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Under the current Exchange Act reporting regime, whether a domestic or foreign private issuer\(^8\) can terminate its reporting obligations under section 13(a) of the Act\(^9\) depends on how it became subject to those obligations. An issuer may have become subject to section 13(a) reporting obligations by:

- listing a class of either equity or debt securities on a national securities exchange and registering this class under section 12(b) of the Exchange Act;\(^{10}\)
- registering a class of equity securities under section 12(g)\(^11\) either voluntarily or because it had 500 or more security holders of record and more than $10 million in total assets\(^12\) and, if a foreign private issuer, more than 300

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\(^7\) 17 CFR 249.324, as proposed.

\(^8\) As defined in Rule 3b-4(c) (17 CFR 240.3b-4(c)), a foreign private issuer is a corporation or other organization incorporated or organized in a foreign country that either has 50 percent or less of its outstanding voting securities held of record by United States residents or, if more than 50 percent of its voting securities are held by U.S. residents, about which none of the following are true:

1. a majority of its executive officers or directors are U.S. citizens or residents;
2. more than 50 percent of its assets are located in the United States; and
3. the issuer's business is administered principally in the United States.


\(^11\) This statutory section only applies to equity securities. See Exchange Act Section 12(g)(1) [15 U.S.C. 78l (g)(1)].

\(^12\) Exchange Act Rule 12g-1 (17 CFR 240.12g-1).
shareholders resident in the United States on the last day of its most recently completed fiscal year,\textsuperscript{13} or

- registering either equity or debt securities under a Securities Act registration statement, which has gone effective, thus triggering section 13(a) reporting obligations under Section 15(d) of the Exchange Act.\textsuperscript{14}

An issuer may be subject to reporting obligations under more than one of the above statutory sections and rules. While an issuer is deemed to have only one active set of reporting obligations, when an issuer attempts to exit the Exchange Act reporting system, it must consider whether there are any dormant or suspended reporting obligations that would preclude the issuer from ceasing its Exchange Act reporting.

For example, an issuer may have active section 13(a) reporting obligations because it has a class of equity securities listed on a national securities exchange and registered with the Commission under section 12(b) of the Exchange Act. When attempting to exit the Exchange Act reporting system, the registrant not only must take steps to effect its delisting from the national securities exchange,\textsuperscript{15} but also it must

\textsuperscript{13} Exchange Act Rule 12g3-2(a) (17 CFR 240.12g3-2(a)). A foreign private issuer may avoid an Exchange Act registration obligation under section 12(g) by establishing the exemption under Exchange Act Rule 12g3-2(b) (17 CFR 240.12g3-2(b)).

\textsuperscript{14} 15 U.S.C. 78o(d). There are other methods by which an issuer may be obliged to file reports under section 13(a), such as, for example, under Exchange Act Rule 12g-3 (17 CFR 240.12g-3) in the case of a successor registrant.

\textsuperscript{15} Exchange Act Rule 12d2-2 (17 CFR 240.12d2-2) governs the process of the delisting of a class of securities from a national securities exchange. To effect the delisting and subsequent termination of an issuer's registration of a class of securities under section 12(b), the national securities exchange or issuer must file a Form 25 with the Commission. We recently adopted amendments to our rules and Form 25 to streamline the procedures for removing from listing, and withdrawing from registration, securities under section 12(b). See Release No. 34-52029 (July 14, 2005), 70 FR 42456 (July 22,
consider whether it has any dormant or suspended reporting obligations under section 12(g)\textsuperscript{16} or 15(d) that will become operative once its section 12(b) registration ceases.\textsuperscript{17}

Exchange Act Rule 12g-4 currently governs whether an issuer may terminate its registration of a class of securities under section 12(g) of the Exchange Act and its corresponding section 13(a) reporting obligations.\textsuperscript{18} Under this rule, a foreign private issuer may seek termination of its registration of a class of securities under section 12(g) by certifying in Form 15\textsuperscript{19} that the subject class of securities is held by less than 300 residents in the United States or by less than 500 U.S. residents when the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent

\textsuperscript{16} A registrant may have section 12(g) reporting obligations following its termination of registration under section 12(b): (1) if it had initially registered the class of securities under section 12(g) prior to listing the securities on a national securities exchange; or (2) under Exchange Act Rule 12g-2 (17 CFR 240.12g-2). That rule provides that any class of securities that would have been required to be registered under section 12(g) except for the fact that it was listed and registered on a national securities exchange shall be deemed to be registered under section 12(g) upon the termination of registration under section 12(b) as long as the class of securities are not exempt from registration under section 12 and are held of record by 300 or more persons.

\textsuperscript{17} Exchange Act section 15(d) automatically suspends the duty to file reports under that section regarding securities registered under an effective Securities Act registration statement once the issuer has registered the class of securities under section 12 of the Exchange Act.

\textsuperscript{18} An issuer must look to this rule both when it has only registered a class of securities under section 12(g) and following the termination of registration of a class of equity securities under section 12(b).

\textsuperscript{19} 17 CFR 249.323.
three fiscal years.\textsuperscript{20} For the purpose of determining the number of U.S. resident shareholders under this rule, a foreign private issuer must use the method of counting provided under Exchange Act Rule 12g3-2(a).\textsuperscript{21} This method requires looking through the record ownership of brokers, dealers, banks or other nominees on a worldwide basis and counting the number of separate accounts of customers resident in the United States for which the securities are held.\textsuperscript{22} Under this rule, issuers are required to make inquiries of all nominees, wherever located and wherever in the chain of ownership, for the purpose of assessing the number of U.S. resident holders.

An issuer that has determined that it meets the threshold requirements for termination of registration of a class of securities under Rule 12g-4, and has also never engaged in a registered offering under the Securities Act, may seek termination of its Exchange Act reporting obligations by filing the Form 15 certification.\textsuperscript{23} However, an issuer that has registered securities under an effective Securities Act registration statement must determine if it has any suspended reporting obligations under

\textsuperscript{20} Exchange Act Rule 12g-4(a)(2) (17 CFR 240.12g-4(a)(2)). Alternatively, a foreign private issuer may seek to terminate its section 12(g) registration under the Rule 12g-4 provision that applies to any issuer, whether domestic or foreign. Under this provision, an issuer must certify on Form 15 that its class of equity securities is held of record by less than 300 persons or by less than 500 persons when the issuer's total assets have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years. Exchange Act Rule 12g-4(a)(1) (17 CFR 240.12g-4(a)(1)).

\textsuperscript{21} 17 CFR 240.12g3-2(a).

\textsuperscript{22} See 17 CFR 240.12g3-2(a)(1).

\textsuperscript{23} Filing this form immediately suspends the issuer's Exchange Act reporting obligations. If, after 90 days from the date of filing the Form 15, the Commission has not objected, the suspension becomes a termination. See Rule 12g-4(b) (17 CFR 12g-4(b)).
section 15(d) that will become operative after it has terminated the registration of a class of securities under Exchange Act section 12(g).

Rule 12h-3\textsuperscript{24} is the Exchange Act rule governing when an issuer may suspend its reporting obligations under section 15(d).\textsuperscript{25} While Rule 12h-3's standards are substantially similar to those under Rule 12g-4,\textsuperscript{26} there are two important differences. First, an issuer may generally not suspend its section 15(d) reporting obligations until it has filed one Exchange Act annual report after the offering in question. Second, an issuer cannot permanently terminate its reporting obligations under section 15(d) but can only suspend those obligations.\textsuperscript{27} Therefore, for as long as the subject class of securities is outstanding, a foreign private issuer must also determine at the end of each fiscal year whether the number of U.S. resident security holders or total number of record holders has increased enough to trigger anew its section 15(d) reporting obligations.

B. The Increased Internationalization of the U.S. Securities Markets

It has been almost four decades since the Commission first adopted the "300 U.S. resident shareholder" standard as the benchmark for determining both when a foreign private issuer must register a class of equity securities under section 12(g) and when it

\textsuperscript{24} 17 CFR 240.12h-3.

\textsuperscript{25} Section 15(d) itself provides that an issuer cannot suspend its reporting obligations unless the subject class of securities is held of record by less than 300 persons at the beginning of a fiscal year other than the year in which the Securities Act registration statement triggering the section 15(d) reporting obligations became effective.

\textsuperscript{26} See, in particular, Rule 12h-3(b)(2) (17 CFR 240.12h-3(b)(2)).

\textsuperscript{27} Exchange Act Rule 12h-3(a) (17 CFR 240.12h-3(a)).
may terminate that registration.\textsuperscript{28} Moreover, it has been over two decades since the Commission adopted Form 15 under Rules 12g-4 and 12h-3.\textsuperscript{29}

Since then, market globalization, advances in information technology, the increased use of American Depositary Receipt ("ADR")\textsuperscript{30} facilities by foreign companies to sell their securities in the United States,\textsuperscript{31} and other factors have increased significantly the number of foreign companies that have engaged in cross-border activities and sought listings in U.S. securities markets, as well as increased the amount of U.S. investor interest in the securities of foreign companies. For example:

- the number of foreign companies with Exchange Act reporting obligations increased from approximately 300 in 1985 to over 1,200 in 2004;\textsuperscript{32}
- the number of foreign companies listed on the New York Stock Exchange ("NYSE") increased from 54, or approximately 3.5\% of the total number of

\textsuperscript{28} See Release No. 34-8066 (April 28, 1967).

\textsuperscript{29} See Release No. 34-20784 (March 22, 1984), 49 FR 12688 (March 30, 1984).

\textsuperscript{30} An ADR is a negotiable instrument that represents an ownership interest in a specified number of securities, which the securities holder has deposited with a designated bank depository. Use of an ADR facility makes it easier for a U.S. resident to collect dividends in U.S. dollars. Moreover, because the clearance and settlement process for ADRs generally is the same for securities of domestic companies that are traded in U.S. markets, a U.S. holder of an ADR is able to hold securities of a foreign company that trades, clears and settles within automated U.S. systems and within U.S. time periods.

\textsuperscript{31} For example, the number of ADR issues traded on the NYSE increased from 134 in 1993 to 344 in 2004. During this same period, the market capitalization of NYSE-traded ADRs nearly quadrupled. See "Summary Data on NYSE-Listed Non-U.S. Companies" located at http://www.nyse.com/attachment/nonussum0916.xls.

NYSE-listed companies in 1985, to 460 or over 16% of the total number of
NYSE-listed companies in 2004;\textsuperscript{33} and

- the average daily trading value of NYSE-traded foreign securities increased
  from over $350 million, or over 5% of the total value of NYSE-traded
  securities in 1991, to over $4.5 billion, or over 10% of the total value of
  NYSE-traded securities in 2000.\textsuperscript{34}

C. Concerns Regarding the Exchange Act Reporting Exiting Rules
   for Foreign Private Issuers

Representatives of foreign companies and foreign industry associations have
recently voiced their concerns to the Commission about the rules that govern whether a
foreign private issuer may exit the Exchange Act registration and reporting regime.\textsuperscript{35}
These representatives maintain that, due to the increased internationalization of U.S.
investor interest, the "300 U.S. resident shareholder" standard has become outdated and
too easily exceeded by a foreign company that may have engaged in very little recent

\textsuperscript{33} See "Stocks of non-U.S. Corporate Issuers" located at
http://www.nysedata.com/factbook; see also "Listed Company Directory" located at
http://www.nyse.com/about/listed/listed.html. A similar increase occurred on Nasdaq.

\textsuperscript{34} See "NYSE Value of Trading-U.S. and non-U.S. Companies" located at
daily trading value of NYSE-traded foreign securities was over 9% of the total value of
NYSE-traded securities.

\textsuperscript{35} See, for example, the letters from the Association Francaise Des Entreprises Privees
("AFEP") and other European industry group representatives, dated February 9, 2004 and
March 18, 2005 (the "AFEP letters"), which we will make publicly available on our Web
site and in the Commission's Public Reference Room in its Washington, D.C.
headquarters, together with comment letters received concerning this proposed
rulemaking.
selling activity in the United States. According to these representatives, after a few years of listing its securities in the United States, a foreign company may discover that there is little U.S. market interest in its securities. Yet because it has not been able to reduce the number of its U.S. shareholders to below 300, it must continue to incur the costs of being an Exchange Act reporting company.

These representatives have further criticized the exit rules' reliance on the number of U.S. resident shareholders because, with the advent of book-entry recording, it is difficult and costly to arrive at an accurate count of a foreign company's U.S. resident shareholders. These representatives also are critical of Rule 12h-3 because it merely suspends rather than permanently terminates a company's section 15(d) reporting obligations. As such, years after filing a Form 15, a foreign company may find that it has once again exceeded the 300 U.S. resident shareholder threshold, and thereupon again become subject to section 15(d) reporting duties, without regard to its U.S. market activity.

Finally, these representatives disagree with the fact that our current rule does not permit a foreign private issuer to obtain the Exchange Act Rule 12g3-2(b) exemption if,

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36 The last three decades have seen the development of a U.S. clearance and settlement system that relies on electronic book-entry to settle securities transactions and transfer ownership rather than one dependent on the use of paper certificates. For an overview of this development, see Release No. 33-8398 (March 11, 2004), 69 FR 12922 (March 18, 2004), the text surrounding n. 104. This movement to electronic book-entry clearance and settlement systems has taken place on a global basis as well, as both developed and developing securities markets have sought to improve efficiency.

37 17 CFR 240.12g3-2(b). Rule 12g3-2(b) provides an exemption from registration under section 12(g) with respect to a foreign private issuer that submits to the Commission, on a current basis, the home country materials required by the rule.
during the previous 18 months, it has had a class of securities registered under section 12
or a reporting obligation, suspended or active, under section 15(d) of the Exchange Act.\textsuperscript{38}

II. DISCUSSION

A. Summary of the Proposed Rule Amendments

In light of the increased internationalization of the U.S. securities markets that has
occurred, we believe that it is time to reconsider the rules allowing a foreign private
issuer to exit the Exchange Act registration and reporting regime. We propose to amend
Rules 12g-4 and 12h-3 to eliminate the provisions that primarily condition a foreign
private issuer's eligibility to cease its Exchange Act reporting obligations on whether the
number of its U.S. resident security holders has fallen below the 300 or 500 person
threshold. In their place, we propose new Exchange Act Rule 12h-6 that would permit a
foreign private issuer that meets the conditions discussed below to achieve the following:

- termination of the registration of a class of equity securities under section 12(g)
  and its resulting section 13(a) reporting obligations;
- permanent termination of its section 15(d) reporting obligations regarding a
class of equity securities; and
- permanent termination of its section 15(d) reporting obligations regarding a
class of debt securities.

\textsuperscript{38} Exchange Act Rule 12g3-2(d)(1) (17 CFR 12g3-2(d)(1)). This exception to the
Rule 12g3-2(b) exemption does not apply to registered Securities Act offerings filed by
Canadian companies on certain Multijurisdictional Disclosure System ("MJDS") forms.
Exchange Act Rule 12g3-2(d) also precludes the Rule 12g3-2(b) exemption to a foreign
private issuer's securities issued to acquire by merger or similar transaction an issuer that
had securities registered under section 12 or a reporting obligation, suspended or active,
under section 15(d), except for a transaction registered on specified MJDS forms. See
Exchange Act Rule 12g3-2(d)(2) (17 CFR 240.12g3-2(d)(2)).
A foreign private issuer would be eligible to terminate its Exchange Act reporting obligations regarding a class of equity securities under proposed Rule 12h-6 if it met the following conditions:

- the issuer has been an Exchange Act reporting company for the past two years, has filed or furnished all reports required for this period, and has filed at least two annual reports under section 13(a);
- the issuer's securities have not been sold in the United States in either a registered or unregistered offering under the Securities Act during the preceding 12 months other than securities:
  - sold to the issuer's employees;
  - sold by selling security holders in non-underwritten offerings;
  - exempt from registration under section 3 of the Securities Act, except section 3(a)(10);\(^{39}\) and
  - constituting obligations having a maturity of less than nine months at the time of issuance and offered and sold in transactions exempted from registration under section 4(2) of the Securities Act;\(^ {40}\) and
- for the preceding two years, the issuer has maintained a listing of the subject class of securities on an exchange in its home country, as defined in Form 20-F,\(^ {41}\) which constitutes the primary trading market for the securities.

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\(^{40}\) 15 U.S.C. 77d(2).

\(^{41}\) 17 CFR 249.220f. Form 20-F General Instruction F defines "home country" as the jurisdiction in which the issuer is legally organized, incorporated or established and, if
Rule 12h-6 would further permit a foreign private issuer seeking to terminate its registration and reporting obligations regarding a class of equity securities to meet one of a set of alternative benchmarks, which are not based on a record holder count, and which depend on whether the issuer is a well-known seasoned issuer. If a well-known seasoned issuer, then a foreign private issuer could terminate its Exchange Act registration and reporting obligations as long as either:

- the U.S. average daily trading volume of the subject class of securities has been no greater than 5 percent of the average daily trading volume of that class of securities in its primary trading market during a recent 12 month period, and U.S. residents held no more than 10 percent of the issuer's worldwide public float at a date within 60 days before the end of that same period; or

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42 For purposes of Rule 12h-6 a "well-known seasoned issuer" means a well-known seasoned issuer as defined in Securities Act Rule 405 (17 CFR 230.405) that meets the requirements of paragraph (1)(i)(A) of that definition. Under Rule 12h-6, therefore, a "well-known seasoned issuer" must have a worldwide market value of its outstanding voting and non-voting common equity held by non-affiliates of $700 million or more, and must satisfy the other requirements of the definition in Securities Act Rule 405 (for example, the issuer must not be an "ineligible issuer"). The time of determination of well-known seasoned issuer status under Rule 12h-6 would be a date within 120 days of the filing of proposed Form 15F. Although Rule 405 also defines "well-known seasoned issuer" alternatively to mean an issuer that has registered a specified amount of non-convertible securities other than equity over a three-year period, that part of the definition is inapplicable under proposed Rule 12h-6. Only the equity prong of the definition is relevant for purposes of termination of registration and reporting requirements under proposed Rule 12h-6. The proposed conditions that would permit a foreign private issuer to terminate its section 15(d) reporting obligations regarding a class of debt securities do not distinguish between well-known seasoned issuers and other issuers.

43 The term "public float" refers to the outstanding voting and non-voting equity securities held by an issuer's non-affiliates. As proposed, when calculating the percentage of its worldwide public float held by U.S. residents, an issuer would include
regardless of U.S. trading volume, U.S. residents held no more than 5 percent
of the issuer's worldwide public float at a date within 120 days before the filing
date of the Form 15F, which is the form that a foreign private issuer would
have to file to certify that it meets the conditions for terminating its Exchange
Act registration and reporting obligations under proposed Rule 12h-6.

If not a well-known seasoned issuer, then a foreign private issuer could terminate
its Exchange Act registration and reporting obligations regarding a class of equity
securities as long as, regardless of U.S. trading volume, U.S. residents held no more than
5 percent of the issuer's worldwide public float at a date within 120 days before the filing
date of the Form 15F.

Under proposed Rule 12h-6, if a foreign private issuer is unable to meet one of
these proposed benchmarks, but satisfies the other conditions of the rule, it could still
terminate its Exchange Act registration and reporting obligations regarding a class of
equity securities as long as that class of securities is held of record by less than 300
persons on a worldwide basis or less than 300 persons resident in the United States at a
date within 120 days before the filing date of the Form 15F.

A foreign private issuer would be eligible to terminate its section 15(d) reporting
obligations regarding a class of debt securities under proposed Rule 12h-6 if it met the
following conditions:

- the issuer has filed or furnished all required reports under section 15(d),
  including at least one annual report pursuant to section 13(a) of the Act; and

in its worldwide public float only the class or classes of equity securities regarding which
there is an Exchange Act reporting obligation.
• at a date within 120 days before the filing date of the Form 15F the class of
debt securities is either held of record by less than 300 persons on a
worldwide basis or less than 300 persons resident in the United States.

Rules 12g-4 and 12h-3 currently require the filing of Form 15 by which an issuer
certifies that it meets the conditions for ceasing its Exchange Act reporting obligations.
Unlike Form 15, proposed new Form 15F would require a foreign private issuer to
provide specified information regarding several items that would enable investors to
obtain information regarding the issuer's decision to terminate its Exchange Act reporting
obligations. In addition, proposed new Form 15F would help Commission staff to assess
whether the issuer qualifies for termination of its Exchange Act reporting obligations. As
under current Rules 12g-4 and 12h-3, the filing of Form 15F would automatically
suspend an issuer's reporting duties. If the Commission has not objected, the suspension
would become a permanent termination 90 days after the filing of the Form 15F.\footnote{The Commission is also proposing to amend its delegated authority rules to permit the Division of Corporation Finance to accelerate the effectiveness of a Form 15F termination of reporting sooner than the 90th day at the request of the issuer. See the proposed amendment to 17 CFR 200.30-1(e). This delegation of authority currently exists with respect to Form 15, although it is rarely used.}

Proposed Rule 12h-6 would further require a foreign private issuer, no later than
fifteen business days prior to the filing of the Form 15F, to publish a notice, such as a
press release, in the United States that discloses its intent to terminate its section 13
reporting obligations, and to submit a copy of the press release either under cover of a
Form 6-K, before or at the time of filing of the Form 15F, or as an exhibit to the
Form 15F.
Finally, we propose to amend Exchange Act Rule 12g3-2(d) to permit a foreign private issuer to establish the Rule 12g3-2(b) exemption for a class of equity securities that is the subject of a Form 15F immediately upon the effectiveness of termination of Exchange Act reporting pursuant to Rule 12h-6. As a condition to maintaining this exemption, a foreign private issuer would have to publish in English the home country materials required by Rule 12g3-2(b) on its Internet web site or through an electronic information delivery system that is generally available to the public in its primary trading market.

We recognize that U.S. investors benefit from the investment opportunities provided by the registration of foreign private issuers with the Commission and listing and publicly offering securities in the United States. The current exit process may serve as a disincentive to foreign private issuers accessing the U.S. public capital markets because of the burdens and uncertainties associated with terminating registration and reporting under the Exchange Act. We believe that these changes to the exit process for foreign private issuers, if adopted, should provide those issuers with a meaningful option to terminate their Exchange Act reporting obligations when, after electing to access the U.S. public capital markets, they find a diminished level of U.S. investor interest in their securities. As a result, foreign private issuers should be more willing initially to register their securities with the Commission when there is a clearly defined process with more appropriate benchmarks by which they can terminate their Exchange Act reporting obligations if after a period of time U.S. investor interest is not significant relative to non-U.S. investor interest.
In addition, we believe the conditions under proposed Rule 12h-6 are consistent with the interests of U.S. investors in other ways. The two-year reporting and the one-year dormancy conditions are intended to provide sufficient time periods of Commission reporting and of not promoting U.S. investor interest through recent capital raising. The conditions relating to trading on a non-U.S. securities exchange and the benchmarks based on relevant U.S. public float and (for well-known seasoned issuers) relative U.S. trading volume support our view that foreign private issuers that would terminate Exchange Act reporting under proposed Rule 12h-6 should be subject to an ongoing disclosure and financial reporting regime, and have a significant market following, in their home market. The conditions relating to the publication of a press release or other notice, the filing of proposed Form 15F, and the immediate availability of the exemption under Rule 12g3-2(b) promote transparency of the exit process as well as access by U.S. investors to ongoing home country information about issuers that terminate their Exchange Act reporting obligations.

B. Proposed Exchange Act Rule 12h-6

1. Purpose and Scope of Proposed Rule 12h-6

Like current Rule 12g-4, proposed Rule 12h-6 would permit a foreign private issuer meeting specified criteria to terminate its registration of a class of securities under section 12(g) and its corresponding section 13 reporting obligations after filing a certification with the Commission. However, unlike the current Exchange Act reporting exiting regime, proposed Rule 12h-6 would also permit a foreign private issuer to terminate permanently, rather than merely suspend, its reporting obligations regarding a class of equity or debt securities, or both, under section 15(d).
The New Federalism of the American Corporate Governance System:

Preliminary Reflections of Two Residents of One Small State

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February 26, 2002

prepared for Penn Law and Economics Institute
Conference on Control Transactions, February 8-9, 2002

This paper can be downloaded without charge from the
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proposal was apparently dropped in view of the outright ban on audit committee participation by such owner-directors contained within Sarbanes-Oxley, but the original recommendation is unlikely to be easily forgotten by shareholder activists or plaintiffs’ lawyers. Indeed, the NASDAQ still requires that if the director is to serve on the Audit committee, he or she must meet the requirements under the Act, be independent as described above, and not own or control 20% or more of the issuer’s voting securities, or such lower measurement as may be established by the SEC under § 301 of Sarbanes-Oxley.⁴⁹

C. The Clearest Example of the New Federalism: The New Substantive and Procedural Checks on Director And Officer Compensation

In one subject area, the 2002 Reforms are easy to see as intrusions on the domain of the states.⁵⁰ In § 402 of Sarbanes-Oxley, Congress explicitly


⁵⁰ Although director and officer compensation is one clear example of federal intrusion into a traditional state domain, it is by no means the only example. For example, establishing and enforcing standards for attorney professional conduct is another area traditionally left to the states. But Section 307 of the Sarbanes-Oxley Act directs the SEC to “issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys.” Accordingly, the SEC recently adopted rules governing attorneys’ professional responsibilities. These proposed “minimum standards” include controversial reporting requirements imposed upon attorneys who come across evidence of an issuer’s violation of securities laws or fiduciary duties. In these circumstances, the attorney must report the evidence to the chief legal counsel or chief executive officer (or the equivalent, including an optional qualified legal compliance committee) of the issuer, and then to the audit committee, another committee of independent directors, or even the full board of directors, if the recipient of
bans corporations from making loans to directors and officers, with certain limited exceptions. This is a direct federal limitation on the power of state-chartered corporations to engage in a particular type of transaction explicitly authorized by state statutory law, a type of limitation that more traditional minds might think should flow from the chartering states, rather than from the federal government. The ban inspired a group of prominent law firms to write a joint memorandum articulating their shared view of the appropriate scope of the ban. In particular, the law firms addressed whether the ban on loans would deny companies the ability to advance litigation costs to directors and officers, in accordance with Delaware law.

the initial report does not appropriately respond to it. SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act, SEC Press Release 2003-13, available at http://www.sec.gov/news/press/2003-13.htm. In addition, the Sarbanes-Oxley Act requires each audit committee to establish procedures to receive complaints and anonymous tips from whistleblowers. Because the regulation of attorney conduct is traditionally a matter of state regulation, it is not surprising that the SEC's proposals have already evoked concern on the part of the Conference of Chief Justices. Letter from the Conference of Chief Justices, to Secretary Jonathan G. Katz, SEC (Dec. 13, 2002) (on file with authors). For our purposes, it is noteworthy that the proposed rules would permit the SEC to sanction attorneys for failing to report breaches of fiduciary duty—thus requiring the SEC to make judgments about whether material evidence of a state corporate law breach existed.

Sarbanes-Oxley § 402 (codified at 15 U.S.C.A. § 78m(k)).

See DEL. CODE ANN. tit. 8, § 143 (2001) (authorizing loans to employees and officers of a corporation whenever "in the judgment of the directors, such loan, guarantee or assistance may reasonably be expected to benefit the corporation.").


