprisingly, the corporate opportunity doctrine has been the frequent subject of criticism, both in the academic literature as well as among members of the practicing bar. Most often, these critics complain of the "vagueness" of the standard to be used in defining what constitutes a corporate opportunity and the uncertainty resulting from this inherent "vagueness."

116. Id.
117. On the other hand, who but the company's managers are in a better position to know what is closely related to the company's line of business or to know of what the company's future plans for expansion consist? Seen in this light, at least some of the criticism as to the uncertainty inherent in applying the line of business test is ameliorated. Along this same line of reasoning—and relying on the traditional line of business approach to decide if a particular business opportunity "properly belonged" to the corporation—at least one court has recently asserted that "[t]he law is clear that 'one entrusted with the active management of a corporation, such as an officer or director, occupies a fiduciary relationship to the corporation and may not exploit his position as an 'insider' by appropriating to himself a business opportunity properly belonging to the corporation.'" In re Villa Maria, Inc., 312 N.W.2d 921, 922 (Minn. 1981) (quoting Miller v. Miller, 222 N.W.2d 71, 78 (Minn. 1974)).
"In an effort to ... ameliorate the often-expressed criticism that the [corporate opportunity] doctrine is vague and subjects today's corporate management to the danger of unpredictable liability," the Supreme Court of Minnesota in Miller v. Miller developed yet another approach by combining the "line of business" test with what amounts to a fundamental "fairness" test. The first step in the Miller approach essentially involves a restatement of the traditional line of business test, while the second step focuses on "the equitable considerations existing prior to, at the time of, and following the officer's acquisition" of this corporate opportunity. Reduced to its essence, Miller's second prong, the "fairness" inquiry, requires the court to take into account "ethical standards of what is fair and equitable under the circumstances" in deciding whether a director has breached his fiduciary duty by usurping a corporate opportunity.

The most recent development in this ongoing struggle to delineate those business opportunities that belong to the corporation is the test adopted by the American Law Institute's Principles of Corporate Governance. The ALI approach tracks the line of business test in that section 5.05 first defines a corporate opportunity as:

(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:

(A) In connection with the performance of functions as a director or senior executive, or under circum-


119. Miller v. Miller, 222 N.W.2d 71, 81 (Minn. 1974).
120. Id. at 81.
121. Id. at 80. In a recent unpublished Minnesota case, the Minnesota Court of Appeals, following the earlier decision in Miller, held that "an officer or director [of a corporation] occupies a fiduciary relationship to the corporation and may not exploit his position as an 'insider' by appropriating to himself a business opportunity properly belonging to the corporation." South Side Sales & Leasing v. Maas, 2000 Minn. App. LEXIS 948, at *3 (2000).
stances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or
(B) Through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or
(2) Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage.123

ALI section 5.05 further prohibits a director or senior executive officer from taking advantage of a corporate opportunity unless he first offers it to the corporation and, as part of this offer, makes certain disclosures to the company's board of directors.124

Thus, the ALI approach is similar to the two-pronged analysis of corporate opportunity established in the Miller decision. First, the threshold determination must be made as to whether the business opportunity is a corporate opportunity that belongs to the corporation. Then the analysis shifts to focus on the manner in which the corporate manager goes about taking personal advantage of this opportunity. In order for the manager to remove the taint of "corporate opportunity" from the prospective business opportunity, the corporation must have made the decision to reject pursuing the business opportunity.125 To be effective, this rejection must satisfy one of the following tests set forth in ALI section 5.05(a)(3):

(A) The rejection of the opportunity is fair to the corporation;
(B) The opportunity is rejected in advance, following such disclosure, by disinterested directors [§ 1.15], or, in the case of a senior executive who is not a director, by a

123. ALI PRINCIPLES, supra note 122, § 5.05(b) (emphasis added).
124. "The truly significant contribution of [ALI PRINCIPLES] section 5.05 is that it causes the director or senior executive officer to first obtain disinterested approval of the board of directors." COX ET AL., supra note 19, at 241.
125. ALI PRINCIPLES, supra note 122, § 5.05(a)(3).
disinterested superior, in a manner that satisfies the standards of the business judgment rule [§ 4.01(c)]; or

(C) The rejection is authorized in advance or ratified, following such disclosure, by disinterested shareholders [§ 1.16], and the rejection is not equivalent to a waste of corporate assets [§ 1.42].

Thus, the ALI approach allows the insider to take advantage of a corporate opportunity but only if the fiduciary has "fully disclose[d] to the corporation, all material facts concerning the opportunity." Because this disclosure-oriented approach provides a clear procedure for the insider to protect herself against liability, several courts have embraced the ALI formulation of the corporate opportunity doctrine.

126. Id. § 5.05(a)(3). "Absent such approval [of the disinterested directors], the only option is the more cumbersome and expensive process of obtaining shareholder approval or the less-predictable burden of proving no unfairness to the corporation." COX ET AL., supra note 19, at 242. The Revised Model Business Corporation Act (RMBCA) was recently amended to add section 8.31. Although it does not specifically address the corporate opportunity doctrine, section 8.31(a) does provide, in relevant part, that a director is not liable to the corporation or its shareholders for the decision to take personal advantage of a corporate opportunity unless the plaintiff can show that "the challenged conduct consisted or was the result of ... receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law." Using language reminiscent of the ALI approach, the comment to this recent amendment to the RMBCA elaborates on the nature of the central concern in the area of corporate opportunity:

It has long been recognized that a director must first offer a "corporate opportunity" to the corporation before taking advantage of it. The term "corporate opportunity" can be readily stated in principle but, when determining the doctrine's application, the facts will often be outcome determinative.

