The Attorney As Director
A Vignette

Facts:

The client: National Telephone Company was founded in 1971 to lease sophisticated telephone equipment systems to commercial customers pursuant to long-term leases.

Growth: from 1971 to 1974-
assets grew from $320,123 to $19,028,613
net income grew from $2,390 to $633,485

The executives:
Hart - CEO, chairman, president, treasurer, controlling shareholder
Lurie - Chief in-house counsel (assisted by Kay)

The attorneys:
Carter - partner, Harvard Law, age 57, corporate and securities
Johnson - partner, Harvard Law, age 42, same focus
Socha - associate, four years

Between 1971 and 1973, National was a prisoner of his own success as a result of the impact of growth on its cash flow situation. During this period it obtained needed capital from an initial public offering of stock under Regulation A, short-term loans from local banks, and an offering of convertible debentures. In mid-1974, National entered into a "Credit Agreement" for $15 million, which was not closed until December 1974. And at the time of closing, the advances totaled $16.8 million and the agreement was modified to cover this total amount, plus $2.2 million for general corporate purposes and an additional $2 million available only upon implementation of a so-called "Lease maintenance program." all three attorneys participated in the negotiation of the credit agreement. For security, the banks wanted National's assets transferred to another entity, Systems, a transaction which required the approval of National's shareholders.

Act I

Carter and Johnson prepared the proxy materials for the June 27, 1974 shareholders' meeting, as well as the 1974 Annual Report. The annual report content contained projections of future lease installations which showed, by each quarter, a doubling of the annual installations from approximately $13.3 million in fiscal 1974 to approximately $27 million in fiscal 1975. Carter advised Hart that it was permissible to include projections in the annual report, but that the assumptions underlying the projections should also be disclosed. Hart ignored this advice and the annual report was distributed without assumptions.

Query: was it feasible for revenues to double in one year without the availability of additional financing which, at this time, was not in the offing. Should an attorney understand this? Should a director understand this? Was the annual report misleading?

Act II
The October non-Letter

Additional facts: Johnson, in his capacity as the newly elected corporate secretary, attended board of directors' meetings on July 1, August 19th, and October 15th, as well as a meeting with the banks on October 18th. At the July 1st board meeting, Hart informed the board that the company had already borrowed $10 million of the $15 million which would be available under the credit agreement. In order to meet revenue projections, it would be necessary to obtain an additional $12 million of financing. At the October meeting with the banks, the company's tight cash position was discussed and Hart indicated that a "wind-down" program was underway.

Two days after the Bank meeting, Johnson instructed Socha to draft a disclosure letter to the company's shareholders. The proposed letter was reviewed by both Johnson and Carter, and sent to the company in early November. The proposed letter concluded:

"The Company's efforts to obtain additional financing have been adversely affected by tight credit conditions, increased interest costs, a generally unfavorable equity market and certain factors that are peculiar to its business such as the negative cash flow described above. In view of these factors the Company has determined that it would be prudent to curtail its sales operations and, therefore, to emphasize liquidity rather than growth until such time as additional debt or equity financing can be obtained."

National's management declined to issue the letter and neither of the partners elected to pursue the matter.

Query: what responsibility does an attorney have in the foregoing circumstance? What responsibility does a director have?

N.B. This series of events triggered an investigation by the SEC into the activities of the outside directors and their failure to ensure proper communication with and disclosure to the public shareholders. Release No. 34-14380, 1978 SEC Lexis 2122.

Act III
The September 30, 1974 Quarterly Report

In early December, Socha received a draft of the company's quarterly report for the second fiscal quarter. The report contained a series of graphs, illustrating the successful results of the company's operations to date, but made no mention of the dire financial straits in which the company found itself in December. Socha asked Lurie if the use of the graphs had been cleared by Johnson. Lurie said that they had.

Query: Why did not Socha ask Johnson if Johnson had cleared the graphs?

Act IV
The Lease Maintenance Plan

In mid-December, a consultant for the banks recommended that the wind-down plan, which the company had supposedly been implementing, was not feasible and recommended that financing be made unavailable for very limited continuing growth with the wind-down implemented as a last resort. The credit agreement was amended to permit up to $19 million of borrowing on or before April 30, 1975. However, if the company failed to meet specified liquidity tests, a lease maintenance plan ("L M P") was to be implemented. The "L M P" was to be attached as an exhibit to the amended credit agreement.

Hart told Carter that he did not want the terms of the "L M P" made public or disclosed to the SEC. Carter then advised Hart that the "L M P" would not need to be filed with the SEC or publicized if it were not an exhibit to the amended credit agreement but merely referred to in such document. Accordingly, the credit agreement was modified to delete reference to the "L M P" as an exhibit. It was understood by all witnesses that the term "lease maintenance plan" had no generally accepted meaning in the industry and, in fact, they had never used or heard this term before.

Query: was this an acceptable recommendation by an attorney for the company? Were Carter to have been a director, what responsibility would he have had with respect to disclosure of the contents of the "L M P"?

Act V
The Credit Agreement Press Release

The amended credit agreement was closed on December 20th and the company immediately borrowed $18 million from the banks. Of this amount, $16.8 million was used to repay existing demand indebtedness based on the advances the banks had made. The company then issued a press release which Carter had drafted the day before. The release stated in part:

"National Telephone Company today announced the execution of a $6 million extension of a $15 million Credit Agreement with a group of banks headed by Bankers Trust Company of New York. Included in the $21 million is a contingency fund of $2 million which is available until June 30, 1975 and which may be utilized by the company only for the purpose of funding a lease maintenance program in the event additional financing is not otherwise available."