Id. (discussing advancement of litigation costs as possibly implicating Sarbanes-Oxley's prohibition on personal loans); see also DEL. CODE ANN. tit. 8, § 145(e) (2001) (enabling corporations to advance litigation costs under certain conditions).
The Exchanges have also delved into the compensation area in a manner that would more typically find its manifestation in a state corporate code. The proposed NYSE and NASDAQ Rules require stockholder approval for certain equity-compensation plans.\textsuperscript{55} In this way, the Exchanges have demonstrated a willingness to go beyond state requirements for stockholder votes when they believe that those requirements are insufficient to protect stockholder interests.

Notably, the Exchanges' more aggressive regulation of the internal affairs of their listed companies is not necessarily limited to the subject of compensation. An interesting NASDAQ proposal requires all related party transactions to be "approved by the company's audit committee or a comparable body of the board of directors."\textsuperscript{56} In contrast, Delaware law allows proof of fairness or stockholder ratification to substitute for use of a special committee in validating an interested transaction.\textsuperscript{57} This protection of interested transactions that are either fair or shareholder-approved is an allowance not afforded under the NASDAQ proposal.


\textsuperscript{56} NASDAQ Proposed Rules, SR-NASD-2002-80.

\textsuperscript{57} DEL. CODE. ANN. tit. 8, § 144 (2001).
With these basic features of the 2002 Reforms in mind, we now turn to some of the implications they have for state corporate law.

II. Are the 2002 Reforms a Shadow Corporate Law?

The most striking feature of the Reforms is a pervasive and general one: the extent to which they can be seen as a shadow corporation law that requires public company boards to comply with a very specific set of procedural prescriptions. 58 This aspect of the Reforms represents a departure from the general spheres in which the three principal sources of corporate governance guidance in the American system have operated. Stated in very rough terms, the division between the two governmental authorities has given primary responsibility for fair disclosure and securities market regulation to the federal government (principally through the SEC). State law retained the substantive regulation of corporate transactions and board conduct. The Exchanges have played a more mixed role, through listing requirements and rules of some diversity, but had generally non-burdensome effects. These include requirements for stockholder votes on

58 For recently released articles that express (in stronger terms) some of the same sentiments and concerns we raise here, the interested reader should consult the provocative and well-written articles by Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards, 30 SEC. REG. L.J. 370 (2002) and Simon Lorne, Sarbanes-Oxley: The Pernicious Beginnings of Usurpation?, 6 WALL ST. LAWYER 1 (Sept. 2002).
certain transactions that do not require such approval under state law,\textsuperscript{59} and, perhaps most notably, for audit committees comprised of independent directors.\textsuperscript{60}

This division of responsibilities has never been marked by bright borders. To the contrary, many federal disclosure requirements have had the natural (and presumably) intended consequence of influencing boardroom practices. Similarly, the state law of fiduciary duties has been an important tool in evolving better disclosure practices, particularly in the context of mergers and acquisitions requiring a stockholder vote or tendering decision. The tug and pull among the various policy actors has occurred in a civil manner, manifesting a sincere concern for the creation of an overall system that functions fairly and efficiently and that avoids whipsawing corporate officials with contradictory or unworkable mandates from different sources of legitimate authority.

In several respects, however, the 2002 Reforms can be seen as different in kind from previous incursions across the rough borders of policy responsibility that have characterized the American system of corporate

\textsuperscript{59} The NYSE has long required a stockholder vote on any transaction that would result in an increase in the listed company's outstanding shares by 20% or more. See N.Y. Stock Exch., Listed Company Manual § 312.03(c). This requirement has often influenced the dynamics of M&A cases arising under Delaware corporate law. See, e.g., Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1146-48 (Del. 1989).

\textsuperscript{60} See N.Y. Stock Exch., Listed Company Manual § 303.01(B)(2).
governance to date. The isolated provision of Sarbanes-Oxley that bans most loans from public corporations to their directors and officers is the most obvious example. By this method, Congress took upon itself responsibility for delimiting the range of permissible transactions that corporations chartered by state law could consummate. In itself, the mandate is relatively trivial, but its precedential significance may not be. What’s next? A ban on going private transactions? Or options-based compensation of executives? Or on interested transactions? The proposed Exchange Rule that requires a stockholder vote on equity compensation plans and plan amendments has a similar quality. Under this rule shareholders must approve all equity compensation plans, other than exempt plans, and brokers may not vote on stock option plans without client instructions. What is the next class of transactions that the

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61 At various times during the past century or so, the federal government and the Exchanges have considered a more full-bodied intrusion into the states’ primary role in governing the internal relations of corporations. There is no doubt that federal statutes exist that vest in the federal government primary or co-equal governance of corporate conduct that might seem to fall principally within the purview of state law (for example, regulation of the corporate proxy solicitation and ballot process). For a provocative and incisive examination of the interaction between the federal government and the states in corporate law policymaking, see Mark J. Roe, Delaware’s Competition passim (Nov. 25, 2002) (unpublished manuscript, on file with authors).

62 As noted, the NASDAQ Proposed Rule Change to its Rule 4350 requires all related party transactions to be approved by the company’s audit committee or a comparable body of the board of directors. SEC Proposed Rule Change, File No. SR-NASD-2002-80. This diminishes the range of options available to corporations under state law, which have typically been able to use proof of fairness or a ratification by disinterested stockholders to validate an interested transaction.

63 NYSE PROPOSED RULES, supra note 5, at § 303A(8).
Exchanges believe should receive stockholder approval, irrespective of the fact that state law empowers directors to consummate them without stockholder approval? In recent years, for example, there has been a great deal of controversy about whether stockholders may adopt a bylaw that requires a board of directors to dismantle a shareholder rights plan or poison pill.\textsuperscript{64} Could the Exchanges (with SEC approval) preempt this state law debate by adopting listing rules requiring stockholder assent to a board’s adoption of a pill in the first place and mandating a stockholder vote on a board’s decision to block a bid through use of the pill in the heat of a takeover battle?\textsuperscript{65}

\textsuperscript{64} See generally John C. Coffee, Jr., The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?, 51 U. MIAMI L. REV. 605 (1997); Jeffrey N. Gordon, “Just Say Never?,” Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511 (1997); Lawrence A. Hamermesh, Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?, 73 TUL. L. REV. 409 (1998). As Professor Thompson commented to us, these examples raise two distinct, albeit related, issues. That is, the distinction between what board decisions stockholders must approve, and what decisions stockholders may make themselves (e.g., through bylaws). For our purposes, this distinction is less important than the potential that the answers to these traditionally state law questions may be dictated by the Exchanges or the federal government.

\textsuperscript{65} The Sarbanes-Oxley Act lacks any specific section expressing an intention to expand the SEC’s reach into corporate internal affairs through Stock Exchange listing requirements. As a result, the SEC’s authority to command state-chartered corporations to comply with those aspects of the proposed Exchange Rules that require the formation of certain types of committees with particular members is unclear. An important decision pre-dating Sarbanes-Oxley casts doubt on the ability of the SEC, through its oversight of Exchange Rules, to regulate the internal affairs of corporations.

In Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990), the United States Court of Appeals for District of Columbia Circuit held that the SEC did not have the statutory authority to promulgate a rule barring national securities exchanges and associations from listing stock of corporations which nullify, restrict or disparately reduce per share voting rights of existing common stockholders. \textit{Id.} at 407. In so ruling, the court held that the provision of the Exchange Act authorizing exchange rules had to be read as addressing certain specified congressional
We have no reason to believe that the Exchanges will in fact enter the poison pill debate anytime soon. But this illustration does highlight the potential problems that could arise if the federal government and the Exchanges are not sensitive to the states’ primary role in the formulation of substantive corporation law.  

Whether everyone is entirely happy with the resulting product, Delaware does have a carefully thought-out model of corporation law — one which corporations and their constituencies are free to choose or to abandon by going to another state. Delaware takes an enabling approach, which broadly empowers corporate boards acting in conformity with their fiduciary purposes, and not as, sub silentio, an intention to supplant state corporation laws. Consistent with that holding, the D.C. Circuit Court found that “the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure . . . and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.” Id.

The court also rejected the SEC’s claim that it had authority to promulgate the rule because the 1975 amendments to the Exchange Act gave the Commission the authority to “facilitate the establishment of a national market system for securities.” Id. at 415. The court refused to read into those words broad-sweeping authority for the SEC to supplant all state corporate law. It stated that the SEC’s “theory can easily federalize corporate law for all companies wishing access to the national capital markets. Yet nothing in the statute and legislative history suggests so broad a purpose.” Id. at 415. The court’s reasoning was, in large part, grounded in the teaching of the United States Supreme Court, found in the landmark case of Santa Fe Industries, Inc. v. Green, where the Court stated that corporations “are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.” 430 U.S. 462, 479 (1977) (emphasis in original).

66 See Bainbridge, supra note 68, at 397-99 (arguing that the nation will suffer if substantive corporate law is federalized through the SEC and Exchanges).
duties to cause their corporations to engage in virtually any lawful activity subject to compliance with relatively flexible statutory constraints.

The statutory constraints on unilateral action that exist in the Delaware General Corporation Law have been chosen with some care. They are designed to protect stockholders in situations when the importance or nature of a transaction seems to require support from the corporate electorate in order to prevent abuse and to fulfill the legitimate expectations of the investors. Thus, our law requires stockholder approval for important items such as charter amendments, increases in the corporation's authorized shares, certain mergers, and a sale of substantially all of the corporation's assets.  

Enforcing these statutory safeguards is the common law of fiduciary duty. The preoccupation of that aspect of corporate law has been the deterrence and remediation of disloyal acts by fiduciaries who use their position of trust to extract private benefits at the expense of their corporations' stockholders. The Delaware courts have deployed a variety

68 § 242(a)(3).
69 E.g., § 251.
70 § 271.
of tools for that purpose, including the entire fairness standard of review for conflict transactions and the heightened *Revlon*\(^72\) and *Unocal*\(^73\) standards that are applied to certain director actions in the M&A context. Within the framework of fiduciary duty review, the Delaware courts have provided strong incentives for corporate boards to use procedures that are designed to protect public stockholders. For instance, our law gives great liability-insulating effect to majority-of-the minority vote provisions and to the deployment of a special committee of independent directors.\(^74\) Indeed, it has long been the case that Delaware law provides a strong incentive for companies to comprise their boards with a majority of independent directors.\(^75\)

What Delaware law has resisted, however, is the recitation (by statute or case law) of a detailed set of particular measures that boards must take, or of certain transactions that boards must avoid, if they are to act equitably and lawfully. This reticence is not inspired by any reluctance to hold boards


\(^73\) *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).


\(^75\) *E.g.*, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).
accountable for improper action, as our case law is replete with examples that refute any assertion of that kind.76 Rather, this cautious approach has rested on a belief that there must be room for creativity and innovation and that the law must accommodate the diversity that exists in corporate America. The restraints that might be useful and workable when applied to the largest fifty companies in America might be ill-suited to smaller public companies. The potency of fiduciary duty review (particularly under the entire fairness doctrine) and the statutory protections given to stockholders (e.g., appraisal rights) were seen as sufficient,77 especially when coupled with a corporate election process that gave stockholders an annual opportunity to elect directors.

The Delaware system takes the electoral process seriously and our courts have been vigilant about policing instances of electoral abuse.78 One natural outgrowth of our system’s view of corporate democracy has been a mindset on the part of Delaware policymakers that does not lightly deprive the stockholders’ chosen representatives of managerial authority. When the


77 This statement subsumes the idea that Delaware’s lawmakers and its judges adapt these protections to address new evolutions, such as the takeover boom of the last twenty-five years.
matter is debatable and no self-dealing exists, the decisions of elected boards have been respected. That is the essence of the business judgment rule.

From the perspective of Delaware and other states, the 2002 Reforms are somewhat problematic because they supplement our principles-based, substantive corporation laws with a variety of specific requirements that are not part of any overall system of corporate governance. This is not to say that the 2002 Reforms do not bespeak an overall philosophy of corporate governance: they do. That philosophy is based on the notion that strong and diligent oversight by independent directors who are required to focus on legal and accounting compliance will result in public companies behaving with integrity. Concomitantly, the Reforms reflect a belief in the behavior-influencing effect of process and disclosure (i.e., by requiring boards and officers to undertake certain tasks and to certify that they have done so (or explain why not). Thus, the Reforms hope to encourage responsible conduct and to deter wrongdoing and imprudent risk-taking.

To two Delaware judges, these beliefs are almost as familiar as the Lord's Prayer. What is not so familiar is the detail in which the Reforms

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79 Academic and professional commentators have raised concerns about this aspect of the 2002 Reforms, as well as the large staff and advisor costs that will be required to implement them. E.g., Peter V. Letsou, Flaw and Folly, The Daily Deal (Oct. 11, 2002).
prescribe the precise means by which directors and officers are to pursue certain ends. The Delaware approach has tended to create incentives for particular good governance practices, while recognizing that what generally works for most boards may not be the best method for some others. The fiduciary duty form of accountability is well-suited to this sort of flexibility, because it is context-specific in application.

But because the Reforms naturally take a more rule-based form, they come with the risk of codifying (by statute or contract) an array of procedures that, when fully implemented in their totality, might be less than optimal. For present purposes, we highlight two risks of the Reforms that seem to stand out. First, there is the hazard that corporate boards will have very little time to concentrate on core business issues given the various tasks and implementation deadlines mandated by the Reforms. Second, there is a danger that the 2002 Reforms may be too costly for smaller firms to

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80 Taken as a whole, the Reforms impose a host of new obligations on listed companies, which come due at various times of the year. By way of example, auditor independence requirements become effective in April, 2003, subject to transition periods. Notably, failure to comply with the strict audit committee standards by this date could subject an issuer to delisting by the Exchanges, as discussed supra at note 25. Provisions requiring enhanced disclosure for non-GAAP financial measures and disclosure of earnings releases on Form 8-K become effective after March 28, 2003. Various other disclosures must be included in annual reports for fiscal years ending on or after July 15, 2003 for most companies, such as Audit Committee "financial expert" disclosure, Code of Ethics disclosure, and Off-Balance Sheet disclosure. Record retention requirements take effect on October 31, 2003. With all of these compliance dates, and many more, contained within the Act, boards will likely feel great pressure to merely meet the baseline requirements, especially at smaller public corporations. A sophisticated law firm's compilation of the required tasks fills a chart spanning five pages and includes another page of proposed rules that still require final
implement efficiently. The intense focus of the Reforms on corporate compliance is both understandable and praiseworthy. What is a bit more questionable is the expansive reach of the Reforms and their attempt to spell out precisely the means through which each board will ensure the goal of legal compliance and accounting integrity.  

By their own terms, the proposed NYSE Rules require several committees comprised entirely of independent directors with specific mandates. Once the independent directors have carried out (or at least “checked the box” on) all their Reform mandated duties—on the audit committee, on the nominating/corporate governance committee, and the compensation committee—they may find it difficult to find time to ponder issues like: Does the company have a good strategic direction? If it does, how well is the company’s management doing in executing that strategy?

Finding the time to think about issues of this kind may be even harder for smaller public companies that may not be able to afford extra staff or a host of outside advisors simply to ensure implementation of the Reforms’ mandates. Likewise, these companies may have more difficulty finding independent directors at an affordable price. These time demands and cost rulemaking before their deadlines are established. See Patricia A. Vlahakis et al., Sarbanes-Oxley Act: Compliance Reminders (Wachtell, Lipton, Rosen & Katz, Feb. 7, 2003).
pressures on smaller public companies could lead to an increase in going private transactions, or to much lower net profitability, as increased advisor and staff costs eat into cash flow. Even at the largest of companies, it will be a challenge for boards to organize themselves in an efficient manner that leaves adequate time for the deep consideration of key business issues and that does not overly diminish the corporations' coffers.\textsuperscript{82}

III. Spillover Effects: State Courts Will Soon Face Fiduciary Duty Cases premised on the 2002 Reforms

Because public companies, as a practical matter, cannot opt out of the 2002 Reforms, their mandates can be seen as reducing the overall flexibility of the American system of corporate governance. Although our state has a strong market position, it still faces competition from other sources of corporate law, a factor which some scholars believe has contributed to a

\textsuperscript{81} See Bainbridge, \textit{supra} note 68, at 394 (expressing concern that the NYSE has "strap[ped] all listed companies into a single model of corporate governance").

\textsuperscript{82} Even well-meaning efforts by the SEC to create flexibility under the new Act surface this challenge. For example, the SEC has given companies flexibility to have required reports by attorneys or accountants go to a Qualified Legal Compliance Committee ("QLCC"), rather than the chief legal counsel or the chief executive officer of the company. \textit{SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act}, SEC Release 2003-13, \textit{available at} http://www.sec.gov/news/press/2003-13.htm. But the QLCC must include a member of the audit committee and two other independent directors. This "flexibility" actually takes away the ability for a board to create a separate legal compliance committee comprised of independent directors to address legal compliance matters that do not related to financial or disclosure issues. Given the substantial new burdens on audit committees and given the far-flung compliance obligations of some big companies, separate committees might make business sense, not only in terms of allocating scarce director resources but in terms of expertise (i.e., the director who is an expert at accounting might be clueless about CERCLA or Title VII). As now proposed, however, some very lucky independent director will get to serve on both the audit and legal compliance committee.
better product. It can be argued, we suppose, that this type of governance choice could be made available through competing Exchange requirements. We find this a bit doubtful. Furthermore, the congressional process is not designed to produce annual updates, such as have characterized state corporate law, at least in Delaware. Nor are the Exchanges likely to gin up the energy for an annual review of their listing requirements.

As a result, corporate America is likely to have to live with the 2002 Reforms for some time. Because the Reforms address boardroom practices traditionally governed by state law but do not, in themselves, constitute a comprehensive body of substantive corporation law, the Reforms will inevitably begin to influence state law adjudication. One of the important factors supporting this intuition is that Congress and the Exchanges did not supply forums for the resolution of implementation disputes at the instance of stockholders.

Unlike Delaware, for instance, the Exchanges do not have a judicial tribunal that regularly applies corporate governance requirements to real-world disputes through a fair process that results in written decisions, which in turn provide feedback to policymakers that stimulates later amendments to the rules. In addition, the Exchanges have only a very blunt tool to use to

\[ \text{See, e.g., Roberta Romano, The Genius of American Corporate Law (1993).} \]
ensure compliance: the threat of delisting or suspending trading in a company’s stock.\textsuperscript{84} Delisting or suspending trading are remedies that do not punish the directors who are responsible for any failures (as fiduciary duty review does) alone; they also punish the stockholders themselves. Therefore, delisting or suspending trading are likely to be viewed as unsatisfactory remedies from the point of view of stockholders. And, under pre-existing law, stockholders have generally been denied the ability to enforce Exchange Rules by way of a private right of action under the Exchange Act.\textsuperscript{85} Sarbanes-Oxley contains no provision suggesting that

\textsuperscript{84} Besides delisting, the NYSE would also wield the power of issuing a “public reprimand letter to any listed company that violates an NYSE listing standard.” NYSE PROPOSED RULES, supra note 5, § 303A(13); NYSE REPORT, supra note 5, at 24. If such a public reprimand fails to move a listed company toward compliance, then the NYSE is left only with a choice of blunt remedies—delisting or suspending trading. Indeed, Delaware judges are sure to hear from the plaintiffs’ bar that the significance of a public reprimand is that a company’s board of directors is “risking delisting.” In any case, NYSE Chairman Dick Grasso has said in public speeches (e.g., at the Duke University Director’s Institute in October 2002) that the NYSE will move to delist noncompliant companies for any material violation.

\textsuperscript{85} It is also true, of course, that the SEC may potentially enforce the listing standards of the Exchanges. The Exchange Act provides that the SEC can bring an action for violations of, or to command compliance with, the rules of a self-regulatory organization if the organization is unable or unwilling to take appropriate action or if the action is “otherwise necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78u(f). In addition, the SEC has recently proposed a rule that would require the Exchanges to prohibit the listing of securities of issuers that do not comply with Sarbanes-Oxley’s audit committee requirements. Proposed Rule 10A-3 of the Exchange Act, Rel. No. 34-47137, available at 68 Fed. Reg. 2638-01 (Jan. 17, 2003). This proposed rule puts teeth in Section 301 of the Sarbanes-Oxley Act.

As noted previously, see supra note 62, the extent of the SEC’s authority to act under this authority is, at the very least, uncertain when the Exchange Rule to be enforced addresses the internal affairs of corporations.

\textsuperscript{85} As a general matter, stockholders attempting to assert a right of action under the Exchange Act based on a violation of Exchange Rules have been denied standing to sue. E.g., Walck v. Am. Stock Exch., Inc., 687 F.2d 778, 786 (3d Cir. 1982) (noting that Congress expressly created a
Congress intends for stockholder-plaintiffs to now be permitted to press such claims.

In fact, Sarbanes-Oxley itself does not, with certain limited exceptions, create new causes of actions for stockholders. Rather, as a general matter, the provisions of Sarbanes-Oxley are to be codified in the Exchange Act and will be exclusively enforced by the SEC or by federal criminal authorities. The inadequacy of delisting as a remedy and the absence of a clear path for aggrieved shareholders to press claims

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private right of action in §§ 9(e), 16(b) and 18 of the Exchange Act, but did not create a private right of action in § 6. The court stated that “[t]he clear implication of the legislative history is that Congress has carefully studied and ‘balanced’ the competing considerations and enacted the statutory schema that in its view would best serve its various goals of promoting transactional efficiency, fair dealing, and investor protection, and of limiting expensive and ineffective federal intervention. We cannot infer in the face of all this evidence that Congress nonetheless authorized by implication authority in the federal courts to intervene in the self-regulatory system at the instance of an injured investor and grant redress in the form of a monetary award against an exchange, conditioned on its failure to enforce its own rules, for the purpose of coercing or encouraging enforcement.... We therefore conclude that application of the Cort v. Ash standards demonstrates a clear congressional intent not to create a private damages remedy in § 6.” (citations omitted).

Sarbanes-Oxley at § 3(b)(1) (“A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.”); Patricia A. Vlahakis et al., Understanding the Sarbanes-Oxley Act of 2002, CORP. GOVERNANCE REFORM, Sept.–Oct. 2002, at 16 (“Except in the case of recovery of profits from prohibited sales during a blackout period and suits by whistleblowers, the Sarbanes-Oxley Act does not expressly create new private rights of action for civil liability for violations of the Act. The Sarbanes-Oxley Act, however, potentially affects existing private rights of action under the Exchange Act by: (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation; and (2) expanding reporting and disclosure requirements that could potentially expand the range of actions that can be alleged to give rise to private suits under Section 10(b) and Section 18 of the Exchange Act and SEC Rule 10b-5.”).
themselves in the federal courts under the 2002 Reforms may, therefore, generate new types of state corporate law cases. In our experience, it is unlikely that stockholder-plaintiffs will be content to leave enforcement of the 2002 Reforms entirely to the SEC and the Exchanges. Rather, if history is any guide, the active corporate plaintiffs' bar will be creative and aggressive in deploying the Reforms as a tool in shareholder litigation under state law.\textsuperscript{87}

After all, unlike the 2002 Reforms, state corporate laws come with a full-service commitment to enforcement at the behest of stockholders who file well-pleaded allegations of breach.\textsuperscript{88} State courts are expected to, and

\textsuperscript{87} In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe—a reality that limits the capacity of judges to delegate very much of the work to law clerks.

As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. Indeed, Chief Justice Rehnquist has regularly noted that the federal courts are overworked and has encouraged reforms (e.g., measures to diminish diversity suits) to reduce, rather than increase, their caseloads. See, e.g., Supreme Court of the United States, 2002 Year-End Report of the Federal Judiciary (last updated Jan. 2, 2003), available at http://www.supremecourtus.gov/publicinfo/year-end/2002year-endreport.html; Milo Geyelin & Arthur S. Hayes, Chief Justice Rehnquist Warns About Swamped Federal Courts, WALL ST. J., Jan. 2, 1992, available at 1992 WL-WSJ 671120. In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the burden of adjudicating corporate governance disputes now handled by state courts.

\textsuperscript{88} Some would note that Delaware courts do not provide a forum to enforce the fiduciary duty of care, leaving a gap for others to fill. This is, at best, partially true. Although it is the case that Delaware corporations can adopt charter provisions that immunize directors from damages liability for due care violations, see DEL. CODE ANN. tit. 8, § 102(b)(7), this does not preclude courts from enjoining transactions resulting from grossly negligent board action. More importantly, many exculpatory charter provisions were adopted at mature public companies with support from sophisticated and activist institutional investors. See Edward Rock and Michael Wachter, Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants,
do, resolve all disputes under their codes, including suits alleging fiduciary misconduct by corporate directors and officers. Indeed, in the recent past, the Delaware courts have entertained claims touching on Exchange Rules. 89 For example, our courts have held that plaintiffs stated a claim for breach of fiduciary duty when directors were alleged to have delisted the company's

96 NW. U. L. REV. 651, 659-60 (2002) ("In the wake of section 102(b)(7), Delaware corporations quickly amended their certificates of incorporation, and thereby immunized directors from liability under Van Gorkom. These amendment were overwhelmingly approved by shareholders at a time when shareholding was already concentrated in the hands of institutions, and at the beginning of the rise of institutional investor activism. In the years since, as institutional investors have become increasingly active, there has been no pressure on firms to re-amend their charters to expose their directors to monetary liability for negligent breaches of the duty of care. This is strong evidence that a judicially enforced duty of care is not in the shareholders' interests. At the very least, intelligent and sophisticated shareholders do not think it is in their interests.").

E. Norman Veasey, The Role of Corporate Litigation in the Twenty-First Century, 25 DEL. J. CORP. L. 131, 147 (2000) ("The strongest support for the principle of self-governance came in the form of the liability limiting charter provisions that were first authorized in 102(b)(7) of the Delaware General Corporation Law. Similar provisions have been enacted in forty-three states and they have been routinely approved when presented to shareholders as charter amendments.") (internal citations omitted). If the federal government wishes to deprive investors of the right to provide such protection, it must consider whether that intrusion on private ordering makes principled sense, especially because it will tend to discourage board service.

89 One Delaware case illustrates the limited utility of Exchange Rules to plaintiffs' lawyers as a direct route to obtaining relief. In Lennane v. Ask Computer Systems, Inc., 1990 Del. Ch. LEXIS 164 (Del. Ch. Oct. 11, 1990), former Chancellor Allen held that stockholder-plaintiffs were third-party beneficiaries of their corporation's listing agreement and, therefore, had standing to enforce the agreement as a matter of contract law. He held that this was so because third party rights are a function of contract and federal regulation of the securities exchanges does not interfere with these rights. Id. ("I decide the current motion on the assumption that the federal regulation of securities exchanges does not itself preclude a shareholder from enforcing terms of a listing agreement intended to benefit shareholders. I assume also that shareholders are third party beneficiaries of at least some of the terms of a securities listing agreement."). But the right that Chancellor Allen recognized to sue was of dubious value, because he observed that a stockholder's only remedies for a breach of the listing agreement as a contract were the same as those available to the direct party to the to the listing agreement, the Exchange—i.e., delisting. Id. ("What third party rights are created by a contract is obviously a function of the contract itself. Here the parties to the listing agreement have negotiated the remedy for breach of the terms of the agreement delisting. It seems plain to me that the NASD itself could not specifically enforce by court order its shareholder voting by-law. Rather the remedy for its breach appears to be limited to delisting of the offending corporation's securities . . . . If this is the case, as I now believe, then
stock in order to further an inequitable purpose.\textsuperscript{90} For that reason, those of us who serve on state courts may be among the first to hear shareholder grievances based on the requirements of the 2002 Reforms.