The application of the corporate opportunity doctrine, in cases where it is operative, is typically conditioned on the corporation's financial ability to exploit the opportunity, although some courts have held it is up to the corporation to judge that ability and the corporation should therefore always be offered [the opportunity]. Relatedly, a formal offer is not essential, so long as the surrounding circumstances indicate an awareness of, and afford the corporation reasonable access to the opportunity and there is indicated disinterest [in pursuing the opportunity], manifested [either] by inaction or due to financial inability. Failure to observe this obligation first to refer a corporate opportunity to the corporation results in a breach of a director's duty.


128. E.g., id.; Northeast Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1152 (Me. 1995). In adopting the ALI approach, the Harris court held that the ALI disclosure requirement
The same fundamental concerns at the heart of the ALI approach are likewise reflected in the most recent Delaware Supreme Court decision addressing the scope of the corporate opportunity doctrine. That decision is the focus of the next section.

B. Delaware Courts and the Corporate Opportunity Doctrine

In *Broz v. Cellular Information Systems, Inc.*, the Delaware Supreme Court further refined its established line of business approach, as originally formulated in its landmark decision, *Guth v. Loft.* The *Broz* decision is important to the story of spinning because of its factual similarity to the conduct of spinning, as well as the further refinements that the Delaware Supreme Court made in its approach to the corporate opportunity doctrine.

Robert Broz was president and sole shareholder of RFB Cellular, Inc. (*RFBC*). Separately, Mr. Broz served as a member of the board of directors at Cellular Information Systems, Inc. (*CIS*). Both companies, RFBC and CIS, were Delaware corporations as well as competitors in the business of providing cellular telephone service. RFBC owned and operated a cellular phone license area in Michigan while CIS owned and operated cellular phone licenses in other states. A brokerage firm representing Mackinac Cellular recognizes the vital importance of the duty of loyalty while protecting the ability of the fiduciary to pursue his/her own business ventures. *Harris*, 661 A.2d at 1152. As one commentator has observed, "a sensible outcome exists if a rule allows a corporate official to proceed justifiably in his or her own self interest without undue delay or inappropriate anxiety about usurping a corporate opportunity." *Gelb, supra* note 118, at 372-73.

129. 673 A.2d 148 (Del. 1996).
130. 5 A.2d 503 (Del. 1939).
131. *Broz*, 673 A.2d at 150.
132. *Id.*
133. *Id.* at 151-52. See also the discussion, *supra* note 107, regarding recent legislative amendments to Delaware's General Corporate Law, which allows Delaware corporations to amend their charter to define what constitutes a corporate opportunity. I believe that this legislative amendment was intended to address the kind of situation that we see in *Broz*, where an individual serves on the boards of two companies that are within the same industry. Generally speaking, this is not the usual practice since most corporations do not want individuals who are related to a competitor to serve on their Board of Directors. However, in Internet-related industries, this practice was often compromised, owing apparently to the dearth of knowledgeable and capable individuals who were willing to serve as directors—especially on the Board of a start-up corporation.
Corporation (Mackinac) contacted Mr. Broz regarding the possible acquisition of the Michigan-2 cellular license by RFBC. However, the brokerage firm did not offer the Michigan-2 license directly to CIS, which at the time was experiencing serious financial difficulties. Mr. Broz did not formally present this opportunity to the CIS board but rather informed the CEO and two other directors of his interest in the opportunity. All three individuals informally told Mr. Broz that they believed CIS itself would not be interested in the Michigan-2 license because CIS had recently emerged from bankruptcy reorganization and the company was actively engaged in the process of divesting itself of its cellular licenses.

Before Mr. Broz acquired the Michigan-2 license, another corporation, PriCellular, Inc. (PriCellular), became involved in steps to acquire CIS. PriCellular was also interested in the Michigan-2 license and negotiated with Mackinac to arrange an option to purchase that license. The CIS Board of Directors was aware that both PriCellular and Mr. Broz were bidding for the Michigan-2 license, but the CIS Board did not get involved. On behalf of RFBC, Mr. Broz submitted the highest bid and RFBC was awarded the Michigan-2 license. At the time of this bidding process, PriCellular had no equity interest in CIS. Subsequent to this bidding process, however, PriCellular bought a controlling interest in CIS. After acquiring control of CIS, PriCellular discharged the members of the CIS Board of Directors, and commenced an action against Mr. Broz for equitable relief, contending that his purchase of the Michigan-2 license constituted the usurpation of a corporate opportunity in breach of his fiduciary duty to CIS.

135. Id.
136. Id. at 151-54.
137. Id. The bidding process at issue in Broz clearly illustrates the potential for conflicts of interest when individuals serve on the Boards of companies that operate within the same industry. Although this is a story that I hope to tell another day, I believe that this is the kind of situation that prompted the Delaware legislature to enact the recent amendment to its General Corporate Law, adding new section 122 (17). See supra note 107 (describing this recent Delaware amendment).
139. Id.
140. Id.
141. Id.
142. Id.
In its opinion, the Delaware Supreme Court asserted that “[t]he corporate opportunity doctrine represents a judicially crafted effort to harmonize the competing demands placed on corporate fiduciaries in a modern business environment."\(^{143}\) In finding that Mr. Broz had not breached his fiduciary duty to CIS, the court employed a list of factors to be considered insofar as they are relevant to the factual situation presented by a particular case.\(^{144}\) Relying on its earlier decision in *Guth v. Loft*,\(^{145}\) the Delaware Supreme Court held that the corporate officer or director may *not* seize a business opportunity for his/her own benefit if:

(1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation’s line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his or her own, the corporate fiduciary will thereby be placed in a position inimicable to his or her duties to the corporation.\(^{146}\)

Notwithstanding the conclusion that a particular business opportunity is a “corporate opportunity,” the Delaware Supreme Court, recognizing the exigencies of modern business reality, went on to assert that

a director or officer *may* take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.\(^{147}\)

In the course of its reasoning, the *Broz* court also made it clear that these factors are to “provide guidelines to be considered by a reviewing court in balancing the equities of an individual case. . . . [N]o one factor is dispositive and all factors must be taken into

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143. *Id.* at 159.
144. *Id.* at 151.
145. 5 A.2d 503 (Del. 1939).
146. *Broz*, 673 A.2d at 155.
147. *Id.* (citing *Guth*, 5 A.2d at 509).
account insofar as they are applicable." Moreover, whether or not a corporate opportunity is usurped is a factual question to be determined by "reasonable inference from objective facts." The Delaware Supreme Court then applied this formulation of the corporate opportunity doctrine to the situation in which Mr. Broz found himself. After a lengthy review of the factual circumstances surrounding Mr. Broz's decision to acquire the Michigan-2 license for RFBC, his wholly owned corporation, the Delaware Supreme Court concluded that Mr. Broz's acquisition of the cellular license did not constitute the usurpation of a corporate opportunity, notwithstanding the close fit between the Michigan-2 license Mr. Broz acquired and the existing line of business of his corporation, CIS.