"Of the $21 million, the company has borrowed $18 million pursuant to a seven-year term loan, of which approximately $16.5 million was used to repay outstanding short-term loans. The balance will be used for general operating expenses.

According to the SEC, the press release did not discuss:

- the precise nature and the effects on the company's business of the "L M P" and the likelihood that the company would be required to implement the "L M P" within a short period of time; and
- the substantial limitations placed on the company's operations by the Amended Credit Agreement.

In addition, the reference that the balance of the financing "will be used for general operating expenses" was misleading in light of the substantial overdue obligations of the company then existing.

Query: Did Carter fulfill his responsibility as attorney for the company? Would his responsibilities have been any different as a director?

Act VI
The Company's December 23rd Shareholder Letter

Without the knowledge of the attorneys, the company sent out a letter to shareholders which contained numerous misstatements and omissions:

- The company "was stronger now than ever before in its history"
- It had "a greater availability of capital expanding productivity and growing earnings" and
- It was "looking forward to an outstanding year in calendar 1975.
- The company could use the entire additional $6 million loan for future operating expenses
- The letter made no reference to the company's repayment of existing bank loans, its continuing cash needs and shortages, or the "LMP"

The attorneys thought that the letter was seriously inadequate and did not make adequate disclosure. Nevertheless, they concluded that, when read together with the earlier December 20th press release, the letter was not materially false and misleading and no corrective action need by taken by the company.

Query: What responsibility did the attorneys have with respect to the above letter to shareholders once they learned of its existence? What responsibility would a director have upon finding out about the shareholder letter?

Act VII
The Banks' Counsel Get into the Picture

Additional Facts: On January 9, 1975, National filed its current report on form 8-K, reporting on the closing under the credit agreement. The credit agreement was attached as an exhibit and made frequent reference to the "L M P" but, as requested by Hart, the "L M P" was not attached as an exhibit. During January, the company's financial condition continued to deteriorate and, on January 20, 1975, the company's consultants notified the company and the banks that the company had borrowed $18,425,000 of the contemplated $19 million available for operations and that the company was only $10,000 away from triggering the "L M P". The "L M P" was triggered on January 31st but, on February 4th, the company issued a press release reporting results for the third quarter and emphasized the dramatic improvements when compared to the same period last year. No effort was made to discuss the nature and the effects of the "L M P" or the fact that its triggering was imminent.

On March 17th, the bank's lawyers advised Carter and Johnson that the "L M P" had been triggered six weeks ago. The bank's lawyers sought assurances from Carter and Johnson that they would determine what disclosure was appropriate and insure that it was forthcoming. The next day, Carter telephoned Lurie and Lurie neither confirmed nor denied that the "L M P" had been triggered. Carter did not press Lurie for a definite answer on whether the "L M P" had been triggered or whether the company's management was in fact implementing the "L M P" as required by the credit agreement.

Carter informed Johnson of the foregoing telephone calls and, while Johnson's first reaction was to find out what the facts were, neither he nor any other attorney sought to verify the facts by contacting anyone at National or by checking with the consulting firm which was responsible for monitoring National's compliance with the credit agreement. Socha had called Lurie and Lurie had assured him that the banks's counsel did not have the facts accurate. Socha did not believe Lurie.

Query: What responsibility did the attorneys have to verify the facts in light of Lurie's representation? What responsibility would a director have? Should either have contacted the company's consultant who was monitoring the "L M P"?

Act VIII
The April Events

After receiving a comment letter from the SEC on the previously filed 8-K report, Carter participated in the preparation of an amendment which dealt with technical matters. However, in connection with the preparation of the amendments, Carter again did not describe the nature of the "L M P" nor the fact that National was obligated to implement it and that failure to do so would be an event of default under the credit agreement.

On April 23, 1975, Carter and Johnson met with Hart and advised him in no uncertain terms that immediate disclosure was required. Thereafter, an officer of one of the banks wrote Hart requesting a written response from National's counsel regarding its obligations to make public disclosure of the events that had transpired. On April 28th, Hart telephone Johnson and asked Johnson to issue a legal opinion for the banks to the effect that disclosure of the triggering of the "L M P" was not necessary. Johnson was incredulous.

NBC Johnson then instructed Socha to draft a disclosure document for National to issue. In so doing, Johnson specified that the draft should be one that wold be "acceptable to a person as emotionally involved as Hart." National did not issue the disclosure document in any form and neither Carter nor Johnson questioned anybody at the company about management's failure to make the suggested disclosure.

On May 9th, the company filed an 8-K report for the month of April. The report made no mention of the company's status under the credit agreements or the event of default from the failure to implement the "L M P". The company would not give Socha a copy of the 8-K report.

Query: At what point do attorneys go directly to the board of directors or resign? At what point should a director resign? If the attorney were also a director what effect would resignation as a director have upon continued status as cousel for the company?

Epilogue

On May 24th, a special meeting of the board of directors was held. Johnson was there, as well as independent counsel who had been consulted by the outside directors. The outside directors then learned that Carter and Johnson had been recommending disclosure for more than a month. Johnson read a draft of his letter which the company had not sent.

Hart resigned each of his corporate offices but remained as a director. Johnson resigned as secretary of the company but the firm continued as company counsel.