One form that these cases may take could involve claims that directors are breaching their fiduciary duties by not complying with the Reforms. The plaintiffs’ argument will likely come in two varieties. The most straightforward will be that Delaware’s common law ought to embrace the substance of a feature of the Reforms (e.g., the Reforms’ definition of independent director or the Reforms’ requirement for independent director

\textsuperscript{90} A corporation’s directors have the power to cause a corporation to withdraw its listing and registration with securities exchanges in their proper exercise of business judgment. Hamilton v. Nozko, 1994 Del. Ch. LEXIS 139 at *18 (Del Ch. July 26, 1994); Lennane, 1990 Del. Ch. LEXIS 164. Such power may be exercised even if the delisting and deregistration may adversely affect the market for the corporation’s securities. But when the power is exercised for an inequitable purpose, the fiduciary analysis becomes interesting. \textit{Id.} In Hamilton v. Nozko, the Court of Chancery found that stockholder-plaintiffs stated a claim for breach of fiduciary duty because they alleged that the delisting, which eliminated the market for their stock and forced them to convey their stock at an unfair price, was undertaken for self-interested purposes. 1994 Del. Ch. LEXIS 139 at *18-*21. Similarly, in Seagraves v. Ustadt Property Co., the plaintiff stockholders were able to withstand a motion to dismiss because they properly alleged a claim for unfair dealing in relation to the wrongful delisting of their stock. 1989 Del. Ch. LEXIS 155 at *11-*12 (Del. Ch. Dec. 4, 1989). Because the delisting was allegedly part of a scheme to lower the market price of the company’s stock so the company could force a cash out merger at an unfair price, the court found that this inequitable purpose could form the basis for a breach of fiduciary duty claim. \textit{Id.}

In another case, defendant directors threatened to delist the shares of the company’s stock if a self-tender offer for the company’s preferred stock proposed by the company’s president did not succeed. This threat was held to be coercive of a stockholder’s decision whether to tender. Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1061-62 (Del. Ch. 1987). When a corporation goes beyond simply informing the stockholders of the possibility of delisting and deregistration, and, instead, threatens that it “intends to request” a delisting of its shares, such a
approval of certain transactions). The more indirect route will be an allegation that directors breach their fiduciary duties by exposing the corporation (and, therefore, its stockholders) to an injurious sanction (e.g., delisting) by not adhering to the Reforms.

There will be some legitimate pressure on state courts to respond with a measure of receptivity to these arguments. After all, there is something to be said for harmonizing state standards with the 2002 Reforms, when that can be achieved fairly and efficiently. And why, plaintiffs’ lawyers will ask, shouldn’t state courts require directors to ensure that their companies do not run afoul of the Exchanges, when that is necessary to guarantee listing of the company’s shares? Isn’t there a fiduciary duty to avoid this kind of harsh penalty? Or, relatedly, to make sure that the corporation doesn’t engage in a transaction that violates Sarbanes-Oxley?

Through arguments of this kind, state courts may soon find themselves immersed in the implementation of the Reforms, even though their own state laws are not directly implicated. In this process, the gravitational effect of the Reforms’ existence will nudge state judges to align

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disclosure “tips the balance and impels the Court to find that the Offer, even if benignly motivated, operates in an inequitably coercive manner.” Eisenberg, 537 A.2d at 1062.

91 Cf Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1062 (Del. Ch. 1987) (finding actionable coercion when board threatened to seek delisting if transaction was not approved).
their own state corporate systems so as to avoid whipsawing corporate
directors with incompatible dictates. At the same time, this process will
generate opportunities for state judges to deepen the dialogue with
policymakers at the Exchanges and in the federal government. In particular,
the resolution of actual disputes may shed light on the utility of the Reforms
and reveal whether they are compatible, in their present form, with the
enabling systems of corporate law that are employed by Delaware and most
other states.

In the remaining sections of this essay, we examine a few specific
subjects that provide good examples of how the Reforms may require
adaptive responses by the states that may reflect pressure back on the
sources of Reforms to modify their initial scope and shape.

IV. Harmonic Convergence or Train Wreck?: The 2002 Reforms’
    Definition of An Independent Director

The 2002 Reforms contain a relatively pristine definition of
independent director — one that builds on the best practice
recommendations of many shareholder activists. Although this definition is
not in all respects identical to preexisting state law, the concerns the
definition seeks to address are ones that state law has always considered

92 Cf. Del. Code Ann. tit. 8, § 102(b)(7) (denying exculpation for acts or omissions involving a
knowing violation of law).
After the 2002 Reforms, it will be even more important for courts to bear all these realities in mind, and not to allow the necessarily nuanced and fact-driven consideration of whether particular human beings must pay damages to be replaced by an overly simple inquiry into status. Otherwise, well-qualified people may be dissuaded from serving on boards, to the resulting detriment of stockholders.

V. The Director Election Process: The Forgotten Element To Reform?

Another related issue provoked by the 2002 Reforms is whether or not it is time that state and federal policymakers examined the management-biased corporate election system. After the 2002 Reforms, it is unquestionable that Delaware, the Exchanges, and the federal government each have policies that express the belief that genuinely independent directors who owe their allegiances entirely to the corporation and its stockholders are valuable to investors. In particular, the proposed NYSE Rule that demands that the nominating process be exclusively the province of independent directors reflects this view.\footnote{NYSE PROPOSED RULES, supra note 5, § 303A(4)(a); NYSE REPORT, supra note 5, at 9.}

If this philosophy is so central to our system of corporate governance, one can rightly ask why the current incumbent-biased corporate election process should be perpetuated. As of now, incumbent slates are able to
spend their companies' money in an almost unlimited way in order to get themselves re-elected. As a practical matter, this renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate. The aberrational cases in which shareholder activists have actually mounted proxy contests tend to prove the incumbent bias of the system, rather than cast doubt on it.\(^{115}\)

Although it would seem to promise more expense than protection to investors to create incentives for lively electoral disputes on an annual basis, it is equally questionable whether the current balance is optimal. Even with the advent of independent nominating committees, there will remain the danger that incumbent slates will become overly comfortable in their positions and that even putatively independent directors will become less than ideally sensitive to stockholder input. A balance of the efficient deployment of corporate resources (\textit{i.e.}, costs) against the utility of a genuinely open election process that generates increased accountability might be reflected in a biennial or triennial system of elections that require equal access to the proxy machinery between incumbents and insurgents with significant (\textit{e.g.}, five or ten percent) nominating support.

Through this means, Delaware could invigorate its system of corporate democracy without undue cost and create a more secure foundation for the 2002 Reforms. The very fact that an open process is created would influence independent directors to be more responsive on an ongoing basis and to consult with key stockholder constituencies in shaping the management slate. Put differently, by facilitating fair contests, the new rules of the game will cut down on the need for them.

This is, of course, not a novel proposal. Its implementation would also require a sensitive corresponding reaction by the SEC, to enable disaggregated investors to communicate in a non-burdensome manner in the electoral process. Reform along these lines needs to be carefully thought out, of course. The reality that thoughtful deliberation on this front is warranted cannot obscure an equally apparent reality: the rhetorical analogy of our system of corporate governance to republican democracy will ring hollow so long as the corporate election process is so tilted towards the self-perpetuation of incumbent directors.

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117 The adoption of this proposal might also be accompanied by another reform to make the analogy to traditional republican democracy even more precise. For years, corporations, stockholders, and the SEC have struggled over the proper role of so-called stockholder
To grasp why this is so, it is useful to consider the delicate subject of executive compensation. As we have explained, the American system of corporate governance involves a dialogue among the federal and state governments and the Exchanges, who each act on the basis of input from various interested constituencies. Policymakers at the state level must listen in this process, as well as speak. For example, it can argued fairly that Delaware’s common law did not react quickly or aggressively enough to changes in compensation practices during the last two decades that were so substantial quantitatively that they required a qualitatively more intense form of judicial review, through, for example, a reinvigorated application of the concept of waste. In the past, the Delaware courts had generally taken a hands-off approach to executive compensation based on the assumption that this was a matter of business judgment, which could also be factored into the electorate’s voting decisions. Before the last twenty years, the overall level of executive compensation did not seem to reflect any major defect in this policy choice. Empirical evidence of the huge Argentina-like inflation in executive compensation in more recent decades creates greater doubt.\textsuperscript{118}

It will not surprise legal scholars that Delaware’s common law was perhaps slower than ideal in adapting to the new realities, which seem to many to cry out for a deeper and more skeptical judicial inquiry. The common law accretes knowledge, but not always at an optimal pace. The 2002 Reforms contain measures reflecting a policy judgment that the constraints of state law on executive compensation are, in themselves, inadequate to protect investors against abusive compensation practices. State law policymakers—including judges shaping the common law—will undoubtedly be responsive to this expression of concern and may use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders.

In that process, a not unfamiliar policy question might arise: is it preferable to react to a potential need for greater restraints on executive compensation by tightening judicial review, or by increasing the ability of stockholders to displace directors who do not set responsible levels of pay? A potent electoral check on director conduct dampens the need for increased judicial intervention and encourages the resolution of corporate disputes within the corporate family.

average chief executive earned 419 times more than his or her coworkers, up from 25 times in 1981, while the 10 highest-paid executives have seen their income soar an astonishing 4,300 percent between 1981 and 2000."
C. Critiques of Sarbanes-Oxley

A first wave of academic commentary has criticized the Act generally for the haste with which it was adopted, and more specifically for what some see as the ill-advised step across the well-respected lines established by the internal affairs doctrine. These substantive critiques, however valid, gloss over an important point. The Act’s very adoption triggered an important reaction and initiated legal reforms with impact beyond its limited substantive provisions. When analyzed as part of the complex dynamic of vertical competition, the Act is properly viewed as a critical political response to public dissatisfaction with the states’ performance as virtually exclusive regulators of internal corporate affairs.

VI Delaware’s Response

A. The Perceived Threat

As the model of vertical regulatory competition would predict, the public outrage over the corporate scandals appears to have affected the Delaware judiciary, which is ever mindful of Congress’ preemptive power. In response, Delaware’s judiciary has taken the initiative to reform its state’s corporate law in an effort to forestall further federal preemption. This reform effort has been facilitated by the state’s open-ended, standards-based jurisprudence which allows judges to adjust the law in response to external forces without having to explicitly acknowledge such efforts.

Powerful parties in Delaware could suffer significantly in the event of broad federal preemption of state corporate law. Most obviously, uniform federal standards could erode Delaware’s relative appeal to corporate managers, resulting in the significant loss of franchise tax revenues. In addition, members of the Delaware bar and judiciary would personally feel the impact of federal preemption. Delaware lawyers rely heavily on revenues generated from serving as local Delaware counsel to corporations located throughout the country. These corporations consult Delaware practitioners due to their exclusive access to the Delaware courts and their expertise in Delaware corporate law. If federal corporate law were to supplant Delaware law, much of this expertise could be rendered moot. Adopting uniform federal standards would make corporate practitioners throughout the country prospective experts in the new federal corporate law, and could reduce or eliminate the need to regularly consult Delaware counsel.

In addition, the Delaware judiciary’s power and prestige might wane if new federal statutes required corporations to litigate significant shareholder disputes in federal court anywhere in the country. Delaware state courts would not exercise jurisdiction over as many high-profile disputes and the judiciary’s prominence would diminish. With so much at stake for so many players, it is not surprising that Delaware’s decision-makers are anxious about the federal preemptive threat.

B. The Judicial Response

The Delaware judiciary is well-situated to respond to the preemptive threat, perhaps better situated than the legislature or other state courts. The open-ended nature of Delaware jurisprudence has allowed its courts to respond swiftly and deftly to

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119See Bainbridge, supra note 1, at 26; Ribstein, supra note 4, at 57-59.
A comprehensive analysis of the substance of the Act is beyond the scope of this Article. Instead, this Article focuses on the Act’s potential impact on state corporate law.

117Bebchuk and Hamdani estimate that 27% of Delaware’s annual tax revenues come from franchise tax revenues. Bebchuk & Hamdani, supra note 6, at 581 n.66.
118See Kahan & Kamar, supra note 6, at 694-99 (discussing benefits to the Delaware bar from litigation centered in Delaware); see also Roman, Law as Product, supra note 5, at 278-79; Law for Sale, supra note 5, at 888-90.
119See Kahan & Kamar, supra note 6, at 694-99.
120See generally Jonathan R. Macey, Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism, 76 Va. L. Rev. 265 (1990) (discussing various interest groups in Delaware and their dependence on the “capital asset” of the Delaware corporate law regime). Corporation service companies which facilitate the formation and legal maintenance of Delaware corporations by out-of-state corporations are another influential group in the development of Delaware law. For a discussion of the corporation service companies’ role in shaping Delaware’s 1967 statutory revisions, see Law for Sale, supra note 5, at 865.
121Delaware’s legislature recently adopted a number of statutory amendments which expand the chancery court’s jurisdiction to assist plaintiffs seeking to
forestall federal action.\textsuperscript{18} Certain Delaware judges have acknowledged their perceived role as first-responders to the threat of federal preemption. These judges have publicly expressed concern with possible problems in state corporate jurisprudence revealed by Enron and other scandals, despite the fact that the largest frauds occurred at corporations chartered elsewhere. These same judges have suggested that unless states act quickly to address these weaknesses, the federal government may preempt their authority.\textsuperscript{17}

Writing in early 2002, Delaware Vice Chancellor Leo Strine predicted that “the Enron debate will create pressure on the current standards of state corporation law, and ... participants in the policymaking process will identify what they perceive as inadequacies in that law, which they will cite as justifying a stronger role for federal regulation.”\textsuperscript{17} Acknowledging the importance of the federal-state competitive dynamic, he predicted that state policymakers “can be expected to be responsive to legitimate concerns.”\textsuperscript{17} He noted that such policymakers include state judges, like himself, “who play the leading role in formulating and enforcing the fiduciary duties of corporate directors and officers.”\textsuperscript{18}

Norman Veasey, Chief Justice of the Delaware Supreme Court, has revealed similar concerns about the federal preemptive threat. He has urged corporate directors to act more vigilantly in settling executive compensation, “not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly

Presented complaint.”\textsuperscript{19} Acknowledging the Delaware courts’ role in forestalling the preemptive threat, the chief justice bluntly stated: “[i]f we don’t fix it, Congress will, but I hope they’ve gone as far as they’re going to have to go.”\textsuperscript{20}

Reflecting the tenor behind judicial pronouncements about the risk of federal preemption, recent Delaware decisions suggest a trend toward stricter judicial scrutiny of director decision-making. Since June of 2002, the Delaware Supreme Court has reversed chancery court decisions in favor of defendant directors, and ruled for the shareholder-plaintiffs six times.\textsuperscript{21} This series of reversals represents a sharp departure from earlier patterns, in both the number of reversals and the number of pro-shareholder decisions.\textsuperscript{22} Moreover, the supreme court’s jurisprudential shift has trickled down to the court of chancery, which apparently has
taken heed of the supreme court’s message after such an unusual string of reversals.\textsuperscript{136}

Ironically, the indeterminacy of Delaware law makes it impossible to demonstrate conclusively that the law has changed, or to identify the causes of any purported shift. The Delaware courts are famous for announcing new standards of conduct, while claiming that such standards have always existed.\textsuperscript{138} In spite of the hazards of speculating about what motivates judges in their decisionmaking,\textsuperscript{137} the following analysis seeks to analyze Delaware’s recent decisions in their political context.

C. Delaware Law: Pre-Enron

The Enron scandal prompted broad scrutiny of corporate law and launched Congressional hearings on corporate reform. Therefore, the scandal serves as a convenient dividing line for an analysis of recent trends in judicial decisionmaking. This section reviews the state of Delaware law before Enron and identifies the legal doctrines that made it difficult for shareholders to enforce the fiduciary duties of officers, directors, and controlling shareholders that are at the heart of corporate law.

Before Enron, Delaware was the state where managers turned for assurances of minimal exposure to personal liability for mistakes, misjudgments, wrongdoing, or self-dealing. As one corporate treatise states, “businesses that quest certainty of results, as well as a sympathetic and experienced ear to the problems of running a public corporation, are assured of finding it in Delaware.”\textsuperscript{128} A combination of legislative provisions, judge-made rules, and procedural mechanisms worked together to provide officers and directors a virtually impregnable shield from monetary liability for corporate misdeeds.

Brehm v. Eisen, 746 A.2d 244 (Del. 2000) (affirming dismissal for failure to make demand but reversing the “with prejudice” aspect of the dismissal).
\textsuperscript{126}See In re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003); In re The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003). These cases are discussed infra at Part VI.D.
\textsuperscript{137}Cunningham & Yablonski, supra note 126, at 1626 (stating that “[p]redicting the course of Delaware law from prior case law is like watching clouds. They seem, at times, to take on recognizable shapes and forms, even to resemble something familiar. But you know that whatever shapes you think you see can vanish in a puff of wind.”).
\textsuperscript{138}Cox & Hazen, supra note 16, at 39.

Rethinking Corporate Federalism

Under standard notions of corporate governance embodied in state law, a corporation’s board of directors and its executive officers manage the affairs of the corporation.\textsuperscript{130} Shareholders’ governance rights are strictly limited to a nominal right to elect directors and the right to veto certain fundamental transactions. The limited governance role afforded shareholders has led to what many consider to be the central problem in modern corporate law: managing the tension caused by the separation of ownership from control in the large publicly-held corporation.\textsuperscript{130}

The separation of ownership from control is said to create the classic agency problem. Managers are tempted by opportunities to shirk and steal.\textsuperscript{131} To deter management malfeasance and to provide shareholders a remedy for managerial shirking or stealing, the law imposes on managers, as agents of the corporation, the fiduciary duties of loyalty and care. Until recently such shareholder protections were more theoretical than real.

1. The Duty of Care

Although Delaware has no statutory formulation of a director’s fiduciary duties, its courts have developed a standard of conduct against which to measure a director’s actions.\textsuperscript{132} Guth v. Loft, Inc. set forth an early formulation of a director’s fiduciary duty, as demanding of a director the duty “not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it.”\textsuperscript{133} So stated, the duty of care appears to impose a significant burden on corporate managers. In reality, however, the state legislature and courts have fashioned a number of mechanisms that, until recently, eliminated any real threat of monetary liability for a breach of the duty of care.

The business judgment rule significantly qualifies the general proposition that directors have a duty of care to the corporation. It imposes a rebuttable presumption that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was

\textsuperscript{130}See Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 114-15 (1968); see also Bauman et al., supra note 16, at 456.
\textsuperscript{131}See Robert C. Clark, Corporate Law 33-34 (1989).
\textsuperscript{132}Id. at 123.
\textsuperscript{133}Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).
in the best interests of the company.\textsuperscript{134} In most instances, the invocation of the business judgment rule suffices to insulate directors from liability to the corporation or its shareholders for losses that result from poor decision-making.\textsuperscript{135} Despite the broad protection the business judgment rule provides, it will not shield every director action from judicial scrutiny. Exceptions to the business judgment rule apply to decisions tainted by fraud, illegality, or conflict of interest.

The most amorphous and unpredictable exception to the business judgment rule is for failure to take proper care in decision-making: the procedural duty of care.\textsuperscript{136} The famous \textit{Smith v. Van Gorkom}\textsuperscript{137} decision invoked this standard, and concluded that the board of directors of TransUnion Corporation had failed to “act with informed reasonable deliberation” before approving the sale of the company.\textsuperscript{138} Although \textit{Van Gorkom} raises the specter of potentially limitless personal liability for directors, the decision was an aberration in Delaware jurisprudence and has been almost uniformly criticized.\textsuperscript{139} No subsequent Delaware decision has premised director liability on a breach of the duty of care.\textsuperscript{140}

Corporate management’s displeasure with \textit{Van Gorkom} led Delaware’s legislature to adopt Section 102(b)(7), a provision that permits corporations to “excuse” or “eliminate,” directors’ monetary liability for the breach of the duty of care.\textsuperscript{141} Section 102(b)(7) does not permit excusal for breaches of duty of loyalty, acts or omissions not in good faith, or knowing violations of law.\textsuperscript{142} Despite these exceptions, the reality remains that if a corporation has adopted an excusable charter provision, its directors enjoy reasonable assurance that they will not incur personal liability for ordinary breaches of the duty of care.\textsuperscript{143} The scarcity of Delaware decisions holding directors liable for the breach of the duty of care,\textsuperscript{144} coupled with the right to exculpation, has led most commentators to conclude that the fiduciary duty of care, if not ephemeral, exists only as an aspirational and unenforceable standard.\textsuperscript{145}

2. Duty of Loyalty

The business judgment rule does not protect board decisions that are alleged to result from an officer’s, director’s, or controlling shareholder’s self-interest.\textsuperscript{146} Ostensibly, the duty of loyalty holds such parties liable for unfairly enriching themselves at the corporation’s expense. As with the duty of care, the common law prohibition on managerial self-dealing has eroded over the years.\textsuperscript{147} Formerly, the dominant common law rule was that an action by a shareholder could void a corporate transaction with an interested director.\textsuperscript{148} This rule gave way to the modern “fairness” test, under which an interested transaction is not void if it is fair to the corporation.\textsuperscript{149} Delaware’s legislature further modified this common law rule when it adopted section 144, which provides that a transaction between a corporation and one of its officers or directors is not void or voidable solely because of the conflict, if the transaction is approved by a majority of the disinterested directors, a committee of disinterested directors, or by

\textsuperscript{134} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).


\textsuperscript{137} See Cox & Hazen, supra note 16, at 191-95 (discussing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)).

\textsuperscript{138} 488 A.2d 858 (Del. 1985).

\textsuperscript{139} In Van Gorkom, the court opined that TransUnion’s board had failed to fulfill its duty of care because the board spent less than two hours considering the merger proposal, and approved the agreement without reading it, relying instead on a 20-minute oral presentation by the CEO who had secretly negotiated the merger. Id.


\textsuperscript{141} See, e.g., Malspie v. Townsend, 780 A.2d 1075, 1093-95 (Del. 2001) (upholding the dismissal of a duty of care claim or the grounds that a § 102(b)(7) provision precluded monetary recovery).

\textsuperscript{142} See, e.g., Clark, supra note 131, at 124-28; Klein & Coffee, supra note 140, at 151-54.

\textsuperscript{143} Id. at 166-75.

\textsuperscript{144} See Harold Marsh, Jr., Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. Law. 9, 36 (1967).

\textsuperscript{145} Id. at 99-100. But see Norwood P. Beveridge, Jr., The Corporate Director’s Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction, 41 DePaul L. Rev. 655, 662 (1992) (disputing Marsh’s analysis).
the shareholders, or if the transaction is fair to the corporation at the time of its approval.\textsuperscript{155}

Disinterested director approval of a conflict of interest transaction has served as a reliable method for protecting potentially opportunistic corporate transactions from judicial scrutiny. Although the law is muddled, many cases have held that approval of a transaction by disinterested directors or shareholders results in application of the business judgment rule.\textsuperscript{156} Thus, directors often succeed in precluding judicial review of conflict of interest transactions by appointing a committee of independent directors to negotiate and approve the terms of such transactions or by obtaining disinterested shareholder approval.\textsuperscript{157} Although Delaware courts have been more rigid in reviewing conflict of interest transactions between a corporation and its controlling shareholders, its courts have frequently accorded such transactions business judgment rule protection.\textsuperscript{158} But, in the controlling shareholder context, courts sometimes hold that disinterested director approval merely shifts the burden to the plaintiffs to show that the transaction is unfair.\textsuperscript{159} This burden-shifting rule has been applied consistently only in the context of cash-out mergers, when minority shareholders are forced to cash in their shares at a price dictated by controlling shareholder or its designated directors.\textsuperscript{160}

\footnotesize{\textsuperscript{155}Del. Code Ann. tit. 8, \textsuperscript{156}See, e.g., Fliegl v. Lawrence, 361 A.2d 218 (Del. 1976); Marciano v. Nakaah, 535 A.2d 400, n.3 (Del. 1987); In re Wheelabrator Tech. S'holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995).

\textsuperscript{157}Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

\textsuperscript{158}See Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (applying business judgment rule to plaintiff's challenge to subsidiary's dividend to its parent); Puma v. Marriott, 253 A.2d 693, 696 (Del. Ch. 1971) (applying business judgment rule to corporation's real estate purchase from controlling shareholders).

\textsuperscript{159}See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (articulating the entire fairness standard); see generally Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110 (Del. 1994) (applying burden shifting rule); Emerald Partners v. Berlin, 720 A.2d 1215, 1222-23 (Del. 1998) (approving by disinterested directors shifts burden to plaintiffs); see also Cooke v. Ocie, 26 Del. J. Corp. L. 609, 625 (Del. Ch. 2000) (noting that plaintiffs must show actual conflict of interest to rebut the presumption that the business judgment rule applies); Rabkin v. Olin Corp., 16 Del. J. Corp. L. 851, 861-62 (1990) (describing the terms under which the burden of proof shifts with a special committee).

\textsuperscript{160}See generally Weinberger, 457 A.2d at 711; Kahn, 638 A.2d at 1117. The emergence of fairness as the unyielding standard of review in cash-out merger cases has a convoluted history. In Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), the Delaware Supreme Court imposed a business purpose requirement for all cash-out mergers. Id. at 980. Seven years later, in Weinberger, the supreme court overturned Singer, abandoning the business purpose requirement for the current fairness rule.

\textsuperscript{157}Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

\textsuperscript{157}Id. at 711.

\textsuperscript{157}Id. at 701 n.7. Kahn, 638 A.2d at 1116-17, reiterated the burden-shifting effect of disinterested committee approval of a cash-out merger transaction. In Kahn, the court held that the burden did not shift to plaintiffs because of evidence that the independent committee that negotiated the merger lacked independence and real bargaining power. Id.

\textsuperscript{157}See Williams v. Geier, 671 A.2d 1988 (Del. 1996) (affirming summary judgment for defendants in challenge to a recapitalization plan approved by an independent committee and shareholders).

\textsuperscript{157}Cox & Hazen, supra note 16, at 429 (asserting that "[t]he demand requirement . . . is the single most challenging hurdle that lies in the path of the derivative suit plaintiff").}
show that such a demand would be futile. The demand requirement as initially interpreted by Delaware courts did not present a significant challenge to plaintiffs. This interpretation changed with the supreme court's decision in Aronson v. Lewis. In Aronson, the court announced a two-part test, under which the court of chancery must determine whether "under the particularized facts alleged, a reasonable doubt is created that the directors are disinterested and independent for that the challenged transaction was otherwise the product of a valid exercise of business judgment." If the complaint satisfies either condition, demand is excused and the case may proceed.

b. Special Litigation Committees

Despite the demand requirement's protective power, instances occurred when courts excused demand based on futility. In this situation, a corporation's directors would have an additional opportunity to avoid litigating the shareholders' case on the merits by appointing a special committee of independent directors to review the litigation. Under this mechanism, interested directors (who had been adjudged disabled from objectively considering a demand) hand-picked the members of a special committee charged with evaluating the merits of the litigation and the corporation's interest in continuing it. The special litigation committee would then engage in an extensive investigation and produce a report that almost invariably concluded that continue.