In finding that Mr. Broz did not usurp a corporate opportunity, the Delaware Supreme Court first considered the manner in which the director learned of the opportunity. The court emphasized the fact that Mr. Broz learned of the opportunity through his individual capacity rather than in his corporate capacity. Mr. Broz learned of the Michigan-2 license opportunity through his company RFBC, rather than as a result of his position at CIS. Indeed, the broker who approached Mr. Broz to offer him the Michigan-2 license never offered the opportunity to CIS, presumably because this broker was aware that CIS was financially distressed.

148. Id.
149. Id. at 155 (quoting Johnston v. Greene, 121 A.2d 919 (Del. 1956)).
150. Id. at 155-57.
151. Id. at 151-53.
152. Id. at 157.
153. Id. at 155.
154. Id.
155. Although relevant, I am not generally in favor of leaving the definition of corporate opportunity to be defined entirely by the conduct or expectations of third parties who are not related to the corporation, such as this broker who offered the Michigan-2 license to Mr. Broz. In this case, however, the broker's decision to offer the Michigan-2 license to Mr. Broz individually seems particularly relevant in that it bears directly on the financially distressed circumstances of CIS. It is worth pointing out that, however, as the leading treatise on California corporate law asserts, a corporate opportunity arises in some circumstances [where the facts show that] a business opportunity [has been] presented to the director [or officer], even when the corporation has had no previous dealings or connections whatever with the other party who presents the business opportunity.

The court then applied its four-pronged approach for determining liability for usurping a corporate opportunity.\textsuperscript{156} The first factor was not satisfied because the court found that CIS did not have the financial ability to exploit the Michigan-2 license.\textsuperscript{157} CIS had recently emerged from a lengthy bankruptcy proceeding and was not in a position to commit its capital to the acquisition of new assets.\textsuperscript{158} In the course of its discussion, the court emphasized that Mr. Broz was required to consider the facts "only as they existed at the time he determined to accept the Mackinac offer."\textsuperscript{159} This emphasis was presumably made by the court to take into account the subsequent acquisition of CIS by Pri-Cellular, a fact that Mr. Broz seemingly did not have to anticipate in deciding whether to bid for the Michigan-2 license.

On the second prong, the Delaware Supreme Court found that the Michigan-2 opportunity was in the same "line of business" in which CIS was engaged.\textsuperscript{160} Specifically, the court ruled that the Michigan-2 opportunity was a cellular service license and both companies were in the business of acquiring cellular service areas.\textsuperscript{161} Unlike the approach in Guth, however, this factor was not, by itself, sufficient to establish that Mr. Broz usurped a corporate opportunity.\textsuperscript{162}

On the third prong, the Broz court found that CIS had no "interest or expectancy" in the Michigan-2 opportunity.\textsuperscript{163} For a

\textsuperscript{156} Broz, 673 A.2d at 155-56.
\textsuperscript{157} Id. at 155-56.
\textsuperscript{158} Id. at 155.
\textsuperscript{159} Id. at 156.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id. at 156-57. This case is typical of the kind of difficult fact determinations that make lawyers and their clients so critical of the corporate opportunity doctrine. See supra note 108 (listing law review articles dealing with corporate opportunity doctrine). On the other hand, the Broz court made it very easy for lawyers and their clients to avoid these often difficult issues of fact. In a close case, the corporate officer or director need only make full and adequate disclosure of the opportunity in order to avoid any personal liability for taking advantage of business opportunities he learned of through his position as a corporate fiduciary. See infra notes 124-28 and accompanying text (discussing disclosure as a complete defense to liability under ALI approach).
\textsuperscript{163} Broz, 673 A.2d at 156-57.
corporation to have an 'actual or expectant interest in any specific property, "there must be some tie between that property and the nature of the corporate business." At the time the opportunity was presented, CIS was actively divesting its license holdings and had no intention to acquire additional licenses. Thus the court held that there was no relationship between the Michigan-2 opportunity and the nature of CIS's future business plans.

Lastly, the fourth prong was not satisfied because the court found that "Broz' interest in acquiring and profiting from Michigan-2 created no duties that were inimical to his obligations to CIS." Instead, Mr. Broz "took care not to usurp any opportunity which CIS was willing and able to pursue." Mr. Broz sought only to compete with an unrelated outside entity, PriCellular, for acquisition of this business opportunity. At that time, his fiduciary obligation to CIS did not obligate Mr. Broz to refrain from competing with PriCellular. In light of the totality of these circumstances, the Delaware Supreme Court concluded that Mr. Broz did not unlawfully usurp an opportunity properly belonging to CIS.

Before shifting focus to an application of corporate opportunity doctrine to the practice of spinning, it is important to note that nothing in the Delaware Supreme Court's decision in Broz is inconsistent with the notion that modern fiduciary duty law should operate to hold managers accountable to their corporation. In this regard, it is quite significant, as a factual matter, that Mr. Broz took advantage of the opportunity to acquire the Michigan-2 cellular license only after making his corporation, CIS, aware of the opportunity, albeit informally. In addition to its analysis of whether the acquisition of the Michigan-2 license constituted a

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164. Id. at 156.
165. Id. at 156-57.
166. Id. at 157. By actively divesting its license holdings, CIS seemingly demonstrated that it had no interest in the Michigan-2 opportunity, or at least this seems to be a fair inference to draw from this conduct. Id. at 156-57.
167. Id. at 157.
168. Id.
169. Id.
170. Id.
171. Id.
172. Id. at 152.
corporate opportunity, the Delaware Supreme Court reiterated its view that a director may seize a corporate opportunity without breaching his fiduciary duty to the corporation, depending on the manner in which the director goes about making the decision to take advantage of a corporate opportunity.173

Along these same lines, it is equally important to consider the Delaware Supreme Court's discussion of the need for the insider (officer or director) to make a formal presentation to the company's Board of Directors in order to insulate himself from personal liability.174 The Broz court rejects any suggestion that its earlier decision in Guth required Mr. Broz to make a formal presentation of the Michigan-2 license to CIS.175 Instead, the Broz court opted for a more loosely formulated requirement of good faith on the part of the director who decides to take advantage of a corporate opportunity.176 The fact that Mr. Broz did not take the opportunity surreptitiously was crucial, therefore, to demonstrating his good faith.177 Indeed, Mr. Broz acted in good faith in that he informed the CEO and two other directors of his interest in the opportunity and all three individuals informally communicated to Mr. Broz that they believed CIS itself would not be interested in the transaction.178 The Broz court held that the failure of a director to make a formal presentation of a corporate opportunity to the corporation does not necessarily result in improper usurpation.179 Although the holding in Broz recognized that adequate disclosure was a complete defense to a claim of usurpation of a corporate opportunity, the Delaware court declined to recognize that nondisclosure, in and of itself, established that a corporate manager had usurped a corporate opportunity in breach of his fiduciary duty.180

As this Article describes in more detail in the next section, the factual circumstances presented in Broz as well as the reasoning used by the Broz court are both quite helpful in understanding the corporate opportunity implications inherent in the story of spinning.

173. Id. at 154-55.
174. Id. at 150, 157-58.
175. Id.
176. Id. at 158.
177. Id.
178. Id. at 152.
179. Id. at 150, 157-58.
C. Applying the Corporate Opportunity Doctrine to the Practice of Spinning

This section applies established principles of the common law doctrine of corporate opportunity, as expanded by the Delaware Supreme Court in Broz, to the situation of "spinning." Specifically, this section will examine whether Mr. Cayre usurped an investment opportunity that belonged to his corporation, GT Interactive, when he accepted shares of the Pixar hot IPO allocated to him by Pixar's lead underwriter, Robertson Stephens.

The Delaware Supreme Court precedent makes it clear that the starting point for the analysis of whether the spinning of Pixar shares to Mr. Cayre's personal account constitutes the usurpation of a corporate opportunity is consideration of the manner in which a particular business opportunity came to the attention of the corporate manager. Thus, the analysis initially focuses on the manner in which the allocation of Pixar's hot IPO shares were deposited in Mr. Cayre's personal discretionary trading account. This allocation of shares in Pixar's hot IPO seemingly was made to Mr. Cayre because he served as the CEO of a company that was widely known among the investment banking community to be itself an IPO candidate. Because the opportunity came to Mr. Cayre as...
a result of his position within the company, this is powerful evidence that this investment opportunity constituted a corporate opportunity.\textsuperscript{182} Even more compelling evidence of a corporate opportunity taint to this allocation of Pixar shares is the underwriter's apparent assumption that Mr. Cayre would direct his company's future underwriting business to Robertson Stephens.\textsuperscript{183}

The Delaware Supreme Court also directed that the other three factors were to "be taken into account insofar as they are applicable."\textsuperscript{184} As to the second factor, Mr. Cayre's investment in an allocation of hot IPO shares is probably "not essential to the corporation," although the corporation probably does hold an interest or expectancy in the investment opportunity within the meaning of the third prong of the \textit{Broz} analysis. Because the opportunity came to Mr. Cayre only because of his position within

\& Co., a New York firm that allocates a relatively small number of IPO shares to corporate executives: "There are a lot of these guys who put the arm on you for the stock."

Siconolfi, \textit{SEC, NASD, supra} note 26, at A3.

182. This conclusion is supported by the only passing reference—as to the nature of the responsibilities of those corporate managers who receive hot IPO allocations—that I could find among the scores of press accounts critically examining the practice of spinning published since November 1997 (when Mr. Cayre's story was first publicized in the \textit{Wall Street Journal}):

The duty of corporate executives in the practice of spinning, regulators and corporate lawyers say, is spelled out in state law under the legal doctrine known as "corporate opportunity." The gist of the law: Corporate executives can't take personal advantage of financial opportunities that come to them by virtue of their position at the company. Instead, the executives are required to offer the opportunities to their company.

"If the opportunity is presented to the officer or director in his corporate capacity or because he is known to the other party as an officer or director of the corporation, it is much easier for the court to determine that he should have given it to the corporation," according to Marsh's California Corporation Law, a legal authority on that state's corporate law.

Siconolfi, \textit{SEC Broadens, supra} note 26, at C20. The same \textit{Wall Street Journal} article goes on to observe that the regulatory scrutiny to date has concentrated on Wall Street underwriting firms and their IPO allocation practices. Despite numerous press accounts of ongoing regulatory investigations (civil and criminal), this is the only reference that I could unearth scrutinizing the "receiving end"—the legal issues surrounding the CEO's decision to accept the "spun shares." \textit{Id.} It is curious that the only published article in the financial press that directly raises the issue of the CEO's culpability refers to the comments of unidentified members of the corporate bar who seem to assume that the practice of spinning creates fiduciary duty problems for the CEO under the corporate opportunity doctrine.

183. \textit{See supra} note 60 (referring to \textit{Wall Street Journal} articles providing support for this assumption of a quid pro quo on the part of the underwriter).