4. Disney Litigation (Disney I)

The court of chancery decision in In re the Walt Disney Co. Derivative Litigation (Disney I) demonstrates the power of these procedural mechanisms to frustrate plaintiffs' meritorious claims. Disney hired Michael Ovitz, a close friend of CEO Michael Eisner, as its president and chief operating officer. By all accounts, Ovitz's tenure at Disney was a spectacular failure. Within twelve months, Ovitz was seeking other employment. With Eisner's help, Ovitz negotiated a soft landing, departing Disney after fourteen months with a severance package worth $140 million. Disney

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163 473 A.2d 945 (Del. 1984).
164 Id. at 914. The facts of Aronson show how this test erects a significant barrier. In Aronson, the plaintiffs challenged an employment agreement and loans to Fink, a former director and 47% stockholder. Id. at 908. The plaintiffs had alleged that Fink dominated the board because he had personally selected the directors and through his voting power controlled the election process. Id. The court held these allegations insufficient to establish an inference of Fink's domination and control. On remand, however, the court of chancery determined that demand excusal was appropriate under the newly announced standard. Lewis v. Aronson, 11 Del. J. Corp. L. 243 (1985).
165 For example, when all of the directors are implicated in the litigation or benefited from the alleged conflict of interest transaction. See, e.g., Rules v. Blasband, 634 A.2d 927 (Del. 1993).
shareholders brought a derivative action against Disney's directors and former directors. They alleged breaches of the fiduciary duties of care and loyalty both for initially approving Ovitz's employment contract and for subsequently approving Disney's non-fault termination of Ovitz, which entitled him to receive such exorbitant benefits.

The Disney defendants moved to dismiss the complaint for failure to make demand. Despite the extraordinary facts alleged in the case, the court displayed a skeptical attitude to the plaintiffs' case. According to the court, the sheer dollar amount of the severance and the unusual circumstances under which it was granted did not mean that conventional corporate governance rules would not apply in evaluating the board's decision. Instead, the court resolved to analyze the plaintiffs' claims "using the same tools it uses in any corporate law case, namely, the requirement of demand or its excusal, the Aronson v. Lewis test, the basic rules of disclosure and, most significantly, the business judgment rule." Central to the plaintiffs' claim of demand futility was that Eisner had an impermissible interest in Ovitz's employment contract, due to his close friendship with Ovitz. Eisner allegedly used his domination over the board to force them to approve Ovitz's ill-advised contract. The plaintiffs also argued that Eisner relied on his domination of the board to goad them to approve Ovitz's "non-fault termination" and the lucrative severance benefits granted thereunder.

The court gave little credence to these arguments. Stating that "a board member is considered to be disinterested when he or she neither stands to benefit financially from nor suffer materially from the decision whether to pursue the claim sought in the derivative plaintiff's demand," the court limited its inquiry into Eisner's independence into any financial benefit to Eisner from the Ovitz agreement or the subsequent non-fault termination. Finding that the plaintiffs had not credibly alleged such financial interest, the court held Eisner's independence beyond reproach. In so holding, the court minimized the relevance of Eisner's relationship with Ovitz stating that "[d]emand is not excused . . . just because directors would have to sue "their friends, family and business associates."

The court also evaluated plaintiffs' claims that Eisner dominated the board of directors. Despite extensive personal and professional ties among Eisner and most of the other Disney directors, the court found that at least nine of the twelve board members were independent of Eisner. Not only did the court deem several Disney executives, former executives, and consultants independent of Eisner, it also found independent individuals with more personal connections to Eisner. For example, Father Leo J. O'Donovan was president of Georgetown University, which Eisner's son had attended and to which Eisner personally contributed more than $1 million. Another director, Reveta Bowers, was the principal of the elementary school that Eisner's children once attended. The court ruled that neither these personal connections to Eisner, nor the relative significance of the directors' fees paid to these individuals created doubt as to their ability to act independently of Eisner. Ultimately, the court concluded that because of plaintiffs' failure to demonstrate Eisner's interest in Ovitz's employment contract, and their failure to raise reasonable doubt of the independence of a majority of the directors, plaintiffs had failed to meet Aronson's first prong for demand excusal.

The plaintiffs fared no better under Aronson's second prong,
which required that the facts alleged raise a reasonable doubt that the "challenged transaction was the product of a valid exercise of business judgment." The fact that directors had not calculated the total cost of the severance package was not fatal to the defendants' claim of business judgment rule protection. The court stated that "the board is not required to be informed of every fact, but rather is required to be reasonably informed." Likewise, the court found plaintiffs' claims of waste deficient because "in the absence of fraud this court's deference to the directors' business judgment is particularly broad in matters of executive compensation." The Disney directors' decision to grant Ovitz a non-fault termination, despite his non-performance and his own initiation of the termination of his employment, was also protected by the business judgment rule.

On appeal, the Delaware Supreme Court upheld the dismissal of all of the plaintiffs' claims. While displaying some concern about the Disney board's performance, the court reserved its contempt for the plaintiffs' pleading efforts. Calling the complaint a "pastiche of prolix invective," the supreme court agreed that plaintiffs had failed to satisfy the demand requirement. In a partial reversal, however, the supreme court granted the plaintiffs' leave to amend their pleadings to satisfy the second prong of Aronsen by alleging facts that created a reasonable doubt that the boards' decisions were entitled to business judgment rule protection.

5. Question of Independence

The Disney I decision highlights the central role that independent directors play in providing a shield from liability for directors accused of a breach of duty. The standard for directorial independence is notoriously low. Importantly, the Delaware courts rejected notions of structural bias that many argue significantly impact directors' decisions. Under this rubric, even allegations of self-dealing that were not entitled to business judgment rule protection could be shielded from judicial scrutiny by relying on independent directors to reject demand or to dismiss derivative litigation through a special litigation committee. These defenses presume the courts' acceptance of the defendants' claims that the directors charged with the relevant decision are "independent." Once courts display a willingness to question the defendants' claims of independent director decision-making, this protective veil falls away, and directors must defend their actions on the merits.

Similarly, business judgment rule protection depends on the court's acceptance of the notion that the board engaged in "informed, good-faith decision-making." If the courts question this presumption (even on occasion), the automatic protection of the business judgment rule becomes elusive. By denying defendants the benefit of the doubt, the courts can significantly alter the substantive law without altering judicial doctrine. Thus, the courts can execute the elegant maneuver of maintaining consistent legal standards while altering the stringency with which these standards are applied on a case-by-case basis.

D. Delaware Law: Post-Enron

Exposure of Enron's frauds triggered a national debate on the need for corporate reform. Even before Sarbanes-Oxley, Delaware jurists began to acknowledge the need for state-level reform to forestall federal action. The Act's provisions merely sharpened the preemptive threat. Delaware's most recent corporate decisions depart dramatically from the tradition of management deference that preceded Enron.

It is possible that Delaware would have proceeded on a path of reform absent the national debate that led to Sarbanes-Oxley. It is also possible that the recent jurisprudential shifts are simply a part of the natural norm evolution that characterizes the common law. Despite these possibilities, judicial comments expressing concern that Congress might displace Delaware's sovereignty

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195 Aronsen, 473 A.2d at 814.
196 Disney I, 731 A.2d at 362.
191 Id.
196 Id. at 364.
198 Brein v. Eisner, 746 A.2d 244 (Del. 2000).
199 Id. at 249.
200 Id. at 248.
201 Id. at 257. The plaintiffs amended their complaint, and the amended complaint, considered post-Enron, received a different reception from the court of chancery. See infra text at notes 207-229.
202 Essentially plaintiffs had to show at the pleading stage, without the benefit of discovery, that a majority of directors would suffer financially unless they refused demand.

193 See Cox & Munsinger, supra note 166, at 85.
194 See Strine, supra note 117.
203 Some may counter that because the major scandals occurred at Enron, WorldCom, and Tyco, none of which were Delaware corporations, Delaware's legislature or judges should not bear any sense of responsibility for these scandals. Such analysis ignores the reality that all states have enacted enabling statutes that substantially mimic Delaware's legal rules, and that most other state courts look to Delaware for precedent on corporate law matters.
provide a reason to explore other factors that might have contributed to this apparent shift.

In his *Business Lawyer* article, Vice-Chancellor Strine foreshadowed many of these judicially-led reforms. For example, Strine presaged reforms in standards for judging directorial independence, stating, "I believe that Enron will ignite a fiery debate centered upon the so-called ‘independent director.’" He predicted that plaintiffs will seek to "reverse existing presumptions, and ask our courts to presume, at the pleading stage, that directors who have questionable ties to management are not independent for purposes of dismissal motions." He also predicted the tightening of procedural mechanisms for dismissing derivative litigation, and the possibility of piercing the protective veil provided by exculpatory charter provisions. On that score, Strine anticipated that "the court will be called on to conclude that a director who is conscious that he is not devoting sufficient attention to his duties is not acting in good faith, and is therefore not entitled to exculpation from damages liability." Delaware's recent decisions appear to draw on Strine's analysis. The courts have refused in preliminary motions to resolve directors' claims of independence in defendants' favor. Furthermore, the courts have denied defendants the protection of the business judgment rule in instances where it probably would have applied in the past.

1. Duty of Care

In *In re Walt Disney Co. Derivative Litig. (Disney II)*, the court undermined the reliability of two stalwart defenses to duty care claims: the business judgment rule and exculpation. In this decision, Chancellor Chandler, the author of *Disney I*, revisited the claims of plaintiffs who had objected to Michael Ovitz's gener- ous severance package. In the pre-Enron era, Chancellor Chandler had dismissed all of plaintiffs' claims. In *Disney II*, he concluded that the boards' alleged conduct may have constituted such gross negligence as to violate Delaware's "good faith" requirements, thereby denying defendants exculpatory protections.

In *Disney II*, the plaintiffs' amended complaint alleged that Disney's directors failed to exercise any business judgment in approving Ovitz's employment agreement and his non-fault termination. Some of the particularized facts in the amended complaint differed from the complaint presented in *Disney I*. Viewed broadly, however, the amended complaint presented the same factual pattern shaped to comply with the limits of the supreme court's remand.

The court evaluated plaintiffs' new allegations only under Aronson's second prong: whether they alleged facts sufficient to raise a reasonable doubt that the challenged transactions were entitled to business judgment rule protection. This time Chancellor Chandler concluded that allegations did create such doubt. Remarkably, he rejected the defendants' exculpation defense, ruling that the facts alleged created a reasonable doubt as to whether

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208. See supra notes 182-199 and accompanying text.
209. The supreme court upheld the chancellor's ruling, but reversed the "with prejudice" aspect of the dismissal of plaintiffs' claims that the boards' processes were not entitled to business judgment rule protection. Brehm, 746 A.2d at 248.
211. The plaintiffs had obtained access to corporate books and records (including board minutes and corporate correspondence) allowing them to provide better factual support for their allegations. Perhaps the most legally significant difference between the old and new complaints was the plaintiffs' allegation in *Disney II* that compensation expert Grief Crystal had not advised the board on Ovitz's agreement. This new allegation eliminated the directors' potential section 141(f) defense of reliance on experts. The new complaint also alleged that Disney's board never formally approved Ovitz's non-fault termination and the consequential severance payments, weakening the directors' claims of business judgment rule protection.
212. Both complaints tell the same basic story: Disney's board capitulated to Eisner in hiring his close friend Ovitz, providing a generous compensation package and severance terms that created perverse incentives by guaranteeing payments for failure. The board compounded its error by permitting Ovitz's non-fault termination which locked in benefits to which Ovitz (based on his performance as president) was not entitled.
213. Aronson v. Lewis, 473 A.2d 805 (Del. 1984). This treatment was consistent with the supreme court's order in Brehm, 746 A.2d at 262.
the directors acted "honestly and in good faith." Because section 102(b)(7) forbids exculpation for "acts or omission not in good faith," this ruling offered plaintiffs a path around the exculpatory provision’s formidable protective barrier. Reminiscent of the widely-disparaged Van Gorkom decision, the court lambasted the board’s decision-making process, scrutinizing the amount of time it spent considering Ovitz’s agreement (ten minutes), the page length of the board minutes (one and one-half pages), and the information made available to the board at the time of such approval.

In Disney I, Chancellor Chandler adopted a deferential approach to evaluating board conduct. He dismissed as insignificant the board’s alleged failure to quantify the value of Ovitz’s termination payout, stating that “[a] board is not required to be informed of every fact, but rather is required to be reasonably informed.” In a remarkable reversal, in Disney II, Chancellor Chandler found the plaintiffs’ allegations quite troubling:

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a "we don’t care about the risks" attitude concerning a material corporate decision.

Such harsh scrutiny of board conduct departs sharply from the

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210 Id. at 286.
211 888 A.2d 858 (Del. 1985).
212 Disney II, 825 A.2d at 287-88.
213 Id. at 362.
214 Disney I, 731 A.2d at 289.
215 Chancellor Chandler attributed the different outcome on the two different allegations in the new complaint. Id. at 279 & n.5. Although this is a plausible explanation of the different outcomes on the motions to dismiss, it fails to fully account for the differences in tone, language, and legal conclusions between the two court of chancery opinions. More seems to be going on than the simple application of consistent legal standards to the facts presented to the court. It seems likely that an altered legal and political environment contributed to Chancellor Chandler’s shift in approach. In Brehm, Chief Justice Veasey described the facts in Disney I as “troubling.” Brehm, 746 A.2d at 249. Concurring, Justice Hartnett viewed the allegations sufficient to survive dismissal. Id. at 268 (Hartnett, J. concurring). In addition, Chief Justice Veasey put the public spotlight on Brehm (and implicitly, the court of chancery’s prospective ruling in Disney II) as an example of how the Delaware courts were willing to scrutinize directors’ executive pay decisions. See Roundtable, supra note 2, at 78. Thus, the partial reversal in Brehm, Chief Justice Veasey’s widely-disseminated comments, and intervening supreme court decisions such as Tokon (discussed infra Section VI.D.2), represent significant additional factors that may have pushed the court toward the legal conclusions reached in Disney II.
216 Disney I, 731 A.2d at 350.
217 Just as the 85,000 ton cruise ships Disney Magic and Disney Wonder are forced by science to obey the same laws of buoyancy as Disneyland's significantly smaller Jungle Cruise ships, so is a corporate board’s extraordinary decision to award a $140 million severance package governed by the same corporate law principles as its everyday decision to authorize a loan...
218 Id. at 290.
219 Id. at 291.
220 Id. (citing Tokon, 802 A.2d at 265).
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business opportunity in question. The court rejected defendants' arguments that independent directors had approved all of the challenged transactions entitling them to business judgment rule protection stating that "[d]irectors must not merely be independent, but must act independently." The plaintiff sought to rebut the business judgment rule's presumptions by alleging that Meyerson dominated the board. The plaintiff cited Meyerson's influence on the directors' compensation, his important position in the company, and the fact that the directors "respected his business acumen and often relied on his counsel" to support its allegations. The court of chancery had dismissed these arguments, correctly observing that "Delaware courts have consistently rejected assertions that a personal friendship without more, establishes a lack of independence." In contrast, the supreme court opined "we cannot say whether or not the other Directors acted independently or were beholden to Meyerson such that they deferred to his will . . . ." The court therefore reversed, stating that, "[o]nly after a full picture of Meyerson's relationship with the other Directors is developed can their independence be ascertained." Thus, despite many successful preliminary motions granted on the basis of directors' assertions of facial independence, the court in Telxon held that a full factual record was necessary to make such a determination.

b. Krasner v. Moffett

Krasner v. Moffett reiterated Telxon's holding. In Krasner, the supreme court again rejected a defense premised on the ability of a committee of independent directors to cleanse a conflict of interest transaction. In Krasner, two related corporations, Freeport McMoRan Sulphur, Inc. (FSC) and McMoRan Oil and

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228 Disney I, 731 A.2d at 380.
229 802 A.2d. 257 (Del. 2002).
230 Id. at 259-62.
231 Id. at 261.
232 Id. at 266. The plaintiffs also alleged that the directors breached their duties by awarding themselves excessive compensation. Id.
233 Telxon, 802 A.2d at 262.
234 Id. at 266.
Gas Co. (MOXY), entered into merger negotiations.\textsuperscript{242} Because the two corporations had a number of common board members, each formed a special committee of independent directors to negotiate the merger.\textsuperscript{243} Under the terms of the resulting merger agreement, MOXY shareholders received a greater percentage interest in the merged entity than the FSC shareholders.\textsuperscript{244} FSC shareholders challenged the merger claiming that its directors had violated their fiduciary duties by approving a transaction that was unfair to FSC.\textsuperscript{245} The court of chancery granted defendants’ motion to dismiss based on the special committee’s role in negotiating the transaction and recommending it to the full FSC board.\textsuperscript{246} The court reasoned that because none of the plaintiffs’ allegations impugned the integrity of the special committee, the FSC board’s decision would be evaluated under the business judgment standard of review.\textsuperscript{247}

The Delaware Supreme Court reversed,\textsuperscript{248} rejecting the defendants’ arguments that the special committee process cleansed the conflicts of interests.\textsuperscript{249} It ruled that the directors had the burden of proving that the committee was independent and had real bargaining power, a burden they could not satisfy at the motion to dismiss stage.\textsuperscript{246} As in Telxon, the supreme court stated that “independence of the special committee involves a fact-intensive inquiry that varies from case to case. Thus, we cannot assume at the pleading stage that the defendants will carry the burden of establishing independence.”\textsuperscript{250}

Two new rules seem to have emerged from Telxon and Krasner. First, approval by facially independent directors no longer suffices to shield conflict of interest transactions from judicial scrutiny.\textsuperscript{251} Actual independence measured in deeds, rather than financial interest, appears to be the new standard.\textsuperscript{252} Second, the question of independence seems to have shifted from primarily a

\textsuperscript{242}Id. at 279-80.
\textsuperscript{243}Id. at 280.
\textsuperscript{244}Id.
\textsuperscript{245}Id. at 281.
\textsuperscript{246}Krasner, 826 A.2d at 281-82.
\textsuperscript{247}Id.
\textsuperscript{248}Id. at 289.
\textsuperscript{249}Id. at 284.
\textsuperscript{250}Id. at 284-85.
\textsuperscript{251}Krasner, 826 A.2d at 286; see also Telxon, 802 A.2d at 265.
\textsuperscript{252}See Krasner, 826 A.2d at 284-87; Telxon, 802 A.2d at 264-65.
\textsuperscript{253}Telxon, 802 A.2d at 264 (“Directors must not only be independent but must act independently.”).
Stanford professors and alumni. The defendants included Michael Boskin, a Stanford economics professor, and William Lucas, a Stanford alumnus who had contributed almost $16 million to Stanford. In addition, defendant CEO, Larry Ellison, had contributed more than $10 million to Stanford, and had negotiated with the school about a potential $170 million contribution to establish an “Ellison Scholars” program at Stanford.

Vice Chancellor Strine ruled that such extensive social and professional connections precluded any presumption that the SLC would evaluate the plaintiffs’ claims solely on their merits, untainted by collegial sympathy or institutional loyalty. He therefore concluded “this was a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it.” Summarized fairly, two Stanford professors were recruited to the Oracle board . . . and soon asked to investigate a fellow professor and two benefactors of the University.

While acknowledging that “there is admittedly case law that gives little weight to ties of friendship in the independence inquiry,” Strine rejected a formalistic approach to questions of independence asserting that, “Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. Homo sapiens is not merely homo economicus. We may be thankful that an array of other motivations exist that influence human behavior . . .”

4. Question of Independence

A common thread weaves through Delaware’s recent opinions. The courts express a new reluctance to credit defendants’ arguments which are premised on the assertion that the directors

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charged with making the challenged decision were independent. In Telxon and Krasner, the court undermined the cleansing power of independent committee approval of conflict transactions by weakening the independence presumption, at least for purposes of preliminary motions.

In Oracle, the court flatly rejected the directors’ assertions of independence that might have been accepted in earlier times. Vice Chancellor Strine squarely acknowledged that his ruling departed from precedent stating:

I readily concede that the result I reach is in tension with the specific outcome of certain other decisions. But I do not believe that the result I reach applies a new definition of independence; rather, it recognizes the importance (i.e., the materiality) of other bias creating factors other than fear that acting a certain way will invite economic retribution by the interested directors.

In Disney II, a case in which the courts had finally adjudicated the question of the directors’ independence in the defendants’ favor, Chancellor Chandler nonetheless based much of his ruling on an underlying presumption that (a) Eisner had an interest in Ovitz’s employment arrangements and (b) Eisner dominated the board of directors. Absent Eisner’s domination and control, why would the board, as alleged by the plaintiffs, abdicate all responsibility for monitoring and approving Ovitz’s employment and termination arrangements? Furthermore, in finding that Ovitz may have breached his duty of loyalty by negotiating directly with Eisner, rather than the independent compensation committee, the Chancellor again impugned Eisner’s independence.

5. Summary

Admittedly, the small number of cases discussed above forms a small sample for making ultimate conclusions about the proper role of federal and state governments in shaping corporate law rules. Nonetheless, a fundamental shift in Delaware corporate jurisprudence does seem to have occurred. Two Delaware judges (including the chief justice) have publicly stated their belief in the necessity of legal reforms in light of the scandals and the
federal preemptive threat. In addition, corporate practitioners have taken notice of the courts' trend toward higher scrutiny of board decision-making. These lawyers' advice to their clients in light of these decisions further supports the inference that a shift in jurisprudence has occurred. As Professor Rock has argued "[i]n a world of vaguely defined norms and rapidly evolving transactional forms what the business lawyer tells the client... is the law." 274

E. Looking Forward

The foregoing analysis demonstrates the evolution of a trend toward stricter judicial decision-making in Delaware. The emergence of this trend correlates in time with significant corporate reforms at the federal level. In addition, public statements from influential Delaware judges support the argument that these recent developments form part of an effort to forestall further preemption. Other observers have reached similar conclusions on the likely explanation for the perceived shift in jurisprudence. 275 Despite the strong circumstantial evidence presented here, it is impossible to definitively establish the precise reasons for this widely-perceived shift. In fact, at least one Delaware judge rejects the proposition that the factors identified in this Article actually

274 See Roundtable, supra note 2; Strine, supra note 117.
275 See J. Travis Laster & Michael K. Reilly, A Warning Shot for Directors? Delaware Supreme Court Reverses Four Court of Chancery Decisions, Insights, Feb. 2003, at 2 (stating that "the issuance of four decisions adverse to directors within a short time period is noteworthy").
276 See, e.g., Memorandum from Weil, Gotshal & Manges, to "Our Clients and Friends" on Director Liability Warnings from Delaware (Jan. 10, 2003) (on file with author); Memorandum from Meredith M. Brown & William D. Regner, Debevoise & Plimpton, to "Our Clients and Friends," on What's Happening to the Business Judgment Rule? (June 19, 2003) (on file with author) (discussing Disney II, Oracle and In re Abbott Laboratories, 325 F.3d 796 (7th Cir. 2002), and concluding, "in our view, recent Delaware cases indicate an increased risk of director liability"); Memorandum from Martin K. Lipton & Paul K. Rowe, Wachtell, Lipton, Rosen & Katz, The Business Judgment Rule is Alive and Well (June 18, 2003) (on file with author) (discussing Disney and Abbott Laboratories and observing that "these two decisions are examples of the heightened scrutiny that all board conduct is subject to in the post-Enron climate").
277 Rock, supra note 74, at 196.
278 See, e.g., Marc Gunther, Boards Beware, Fortune, Nov. 10, 2003 ("It would not be unreasonable to assume that the Delaware courts are responding to the Enron and WorldCom headlines and the intrusion, so to speak, of the federal government into the internal governance of corporations." (quoting former Delaware Chancellor William T. Allen)); Triumph of the Pygmy State, Economist, Oct. 25, 2003 at 55, 56. ("Reacting to the latest anti-business sentiment in Washington, D.C., Delaware's judges appear ready to adopt a more hawkish line on the duty of directors to represent shareholders' interests.").

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influence judges in their decision-making. Having laid out the case that the preemptive threat plays a significant role in Delaware's current jurisprudence, I must leave it to readers to accept or reject this argument. For those who are receptive to the analysis set forth here, a few prescriptive observations are in order.

There is reason to suspect that if the federal threat recedes, Delaware will revert to its more lax jurisprudence. The history of Delaware law is replete with examples of the imposition of strict judicial standards, followed by prolonged periods of deference. The same indeterminacy that permits judges to impose more restrictive standards of director conduct can be used to relax such standards when the political climate changes. 279 Though perhaps inescapable, this possibility only bolsters arguments for sustained federal engagement in corporate governance issues to prevent such retraction. Congress must continue to monitor corporate conduct, remaining apprised of developments in state corporate codes and jurisprudence. In addition, Congress must be willing to preempt objectionable state law rules.

Congress can maintain a credible preemptive threat by demonstrating a sustained interest in corporate governance issues. The SEC, through its enforcement and rule-making functions, should remain at the forefront of this vigilance. Congress can demonstrate its continued engagement by holding hearings on governance issues, investigating corporate misconduct, and actively overseeing the SEC's enforcement of federal securities laws, including the Sarbanes-Oxley Act.

VII Conclusion

The response in Congress and in Delaware to the recent corporate scandals demonstrates that the model of vertical regulatory competition framed in the Federalist Papers endures. This political dynamic also reveals flaws in modern federalist arguments denouncing national-level regulation. Unreflective al-

278 In comments to the author, Chancellor Chandler states:
Judges (whether or not you believe this) decide cases based on the particularized facts before them, not on whether it will affect the competitive position of the state vis-a-vis other competitors for corporate charters... And in a larger sense, I also think academics sometimes miss the point that judges are not legislators, and they are not given a commission to change the laws based on the headlines of the day.

E-mail from William B. Chandler III, Chancellor, Delaware Court of Chancery, to author (Nov. 6, 2003) (on file with author).
279 Van Gorkom, 488 A.2d at 858, and Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), are examples of Delaware decisions that imposed strict standards of liability that were later reversed or disregarded by courts.
280 Rock, supra note 74, at 1105.
legiance to the internal affairs doctrine and the economic theories invoked in its defense should no longer serve to dissuade Congress from preempting objectionable provisions of state corporate law. Instead, the threat of federal preemption remains a necessary predicate to the ability of the national citizenry to pressure the state of Delaware to shape its corporate law to reflect national rather than parochial interests.

American Corporate Governance and Children: Investing in Our Future Human Capital During Turbulent Times

Marleen O'Connor-Felman

Impact of Recent Regulatory and Legal Developments on US Listings by Non-US Companies

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With the passage of the US Sarbanes-Oxley Act and the heightened scrutiny of listed companies by US regulatory authorities, the number of non-US companies willing to undertake or maintain a US listing and to deal with the consequent regulatory and legal requirements and risks seems to have decreased. This trend looks likely to continue at least into next year, as US-listed foreign companies become subject to even more requirements under the Sarbanes-Oxley Act and the risk of US private class action litigation continues to rise. In addition, in response to mounting calls from legal commentators and industry groups, the US Securities and Exchange Commission (SEC) is considering making it more feasible for non-US companies to deregister a class of securities under the US Securities Exchange Act of 1934 (the ‘Exchange Act’).

This article examines the impact of the Sarbanes-Oxley Act and other regulatory and legal developments (some of which may be more significant than the Sarbanes-Oxley Act) on US listings by foreign companies and what other factors may now or in the future be relevant for foreign companies evaluating US listings.