184. \textit{Broz}, 673 A.2d at 155.
the corporation and in apparent anticipation that he would direct
the corporation's investment banking business to Robertson
Stephens, it would seem the corporation's interest predominates
the individual interests of the corporation's CEO, Mr. Cayre.
Accordingly, if this allocation was made in order to obtain the
company's future business, it would seem that this investment
opportunity should be shared with all shareholders of GT
Interactive. On the final prong of the Broz criteria, it would seem
that Mr. Cayre has not directly employed the resources of his
corporation since he appears to have purchased the Pixar shares
using his own funds, so that this prong is not directly implicated on
these facts.

At this point in analyzing the four-pronged criteria of the Broz
decision, it is important to remember that the Broz court held that
the determination of corporate opportunity is a factual question to
be determined by "balancing the equities of an individual case." The
circumstances outlined in the November 1997 Wall Street Journal
article clearly seem to give rise to a corporate opportunity problem.
The underwriter, Robertson Stephens, was spinning out these
shares to the CEO, Mr. Cayre, as an apparent quid pro quo for
future business from this CEO's employer, GT Interactive. As
such, this allocation was not made because of the personal business
that the underwriter anticipated receiving directly from the CEO as
an individual investor. Instead, this spinning activity seems to
have been directly related to the individual's position as CEO
within the corporation. On these facts, I have no doubt that the
common law, including Delaware, would find that this investment
opportunity constituted a corporate opportunity. Alternatively, if
in fact this CEO has an ongoing relationship with this particular
investment banking firm—that includes the specific investment
strategy of getting as many hot IPO allocations as he can—then the
default rule should require this CEO to make disclosure of his
earlier transactions with the company's prospective underwriter and

185. See supra notes 72-85 and accompanying text.
186. Indeed, on these facts, the underwriter's spinning activity creates, at the very least,
the appearance of a quid pro quo for future business—something in the nature of a bribe. See
supra notes 50-54 and accompanying text (discussing the NASD rule on illegal payment of a
"gratuity"); note 30 and accompanying text (describing spinning as being in the nature of a
"bribe").
explain why receiving hot IPO allocations does not involve the usurpation of a corporate opportunity. Consistent with the reasoning in Broz, this type of disclosure removes the corporate opportunity taint from the CEO's decision to purchase these hot IPO shares because the CEO can establish that his prior personal relationship with this investment banking firm was the driving force behind the underwriter's decision to spin shares out to the CEO. 187

Finally, and perhaps most significantly for the story of spinning, is the reaction of Wall Street participants—both investors and investment bankers—to Mr. Cayre's conduct. Their reaction clearly supports the conclusion that Mr. Cayre usurped a corporate opportunity that belonged to his corporation, GT Interactive. Numerous press accounts appeared in the wake of the November 1997 Wall Street Journal article which originally described Mr. Cayre's spinning activity. These articles quote various investors and their financial advisors as condemning the practice of spinning, many likening it to a "bribe," or at the very least, a smarmy business practice. 188 This reaction clearly reflects the strong sentiment that Mr. Cayre received this allocation of Pixar shares only because of his position within the corporation, GT Interactive.

187. Under this line of reasoning, the spinning activity would not be attributable to the CEO's position within the corporation. This approach is also consistent with the NASD Free-Riding Rule, which allows allocations of hot IPO shares to certain categories of "restricted persons" if the underwriter can show that such an allocation is not disproportionate and is consistent with the person's established investment practice. See supra notes 51-54 and accompanying text. In the rather unlikely case where the CEO can satisfactorily establish that shares that were spun out to his personal account do not involve a corporate opportunity, this relationship nonetheless should be brought to the attention of the board as part of its decision-making process because it bears directly on the independence of the CEO and therefore bears on the credibility of the CEO's recommendation as to the selection of the lead underwriter for the company's IPO. Indeed, at a minimum, the fiduciary duty of the corporate manager should obligate him to come forward and volunteer disclosure of this relationship, which arises as a result of his prior spinning activity with a prospective underwriter for the company. To the extent that the law and economics school of thought may try to argue that this was implied compensation, the appalled reaction of so many observers clearly reflects that there is no basis for this assumption; in other words, investor reaction clearly shows that this is not an implied term of the manager's compensation, contrary to the contractarian view.

188. E.g., Lashinsky, supra note 30, at 1E ("[S]ome say the investment bankers are bribing the CEOs to win future investment banking fees."); Siconolfi, supra note 3, at A1 ("Spin shares don't go to the corporate customer itself—they go to individuals at the corporation who are in a position to sway the company's decisions. 'It's a bribe, no question about it,' contends Robert Messih, a managing director at Salomon Inc. . . . .").
That reaction, coupled with Mr. Cayre's failure to disclose this investment opportunity to his corporation before seizing it for himself, clearly reinforces the conclusion that, based on the story told in the *Wall Street Journal*, he has left himself open to a claim of breaching his fiduciary duty by usurping a corporate opportunity.

As a final observation regarding investor reaction to Mr. Cayre's conduct, even a casual perusal of this fallout reflects a fundamental concern within the business community as to the fairness of this spinning activity, and calls into question the ethics of both the investment banker who spins the hot IPO shares, and the CEO who personally profits from flipping these shares. Part IV addresses these ethical concerns.

IV. THE STORY OF SPINNING—A MATTER OF BUSINESS ETHICS?

A. *The Importance of Fiduciary Duty Law in Regulating the Business Ethics of Corporate Managers*

In considering these reports of investor reactions to press accounts of Mr. Cayre's conduct and his story of spinning, is it possible to see a more profound problem reflected in their disappointed expectations? Does their disappointment somehow reflect investors' legitimate and reasonable expectations about how their CEO would behave in the face of an unanticipated event—such as the opportunity to receive an allocation of shares in a "hot IPO"? As such, is this different from the situation where the investment banker pays the greens fees to go golfing with the CEO? Is—or should—this distinction be relevant in considering whether spinning activity constitutes usurpation of a corporate opportunity?

One way to look at this distinction is to say that today's investors have come to regard the payment of the CEO's greens fee as an "accepted business practice." As such, investor expectations as to the

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189. "Says Carl Thoma, a venture capitalist and former chairman of the National Venture Capital Association: 'Once the securities industry senses it's getting in trouble, it's pretty quick to deal with the issue. This reality relieves the incentive for the SEC to pursue some enforcement cases." Gasparino et al., *supra* note 2, at C1; see also Siconolfi, *supra* note 3, at A1 ("Recently, however, Wall Street has seen a bit of a backlash. The National Venture Capital Association, a trade group, has cautioned members that taking such IPOs could lead to regulation of the venture-capital community.").
behavior and business practices of their CEO are shaped based on this shared understanding of what is an acceptable business practice in today's world. But—in the face of an unprecedented hot IPO market, where allocations are very hard to come by—investors react quite differently upon learning that their CEO has used his position to influence the underwriter in order to obtain shares of a hot IPO for himself personally. As such, the CEO's behavior exceeds what investors consider to be ethical standards of acceptable business practice, and gives rise to investor disappointment, and even anger, at how their CEO behaved in a situation not previously encountered and, as such, not explicitly dealt with by the parties in advance.\textsuperscript{190}

Seen from this perspective, the story of spinning provides a compelling reason for the law to continue to enforce a fairly rigorous standard of fiduciary duty. In framing the default rule for corporate opportunity to include the CEO's receipt of an allocation of shares in a hot IPO, the law continues its traditional role in shaping the standards of what members of the business community can reasonably expect as "fair commercial practice." The recent developments surrounding the practice of spinning provide a concrete illustration of the continuing importance of the role of fiduciary law as the default rule. Rigorous judicial enforcement of fiduciary duty standards as the default rule—a rule that cannot be completely waived by the parties—provides the courts with the

\textsuperscript{190}. This line of inquiry raises the question of whether it is reasonable and legitimate for these investors to expect their CEO to turn over this IPO investment opportunity to his or her corporation—or, at a minimum, to disclose the spinning activity to his corporation—rather than seizing the opportunity to buy hot IPO shares for his own personal trading account. What are these investors entitled to expect from their CEO? I believe that the courts, in evaluating whether the CEO's conduct constitutes a breach of fiduciary duty, will take into account the legitimate expectations of investors (including the specific expectations of the shareholders of a privately held company, such as GT Interactive). This conclusion is reinforced by the recent opinion of Judge Bedsworth of the California Court of Appeals in \textit{BT-I v. Equitable Life Assurance Soc'y of the United States}, 89 Cal. Rptr. 2d 811 (Cal. App. 1999). Although not directly on point, since \textit{BTI} involved issues of partnership opportunity, the approach that Judge Bedsworth used reflects what is the predominant judicial attitude towards these types of breach of fiduciary duty issues. I believe that Judge Bedsworth's opinion reflects that modern courts do take into account the reasonableness of investors' expectations in deciding what is the scope of a CEO's fiduciary duty to his or her corporation. \textit{See also} Rutheford B. Campbell, Jr., \textit{Corporate Fiduciary Principles for the Post-Contractarian Era}, 23 Fla. St. U. L. Rev. 561, 562 (1996) ("For good reasons, society is not about to relieve corporate managers of \textit{all} their fiduciary responsibilities.") (emphasis added).
basis for intervening to protect the legitimate expectations of investors as to what constitutes fair business practice. To leave this exclusively to contract and the reputation market, as many corporate law scholars advocate, is to abdicate any further judicial responsibility for monitoring the behavior of managers. Unlike these other scholars, I believe that the courts should continue to play an influential role in shaping standards of fair and ethical conduct for corporate managers.

If we assume that the default rule is to treat spinning as a corporate opportunity, then the next question is whether the CEO can expressly contract with his corporation for the right to keep for himself any shares that are spun out to him as part of some other issuer's hot IPO offering. In other words, can the corporate manager contract away the limitations imposed by the common law doctrine of corporate opportunity? This issue is examined in the next section.

B. Contractual Limitations on the Scope of the Corporate Opportunity Doctrine

Once we establish that the default rule of fiduciary duty law will treat spinning as a corporate opportunity, then the next logical question is whether this default rule may be varied by contract. It seems that the answer to this question turns on whether the CEO/manager can contract to limit (or even eliminate altogether) his fiduciary duty obligations to his corporation. This is an issue of considerable debate among legal scholars today. The story of spinning has important implications for this debate as well.

When the practice of spinning received heightened scrutiny in the press, it was foreseeable that corporate managers and their boards of directors would bargain directly over who had the right to keep any shares that were to be allocated by those broker-dealer firms

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191. The debate over these issues of business ethics continues to rage. See, e.g., Jeff D. Opdyke, Guidelines Aim to Polish Analysts' Image, WALL ST. J., June 13, 2001, at C1 (describing guidelines that are intended to address "what critics say is the lack of sufficient independence of analysts within Wall Street firms").

192. This perspective on the continuing importance of rigorous judicial enforcement of fiduciary duty law—and its associated role in defining investors' reasonable expectations as to standards of fair and ethical conduct for corporate managers—is further reinforced when one considers the role of the lawyer in rendering legal advice in the context of spinning. See infra section IV.C.
with which the company did business or anticipated doing business in the future. For purposes of this Article, what is of crucial importance is that the starting point for parties' negotiations in this matter appears to have assumed that the modern fiduciary duty standard imposed on corporate managers includes the corporate opportunity doctrine. As to specific allocations of corporate opportunities that are openly and fully bargained for, I assume courts will stand ready to enforce such agreements.