Sarbanes-Oxley and section 10A investigations

The Sarbanes-Oxley Act was enacted on 30 July 2002 and was followed by a series of new SEC rules. Historically, non-US issuers have been exempt from certain of the requirements of the US federal securities law (primarily relating to reporting, US GAAP, proxy statements and the ‘section 16’ insider trading rules), so long as such issuers

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1 Cravath Swaine & Moore LLP represented the issuers or underwriters in certain of the offerings referred to herein (Prudential plc, Terna Sp A, Tata Consultancy Services Limited and National Thermal Power Corporation Limited), and has been advising the Royal Dutch/Shell Group of Companies in connection with its restatements and reorganisation and Vivendi Universal, SA in connection with its securities litigation referred to herein. The authors would like to thank Mark R Hageman of Cravath Swaine & Moore LLP for his input.
complied with their home country requirements. However, while the fundamental differences in the treatment of non-US issuers remain unchanged, most of the new disclosure-related and governance-related requirements imposed by the Sarbanes-Oxley Act apply equally to both US and non-US issuers.

Briefly, the new principal requirements are:

(a) certifications by the CEO and CFO in each registration statement and annual report on Form 20-F filed with the SEC (with the risk of civil and criminal liability attaching to such certifications);
(b) reports by the issuer and its outside auditors on its internal controls over financial reporting (the so-called ‘section 404 reports’);
(c) the introduction and maintenance of adequate disclosure controls and procedures;
(d) an audit committee entirely made up of independent directors (with independence determined according to SEC standards), disclosure regarding an ‘audit committee financial expert’ and specific audit committee duties and responsibilities;
(e) new auditor independence standards, including a prohibition on the provision of specified non-audit services by outside auditors and pre-approval by the audit committee of all audit and permitted non-audit services;
(f) limitations on the use of non-GAAP financial measures and enhanced disclosure requirements for the ‘Management’s Discussion and Analysis’ section (MD&A);
(g) a prohibition on personal loans (broadly defined) by the issuer to its executive officers and directors;
(h) enhanced penalties, whistleblower protections and up-the-ladder attorney reporting of violations;
(i) disclosure regarding a code of ethics and regular SEC review of the issuer’s SEC filings; and
(j) regulation of the outside auditors by the Public Company Accounting Oversight Board (PCAOB), requiring, among other things, non-US auditors to provide their ‘work papers’ to the SEC upon request.

The Sarbanes-Oxley Act also introduced amendments to Section 10A under the Exchange Act. Section 10A, as an increasing number of issuers are learning, now requires, among other things, an issuer’s outside auditors to determine and consider the possible effects of ‘illegal acts’ on the issuer’s financial statements and to determine that the audit committee has been ‘adequately informed’ of such illegal acts and that ‘timely and appropriate remedial actions’ have been implemented.

In practice, Section 10A means that when an irregularity is discovered, an investigation by independent US counsel on behalf of the audit committee may need to be undertaken. In addition, outside auditors and the SEC are increasingly scrutinising whether

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2 The MD&A section is referred to as ‘Operating and Financial Review and Prospects’ in the Annual Report on Form 20-F required to be filed by foreign private issuers with the SEC.
restatements of financial statements are required and whether issuers have appropriately disclosed and dealt with illegal acts and other problems. The vigor of the SEC’s current criminal and civil enforcement programme has generated substantial media coverage and much controversy, and does not show any signs of abating. Several non-US companies, including Adecco SA, Royal Ahold NV, Nokia Corporation, Nortel Networks Corporation and the Royal Dutch/Shell Group of Companies, have recently undergone high-profile investigations. The consequences of investigations, restatements and enforcement actions can obviously be severe for a company and its board of directors, management and share price and typically also result in US private class action litigation.

Other regulatory and legal developments

Recent US cases suggest that foreign issuers whose shares are principally traded outside the United States but who are concurrently registered and listed in the United States may be forced to defend securities class actions in US courts brought not only on behalf of the US purchasers of their US-listed securities, but also on behalf of foreign shareholders who purchased shares outside the United States (indeed, in the foreign issuer’s home country) in transactions having no connection to the United States. The possibility that class action suits may include such foreign purchasers could vastly increase the risk posed by such suits, because the class, if certified, would include the much greater number of shares traded outside the United States.

The listing requirements of the New York Stock Exchange (NYSE) and NASDAQ in general continue to defer to a non-US issuer’s home country requirements and practice, instead of imposing the same requirements that otherwise apply to US domestic issuers. However, other advantages that non-US issuers used to enjoy with the SEC have been

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3 In the first nine months of 2004, at least nine non-US companies were the subject of investigation by the SEC or the US Department of Justice, closely followed by private class action litigation. At least eight other non-US issuers have been subject to US class action claims where no accompanying investigation has yet been announced.

4 In In re Vivendi Universal, SA Securities Litigation, 2003 WL 22489764 (S.D.N.Y. 3 November 3 2003), a federal court in New York refused to dismiss securities fraud class action claims brought on behalf of non-US purchasers of shares of Vivendi, even though their purchases had no nexus to the United States. Vivendi argued unsuccessfully that the US court did not have subject matter jurisdiction to adjudicate such claims. The court held that the activities in the US of Vivendi’s top executives, who ‘move[d] to the United States, allegedly to better direct corporate operations and more effectively promote misleading perceptions on Wall Street,’ were sufficient for the court to assert subject matter jurisdiction over the claims that US federal securities laws were violated. After the case was reassigned to another federal judge, Vivendi sought reconsideration of this decision. The new judge declined to change the ruling. 2004 WL 2375830 (S.D.N.Y. 22 October 2004).

5 In the United States, issuers are subject to separate regulation by both the SEC and the listing authorities.
ered over the last few years. Registration statements for non-US issuers are no longer reviewed confidentially by the SEC (except for first-time filers, such as in the case of an IPO). SEC comment and response letters are also now being made publicly available (subject to limited exceptions), whereas before they remained confidential except in the infrequent event of successful requests by third parties (eg journalists) under the US Freedom of Information Act (FOIA). In addition, non-US issuers now must make all their filings via the SEC’s EDGAR (Electronic Data Gathering, Analysis and Retrieval system) electronic document system.

Finally, other US legislative and regulatory developments are in many cases disproportionately affecting non-US companies. For example, the US Patriot Act of 2001 has resulted in a major expansion of US anti-money laundering laws, which are broadly defined, impose new compliance obligations on US and non-US financial institutions and can lead to criminal liability. The US Office of Foreign Assets Control (OFAC) has increased its scrutiny of dealings by issuers with ‘blacklisted’ countries (currently Cuba, Iran, Myanmar (Burma) and Sudan)6. Although non-US entities are not required to comply with the US economic sanctions administered by OFAC, US persons such as underwriters may be at risk of illegally ‘facilitating’ transactions with OFAC-sanctioned entities, to the extent that they engage in capital markets transactions with non-US entities that do business with OFAC-sanctioned entities. The SEC also appears to have stepped up its enforcement of the US Foreign Corrupt Practices Act (FCPA), an anti-bribery law that has historically received little attention from many companies, but that applies to all SEC registrants.

New listings

Historically, non-US companies have sought listings on the NYSE or NASDAQ for a variety of reasons, including for enhanced research analyst coverage, increased visibility and public awareness, a more attractive US acquisition currency, share-based compensation plans for US employees, an enhanced company image, and, depending on the company’s trading profile and home market, improved access to capital markets and trading efficiency. For some foreign issuers (usually from emerging markets), a US listing becomes their ‘primary’ listing, whereas for other issuers (such as those from Europe), a US listing is intended to be and has typically remained a ‘secondary’ listing. Since 2002, various companies such as Benfield Group Limited (UK), Porsche AG (Germany), Daiwa Securities Group Inc (Japan) and Fuji Photo Film Co, Ltd (Japan) have publicly abandoned plans to list on the NYSE or NASDAQ.

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6 There are also OFAC-administered sanctions against dealings with North Korea and Syria, although these sanctions do not normally bar financial or securities transactions involving the US capital markets.
In many cases, the impact of the Sarbanes-Oxley Act has been a factor in the decision not to list. In contrast to past years, of the 107 companies that listed on the NYSE in 2003, only 16 were non-US companies. In 2003, only one non-US company listed on NASDAQ. So far in 2004, 11 non-US companies have listed on the NYSE and four non-US companies have listed on NASDAQ. Most recently, Air China ruled out a NYSE listing ostensibly for technical accounting reasons, although some press reports suggest that the Sarbanes-Oxley Act may have been a factor.

Another indicator of the reticence of non-US companies to list in the United States is the increasing reliance on Rule 144A under the US Securities Act of 1933 (the ‘Securities Act’), which provides an exemption from the registration requirements of the Securities Act for certain private resales of securities to qualified institutional buyers. In 2003, non-US companies issued almost half of the US$4.5 billion of equity securities placed pursuant to Rule 144A10. In Europe’s second-largest IPO of 2004 to date, Terna Sp A, Italy’s largest electricity transmission company, listed on the Borsa Italiana and relied on Rule 144A for sales into the United States.

Likewise, many Chinese and Indian companies have recently opted to list only on domestic stock exchanges and rely on Rule 144A for sales into the United States. Nine of the ten largest IPOs in China from 1 January 2003 to 20 October 2004 included Rule 144A placements but no US listing. This trend seems to be even more significant in light of the difficulties experienced by China Netcom Group Corporation (which has warned that it may not be able to comply with Section 404 of the Sarbanes-Oxley Act) and China Life Insurance Company Limited (which is now the subject of private class action litigation in the United States), both of which have pursued high-profile US listings. The nine equity offerings with US tranches completed in India to date in 2004 have utilised Rule 144A or another exemption from registration, instead of a US listing. In fact, only two Indian companies (Tata Motors Limited and Sify Limited) have listed in the United States since 2002, in spite of the recent substantial gains in the Indian economy and equity capital markets.

Delistings and deregistrations

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7 For example, 33 and 51 non-US companies (excluding those that moved their listing to the NYSE from NASDAQ) listed on the NYSE in 2002 and 2001, respectively.

8 The foregoing excludes non-US companies who moved their listing to the NYSE from NASDAQ.

9 Rule 144A is not available for securities that are fungible with securities listed in the United States. For securities that already have a US listing, section 4(2) under the Securities Act affords a similar, but somewhat more restrictive, private placement exemption to Rule 144A. For example, Prudential plc, in its recent £1 billion rights offering, utilised section 4(2) to privately place rights to certain qualified institutional buyers in the United States.

10 Source: Thomson Financial.
The impact of US regulatory and legal developments may also be evidenced by the increased interest of foreign companies in delisting and deregistering in the United States. By delisting a class of securities from the NYSE or NASDAQ and subsequently deregistering the class under the Exchange Act, an issuer can free itself of the Sarbanes-Oxley Act and the other reporting and governance requirements applicable under US federal securities law.11

Various European companies listed in the United States have explicitly cited the impact of the Sarbanes-Oxley Act on their decisions to terminate their US listings and, in some cases, to deregister under the Exchange Act. To date in 2004, at least ten foreign issuers have reportedly voluntarily delisted from NASDAQ, including lastminute.com PLC (UK), which has delisted from NASDAQ and announced its intention to deregister; Intershop Communications AG (Germany), which has delisted from NASDAQ and deregistered; and TeliaSonera AB (Sweden), which has delisted from NASDAQ. At least four foreign issuers have voluntarily delisted from the NYSE to date in 2004 (Boardwalk Equities Inc (Canada), Tenon Limited (New Zealand), Internacionál de Cerámica, SA de CV (Mexico) and Telefónica del Perú SAA (Peru)).

Importantly, although delisting from the NYSE or NASDAQ is not particularly difficult12, deregistering under the Exchange Act is not possible for most companies. An issuer is only eligible to terminate registration of its securities once its securities are held of record by fewer than 300 persons resident in the United States or fewer than 300 persons worldwide13 (or, for issuers with assets worth below US$10 million, fewer than 500 persons worldwide)14. Holders of both ADRs and ordinary shares are counted towards the foregoing thresholds. Even for an issuer with ADRs that are thinly traded, it can rarely be established with sufficient comfort and headroom that the issuer has, and will continue to have, less than the requisite number of securityholders.

Since the more burdensome US regulatory requirements apply to all SEC registrants, whether or not listed on the NYSE or NASDAQ, delisting without deregistering does not accomplish much (other than reducing US liquidity and thereby increasing the likelihood that eventually fewer than 300 US residents will own the issuer’s shares), and leaves the

11 Note that issuers remain subject to the registration requirements under the Securities Act for any subsequent offer and sale of securities.

12 Terminating or unwinding an ADR programme may involve significant out-of-pocket costs for an issuer, depending on the terms of the issuer’s ADR deposit agreement.

13 The ‘look-through’ requirements for the 300 worldwide holders alternative are different from those for the 300 US resident holders test.

14 Moreover, if after deregistering, the securities are held by more than 300 US residents on the last day of a subsequent fiscal year, the issuer must re-register the class of securities under the Exchange Act. (If the issuer had never registered the class of securities in the first place, the issuer could have utilised Rule 12g3-2(b) under the Exchange Act to avoid registration.)
issuer with basically all the burdens of SEC registration without the primary benefits of a US listing. Needless to say, the difficulty in deregistering has come as an unpleasant surprise to many (most?) non-US issuers. By way of contrast, in many European countries, a company can terminate a secondary listing by providing notice to the relevant regulatory authorities and observing a waiting period or complying with certain limited undertakings.

In light of the difficulties that issuers face in deregistering, proposals have been submitted to the SEC advocating modernisation of the deregistration requirements, including allowing an issuer to terminate its SEC registration two years after a US public offering or listing if US trading does not represent at least five per cent of its worldwide trading volume (subject to the issuer continuing to furnish home country reports that meet certain disclosure and financial reporting standards). Another proposal would allow deregistration if the percentage of US resident holders relative to the issuer’s total number of securityholders is below a certain threshold (such as ten per cent). Alternatively, the current deregistration threshold of 300 US resident securityholders may be increased.\(^{15}\) The SEC is currently considering such proposals and at least some changes to the deregistration requirements are expected, although the extent and timing of such changes are uncertain. Ultimately, perhaps some sort of mutual recognition regime between the United States and other jurisdictions will be feasible and indeed necessary.

Analysis

Given the foregoing data, it seems clear that the Sarbanes-Oxley Act and other US regulatory and legal developments have had at least some impact on the willingness of foreign companies to seek or maintain US listings. However, it should be noted that there are other factors at work as well. Perhaps most important has been the declining or at least stagnant equity markets, especially for IPOs, and the fact that many companies have been internally focused, dealing with restructurings and reorganisations and ensuring that their own ‘house’ is in order first. Relatedly, the level of cross-border acquisitions of US companies has been fairly low over the last few years, meaning that fewer non-US companies have needed to seek US listings to create acquisition currency. The value of a US acquisition currency has also come under greater scrutiny, given the recent negative experience of some non-US acquirers with shares ‘flowing back’ from the US market to their home market and the overhang effect on their share price that the risk of such flowback creates. In addition, share-based compensation plans for US employees are less attractive than before, given new accounting rules in some jurisdictions that require

\(^{15}\) The proposals would also modify the rules so that a company would not become permanently unable to use Rule 12g3-2(b) under the Exchange Act as a result of the original registration. See note 14 above.
issuers to recognise (or at least disclose) stock options as an upfront compensation expense.

US investors can more easily than ever directly buy shares of foreign companies, as markets become more global, technologically advanced and liquid, information is more readily available and investors are more at ease dealing with local legal restrictions and currency risk. For example, India has relaxed many of its foreign ownership rules. Limited liquidity in most ADR programmes, especially since the enactment of Rule 144A in 1990, further compounds the unattractiveness of US listings. Many non-US exchanges are also more liquid than ever before, and Rule 144A (and Section 4(2)) under the Securities Act are viable alternatives for accessing at least the institutional portion of the US capital markets. Furthermore, it seems that most of the significant US investment banks, mutual funds and other financial institutions now have sellside and buyside analysts located in the significant European and Asian markets, helping to reduce or eliminate the need for a non-US company to list on the NYSE or NASDAQ to ensure adequate US analyst coverage. But, given the now more restrictive regulatory environment for research analysts and their potentially diminished role, some financial institutions are reportedly beginning to cut back on the number and location of their analysts.

Non-US stock exchanges, such as the London Stock Exchange and Singapore Stock Exchange, appear to have stepped up their efforts of late to compete more directly with the NYSE and NASDAQ. To varying degrees, the non-US exchanges may either advocate their own governance and disclosure standards, or even highlight more relaxed standards, to attract issuers. In addition, the prestige and favourable publicity that some non-US companies have coveted with a US listing is presumably diminished in the post-Enron era. However, issuers in industries such as media and technology may benefit

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17 Tata Consultancy Services Limited, India’s largest information technology services company, launched a US$1.1 billion IPO in August 2004 and received a then-record US$5.6 billion worth of applications from retail buyers, a total of US$10 billion of orders overall, and placed 38 per cent of the offering with international funds, including pursuant to Rule 144A. The US$1.2 billion IPO in November 2004 by National Thermal Power Corporation Limited, India’s largest power generating company, fared similarly, with total orders of US$16 billion and an international allocation of 38 per cent, including pursuant to Rule 144A.

Between 1983 and 2003, average daily trading volume on the principal market of the Paris Stock Exchange increased from the equivalent of €206 million to over €3.4 billion, and on the London Stock Exchange increased from £208 million to over £14 billion.

18 The foregoing factors have been cited as reasons for not seeking a US listing by, among others, adidas-Salomon AG (Germany), BMW AG (Germany), Greencore Group plc (Ireland), Rexam PLC (UK), Roche Holding Ltd (Switzerland) and Samsung Electronics Co, Ltd (South Korea).
more than others from a valuation on the NYSE or NASDAQ benchmarked against US competitors.

Last but certainly not least, companies are increasingly aware of and focused on the risk of US liability and regulatory scrutiny, whether as a result of SEC enforcement proceedings, private class action litigation (both inside and outside the United States) or other proceedings. Historically, class action litigation was directed almost entirely at US companies, but more non-US companies are now the subject of class action litigation in the United States (including potentially for claims by non-US purchasers19) and even increasingly outside the United States. The Sarbanes-Oxley Act has also focused the attention of senior management and board members on the burdens of a US listing and on the question of whether the benefits outweigh the cost and risk of the listing. Even the ‘ordinary’ costs of a US listing can be significant with not only accountants’, lawyers’ and filing fees, but also costs to establish an ADR or ‘global share’ programme.

Conclusions

Of course, as indicated above, at least some foreign companies still consider US listings attractive, especially those that view their US listing more as a ‘primary’, as opposed to a ‘secondary’, listing. There are several other factors, which in the short term may also impact the attitude of non-US companies towards US listings. The pending move to IFRS may make European companies less willing to tackle the US GAAP reconciliation that a US listing would require. On the other hand, convergence between US GAAP and IFRS may make a US listing less daunting20. The European Union’s Prospectus Directive also now requires companies to prepare disclosure documents in accordance with the recommendations of the International Organization of Securities Commissions (IOSCO). The Prospectus Directive and other EU regulations seem likely to result in a larger and deeper pan-European market with more uniform standards, further dampening any enthusiasm for an additional listing in the United States.

Pursuant to Section 404 of the Sarbanes-Oxley Act, non-US companies will be required, beginning with fiscal years ending on and after 15 July 2005, to report specifically on their internal controls over financial reporting. The outside auditors must also ‘attest’ to such reports. The cost and workload required for section 404 reports is substantial in most cases. A recent report estimates that large US companies (defined as having annual revenues in excess of US$5 billion) will spend on average US$8 million for the first year of section 404 reports. Total estimated ‘year one’ costs for all surveyed US companies

19 See note 4 above.

20 Harmonisation between US GAAP and IFRS remains a significant challenge, including, for example, in the accounting for leases, insurance and pensions. According to a report in the Financial Times on 9 November 2004, the current target for convergence is 2007-2008, although there will be ‘blood all over the streets’ before convergence finally occurs.
(with average annual revenues of US$2.5 billion) is on average US$3 million. The foregoing excludes indirect costs such as slower decision-making and lower productivity, although some of the section 404 direct costs would have presumably been incurred by issuers anyway (such as for IT systems). Although most non-US companies have already begun undertaking the work necessary to comply with section 404, the cost and workload for section 404 means that such companies are examining the value of their US listings even more closely.

The attitude and approach of the SEC and other US regulators and legal authorities to non-US companies will also be closely watched in boardrooms and among advisers to gauge the level of difficulty and risk that US listings entail. Ironically, by making it more feasible for foreign companies to deregister under the Exchange Act, the SEC could actually help attract more US listings, since foreign issuers would not have to view a US listing and registration as practically permanent and also might more generally be encouraged that the SEC will accommodate the particular needs of non-US companies.

The SEC should want to accommodate non-US issuers, since the alternative is to watch such issuers increasingly utilise Rule 144A (or section 4(2)) under the Securities Act and remain free of the Sarbanes-Oxley Act and direct SEC oversight. Other pending reform of certain provisions of the US federal securities law may make it easier for issuers, especially ‘well-known seasoned issuers’ to access the US capital markets without some of the more unnecessary and outmoded restrictions currently imposed in an SEC-registered offering. In addition, for better or worse, the Sarbanes-Oxley Act seems to have become something of a ‘model’ for governance and disclosure reform in certain other jurisdictions. As such governance and disclosure standards converge, a US listing

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21 See Financial Executives International (FEI), July 2004: ‘Special Survey on Sarbanes-Oxley Section 404 Implementation Executive Summary’ (www.fei.org). The FEI survey found that estimated section 404 ‘year one’ compliance costs had increased 62% since its initial survey in January 2004. For large companies, the estimated costs had nearly doubled (from US$4.6 million in January 2004).

22 According to the SEC’s proposal, a ‘well-known seasoned issuer’ generally has a market capitalisation of at least US$700 million (or, in limited circumstances, has issued US$1 billion in SEC-registered debt in the last three years), has been public for at least one year, is current with all its SEC filings, has not defaulted in the current fiscal year on any of its preferred stock or debt instruments and is not otherwise an ‘ineligible issuer’ as defined by the SEC. An ineligible issuer includes any issuer that within the past three years has entered into a settlement or consent decree with the US federal government to resolve allegations of violation of the US federal securities laws (the language of the proposed exclusion would generally track the existing exclusion from the forward-looking statement safe harbour provisions).

23 See www.sec.gov/rules/proposed/33-8501.pdf. The proposed reforms were announced by the SEC on 26 October 2004, and are pending public comment and final adoption. The proposals involve, among other things, significant changes to registration procedures, communication requirements and prospectus delivery mechanics under the Securities Act. In particular, the proposals would (i) liberalise the rules relating to pre-offering communications (often called ‘gun jumping’) and (ii) create revised offering procedures, including automatic registration without the delay of possible SEC review, for certain ‘shelf’ registrations for offerings by ‘well-known seasoned issuers’.
may not be perceived to be as burdensome as it is currently. It is likely that there will remain, however, the increased risk of liability and regulatory scrutiny in the United States. New high-profile investigations and legal proceedings against either US or non-US listed companies could further negatively influence attitudes towards US listings.

Given the various factors at work and the seeming trend away from US listings by foreign issuers, it will be most revealing to see how such issuers respond when there is a more sustained uptick in US inbound M&A activity and in equity capital markets. Will it indeed be true that a rising tide lifts all boats . . . ?
SEC SETTLES ENFORCEMENT ACTION AGAINST PARMALAT

Settlement Continues SEC Trend of Imposing Corporate Governance Reform through Enforcement Actions

The Securities and Exchange Commission announced last week that it reached a settlement with Parmalat Finanziaria, S.p.A. ("Parmalat"). The settlement brings to a close an enforcement action in which the SEC alleged that Parmalat perpetrated a massive accounting fraud on institutional U.S. investors who bought over $1 billion in Parmalat bonds between 1997 and 2003. *Sec v. Parmalat Finanziaria, S.p.A.*, Lit. Rel. No. 18803, 2004 SECLEXIS 1631 (July 28, 2004). The settlement, filed in the United States District Court for the Southern District of New York, is significant because Parmalat agreed to a variety of corporate governance reforms. As such, the Parmalat case marks the continuation of a trend in which corporate governance undertakings are becoming a common remedy in major SEC enforcement actions.

The SEC's Allegations

In its First Amended Complaint, the SEC alleges that, from 1997 through 2003, Parmalat "engaged in one of the largest financial frauds in history" though the efforts of its founder, chairman, and CEO Calisto Tanzi, and its CFO, Fausto Tonna. The complaint alleges three facets of the fraud: First, the company concealed losses and overstated assets through related entities including nominee companies. It used nominee companies, for example, to conceal uncollectible and impaired receivables; extend loans to Parmalat subsidiaries, which those subsidiaries used to hide expenses; and serve as counterparties to transactions from which Parmalat subsidiaries recorded inflated or fictitious revenue. Second, Parmalat allegedly understated debt by approximately $9.16 billion, or 123.4 percent. According to the SEC's complaint, for example, Parmalat eliminated about $3.8 billion in debt through a fictitious transaction in which a nominee entity purportedly acquired that debt, and falsely portrayed another $1.16 billion in debt as equity. Third, the SEC alleges that Parmalat unlawfully diverted about $400 million to members of the Tanzi family. The company allegedly concealed these payments by recording them as receivables to unrelated third parties.

The SEC's complaint alleges that, as a consequence of this scheme, Parmalat's financial statements were materially false and misleading. By means of these financial
statements – the complaint further alleges – Parmalat offered several classes of bonds to US institutional investors between 1997 and 2003. These offerings were exempt from SEC registration and the company’s financial statements accompanied private placement memoranda. Parmalat also allegedly misled investors during 2002 road shows during which its CFO, Tonna, met with potential investors, and the company provided investors with a 40 page booklet containing materially false data from the company’s financials.

**Parmalat’s Corporate Governance Undertakings**

Without admitting or denying the allegations, Parmalat settled to a Judgment of Permanent Injunction enjoining the company from violating antifraud provisions of the federal securities laws – Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. The judgment, approved by the court on July 29, incorporates by reference Parmalat’s accompanying Consent and Undertakings (the “Consent”), pursuant to which Parmalat agreed to a variety of corporate governance reforms. The Consent explains that the reforms will go into effect upon the company’s reorganization in bankruptcy proceedings pending in Italy and in the United States. According to the Consent, the corporate reforms “are designed to ensure transparency and correctness in the company’s conduct of business and to protect the shareholders’ interests by providing for their substantial involvement in the company’s governance.” The corporate governance reforms include:

- **Selection and Composition of Board of Directors.** Pursuant to the Consent, Parmalat must adopt by-laws providing for governance by a shareholder-elected board, the majority of which must consist of independent directors. Each director may not serve longer than a specified term. According to the Consent, “[t]he by-laws will mandate that the positions of chairman of the board of directors and chief executive officer . . . be held by two separate individuals.”

- **Board Responsibilities.** The by-laws must specifically delineate the duties of the board, which will include reviewing and approving strategic company plans, reviewing and approving material transactions, assessing whether directors meet independence requirements, and appointing chief executive officers.

- **Code of Conduct.** The Consent provides that board must adopt a Code of Conduct governing its duties and activities. Among other things, the Code of Conduct will set forth the board’s responsibility for company reporting and disclosure. Concerning that responsibility, the board will be required to meet at least quarterly and receive quarterly reports on operations and material transactions.