If a manager can contract to eliminate his fiduciary duty with regard to corporate opportunities, then presumably the law should only be concerned with establishing a clear default rule—a rule that will serve in future cases to allocate the transaction costs of negotiating for a different liability rule in cases involving the spinning (allocation) of hot IPO shares. Once again, however, this view assumes that there is an important role for the law of fiduciary duty to play, but that once the default rule of corporate opportunity doctrine operates to impose obligations on the company's managers, they can vary these obligations by contract. Although the parties may contract to allocate specific opportunities, it is doubtful to me that all vestiges of corporate opportunity doctrine can be eliminated by agreement between the corporation and its managers. Since I doubt that the contract can adequately anticipate all future situations that may give rise to a corporate opportunity, I do not believe that the parties may contract to eliminate the corporate opportunity doctrine altogether.

In this way, the story of spinning also emphasizes the continuing importance of modern fiduciary duty law.193 In the face of an unanticipated development such as spinning, which was not specifically addressed by the terms of the parties' bargained-for agreement, the law of fiduciary duty takes over to define the scope

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193. As a corollary, the manager may contract in advance to avoid the results imposed by this default rule. As with any default rule, however, this approach has the added virtue of clearly allocating the transaction costs of bargaining around the default rule. Under a traditional analysis of corporate opportunity doctrine of the type laid out in this Article, these costs get allocated to the manager, who knows that in the absence of disclosure and appropriate contractual arrangements, the doctrine of corporate opportunity will continue to be rigorously enforced by the courts. To avoid personal liability, the manager's fiduciary duty requires that he or she assume the costs of contracting to avoid these obligations. E.g., Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995).
of responsibility in the face of this unanticipated contingency. Investor reaction to the conduct of their managers serves as a poignant modern day reminder that there is an important residual role for the rule of law to play in determining the scope of fiduciary responsibilities of corporate managers. In this way, the law of fiduciary duty continues to shape the standards of decency and fairness that investors can reasonably expect to govern their corporate managers.

In an interesting twist of affairs, investment banking firms responded to public criticism by moving on their own initiative to adopt internal policies prohibiting the practice of spinning. In another apparent reaction to various press accounts of spinning activity, many venture capital firms were also prompted to adopt “best practices” as to spinning in an apparent effort to further curb

194. At a minimum, the CEO must make disclosures to the company's board of directors, for the reasons set forth in the accompanying text. A separate question arises, however, when considering whether disclosure of the prior spinning activity must be made to the company's shareholders—that is, to other investors in the company who may not also be serving as board members and therefore are not privy to the disclosure made to the company's board of directors. In considering the scope of the disclosure obligation to the company's shareholders, the distinction between public and private companies may be most relevant. I do not believe, however, that the distinction between publicly held and privately held companies is relevant in determining, in the first instance, the CEO's obligation to provide disclosure to the corporation's board of directors. The appearance of impropriety and the potential for directors to suffer a loss of reputation with the company's investors is just as great in the case of directors who have to answer to a cadre of venture capitalists and other individual investors in a privately held firm as in the case of those directors who have to answer to the scrutiny of a broader array of institutional and individual shareholders in a publicly held firm. As for the separate issue of whether there is a need to inform the company's investors, at least one regulator has been heard to say that investors have a “right” to know that the company's CEO was allocated hot IPO shares by the investment bank ultimately selected to serve as the lead underwriter for the company's IPO.

State securities regulators condemned underwriters' practice of setting aside shares of hot new stocks for corporate executives and venture capitalists, and said they will join their national counterparts in looking at the incentive. ... "Wouldn't you as an investor in a company want to know why the chief executive may have chosen a certain investment banker to handle the company's IPO?"

Regulators to Review Stock "Spinning" Practice; Some Disapprove of Underwriters Setting Aside IPO Shares for Executives, Venture Capitalists, DALLAS MORNING NEWS, Nov. 18, 1997, at 4D (quoting Mark J. Griffin's final speech as President of the North American Securities Administrators Association). Needless to say, the timing and mechanism for making this kind of disclosure will depend in large part on whether the company is privately or publicly held; any further discussion of this issue, however, lies outside the scope of this Article.

195. See supra notes 76-78 and accompanying text.
abusive practices in this area. All of these reform efforts within the Wall Street community ultimately led the SEC's top enforcement official for Wall Street, Richard Walker, Director of the SEC's Division of Enforcement, to observe—a scant six months after the Wall Street Journal first published its high profile account of Mr. Cayre's spinning activity—that "the public's focus on spinning has had the greatest impact in stamping out the practice." In order for this self-correcting process to occur, however, the conclusion I draw from all these reform efforts voluntarily undertaken by various market participants is that the law of fiduciary duty must be rigorously enforced. In this way it allocates responsibility in such a way as to encourage disclosure of these potentially abusive practices, such as spinning, which by their very nature present significant potential for conflict of interests. By enforcing a default rule that encourages the corporate manager to disclose spinning activity, the rule of law promotes transparency in corporate decision making, thereby making it easier for investors and others to hold corporate managers accountable for their boardroom decisions and other actions taken on the company's behalf. In this way, the courts continue their tradition of enforcing fiduciary duty standards to monitor business ethics of corporate managers.

In sum, the story of spinning provides a real and concrete testimonial in support of the proposition that managers cannot contract away all vestiges of their fiduciary duty. In the face of academic proposals that modern corporate law reflects a nexus of contracts that provides parties with complete freedom to negotiate terms of their bargain, including the freedom to define completely the scope of fiduciary duties of corporate managers, other scholars have suggested that the courts should—and will—refuse to adopt this approach. Our recent experience with spinning offers support for the view that the rule of law is not dead and that the courts should be encouraged to rely on the doctrine of fiduciary duty in

196. See supra notes 76-78 and accompanying text (describing reaction and reform efforts voluntarily undertaken within the venture capital industry).
197. Siconolfi, SEC Broadsens, supra note 26, at C1.
198. Campbell, supra note 190, at 561.
order to monitor the standards of fair and ethical conduct on the part of modern corporate managers.