- **Internal Control and Governance Committee.** The company will establish an Internal Control and Governance Committee – consisting of independent directors – to have oversight for the company’s internal controls systems.

- **Code of Insider Dealing and a Code of Ethics.** The company will adopt a Code of Insider Dealing limiting insider trades to particular time periods “following disclosure of operating and financial data” and setting forth disclosure requirements for insider transactions. The company also will adopt a Code of Ethics establishing standards of behavior for Parmalat officers and employees. The company will also adopt a scheme of penalties for violations of that Code; procedures for preventing, reporting, and investigating violations; and procedures for verifying compliance.

**Observations**

*Parmalat* is the latest chapter in a line of recent SEC settlements in which the Commission has sought measures reforming corporate governance procedures. The other recent settlements generally come within two categories: (1) settlements with issuers concerning accounting fraud and other financial reporting violations, and (2) settlements with
mutual fund advisers concerning allegations of market timing and late trading.

SEC v. WorldCom, Inc., Lit. Rel. No. 17866, 2002 SEC LEXIS 3043 (Nov. 26, 2002), exemplifies the first category. In that case, WorldCom consented to a partial judgment that required WorldCom's special investigative committee to provide WorldCom's corporate monitor with a report on WorldCom’s corporate governance procedures and required the corporate monitor, in turn, to review the adequacy of these procedures and summarize his recommendations in a report. The judgment further required that WorldCom’s board report to the court and the SEC on its progress in acting on the corporate monitor’s recommendations 60 days after receiving his report. The judgment also required WorldCom to hire a qualified independent consultant to monitor the company’s efforts to remedy its internal controls deficiencies. The result was the Corporate Monitor’s 150 page August 2003 report, Restoring Trust, which proposed some 78 specific reforms to WorldCom’s corporate governance structure and procedures.

SEC v. Hollinger International, Inc., Lit. Rel. No. 18551, 2004 SEC LEXIS 131 (Jan. 21, 2004), is another example of a financial reporting case in which the Commission imposed corporate governance reforms on an issuer through settlement. There, the SEC filed a civil injunctive action alleging that Hollinger’s SEC filings contained misstatements and omitted to state material facts regarding transfers of corporate assets to certain of Hollinger’s insiders and related entities. Hollinger International entered into a consent judgment in which it agreed to a “springing” corporate monitor. The SEC’s litigation release explained the relief as follows: “[u]nder the order, Hollinger International is required to maintain its Special Committee to, among other things, continue its investigation of alleged misconduct and its efforts to recover and maintain corporate assets. In the event the Special Committee’s authority were in any way impaired, including through a change in control of the company, Richard C. Breeden (the current Counsel to the Special Committee) would serve as a court-ordered Special Monitor to protect the interests of Hollinger International shareholders.” Id. Recently, the district court upheld the consent judgment, including the Special Monitor provision, over the objections of Hollinger International’s controlling shareholder. SEC v. Hollinger International, Inc., 2004 U.S. Dist. LEXIS 9097 *22-23 (N.D. Ill. May 17, 2004).

In the matter of Pilgrim Baxter & Associates, Ltd., Inv. Co. Act Rel. No. IC-26470, 2004 SEC LEXIS 1267 (June 21, 2004), is a recent example of the second category of cases – those involving governance reform for mutual fund complexes. In Pilgrim Baxter, the SEC brought a settled administrative proceeding against Pilgrim Baxter, a mutual fund adviser, charging it with violations of the federal securities laws for, among other things, permitting a select group of investors to trade rapidly in and out of the PBHG Funds, reaping profits and diluting the value of the funds to the detriment of long-term investors. Pilgrim Baxter agreed to undertake a series of compliance and mutual fund governance reforms, such as: (a) maintaining a Code of Ethics Oversight Committee having responsibility for all matters relating to issues arising under the Pilgrim Baxter Code of Ethics; (b) establishing an Internal Compliance Controls Committee; (c) requiring Pilgrim Baxter’s Chief Compliance Officer to report to the independent Trustees of the PBHG Funds any breach of fiduciary duty and/or the federal securities laws of which he becomes aware; and (d) retaining an Independent Compliance Consultant to review and recommend improvements to Pilgrim Baxter’s compliance and market timing departments. See also, e.g., In the matter of Franklin Advisers, Inc. Inv. Co. Act Rel. No. IC-26523 (Aug. 2, 2004) (settled administrative proceeding ordering similar measures).

Parmalat is a particularly expansive application of corporate governance reform as an SEC enforcement remedy. Parmalat imposes corporate governance reform on a company that is not a domestic issuer – or even a foreign private issuer filing
annual reports with the SEC on Form 20-F. Parmalat is an Italian company, whose stock traded on the Milan Stock Exchange. As mentioned above, the allegations concern fraud on institutional investors who bought debt securities pursuant to an exempt offering. Parmalat also sponsored ADRs which were sold over-the-counter and quoted on the “Pink Sheets.” The corporate governance reforms set forth in the settlement apparently mirror those to which the company agreed in its bankruptcy proceedings in Italy.

The settlement demonstrates just how broad a net the SEC is willing to cast to impose corporate governance reform through enforcement actions. Federal courts have authority to impose that type of relief pursuant to their general equitable powers to tailor-make remedies for the benefit of investors in SEC cases. Originally a creature of case law, this principle was codified by Section 305 of the Sarbanes-Oxley Act, which states, “[i]n any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.” Whether a court in the context of contested litigation would award similar relief under the same facts is an issue for another day.

Foreign private issuers that raise funds in the U.S. capital markets need to be particularly mindful of the SEC’s increasing use of this enforcement remedy. Even foreign issuers that are not listed on U.S. exchanges, and that are not subject to the corporate governance, disclosure, and internal controls provisions of the Sarbanes-Oxley Act of 2002, can still be subject to SEC enforcement for exempt sales of securities in the U.S.

For more information, please call your regular Sidley Austin Brown & Wood LLP contact or any of the attorneys listed on the front. Please also visit our website, where we have posted prior client bulletins about securities enforcement, Sarbanes-Oxley Act developments, and corporate governance issues (www.sidley.com/corporategovernance).

The affiliated firms, Sidley Austin Brown & Wood LLP, a Delaware limited liability partnership, Sidley Austin Brown & Wood LLP, an Illinois limited liability partnership, Sidley Austin Brown & Wood, an English general partnership and Sidley Austin Brown & Wood, a New York general partnership, are referred to herein collectively as Sidley Austin Brown & Wood.
Final NYSE

Corporate Governance Rules

What follows are the final corporate governance rules of the New York Stock Exchange approved by the SEC on November 4, 2003, other than Section 303A.08, which was filed separately and approved by the SEC on June 30, 2003. These final rules will be codified in Section 303A of the NYSE's Listed Company Manual.

303A

General Application

Companies listed on the Exchange must comply with certain standards regarding corporate governance as codified in this Section 303A. Consistent with the NYSE's traditional approach, as well as the requirements of the Sarbanes-Oxley Act of 2002, certain provisions of Section 303A are applicable to some listed companies but not to others.

Equity Listings

Section 303A applies in full to all companies listing common equity securities, with the following exceptions:

Controlled Companies

A company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the requirements of Sections 303A.01, .04 or .05. A controlled company that chooses to take advantage of any or all of these exemptions must disclose that choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Controlled companies must comply with the remaining provisions of Section 303A.

Limited Partnerships and Companies in Bankruptcy

Due to their unique attributes, limited partnerships and companies in bankruptcy proceedings need not comply with the requirements of Sections 303A.01, .04 or .05. However, all limited partnerships (at the general partner level) and companies in bankruptcy proceedings must comply with the remaining provisions of Section 303A.

Closed-End and Open-End Funds

The Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940,
given the pervasive federal regulation applicable to them. However, closed-end funds must comply with the requirements of Sections 303A.06, .07(a) and (c), and .12. Note, however, that in view of the common practice to utilize the same directors for boards in the same fund complex, closed-end funds will not be required to comply with the disclosure requirement in the second paragraph of the Commentary to 303A.07(a), which calls for disclosure of a board's determination with respect to simultaneous service on more than three public company audit committees. However, the other provisions of that paragraph will apply.

Business development companies, which are a type of closed-end management investment company defined in Section 2(a)(48) of the Investment Company Act of 1940 that are not registered under that Act, are required to comply with all of the provisions of Section 303A applicable to domestic issuers other than Sections 303A.02 and .07(b). For purposes of Sections 303A.01, .03, .04, .05, and .09, a director of a business development company shall be considered to be independent if he or she is not an "interested person" of the company, as defined in Section 2(a)(19) of the Investment Company Act of 1940.

As required by Rule 10A-3 under the Exchange Act, open-end funds (which can be listed as Investment Company Units, more commonly known as Exchange Traded Funds or ETFs) are required to comply with the requirements of Sections 303A.06 and .12(b).

Rule 10A-3(b)(3)(ii) under the Exchange Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. In view of the external management structure often employed by closed-end and open-end funds, the Exchange also requires the audit committees of such companies to establish such procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. This responsibility must be addressed in the audit committee charter.

Other Entities

Except as otherwise required by Rule 10A-3 under the Exchange Act (for example, with respect to open-end funds), Section 303A does not apply to passive business organizations in the form of trusts (such as royalty trusts) or to derivatives and special purpose securities (such as those described in Sections 703.16, 703.19, 703.20 and 703.21). To the extent that Rule 10A-3 applies to a passive business organization, listed derivative or special purpose security, such entities are required to comply with Sections 303A.06 and .12(b).

Foreign Private Issuers

Listed companies that are foreign private issuers (as such term is defined in Rule 3b-4 under the Exchange Act) are permitted to follow home country practice in lieu of the provisions of this Section 303A, except that such companies are required to comply with the requirements of Sections 303A.06, .11 and .12(b).
Preferred and Debt Listings

Section 303A does not generally apply to companies listing only preferred or debt securities on the Exchange. To the extent required by Rule 10A-3 under the Exchange Act, all companies listing only preferred or debt securities on the NYSE are required to comply with the requirements of Sections 303A.06 and .12(b).

Effective Dates/Transition Periods

Except for Section 303A.08, which became effective June 30, 2003, listed companies will have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new standards contained in Section 303A, although if a company with a classified board would be required (other than by virtue of a requirement under Section 303A.06) to change a director who would not normally stand for election in such annual meeting, the company may continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. In addition, foreign private issuers will have until July 31, 2005, to comply with the new audit committee standards set out in Section 303A.06. As a general matter, the existing audit committee requirements provided for in Section 303 continue to apply to listed companies pending the transition to the new rules.

Companies listing in conjunction with their initial public offering will be permitted to phase in their independent nomination and compensation committees on the same schedule as is permitted pursuant to Rule 10A-3 under the Exchange Act for audit committees, that is, one independent member at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year. Such companies will be required to meet the majority independent board requirement within 12 months of listing. For purposes of Section 303A other than Sections 303A.06 and .12(b), a company will be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The Exchange will also permit companies that are emerging from bankruptcy or have ceased to be controlled companies within the meaning of Section 303A to phase in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an initial public offering. However, for purposes of Sections 303A.06 and .12(b), a company will be considered to be listing in conjunction with an initial public offering only if it meets the conditions of Rule 10A-3(b)(1)(iv)(A) under the Exchange Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act.

Companies listing upon transfer from another market have 12 months from the date of transfer in which to comply with any requirement to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of that market's rule, which period had not yet expired, the company will have the same transition period as would have been available to it on the other market. This transition period for companies transferring from another market will not apply to the requirements
of Section 303A.06 unless a transition period is available pursuant to Rule 10A-3 under the Exchange Act.

References to Form 10-K

There are provisions in this Section 303A that call for disclosure in a company’s Form 10-K under certain circumstances. If a company subject to such a provision is not a company required to file a Form 10-K, then the provision shall be interpreted to mean the annual periodic disclosure form that the company does file with the SEC. For example, for a closed-end fund, the appropriate form would be the annual Form N-CSR. If a company is not required to file either an annual proxy statement or an annual periodic report with the SEC, the disclosure shall be made in the annual report required under Section 203.01 of the NYSE Listed Company Manual.

1. Listed companies must have a majority of independent directors.

Commentary: Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

2. In order to tighten the definition of “independent director” for purposes of these standards:

(a) No director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director’s relationship to a listed company (references to “company” would include any parent or subsidiary in a consolidated group with the company). Accordingly, it is best that boards making “independence” determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director’s relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The basis for a board determination that a relationship is not material must be disclosed in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K.
filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board’s independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition:

(i) A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.

*Commentary:* Employment as an interim Chairman or CEO shall not disqualify a director from being considered independent following that employment.

(ii) A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

*Commentary:* Compensation received by a director for former service as an interim Chairman or CEO need not be considered in determining independence under this test. Compensation received by an immediate family member for service as a non-executive employee of the listed company need not be considered in determining independence under this test.

(iii) A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not “independent” until three years after the end of the affiliation or the employment or auditing relationship.

(iv) A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serve on that company’s
A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not "independent" until three years after falling below such threshold.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Charitable organizations shall not be considered "companies" for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year exceeded the greater of $1 million, or 2% of such charitable organization's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commentary to Section 303A.02(b): An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated. In addition, references to the "company" would include any parent or subsidiary in a consolidated group with the company.

Transition Rule. Each of the above standards contains a three-year "look-back" provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the "look-back" provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.
As an example, until November 3, 2004, a company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the company would need to look back the full three years provided in Section 303A.02(b)(ii).

3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. “Non-management” directors are all those who are not company officers (as that term is defined in Rule 16a-1(f) under the Securities Act of 1933), and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.

Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. There need not be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session. For example, a company may wish to rotate the presiding position among the chairs of board committees.

In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group. Companies may, if they wish, utilize for this purpose the same procedures they have established to comply with the requirement of Rule 10A-3 (b)(3) under the Exchange Act, as applied to listed companies through Section 303A.06.

While this Section 303A.03 refers to meetings of non-management directors, if that group includes directors who are not independent under this Section 303A, listed companies should at least once a year schedule an executive session including only independent directors.

4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:
(i) the committee’s purpose and responsibilities – which, at minimum, must be to: identify individuals qualified to become board members, consistent with criteria approved by the board; and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance principles applicable to the corporation; and oversee the evaluation of the board and management; and

(ii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board’s most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm’s fees and other retention terms.

Boards may allocate the responsibilities of the nominating/corporate governance committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

5. (a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee’s purpose and responsibilities – which, at minimum, must be to have direct responsibility to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals
and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO’s compensation level based on this evaluation; and

(B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and

(C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company’s annual proxy statement or annual report on Form 10-K filed with the SEC;

(ii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company’s CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with or without ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)).

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm’s fees and other retention terms.

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

Nothing in this provision should be construed as precluding discussion of CEO compensation with the board generally, as it is not the intent of this standard to impair communication among members of the board.

6. Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.

Commentary: The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the
generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.

7. (a) The audit committee must have a minimum of three members.

Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the company’s board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company’s board interprets such qualification in its business judgment. While the Exchange does not require that a listed company’s audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee’s demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC.

(b) In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.

(c) The audit committee must have a written charter that addresses:

(i) the committee’s purpose – which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company’s financial statements, (2) the company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications and independence, and (4) the performance of the company’s internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the company’s annual proxy statement;

(ii) an annual performance evaluation of the audit committee; and
(iii) the duties and responsibilities of the audit committee – which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act, as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm’s internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor’s independence) all relationships between the independent auditor and the company;

Commentary: After reviewing the foregoing report and the independent auditor’s work throughout the year, the audit committee will be in a position to evaluate the auditor’s qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company’s internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) discuss the company’s annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company’s disclosures under “Management’s Discussion and Analysis of Financial Condition and Results of Operations”;

(C) discuss the company’s earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee’s responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;
Commentary: While it is the job of the CEO and senior management to assess and manage the company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company’s major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management’s response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor’s activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were “passed” (as immaterial or otherwise); any communications between the audit team and the audit firm’s national office respecting auditing or accounting issues presented by the engagement; and any “management” or “internal control” letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company’s internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals’ familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set
hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company’s financial statements, the company’s compliance with legal or regulatory requirements, the performance and independence of the company’s independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A.07(c): While the fundamental responsibility for the company’s financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company’s selection or application of accounting principles, and major issues as to the adequacy of the company’s internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of “pro forma,” or “adjusted” non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

(d) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.

General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

8. Reserved.

9. Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each
listed company’s website must include its corporate governance guidelines and the charters of its most important committees (including at least the audit, and if applicable, compensation and nominating committees). Each company’s annual report on Form 10-K filed with the SEC must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the company’s policies and procedures, as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and .02. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

- **Director access to management and, as necessary and appropriate, independent advisors.**

- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors’ independence may be raised when directors’ fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.
10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

Commentary: No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board’s performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company’s website must include its code of business conduct and ethics. Each company’s annual report on Form 10-K filed with the SEC must state that the foregoing information is available on its website and that the information is available in print to any shareholder who requests it.

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A “conflict of interest” occurs when an individual’s private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the
company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

- **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company’s customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as “at will” employment arrangements.

- **Protection and proper use of company assets.** All employees, officers and directors should protect the company’s assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company’s profitability. All company assets should be used for legitimate business purposes.

- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

- **Encouraging the reporting of any illegal or unethical behavior.** The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

**Commentary:** Foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. However, foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country’s corporate governance practices are better or more effective than another. The Exchange
believes that U.S. shareholders should be aware of the significant ways that the
governance of a listed foreign private issuer differs from that of a U.S. listed
company. The Exchange underscores that what is required is a brief, general
summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their web site
(provided it is in the English language and accessible from the United States)
and/or in their annual report as distributed to shareholders in the United States in
accordance with Sections 103.00 and 203.01 of the Listed Company Manual
(again, in the English language). If the disclosure is only made available on the
web site, the annual report shall so state and provide the web address at which the
information may be obtained.

12. (a) Each listed company CEO must certify to the NYSE each year that he or she
is not aware of any violation by the company of NYSE corporate governance
listing standards.

Commentary: The CEO’s annual certification to the NYSE that, as of the date of
certification, he or she is unaware of any violation by the company of the NYSE’s
corporate governance listing standards will focus the CEO and senior
management on the company’s compliance with the listing standards. Both this
certification to the NYSE, and any CEO/CFO certifications required to be filed
with the SEC regarding the quality of the company’s public disclosure, must be
disclosed in the company’s annual report to shareholders or, if the company does
not prepare an annual report to shareholders, in the companies annual report on
Form 10-K filed with the SEC.

(b) Each listed company CEO must promptly notify the NYSE in writing after
any executive officer of the listed company becomes aware of any material non-
compliance with any applicable provisions of this Section 303A.

13. The NYSE may issue a public reprimand letter to any listed company that
violates a NYSE listing standard.

Commentary: Suspending trading in or delisting a company can be harmful to the
very shareholders that the NYSE listing standards seek to protect; the NYSE must
therefore use these measures sparingly and judiciously. For this reason it is
appropriate for the NYSE to have the ability to apply a lesser sanction to deter
companies from violating its corporate governance (or other) listing standards.
Accordingly, the NYSE may issue a public reprimand letter to any listed
company, regardless of type of security listed or country of incorporation, that it
determines has violated a NYSE listing standard. For companies that repeatedly
or flagrantly violate NYSE listing standards, suspension and delisting remain the
ultimate penalties. For clarification, this lesser sanction is not intended for use in
the case of companies that fall below the financial and other continued listing
standards provided in Chapter 8 of the Listed Company Manual or that fail to
comply with the audit committee standards set out in Section 303A.06.
processes and procedures provided for in Chapter 8 govern the treatment of companies falling below those standards.
other business designated by Treasury.

annual remaining receipt of more than $1,000,000; and certain

financial institutions, such as banks or holding companies with

duty or power of business described in the definition of a

Federal or any State or local government entity or a

established by the United States Postal Service, an agency of

vehicles. Persons involved in real estate closings and

investment companies. Any business engaged in

businesses under the

businesses engaged in

liened lender of money or any other person who makes as

pawnbroker, a loan of finance company; a travel agency;

company; a dealer in precious metals, stones or jewels;

insurance; an operation of a check cashing system; an insurance

lender of checks, money orders or similar

currency exchange; an issuer,Recorder or Celebrant of

registered; an investment banker or investment company; a

dealer in securities or commodities whether or not

the SEC under the Securities Exchange Act of 1934; a broker

branch of a foreign bank in the United States; any credit

bank or atrust company; Foreign banks; an agency of

transactions abroad and through foreign companies raising

occurred both in the number of U.S. companies involved in

including the Foreign Corporation Proceeds Act. The growth has

markets, and thus are subject to U.S. disclosure requirements.

over growing number of companies engaged in foreign

Reviving Corporate Integrity

IX. The Foreign Corporation Proceeds Act and

part of the anti-money laundering compliance program.

establish procedures for filing and reporting as employees as

company is required to file a SARS, the company should
Disclosure obligations.

The section requires issuers to make and keep books, records, and accounts, which in reasonable detail, describe the assets of the issuer, reflect the transactions and dispositions of its assets, and enable them to fulfill their accounting obligations. Any person who, directly or indirectly, felony or cause to be filed, any book, record, or account shall be liable for a fine of $1,000 and imprisonment for not more than 20 years.

B. Accounting Books and Records Provisions

The SEC may require issuers to maintain books, records, and accounts that reflect the transactions and dispositions of assets. The SEC may also require issuers to maintain books, records, and accounts that are reasonable and necessary to reflect the transactions and dispositions of assets. The SEC may also require issuers to maintain books, records, and accounts that are reasonable and necessary to reflect the transactions and dispositions of assets.


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V. Background

The SEC has the power to require issuers to maintain books, records, and accounts that are reasonable and necessary to reflect the transactions and dispositions of assets. The SEC may also require issuers to maintain books, records, and accounts that are reasonable and necessary to reflect the transactions and dispositions of assets.

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The Foreign Corrupt Practices Act

Section 13(a)(2)(B) provides that an issuer must maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

1. To maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

- The foreign accounting controls and procedures required by the Commission are consistent with internal control standards prescribed by the Commission under paragraph (e) of this section.
- The foreign accounting controls and procedures required by the Commission are effective in preventing and detecting any illegal foreign payments.

2. To maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

- The foreign accounting controls and procedures required by the Commission are consistent with internal control standards prescribed by the Commission under paragraph (e) of this section.
- The foreign accounting controls and procedures required by the Commission are effective in preventing and detecting any illegal foreign payments.

Although there is materiality requirement in Rule 13(a)(2), no director or officer
Companies Under the FCPA

Accounting Requirements and Practices for Effective Controls and Corporate Education Programs.

The SEC emphasizes the importance of effective corporate compliance programs and corporate education programs. The SEC encourages companies to implement programs that promote compliance with the FCPA and other relevant laws and regulations. The SEC has issued guidance on how companies can design, implement, and monitor such programs to ensure effectiveness and to minimize compliance risks.

D. The SEC

The SEC is responsible for enforcing the FCPA and ensuring compliance with its requirements. The SEC can investigate and take enforcement action against companies and individuals who violate the FCPA. The SEC can also issue orders and rules to implement the provisions of the FCPA and to ensure compliance.

The SEC has broad civil enforcement powers over foreign issuers and U.S. issuers with foreign operations. The SEC can impose civil penalties on individuals and entities that violate the FCPA. The SEC can also issue cease-and-desist orders and seek injunctions against violations.

Preemption of State Laws. The FCPA preempts state laws that are inconsistent with its provisions. The SEC has issued guidance on how to determine whether a state law is inconsistent with the FCPA.

Amendments of 1988

The Foreign Corrupt Practices Act Amendments of 1988 (the "1988 Amendments") to the FCPA created a new requirement for companies to maintain internal control systems to prevent or detect violations of the FCPA. The SEC has issued guidance on how companies can design and implement such systems.
The Auditor's Role

The auditor's role in internal accounting controls involves ensuring that management has established and implemented effective internal control procedures. This includes:

1. Providing independent professional review of the corporation's financial statements.
2. Assessing the effectiveness of the corporation's internal control systems.
3. Identifying any weaknesses or deficiencies in internal control.
4. Making recommendations for improvements to the internal control systems.
5. Reporting to management and the board of directors on the results of the audit.

The auditor's role is critical in maintaining the integrity and reliability of financial reporting. By performing independent reviews, auditors help ensure that management is fulfilling its responsibilities for internal controls and that the financial statements are presented fairly and in accordance with applicable accounting standards.
The information itself, however, is not entirely shielded from
issuers' project interests as well as the confidential
information is. Indeed, the SEC has placed a
considerable importance on the protection of
confidential information. This has resulted in
enforcement efforts (especially in the recent
period) to protect issuers from
inexperienced and well-intentioned
issuers. However, the SEC has
noted that the issues being
raised are significant and require
careful consideration by
issuers. The SEC has
emphasized the importance of
providing issuers with
adequate information on
how to comply with
issuers' SEC
requirements.

In response to comments received during the
provisional period, the SEC has
modified its views on
issuers' need for
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has clarified that issuers
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On March 12, 1997, new rules implementing the
Receives under GASS

§ 201.1-20(d) provides the SEC to supplement in audits

1st A recent amendment to Regulation S-x 17 CFR

the company's

104-67 (additions to section 10A to the Exchange Act), the

SECs

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requirements.
Sealed Document
02/631 HHG

SEC v. Monodcon CIV. ACTION NO. 1:96 CV

The complaint, made by the SEC on February 2, 1996

Form 20-F

The SEC alleged that the company failed to file annual reports with the SEC on time, and failed to disclose material information in the reports. The SEC alleged that the company's financial statements were false and misleading, and that the company's management had engaged in a pattern of fraud.

On November 21, 1996, the SEC initiated a civil enforcement action against the company.

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Relevant SEC Enforcement Actions

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Enforcement Division

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[Redacted information about enforcement actions is collapsed to protect personal information.

Disclosure since the rule does not affect an issuer's obligation to disclose material information is important. It is essential for maintaining transparency and investor confidence in the financial reporting process.

Disclosure of material information is crucial for stakeholders to make informed decisions. The SEC's enforcement actions serve as a deterrent for corporate fraud and ensure that companies comply with legal and regulatory requirements.

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1997
Action No. 1997-COM-4017 (R:\FTD\D:\JC\February 27, 1997)

Sec. 5.05.0, 01 Energy Corporation, et al.

The Commission's complaint alleges that during the

The provision, entitled "Punitive Damages," does not concern offenses that are designated as in order to

On February 27, 1997, 01 Energy Corporation

The 01 Energy Corporation, and the 01 Energy Corporation's employees and agents, also are concerned in the

On February 27, 1997, 01 Energy Corporation

...
Evidence of illegal payments from the parent company, Samsung Electronics America, Inc., was uncovered as part of investigations into potential violations of the Foreign Corrupt Practices Act (FCPA) and other laws. The SEC, in a complaint filed on October 3, 2007, alleged that Samsung Electronics America, Inc., Samsung Electronics, Inc., and Samsung affiliates violated the FCPA by making payments to a foreign intermediary to influence the award of a contract with a foreign government entity. The SEC further alleged that Samsung failed to maintain adequate internal controls over its foreign subsidiaries, which resulted in illegal payments. The SEC sought a judgment against Samsung and its affiliates, including disgorgement of profits and disgorgement of profits in the amount of the illegal payments. The case was settled on December 21, 2000.
transaction during its audit process, and influenced an internal

The company discovered and accused the

recorded the $27,990,000 payment by a consulting firm

because of one of more senior officials. The corruption

problem for one of more senior officials. The corruption

reported to the Swiss account to serve as a

examiner at the Swiss National Bank. The anti-corruption

officer, Konrad Kopp, was directed by one of the

executive vice presidents and then executive vice president and

government. According to the complaint, then chairman and

second-in-command to produce false statements for the Swiss

bank's account in an effort to

This matter relates to ill-gotten payments made to Swiss


180/18/04 March 10, 2000

SEC v. Homewealth Financial Corporation,

17069/AFER REO No. 1425/2001

5/3/2001 SEC v. Joseph C. Marineau,

1425/2001

American Bank Note Corporation

American Bank Note Corporation

American Bank Note Corporation

American Bank Note Corporation

[5] In the Matter of American Bank Note
subsidized internal controls.

subsidiary's internal controls.

subsidiary's internal controls.