C. The Implications of the Story of Spinning for the Role of the Lawyer as Counselor-at-Law

Judicial adherence to the traditional rule—that the law of fiduciary duty continues to serve an influential residual role in defining the scope of managers’ responsibilities—has important implications for the role of lawyers in counseling their clients in a transactional setting. Rigorous judicial enforcement of fiduciary duty law offers the added virtue of strengthening the professional responsibilities of lawyers who must advise clients as to the application of fiduciary duty principles in the context of new and unanticipated developments in the markets, such as that presented by the recent controversy surrounding the practice of spinning. If the lawyer knows that the courts stand ready to rigorously enforce modern fiduciary duty standards, then the lawyer knows that she stands on firm ground in advising clients how to deal with circumstances not anticipated by the specific terms of the parties’ agreement. To do anything else is to further erode the role of the lawyer as a professional legal advisor by fostering an environment where business people are encouraged to shop for legal advice to their liking, a socially undesirable and unproductive outcome.

This perspective on the role of the lawyer as counselor-at-law is usefully illustrated in the story of spinning. Let us now examine the story of spinning from the perspective of the lawyer who is approached for legal advice as to the scope of fiduciary responsibilities that arise in the context of spinning activity of the kind originally described in the Wall Street Journal article regarding Mr. Cayre of GT Interactive. Assuming the lawyers were to analyze this problem under well-established or traditional principles of fiduciary law, the corporate lawyer in this situation would be well-advised to counsel his client that the default rule of fiduciary duty law requires that, at a minimum, the manager, Mr. Cayre, come forward and make disclosure of the spinning opportunity before accepting the shares. By analyzing the practice of spinning under modern principles of corporate opportunity doctrine, the lawyer advising Mr. Cayre could confidently conclude that this type of
disclosure should serve to protect this CEO/manager from future claims of breach of fiduciary duty by removing the corporate opportunity taint from his acceptance of the allocation of Pixar's hot IPO shares.

In considering the application of fiduciary duty principles to the practice of spinning, one important aspect of this analysis is often overlooked. By continuing to adhere to this demanding standard of fiduciary duty as the default rule, lawyers will be encouraged to analyze the conduct at issue (in this case, the practice of spinning), and reach a reasoned conclusion as to the prospect for a claim of breach of fiduciary duty in the future. In this way, lawyers are not allowed to abdicate their professional responsibilities as counselors-at-law. To do otherwise, I fear, is to erode the meaningful professional role that the lawyer traditionally has provided in counseling clients in the transactional setting.\textsuperscript{201} I believe that rigorous judicial enforcement of fiduciary duty has the important, but usually overlooked, incidental advantage of strengthening the professional role of lawyers by giving them firm ground on which to exercise their professional judgment in advising their clients on thorny issues involving potential conflicts of interest.

As this Article has demonstrated, the story of spinning offers a number of different reasons why the courts should continue to vigorously enforce the rule of law. By continuing to adhere to strict fiduciary duty standards as the default rule, I believe that this judicial approach has the added value of holding lawyers to an exacting standard in counseling their clients in situations where questionable or unethical business practices arise.\textsuperscript{202}

**CONCLUSION**

This analysis of the recent (and ongoing) controversy over the practice of “spinning” serves as a compelling real-world reminder

\textsuperscript{201} The trend I perceive under a contract-based approach—that allows parties to contract away all vestiges of fiduciary duty other than what is set forth under the terms of the parties' bargain—would allow the lawyer to avoid making difficult judgment calls as to potential conflicts of interest that may give rise to possible breach of fiduciary duty claims in the future.

\textsuperscript{202} \textit{E.g.}, Kostant, \textit{supra} note 67, at 1267 (2000) (advocating a gatekeeper function for corporate lawyers practicing in the transactional setting that would likewise have the virtue of promoting “norms of corporate legal practice [that] will better conform with the evolving norms of corporate governance”).
that the law of fiduciary duty cannot be completely eliminated by appropriate contractual provisions. The manner in which securities regulators, market forces, and Wall Street participants themselves have dealt with potential conflict of interest problems inherent in the practice of spinning more than amply demonstrate the important residual role that the law of fiduciary duty continues to play in defining the scope of a corporate manager’s responsibilities to his or her corporation.

Although spinning may not be as prevalent a practice as it was when the IPO market was sizzling a few years ago, there are nonetheless important lessons to be learned from our recent experience dealing with the pernicious practice of spinning. The framework that is used to analyze the validity of recent spinning practices—as presenting a situation involving unanticipated market developments—is instructive for analyzing future cases of unanticipated circumstances and conduct, in the context of IPOs as well as in other types of transactions. The analytical framework and legal response to spinning are instructive because they suggest how investors expect the courts to go about interpreting the scope of modern fiduciary duty law as applied to the next unanticipated situation to present a potential conflict of interest problem for the corporate manager—a situation that will inevitably arise as the securities markets grow and as commercial practices evolve to accommodate these changing market conditions.

In responding to the recent controversy over the practice of spinning, I am not recommending promulgation of yet another rule, although some securities lawyers have suggested that the SEC should mandate disclosure of the practice of spinning. Instead, I am of the view that lawyers have an important role to play in giving advice to their clients about the potential for conflict-of-interest problems in cases such as spinning. I therefore recommend that we rigorously enforce an exacting standard of fiduciary duty, which will have the virtue of compelling corporate managers to come forward with full disclosure, and also encourage lawyers to advise their clients to do so and thereby avoid potential liability for breach of their fiduciary duty to the corporation and its investors.

This Article offers support for continuing the common law tradition of vigorous judicial enforcement of fiduciary duty standards as applied to the conduct of modern corporate managers
(and, of necessity, to their lawyers). Indeed, the very reason to tell the story of spinning is that it serves as a powerful reminder of how fiduciary duty law continues to be important in fulfilling investors' legitimate expectations as to what is fair and ethical conduct for corporate managers in today’s complicated business world. This is a story well worth telling.