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subsidiary's internal controls.
Baker Hughes also consented to a permanent

provision. FCPA’s anti-bribery, books and records and internal controls

provisions. Pursuant to the FCPA’s anti-bribery and books and records

provisions, the Commission alleged that Baker Hughes violated the

provisions of the FCPA by failing to maintain adequate internal controls

and failing to disclose adequate information to the Commission. The

proposed settlement provides for a $15 million civil penalty and

remedial actions, including disgorgement of profits and a corporate

resolution. The settlement also includes a corporate compliance

program and a corporate integrity obligation. The Commission will

recommend that the Justice Department refer the matter to the

Department of Justice for criminal charges. The Commission will

also refer the matter to the SEC for potential enforcement actions.

On August 6, 2003, following a July trial before

the U.S. District Court for the Southern District of New

York, Morris W. Wilkerson was convicted of conspiracy,

false statements to auditors, false entries in records, and

making false statements to the SEC. The judgment

awarded $73.5 million in damages.
The legislation with jurisdiction over the foreign ownership restriction, according to the complainant, is the Foreign Investment Act of 1974. The complainant argues that the legislation has been applied in an unconstitutional manner, violating the rights of the complainant.

The complainant, Bellshool Corporation, argues that the legislation has improperly interfered with its business operations. The legislation was allegedly used to suppress the complainant's business operations and was applied in an unconstitutional manner.

The complainant also alleges that between October 1999 and June 1999, Bellshool's net income was $1 million.

The complainant further argues that the legislation was applied in an unconstitutional manner, violating the rights of the complainant.

In conclusion, the complainant requests that the decision be reversed and that the case be remanded to the District Court for further proceedings.

Shades v. Key

The complainant argues that the decision was based on incorrect facts and was applied in an unconstitutional manner, violating the rights of the complainant.

The complainant also argues that the legislation was applied in an unconstitutional manner, violating the rights of the complainant.

The complainant requests that the decision be reversed and that the case be remanded to the District Court for further proceedings.

The complainant further argues that the legislation was applied in an unconstitutional manner, violating the rights of the complainant.

The complainant requests that the decision be reversed and that the case be remanded to the District Court for further proceedings.

The information included in the previous paragraphs is not relevant to the current discussion.
In this regard, a meaningful and meaningful concern must be maintained in that aspect of the company's transactions for its operations.

In order to address the importance of the issues, the SEC has promulgated the regulations that are currently in existence. While the provisions apply to all companies, the regulations for the SEC's enforcement are more specific and are applicable to the particular regulatory problem or controversy that has arisen.

The provisions focus on the company's business. While the company maintains and audits the books and records that are necessary to record the company's business, the provisions apply to the books and records that are necessary to maintain the record of the company's business.

The order also notes that Bellowsfield has utilized an enhanced compliance program.

On January 15, 2002, the SEC issued a report, entitled "Bellowsfield's Enhanced Compliance Program: The Supreme Court's Decision on the Enforcement of the FCPA Against Bellowsfield," which provides the SEC with the opportunity to explain its decision and the reasons for its decision.

The SEC has promulgated the regulations that are currently in existence. While the provisions apply to all companies, the regulations for the SEC's enforcement are more specific and are applicable to the particular regulatory problem or controversy that has arisen.
In July of 2002, the SEC filed suit in the United States District Court for the Southern District of Texas against two former officers of American Rice Co., Inc. who allegedly authorized more than $500,000 in bribery payments to Haitian officials. The SEC alleged that Douglas Murphy and David Kay authorized payments during 1998 and 1999 in order to reduce American Rice’s import taxes by approximately $1.5 million. American Rice was a public company headquartered in Houston, Texas.

The SEC alleges that Mr. Murphy was American Rice’s President and one of its directors, and Mr. Kay was the company’s vice president of Caribbean operations, during the relevant period. According to the complaint, Kay directed an American Rice employee to prepare false shipping records and underreport the tonnage of rice arriving on certain vessels. Customs officials in Haiti used the false records to clear the vessels through customs. At Kay’s direction, American Rice employees paid cash bribes to customs officials after the vessels cleared customs. Kay allegedly directed the American Rice controller in Haiti to record the payments as routine business expenditures in order to conceal the nature of the payments. The complaint alleges that American Rice employees made at least 12 bribery payments totaling approximately $500,000 in order for the company to avoid $1.5 million in import taxes.

The commission charged that Murphy was aware of the bribery scheme but took no action to stop the payments and that Lawrence Theriot, formerly the Caribbean operations consultant for American Rice, allegedly assisted Kay and Murphy by monitoring the bribery scheme and exploring alternative arrangements.

The SEC noted in its Litigation Release that the indictment in the criminal matter had been dismissed, but that the Department of Justice had appealed the decision. SEC Litigation Release No. 17651 (August 1, 2002).

On January 30, 2003, American Rice, Joseph A. Schwartz, Jr., Joel R. Malebranche and Allen W. Sturdivant consented to the issuance of an order requiring that the cease and desist from committing or causing any future violations of the Securities Exchange Act of 1934. The order included a finding that Schwartz, the former controller for Haitian operations, and employees Malebranche and Sturdivant, had participated in a scheme to bribe Haitian customs officials in violation of the FCPA. The order included a finding that American Rice had violated the books and records component of the FCPA.

The United States District Court for the Southern District of Texas dismissed the indictments against Murphy and Kay on the grounds that the challenged payments were not covered by the FCPA because they were not made to obtain or retain business in Haiti. In ruling on defendants’ motion to dismiss for failure to state an offense under 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), the court held that neither the language of the statute nor the legislative history supported the Government’s argument that the FCPA encompassed payments made to reduce customs duties or tax obligations. Defendants argued that the alleged payments to Haitian officials if made, could not have been for the purpose of obtaining or retaining new business, since American Rice had already established its business in Haiti. Instead, the
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[6]

The implications of American

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advertising expenses.

According to the complaint, the SEC alleged that the
company's revenues were improperly recorded as promotional and
advertising expenses. The company's financial statements did not
correctly reflect the expenses associated with the promotional and
advertising activities. As a result, the company overstated its
revenues and earnings. The SEC alleged that the company failed to
adequately disclose these expenses in its financial reports.

The SEC charged the company with violating the SEC Act of 1934 and
its rules and regulations. The company was ordered to pay a
$1 million civil penalty and to undertake remedial measures to
correct the deficiencies in its financial reporting.

In the criminal matter, the SEC charged the company with
violating the SEC Act of 1934 and its rules and regulations. The
company was fined $1 million and was ordered to pay a
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173.

Management should be especially vigilant of management's duties to investors and other interested parties. The SEC has demonstrated its commitment to enforcement of the securities laws through many recent initiatives to prevent violations of the laws. These efforts have resulted in significant fines and penalties for violators.

174. Violations of the laws are not only a matter of concern to investors and regulators, but also to the broader public. The securities laws are designed to protect the public from fraudulent and misleading practices in the marketplace. When these laws are violated, the public is put at risk.

175. To ensure that the securities laws are properly enforced, it is necessary to hold violators accountable. This can be accomplished through criminal and civil penalties, as well as through educational efforts to inform the public of the importance of the securities laws.

G. Implications

Government agencies were not challenged.

Penalties in doctors of practice facilities.

Exemptions and the ability to appeal in these facilities.

While the allegations resolved through the SEC.
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Department of Justice?

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Department of Justice?

The practice act and the reality of the SEC and the

A second illusion of this problem would occur
to recalculate its practical implementation. International community may cause United States regulators to return to the persons prime role but its recalculation by the recent enactment of the Sarbanes-Oxley Act constitutes an attempt to involve the United States courts to become involved. The recent increase in inspections to justify the existence of the SEC and enforcement of general securities laws violators and more stringent federal regulations in some circumstances, regulators in understanding that in some circumstances, regulators in the assertion of authority by the United States Tecnica for the first time, the expansive interpretation of United States jurisdiction. This limitation of United States jurisdiction has been long regarded as the expansion of regulation of markets worldwide and better cooperation in resulting in a limitation of the power of United States regulators to act as persons of the power of United States.
Enforcement Actions under the Foreign Corrupt Practices Act: The Bitter and Costly Lessons of Mishandling Intermediaries

September 21, 2004

Two major cases brought recently by the U.S. Justice Department under the Foreign Corrupt Practices Act ("FCPA") reveal the current focus of U.S. law enforcement efforts and raise critical compliance issues for U.S. companies and for foreign companies which have listed their shares on U.S. stock exchanges and are thereby subject to the FCPA. The cases, U.S. v. James H. Giffen and U.S. v. Hans Bodmer, highlight the risks companies face in doing business with intermediaries who purport to create or facilitate opportunities in emerging markets. In each case, the companies and their officials who retained Mr. Giffen and Mr. Bodmer, respectively, face indictments themselves. The outcome of these cases will refine the standards of legal responsibility that companies must meet to avoid liability when they use consultants and operate through intermediaries to develop and implement business opportunities.

The Giffen case arises out of a series of oil and gas exploration and development agreements, which Mr. Giffen brokered as an advisor to the government of Kazakhstan, with major international energy companies. Mr. Giffen allegedly diverted to the President and Prime Minister of Kazakhstan more than $78 million from payments made under those contracts. Such payments were diverted in a variety of ways. Mr. Giffen's company, Mercator Corporation, accepted into its New York bank account on behalf of the government of Kazakhstan payments made under contracts and then diverted the proceeds. Payments were also made in the form of advances to a company without assets in what were alleged to be sham transactions with the result that funds were passed on illegally to government officials. Other payments were made from escrow accounts to a British Virgin Islands company controlled by the government of Kazakhstan. Payments due to the government were also directed by a government official to be deposited into several Swiss bank accounts, and portions were diverted to government officials.

Bodmer involves allegations by the U.S. government that Mr. Bodmer, in his capacity as a Swiss attorney, accepted substantial funds from U.S. investors who sought to acquire shares in the State Oil Company of Azerbaijan ("SOCAR"), whose privatization they believed was imminent. The Justice Department's indictment alleges that Mr. Bodmer arranged for substantial portions of those funds to be paid as bribes to Azerbaijani government officials to procure for his clients preferential treatment in acquiring privatization vouchers and options and otherwise to secure the corrupt support of such officials so that his clients could gain control of SOCAR. Such funds were paid in cash or by wire transfer to bank accounts for the benefit of Azerbaijani government officials.

The U.S. government's cases under the FCPA and money laundering statutes are strong against both Mr. Giffen and Mr. Bodmer, but significant liability in both these cases also threatens major U.S. energy and investment companies. Whether indictments are issued against such companies and whether any of them ultimately faces criminal or civil liability depends to a great extent on the outcome of the Giffen and Bodmer cases.

Whatever the outcome, there are important lessons for companies seeking to minimize potential liability under the FCPA by effectively initiating, structuring and monitoring their relationships with consultants and intermediaries.

Those lessons are summarized below.
1. Appearances Can Be Deceptive: Do not rely on the perception of reputation and effectiveness in retaining an intermediary.

Mr. Giffen was an advisor to the Kazakhstan government, with over 30 years of experience in the former Soviet Union. Mr. Bodmer is a Swiss lawyer and a member of the Board of Directors of a prominent Swiss bank. While presumptions in favor of the experience, effectiveness and even propriety of such intermediaries may not have been unreasonable, such presumptions proved false with serious consequences to the companies. To avoid liability a company must have in place due diligence practices that go beyond merely the reputation and experience of intermediaries and extend to a careful evaluation of the nature of the transactions in which those intermediaries will engage on behalf of the companies. In other words, it is not enough to know about the person with whom you are dealing, you must also know how that person will conduct transactions on your behalf. Such due diligence would have revealed the "red flags" in both the Giffen and Bodmer cases and might have resulted in a proper structuring of those transactions to avoid liability or even in a decision on the part of the companies to walk away from the opportunities where the demands for improper payments from government officials could not be avoided.

2. Complexity increases risk: Companies must get behind complex offshore structures.

It is no longer acceptable for companies to engage without question with their potential contracting parties in direct or indirect participation in complex offshore corporate structures, especially involving tax havens or other jurisdictions of questionable reputation. In Giffen, oil companies were instructed to make payments into Swiss accounts and the funds were then transferred to various tax haven jurisdictions until substantial portions reached trusts maintained for the benefit of Kazakhstan government officials. In Bodmer, the government alleged that Bodmer created a number of shell companies, located in the British Virgin Islands and elsewhere, in which Azeri government officials had interests.

Companies must know the identities of the persons with whom they are doing business. Contracting with parties whose ownership is undisclosed not only creates the risk of FCPA violations if those undisclosed parties are government officials or acting for government officials, but also creates other potential legal exposure, such as for money laundering, if those undisclosed parties are engaged in illegal activities the proceeds of which are used in transactions involving your company.

3. Focus on business purpose: The business purpose of every transaction must be evident and bona fide.

In the Giffen case, Mobil Corporation (prior to its merger with Exxon to become ExxonMobil) entered into contracts with a European company, allegedly controlled by a Kazakhstan government official, to finance that company's purchase of gas condensate. The Justice Department has alleged that Mobil's contractual counterparty was a shell company and that there was no legitimate business purpose for the transaction. Despite the fact that the company had no assets, Mobil did not obtain any security for the performance of the company's obligations to Mobil. Subsequent reports have speculated that Mobil entered into this contract as a goodwill gesture in connection with its efforts to acquire an interest in the Tenghiz project in Kazakhstan. Proceeds from this transaction are alleged to have been funneled to Kazakhstan government officials.

The key lesson for U.S. companies is to be sure that, in the planning and structuring of a transaction with parties in emerging markets where the risk of bribes is high, careful attention is paid to ensuring that such transaction has a legitimate business purpose and is structured and implemented with sound business judgment. Obvious flaws in planning and structuring that call into question the fundamental business purpose of the transaction and the judgment of the officers who effected the transaction may form the basis for the allegation that the company (and its officers) had sufficient knowledge of the likelihood of an improper payment to satisfy the "knowledge" requirement of the FCPA. In other words, such flaws are strong evidence that the parties were sufficiently aware of circumstances indicating a high probability that illegal payments would be made. Once such evidence is available to the DOJ, the likelihood of indictment increases significantly.
4. Link payments to the jurisdictions of projects: Pay careful attention to payments to governments.

The crux of any liability that energy companies could face in Giffen arises from certain critical decisions made regarding how and to whom payments would be made. First, several companies agreed to pay an agent (Mr. Giffen’s company, Mercator) on behalf of the Kazakhstan government. Second, payments made directly to the Kazakhstan government were made not to the Central Bank of Kazakhstan, the logical place for payment, but to accounts represented to be government accounts in Switzerland.

Once circumstances exist that indicate a high probability of illegal payments — in this case, the problem of corruption was well known in Kazakhstan — particular attention to the location of payments is critical. It is much easier for government officials, as the facts in Giffen indicate, to hide payments offshore than it would have been if those payments had been made to the Central Bank of Kazakhstan.

5. Limit the tasks: Define carefully and monitor the intermediary’s role.

Although an advisor to the Kazakhstan government, Mr. Giffen “wore many different hats” — payment agent, consultant, intermediary — leading to confusion over his loyalties which ultimately contributed to the liberties he was able to take. Mr. Bodmer provided substantially more than legal advice and no one with any understanding of the profound risks of liability to his clients exercised any oversight.

Careful attention should be paid to defining and accurately documenting — with a proper degree of specificity — the role and responsibilities of the intermediary. Observing such procedures can be an important source of protection from liability if the intermediary exceeds its authority or breaches its obligations to the company. In addition, monitoring the activities of the intermediary through periodic reviews, insisting on reports, exercising audit rights and imposing other measures of accountability are vital to minimize the risk of liability.

6. Avoid trouble: Make compliance and effective due diligence a priority.

No FCPA prosecution focuses only on the FCPA. In both Bodmer and Giffen, money laundering charges as well as the typical collateral charges are present in these circumstances: wire fraud, mail fraud and various conspiracy charges. Quite clearly, false records were created to disguise payments so that if the prosecution proceeds against major oil companies which are subject to the “books and records” requirements of the FCPA, as well as the reporting obligations of the Sarbanes-Oxley Act, one can only imagine how complex, time-consuming and costly such corruption investigations will be. Those factors, plus the inevitable adverse publicity, demonstrate the problems companies face even if they avoid indictment and conviction. The key lesson here is that prudent companies should invest the time and effort to develop effective compliance policies and properly train and hold accountable employees to minimize the risk that violations of anti-corruption legislation will occur.

In our judgment, the two critical compliance issues are: (i) the commitment of the company’s leadership to the underlying values of integrity, transparency and accountability; and (ii) the quality of a company’s due diligence standards and their effective implementation in transactions. Little need be said about the first issue: such commitment either exists or it does not. But if it does not, no matter how “state of the art” a company’s compliance policies are, they will fail without the commitment of leadership.

However, the second issue merits careful consideration by companies. It is common knowledge that due diligence standards should focus on the characteristics of the company’s contractual counterparty (reputation, expertise, experience, financial stability, etc.) and the transaction (business purpose, bona fides, proper structure). The use of additional prosecutorial tools, as noted above, should lead companies to broaden these due diligence standards. For example, the growing incidence of money laundering charges in corruption cases imposes upon companies the necessity to include in their due diligence procedures a means to identify the source of funds to be paid by a contractual counterparty or contributed by a joint venture party. Moreover, greater
scrutiny and even skepticism is necessary before participating in complex offshore structures, commonly used for tax purposes, to ensure that they cannot be recharacterized by a creative prosecutor as a scheme to disguise the source of funds and thus trigger money laundering charges.

The use of the “books and records” provisions of the FCPA and the internal control certification requirements of Sarbanes Oxley underscores the importance of due diligence procedures which extend to review the proper recordation of payments and the accuracy of contracts and other documents related to transactions under consideration.

7. Today’s consultant may be the government’s star witness tomorrow.

These two cases teach an important lesson about the objectives and tactics of U.S. law enforcement agencies. There is no doubt in the Bodmer case that Mr. Bodmer was arrested and subsequently indicted to pressure him to plead guilty to reduced charges in exchange for his testimony against his clients, which are major U.S. investment and financial companies. This may well be true in Giffen except that Mr. Giffen’s activities were so pervasive and have been judged by the authorities to be so severe that it is unlikely that he can escape liability by providing evidence against major oil companies.

8. In the end, it’s all about the people.

Mr. Giffen was a well-known intermediary of questionable reputation in the market. Tolerating his company as an intermediary to receive payment was risky at best and foolish at worst. J. Bryan Williams, the Mobil executive who has pled guilty to tax evasion in connection with receiving a kickback from Mr. Giffen, was in charge of Mobil’s operations in Kazakhstan. Care in selecting one’s own personnel and preparing them with proper training for the pressures, demands and temptations of emerging market duties is every bit as important as using vigorous criteria for selecting agents and consultants.

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SEcurities and EXchange COMMISSION
17 CFR Part 211
[Release No. 34-51689; Staff Accounting Bulletin No. 99]

AGENCY: Securities and Exchange Commission

ACTHIN: Publication of Staff Accounting Bulletin

SUMMARY: This staff accounting bulletin expresses the views of the staff that exclusive reliance on
certain quantitative benchmarks to assess materiality in preparing financial statements and performing
audits of those financial statements is inappropriate; misstatements are not immaterial simply because
they fell beneath a numerical threshold.

DATE: August 12, 1999

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SUPPLEMENTARY INFORMATION: The statements in the staff accounting bulletins are not rules or
interpretations of the Commission, nor are they published as having the Commission's official
approval. They represent interpretations and practices followed by the Division of Corporation Finance
and the Office of the Chief Accountant in administering the disclosure requirements of the Federal
securities laws.

Jonathan G. Katz
Secretary

Date: August 12, 1999

Part 211 - (Amend) Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended
by adding Staff Accounting Bulletin No. 99 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN No. 99

The staff hereby adds Section M to Topic 1 of the Staff Accounting Bulletin Series. Section M, entitled
"Materiality," provides guidance in applying materiality thresholds to the preparation of financial
statements filed with the Commission and the performance of audits of those financial statements.

STAFF ACCOUNTING BULLETINS

TOPIC 1: FINANCIAL STATEMENTS
At Materiality

1. Assessing Materiality

**Facts:** During the course of preparing or auditing year-end financial statements, financial management and the registrant's independent auditor becomes an awareness of financial statements. When combined, the misstatement results in a 4% overstatement of net income and a $502 million overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is overstated by more than 5%, management and the independent auditor conclude that the deviation from generally accepted accounting principles ("GAAP") is immaterial and that the accounting is permissible.

**Question:** Each Statement of Financial Accounting Standards adopted by the Financial Accounting Standards Board ("FASB") states, "The provisions of this Statement are not to be applied in unmaterial items." In the staff's view, a registrant or the auditor of its financial statements may remove the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements.

**Interpretive Response:** No. The staff is aware that certain registrants, over time, have developed qualitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items may be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of these financial statements that exclude reliance on any percentage or numerical threshold has no bearing on the accounting for the item.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that, without considering all the relevant circumstances, the deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is negligible. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality. It cannot appropriately be used as a substitute for a full analysis of all relevant and relevant circumstances. Materiality consists in the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person relying on the report would be influenced by the omission or correction of the item.

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is a substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered "qualitative" factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement No. 2, the FASB noted that some had urged it to promulgate quantitative materiality guidelines for use in a variety of situations. The FASB rejected such an approach as representing only a "numeral view," stating:

The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures. It took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income. The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions" in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that:

"[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment."

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances and the staff believes that there are numerous circumstances in which misstatements below 5% could be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material, as stated in the auditing literature:

"As a result of the interaction of qualitative and quantitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements."

Among the considerations that may well tend to materialize a quantitatively small misstatement of a financial statement item are:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement makes a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;
- whether the misstatement changes a loss into income or vice versa;
- whether the misstatement concerns a segment or other portion of the registrant's business that has
been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation, for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement. Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether a misstatement is material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material. When, however, management or the independent auditors expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example, those pursuant to actions to "manage" earnings, are immaterial. While the intent of management does not affect its materiality, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so to believe that the resulting amounts and trends would be significant to investors and to the registrant's financial statements. The staff believes that investors generally would consider as significant an accounting practice to over- or understate earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, renders all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on whether it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole. "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity" is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information - as well as in other financial statements - situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements. "A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and consider whether, in relation to individual line item amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole."

This requires consideration of -
- the significance of an item to a particular entity (for example, inventories in a manufacturing company);
- the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items); and the effect of the misstatement on the financial statements taken as a whole.

Registrants and their auditors should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially misleading.

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or to appropriately allocate) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should not be purely mechanical, given the imprecision inherent in estimates, there is by definitions a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, when auditing literature states, "Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated," even though the auditor has concluded that the adjustments are not material to the current financial statements.

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements That are Intentional

Failure A registrant's management intentionally made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been affected at the direction or in consequence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.
Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions Under the Exchange Act

Even if misstatements are immaterial, registrants must comply with Sections 13(b)(2) and 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act, or required to file reports pursuant to Section 15(d), must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs. Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then-Chairman Harold M. Williams. In his address, Chairman Williams noted that, unlike materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records." Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) and 15(d) of the Exchange Act.

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate in reasonable detail, registrants and their auditors should consider, in addition to the factors discussed above, concerning an evaluation of a misstatement's potential materiality, the facts set forth below.

• The significance of the misstatement. Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

• How the misstatement arose. It is unlikely that it is ever "reasonable" for registrants to record misstatements unrelated to correct known misstatements or not to correct known misstatements even if immaterial -- as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate in reasonable detail.

• The cost of correcting the misstatement. The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements. Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."

• The clarity of authoritative accounting guidance with respect to the misstatement. Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate in reasonable detail. Where, however, there is little ground for reasonable disagreement, the case for

leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act. The statute specifies that these obligations are triggered "whether or not the illegal acts are perceived to have a material effect on the financial statements of the issuer . . . ." Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inadvisable) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

As noted, an intentional misstatement in immaterial items of a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor will be required to report that illegal act to the audit committee irrespective of any "setting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, Statement on Auditing Standards No. 34, "Illegal Acts by Clients," and SAS 12, "Consideration of Fraud in a Financial Statement Audit." Pursuant to paragraph 38 of SAS 82, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS 82 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users." SAS 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records, misrepresenting or omitting events, transactions, or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements. The clear implication of SAS 82 is that immaterial misstatements may be fraudulent financial reporting.

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting. As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treasury Commission, in its 1987 report,

The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of the reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course
of the examination of the registrant's financial statements.

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature. This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogous to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When misstatements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

Footnotes

1. American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") § 312, "Audit Risk and Materiality in Conducting an Audit," states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with generally accepted accounting principles. The purpose of that Staff Accounting Bulletin ("SAB") is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (i.e., (b) above) so that SAB is not intended to provide definitive guidance for assessing "materiality" in other contexts, such as evaluations of audit independence, as other factors may apply. There may be other rules that address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

2. As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.


5. See, e.g., Concepts Statement No. 2, 121-124; AU § 312.10 ("...materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations"); AU § 312.24 ("...qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material"). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.


AU § 312.11.

13. As stated in Concepts Statement No. 2, 130:

Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the allowable degree of precision decreases. For example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second.

This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion No. 20, Accounting Changes 10, 11, 31-33 (July 1971).

The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about material misstatements. See generally Big Five Audit Materiality Task Force, "Materiality in a Financial Statement Audit - Considering Qualitative Factors When Evaluating Audit Findings" (August 1998). The Task Force memorandum is available at www.aicpa.org.


14. If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 38 and 39 infra.
Assumptions of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., in the Matter of Venator Corp., Inc., AAER 1039 (June 20, 1989).


AAER 1140.33.

Id.

The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AAER 312.42. See also AAER 312.44.

AAER 312.44. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders’ equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

AAER 312.36.

Id.

AAER 312.34.

AAER 312.49.

AAER 312.49. FASB Statements of Financial Accounting Standards ("Standards" or " Statements") generally provide that "the provisions of this Statement need not be applied to immaterial items." This SAB is consistent with that provision of the Statements. In theory, the language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plausibly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

15 USC §§ 78m(b)(2). [7]

15 USC § 78i.

15 USC § 78d.

[1] Criminal liability may be imposed upon a person knowingly or wilfully fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 USC §§ 78m(b)(4) and (14) See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, "No person shall, directly or indirectly, falsify, destroy or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

15 USC § 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA") in the conference committee report regarding the 1988 amendments to the FCPA, the committee stated:

The conference committee adopted the proudest man qualification in order to clarify that the current standard does not constitute an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.


As far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in detail, SEC v. World Wide Wood Investments, Ltd., 567 F. Supp. 724 (D. Md. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., Lanb v. Philip Morris Inc., 915 F.2d 1024 (Fed. Cir. 1990) and 15 Service Center (Corporation) v. General Electric Electric Services Company, 97 F. Supp. 316 (S. D. N. Y. 1996).


Id. at 46 FR 11546.

Id.

For example, the conference report regarding the 1988 amendments to the FCPA stated:

"As Chairman Williams noted with respect to the internal control provisions of the FCPA, 'thousands of dollars ordinarily should not be spent conserving hundreds.' 46 FR 11546.

"Id. at 11547.

[1] Section 10A(a) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definiton of an "illegal act" in 15 USC § 737(d), which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

15 USC § 316.04. See also 15 USC § 316.03. An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AAER §§ 110 n.1. § 316.04 n.1, § 317.05 and § 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case. See AAER § 316 note 3.

[1] 15 USC § 316.04. Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 82 requires the auditor to evaluate several fraud "risk factors" that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 82 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of communicating to analysts or others that it will achieve unusually aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve
unusually subjective judgments or uncertainties. See AU § 316.27a and 27c.

AU §§ 316.24 and 316.35, in requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, make clear that fraud can involve material misstatements. Indeed, a misstatement can be "unconceivable" and still involve fraud.

Under SAS 82, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at the completion of the audit. SAS 82 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. AU § 316.33. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

AU §§ 316.34 and 316.36. Auditors should document their determinations in accordance with AU §§ 316.37, 316.39, and other appropriate sections.

See, e.g., AU § 316.39.

Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Auditing Committees (February 8, 1990).

AU § 315.3. See also AU § 315.07, which, in discussing matters to be communicated by the auditor to the audit committee, states,

The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements.

See AU § 315.05.

The AICPA Discussion Memorandum, Criteria for Determining Materiality, states that the financial accounting and reporting process considers that "a great deal of the time may be spent during the auditing process considering significant matters." It presents materiality as something that is "presented in a timely basis and presented in a concise and intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from significant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting cycle processes, such as a clerical error or an adjustment for a missed account payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the PCAOB or other procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not cause the costs associated with recordkeeping or with audits of financial statements.

http://www.sec.gov/rules/interp/sab09.htm
June 13, 2005

MEMORANDUM

Re: SEC Charges Huntington Bancshares and Senior Officers with Financial Reporting Fraud Based on Qualitative Materiality

SUMMARY

The Securities and Exchange Commission has settled a civil enforcement action alleging that Huntington Bancshares, Inc., its chief executive officer, its former chief financial officer and its former controller engaged in financial reporting fraud in connection with the company’s 2001 and 2002 financial statements. The complaint also alleges failure to maintain accurate books and records and adequate internal controls, and the filing of materially false CEO and CFO certifications. The following points are of particular interest:

- In assessing the materiality of the alleged accounting improprieties, the SEC focused on qualitative materiality factors. In particular, the SEC stressed that, while the increases in reported operating earnings resulting from the improper accounting methods may have been quantitatively fairly small (3% in 2001 and 5% in 2002), they were material because they enabled Huntington to meet or exceed Wall Street analysts’ earnings per share (EPS) estimates and to meet internal EPS targets that determined management bonuses.

- The alleged improper accounting occurred despite Huntington and its management team having in place a due diligence and disclosure process, involving meetings at which senior management discussed the accounting treatment with, among others, external auditors and legal advisors. The SEC alleged that in some cases the defendants acknowledged in these meetings that the accounting was improper, but concluded it need not be changed because the errors were not material.

- In several cases, the alleged improper accounting was a continuation of accounting practices that were established years earlier – before the individual defendants were at the company – and were approved by outside auditors at the time of establishment and on an ongoing basis.
IMPLICATIONS

The SEC’s emphasis in this case demonstrates the importance of considering the qualitative factors set forth by the SEC in Staff Accounting Bulletin No. 99\(^1\) in assessing the materiality of financial statement disclosure. Even quantitatively small adjustments may be deemed qualitatively material if, among other things, they can be seen as part of an attempt to manage earnings for internal or external purposes, such as internal compensation arrangements or Wall Street earnings expectations. For example, one accounting entry detailed by the SEC increased reported operating EPS by only $0.008, but had the qualitative effect of causing Huntington to meet its targeted EPS. Companies must carefully consider all the factors set forth in SAB 99 before making any determination that a disclosure deficiency or an accounting adjustment is immaterial.

This complaint also illustrates that, while it is important for companies to have a due diligence and disclosure process, the mere existence of this structure will not insulate the company or its management from allegations of fraud. The fact that a company involves all the right decision-makers and advisers in the disclosure process and considers all the right factors will not prevent the SEC or others from questioning and criticizing the final decisions made by the participants through the process. This is the case even when the decisions are consistent with long-standing, pre-existing practices approved by outside auditors.

DISCUSSION

On June 2, 2005, the SEC announced that it filed a complaint in federal district court against Huntington Bancshares, Inc., as well as its CEO, its former CFO and its former controller.\(^2\) The complaint alleges that the company’s 2001 and 2002 financial statements used improper accounting methods to materially inflate earnings. The defendants, without admitting or denying the allegations, have agreed to a settlement.

involving penalties of $7.5 million from the company and a total of $1.13 million from the individual defendants.

As discussed further below under “Alleged Improper Accounting Methods,” the effects of the alleged accounting improprieties were quantitatively small – the aggregate effect was approximately 3% of operating earnings in 2001 and 5% of operating earnings in 2002, and most of the alleged improprieties individually amounted to less than 1% of operating earnings. Nevertheless, the SEC focused on the qualitative materiality of the accounting methods, in that they permitted the company to report earnings per share that met Wall Street analysts’ expectations and that met internal targets for management bonuses, as discussed further in the next section. These are among the qualitative materiality factors specified in SAB 99.

**Earnings Guidance and Management Incentive Plan**

Prior to the issuance of the financial statements in question, Huntington had established the practice of providing earnings guidance to analysts and to the public for expected annual operating earnings per share. For example, in mid-2001, Huntington estimated that 2001 operating EPS would be between $1.15 and $1.17. The consensus operating EPS estimate among Wall Street analysts for 2001 was $1.17. For 2002, Huntington estimated operating EPS at $1.32 to $1.36, and the analyst consensus estimate for operating EPS was $1.33.

Operating EPS was also the basis for a portion of management bonuses under Huntington’s management incentive plan. In 2001, the plan set levels of $1.15 for the minimum bonus, $1.18 for the target bonus and $1.25 for the maximum bonus. In 2002, the levels were set at $1.32 for the minimum bonus, $1.35 for the target bonus and $1.40 for the maximum bonus. In both years, all or a significant portion of the individual defendants’ bonuses were tied to these target EPS levels.

The actual reported operating EPS for 2001 was $1.17, which met the analyst consensus estimate and met the required level for the minimum bonus under the

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management incentive plan. For 2002, the actual reported operating EPS was $1.35, which again met analyst estimates, as well as the EPS level for the “target bonus.” The SEC alleges that without the use of improper accounting methods, the operating EPS for 2001 and 2002 would have been $1.13 and $1.27, respectively, which would have been below both analyst estimates and the EPS level for triggering the minimum bonus.

**Due Diligence Process**

In mid-2002, the company’s senior executives began a series of due diligence meetings to support the signing and filing of the CEO and CFO certifications. At these meetings, senior executives met with, among others, the company’s outside auditors, the company’s internal legal advisors and, in some cases, the company’s external lawyers, to discuss the company’s financial statements and other disclosures. The company had also obtained a memorandum from their outside counsel setting forth the factors to consider in determining materiality. The memorandum described the qualitative factors included in SAB 99, including whether the misstatements or omissions affected management compensation or hid a failure to meet analyst expectations.

The alleged accounting improprieties included in the SEC complaint were (with one exception) discussed by the participants in these sessions, as was the potential application of the SAB 99 qualitative factors. The participants concluded that these misstatements were not material.

**Alleged Improper Accounting Methods**

The SEC identified six alleged accounting improprieties that were used in preparing Huntington’s 2001 and 2002 financial statements.

*Upfront recognition of loan and lease origination fees.* In 2001 and 2002, the company recognized loan origination fees as income entirely in the period received, while deferring the related costs. This practice originated in 1997, and was done with the concurrence of the company’s outside auditors. The SEC complaint states that under generally accepted accounting principles (GAAP), loan origination fees should
be deferred if they are material, and in fact the company disclosed in its financial statements that its practice was to defer origination fees where material. However, since 1997, the company did not defer recognition of the fees. In 2002, the company and its advisors concluded that the fees were not material, and did not require deferral.

According to the SEC, this improper recognition of income led to an inflation of earnings of approximately 3.3% in 2001 and approximately 2.4% in 2002. This was, by far, the largest effect of any of the alleged improprieties.

**Capitalization of commission expenses.** Beginning in 1997, again with the concurrence of the outside auditors, the company deferred the expense of certain sales commissions paid to employees for originating deposit accounts, amortizing the expenses over the expected life of the account. The SEC claims that, although accounting pronouncements do not specifically address the matter, GAAP requires immediate recognition of such sales expenses.

The effect of this alleged improper accounting method was 0.5% of earnings in 2001 and 0.3% of earnings in 2002.

**Deferral of pension costs.** In 2002, the company changed its accounting treatment relating to pension costs, and deferred recognition of a pension settlement loss over eight years, rather than expensing the loss immediately. The company’s outside auditors concluded that the change was not inappropriate and was not sufficiently material to require disclosure. The SEC maintains that, regardless of the appropriateness of the change, it had a qualitatively material effect and should have been disclosed.

The effect of the undisclosed change in treatment was a 0.7% increase in 2002 earnings.

**Misstatement of auto residual reserve.** At the end of 2002, the company went through the process of setting its reserve to cover uninsured losses relating to the decline in value of certain leased automobiles. The company’s risk management group

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provided an estimate of the reserve of between $22.9 million and $30.8 million, and the company had historically relied on this group’s estimate to set the reserve. At one of the company’s due diligence sessions, the participants discussed that the estimated range would have a low end of $21.2 million if it were discounted for present value, though such a discount had not been applied before. The book balance of the reserve was $20.2 million, which was still $1 million below the discounted present value.

If the company had expensed the difference between the book value and the nondiscounted estimate of the reserve, it would have led to a 0.5% decrease in 2002 reported earnings.

**Improper deferral of income.** At the end of 2001, the company learned that it had a gain resulting from an increase in the cash surrender value of certain bank owned life insurance. The company’s officers determined to recognize the gain in 2002 rather than in 2001, and the SEC claims that this was an improper deferral arising from the fact that the company did not need the gain in 2001 to meet analyst consensus estimates for EPS. Unlike the other alleged accounting improprieties, this matter was not discussed at the company’s due diligence meetings.

This deferral of income led to a decrease in 2001 earnings, and an increase in 2002 earnings, of less than 1%.

**Misclassification of non-operating income as operating income.** At the end of 2002, the company released $2.2 million from an existing restructuring reserve, and reported this amount as operating income. Although the SEC did not allege that the reduction of the reserve was inappropriate, it maintained that the amount was inappropriately included in operating income – and therefore affected operating EPS – since the reserves had earlier been recorded as non-operating special charges.

The classification of this amount as operating income led to an increase in operating earnings of 0.4% in 2002. In particular, the SEC’s complaint points out that the classification led to an increase in reported operating EPS of $0.008. This increased reported operating EPS from $1.338 to $1.346, which the company then rounded up to
$1.35. This permitted the company to precisely meet the internal EPS level for target bonuses discussed above, and also to beat the analyst consensus estimate by $.02.

* * *

If you have any questions regarding the Huntington complaint or materiality considerations in general, please contact H. Rodgin Cohen (+1 212 558-3534), John T. Bostelman (+1 212 558-3840) or Robert W. Reeder (+1 212 558-3755) in our New York office or any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on financial disclosure matters. The SEC’s complaint against Huntington Bancshares is available at http://www.sec.gov/litigation/complaints/comp19243.pdf and SAB 99 is available at http://www.sec.gov/interps/account/sab99.htm. You may also obtain copies of these materials and our other memoranda by contacting Melissa Caprio (+1 212 558-3864; capriom@sullcrom.com) in our New York office.

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2. Disclosures of Material Nonpublic Information

The final regulation, like the proposal, applies to disclosures of "material nonpublic" information about the issuer or its securities. The regulation does not define the terms "material" and "nonpublic," but relies on existing definitions of these terms established in the case law. Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available." Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.

The use of the materiality standard in Regulation FD was the subject of many comments. Some commenters supported the use of the existing definition of materiality, noting that attempts to define materiality for purposes of Regulation FD could have implications beyond this regulation. Other commenters, however, including securities industry representatives, securities lawyers, and some issuers or issuer groups, stated that using a general materiality standard in the regulation would cause difficulties for issuer compliance. These commenters claimed that materiality was too unclear and complex a standard for issuer personnel to use in making "real time" judgments about disclosures, and that this vagueness would lead to litigation and a chilling effect on corporate disclosure practices. These commenters offered a variety of recommendations to address this issue.

Some commenters suggested that the regulation include a bright-line standard or other limitation on what was material for purposes of Regulation FD, or identify in the regulation an exclusive list of types of information covered. While we acknowledged in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material" items for purposes of Regulation FD. The problem addressed by this regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case. As the Supreme Court stated in responding to a very similar argument: "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive."

Other suggestions from commenters included providing more interpretive guidance about types of information or events that are more likely to be considered material. While it is not possible to create an exhaustive list, the following items are some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a
Selective Disclosure and Insider Trading

contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities -- e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.47

By including this list, we do not mean to imply that each of these items is per se material. The information and events on this list still require determinations as to their materiality (although some determinations will be reached more easily than others). For example, some new products or contracts may clearly be material to an issuer; yet that does not mean that all product developments or contracts will be material. This demonstrates, in our view, why no "bright-line" standard or list of items can adequately address the range of situations that may arise. Furthermore, we do not and cannot create an exclusive list of events and information that have a higher probability of being considered material.

One common situation that raises special concerns about selective disclosure has been the practice of securities analysts seeking "guidance" from issuers regarding earnings forecasts. When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.

At the same time, an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a "mosaic" of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to discourage this sort of activity. The focus of Regulation FD is on whether the issuer discloses material nonpublic information, not on whether an analyst, through some combination of persistence, knowledge, and insight, regards as material information whose significance is not apparent to the reasonable investor.

Finally, some commenters stated that greater protection would be afforded to issuers if we made clear that the regulation's requirement for "intentional" (knowing or reckless) conduct also extended to the judgment of whether the information disclosed was material.48 We agree that this clarification is appropriate. As adopted, Rule 101(a) states that a person acts "intentionally" only if the person knows, or is reckless in not knowing, that the information he or she is communicating is both material and

http://www.sec.gov/rules/final/33-7881.htm

04/04/2001
nonpublic.49 As commenters suggested, this aspect of the regulation provides additional protection that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases.

3. Intentional and Non-intentional Selective Disclosures: Timing of Required Public Disclosures

A key provision of Regulation FD is that the timing of required public disclosure differs depending on whether the issuer has made an "intentional" selective disclosure or a selective disclosure that was not intentional. For an "intentional" selective disclosure, the issuer is required to publicly disclose the same information simultaneously.50

a. Standard of "Intentional" Selective Disclosure

Under the regulation, a selective disclosure is "intentional" when the issuer or person acting on behalf of the issuer making the disclosure either knows, or is reckless in not knowing, prior to making the disclosure, that the information he or she is communicating is both material and nonpublic.51 A number of commenters thought that the distinction between intentional and non-intentional disclosures was appropriate.52 Others, however, stated that the "intentional" standard should not include reckless conduct, because of the risk that this standard, in hindsight, could be interpreted as close to a negligence standard.53 Some commenters suggested that there be a safe harbor for good-faith efforts to comply with Regulation FD or for good-faith determinations that information was not material.54

After considering these comments, we have determined to adopt the "intentional"/non-intentional distinction essentially as proposed. By creating this distinction, Regulation FD already provides greater flexibility as to the timing of required disclosure in the event of erroneous judgments than do other issuer disclosure provisions under the federal securities laws; it essentially incorporates the knowing or reckless mental state required for fraud into this disclosure provision. Since recklessness suffices to meet the mental state requirement even for purposes of the antifraud provisions,55 we believe it is appropriate to retain recklessness in Regulation FD's definition of "intentional" as well. Further, in view of the definition of recklessness that is prevalent in the federal courts,56 it is unlikely that issuers engaged in good-faith efforts to comply with the regulation will be considered to have acted recklessly.

As requested by several commenters, moreover, we emphasize that the definition of "intentional" in Rule 101(a) requires that the individual making the disclosure must know (or be reckless in not knowing) that he or she would be communicating information that was both material and nonpublic. Thus, in the case of a selective disclosure attributable to a mistaken determination of materiality, liability will arise only if no reasonable person under the circumstances would have made the same determination.52 As a result, the circumstances in which a selective disclosure is made may be important. We recognize, for example, that a materiality judgment that might be reckless in the context of a prepared written statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question.
FINANCIAL STATEMENT DUE DILIGENCE AFTER WORLDCOM

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Introduction

On December 15, 2004 Judge Denise Cote of the U.S. District Court for the Southern District of New York denied summary judgment motions by the underwriters for two SEC-registered bond offerings by WorldCom, Inc.\(^1\) One of the offerings was made in 2000 in the amount of $5 billion, and the second offering was made in 2001 in the amount of $11.9 billion. The second offering was said to have been the largest public debt offering in U.S. history.

WorldCom announced a massive restatement in June 2002, focusing mostly on $3.8 billion of line costs improperly accounted for as capital expenditures rather than expenses. It filed for bankruptcy in July 2002 and eventually made $76 billion in adjustments, reducing its net equity from $50 billion to minus $20 billion.

The buyers of the WorldCom bonds brought class actions based in part on Sections 11 and 12(a)(2) of the 1933 Act against WorldCom, its directors, certain officers, its auditors (Arthur Andersen) and the underwriters of the two offerings, with Salomon Smith Barney (a Citigroup subsidiary) and J.P. Morgan Chase & Co. as the leads.

Citigroup settled with the plaintiffs in May 2004 for $2.5 billion. Following Judge Cote’s denial of the underwriters’ motion for summary judgment in December 2004 and the criminal conviction of WorldCom’s CEO in March 2005, all the remaining underwriters settled for a total of more than $6 billion. Within a short time, WorldCom’s former outside directors also agreed to a settlement to which they contributed more than $20 million out of their own pockets.

The plaintiffs’ case was built entirely on deficiencies in WorldCom’s financial statements (with the exception of one allegation relating to use of proceeds). The improper capitalizing of line costs began in April 2001 and affected the first quarter of 2001, the financial statements for which were incorporated into the registration statement for the $11.9 bond offering later that year. For that reason, Judge Cote granted summary judgment for the plaintiffs on the 2001 registration statement being false and misleading. Plaintiffs also claimed that the audited financial statements in the 2000 and 2001 registration statements were false and misleading, although Arthur Andersen had never withdrawn its audit report on those statements.

The underwriters based their summary judgment motion on the fact that Arthur Andersen had “expertized” the full-year financial statements for purposes of Section 11 of the 1933 Act. This meant that the underwriters could prevail on their due diligence defense if they could show that they had “no reasonable ground to believe” (and did not believe) that the financial statements were untrue or rendered misleading by an omission. It would not be necessary for the underwriters to show, as they would have to in respect of non-expertized portions of the registration statement, that they had also performed a “reasonable investigation.” As for WorldCom’s financial statements for the first quarter of 2001, which were not the subject of an audit, the underwriters argued that they had discharged their obligation of a reasonable investigation by requesting and receiving a “comfort letter” from Arthur Andersen.

Underwriters’ Due Diligence Regarding WorldCom

In considering the underwriters’ motion for summary judgment based on their due diligence defense, Judge Cote described the due diligence performed by the underwriters for the two offerings.

2000 offering

The only written record of the underwriters’ due diligence for the 2000 offering was a May 26, 2000 memo prepared by underwriters’ counsel reflecting due diligence from May 15 to 23. It described a May 17 telephone call with WorldCom’s chief financial officer in which he responded to some questions. The memo also described board minutes, public filings, press releases and some documents relating to Sprint (which was a potential merger partner). Judge Cote quoted at length from a J.P. Morgan Chase policy statement referring to the need not to take issuer’s statements “at face value.” She also described work done by Arthur Andersen to back up its comfort letter.

2001 offering

Judge Cote described a May 16, 2001 memo prepared by underwriters’ counsel to describe due diligence done over nearly a month’s time. It included a list of questions forwarded to WorldCom and three telephone conversations with the issuer, including one in which Arthur Andersen participated. It described the bankers’ questions and the chief financial officer’s responses.

Judge Cote noted that some of the bankers on the 2001 deal were aware of their own firms’ internal downgrading of WorldCom or their effort to lay off credit risk by swaps. She described a roadshow presentation for the 2001 offering that some bankers thought was misleading about WorldCom’s financial condition.

She also quoted from emails among bankers that could be interpreted as demonstrating a reluctance to offend WorldCom rather than a desire to achieve better disclosure.

Underwriters’ Summary Judgment Motion

The underwriters’ motion for summary judgment was based solely on their right to rely on the audited financial statements and on the Arthur Andersen comfort letter that covered the first quarter of 2001. They argued that Section 11 permitted them to rely without investigation on audited financial statements and that a comfort letter based on an SAS 71 review was a sufficient means of discharging the requirement of a reasonable investigation in cases involving “seasoned issuers” and shelf registration.

But Judge Cote noted that the expertization defense still required the defendant to have “no reasonable ground to believe” and not to believe that the expertized statements were untrue. Reliance on audited financial statements can therefore not be blind reliance. “Rather, where ‘red flags’ regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability.” And “[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag, whether or not it relates to accounting fraud or an audit failure.”

Judge Cote admitted that “red flags” are warning signals that are usually alleged in Rule 10b-5 cases to show a defendant’s recklessness for scienter purposes. But she noted that the Ninth Circuit in Software Toolworks 2 had made it clear that ignoring “red flags” could undermine underwriters’ attempts to establish a due diligence defense, and she contrasted IPO cases in which summary judgment had been granted for underwriters, noting the extensive due diligence done in the offerings involved in those cases. She then cited dictionary definitions from 1934

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and 1993 of “investigation,” emphasizing “thorough” or “searching” with “systematic attention to detail.”

The plaintiffs had cited several red flags—“facts extraneous to WorldCom’s audited figures”—but the one that Judge Cote chose to emphasize was that WorldCom’s ratio of line expense to revenue was more favorable than that of its two major competitors. (It should be noted that, for the full years 1999 and 2000, this ratio was unaffected by the fraud that started in the first quarter of 2001. It was, however, favorably influenced during 1999 and 2000 by other adjustments that plaintiffs alleged were improper.)

Once there are red flags, the question is whether the underwriters’ response was reasonable. Plaintiffs emphasized the limited number of conversations with the issuer and its accountants, the cursory nature of the inquiries, the failure to follow up the “almost formulaic answers” and the failure to inquire into questions raised in their own internal credit evaluations or in the financial press. WorldCom was in a deteriorating financial position in a troubled industry. According to Judge Cote, given the “enormity” of the two bond offerings and the general deterioration in WorldCom’s situation, a prudent person would have undertaken a “particularly probing inquiry.”

Judge Cote described in detail the history of shelf registration and observations over three decades that shelf registration had made it difficult for underwriters to conduct traditional due diligence. She dismissed the significance of such observations, noting that the SEC’s formal position was still that no underwriter is ever compelled to underwrite an offering if it is unable to perform a reasonable investigation.

Judge Cote discounted the underwriters’ claim that their inability to rely on a comfort letter as they would an audit report would increase the cost of capital formation because they would have to hire own auditor. “The term ‘reasonable investigation,’” she said, “encompasses many modes of inquiry between obtaining comfort letters from an auditor and doing little more, on one hand, and having to re-audit a company’s books on the other.”

The underwriters did not move for summary judgment based on their “continuous due diligence” with respect to WorldCom—i.e., what they had learned about WorldCom in the course of their involvement with the company in transactions other than the two bond offerings. It would have remained open to them to show at trial that they were entitled to prevail on this basis.

How could underwriters be exposed to such massive liabilities as a result of deficiencies in audited financial statements or as to quarterly financial statements covered by an accountant’s comfort letter? What consequences should underwriters draw as a result of the WorldCom example?

“Expertization” of Financial Statements

Section 11(b)(3)(C) of the 1933 Act makes it easier for an underwriter or other defendant to escape liability for any part of the registration statement that purports to have been “made on the authority of an expert.” In such cases, it is sufficient if the defendant had “no reasonable ground to believe (and did not believe) that the “expertized” portion of the registration statement was untrue or rendered misleading by an omission or that it did not “fairly represent the statement of the expert”. Unlike as to other portions of the registration statement, there is no need for the defendant to demonstrate:

- having had affirmative reasonable grounds to believe in the accuracy of the expertized portion, or
- having had an actual affirmative belief in the accuracy of the expertized portion or
- having conducted a reasonable investigation as a basis for not having reasonable ground to believe and not believing in the untruth or incompleteness of the expertized portion.

Accountants are the quintessential “experts” under the 1933 Act, and the audited financial statements are the quintessential expertized portions of the registration statement. But interim financial statements and other unaudited financial information are not “expertized.” In re WorldCom, Inc. Securities Litigation, CCH Fed. Secs. L. Rep. ¶ 93,057 (S.D.N.Y. December 15, 2004) at 95,182-83.

Due Diligence After WorldCom

WorldCom is indeed the train wreck everyone has been expecting since shelf registration was introduced—but the underwriters actually had more notice about the WorldCom offerings than is the case for typical shelf takedowns. And few people would have expected the train wreck to be caused exclusively by alleged misstatements in the audited full-year and unaudited quarterly financial statements.
The question facing underwriters is how to use available resources to identify “red flags” in the issuer’s audited financial statements—i.e., facts suggesting that all is not what it seems to be—and to document how they addressed these concerns. It would be foolish to wait for plaintiffs to identify the red flags in their complaint!

As WorldCom also shows—and, again, it should have come as no surprise—the comfort letter is an empty shell when it comes to supporting due diligence on audited financial statements. For interim periods, it is not clear what it adds to SAS 100 reviews. It may be more useful to cover changes during bring-down periods, i.e., portions of an accounting period, but this is likely to be more important in equity deals than in debt deals.

What can the underwriters do? It is certainly not necessary to do a "re-audit"—every defendant’s standard response to allegations based on audited financial statements. But a lot can be done to show that there is a process and that it is functioning:

Accounting is—and always has been—too important to be left to the accountants!

Even though Section 11 does not expressly require a “reasonable investigation” as to “expertized” material such as audited financial statements, this does not mean that an underwriter should not understand the issuer’s financial statements and the choices that were made in preparing them.

- First, as Judge Denise Cote’s decision in WorldCom demonstrates, it is relatively easy for plaintiffs to allege and for a court to identify “red flags” that should have alerted underwriters to the need to make further inquiries, and the failure to follow up on such “red flags” relating to audited financial statements may well mean that it will be up to a jury to decide whether underwriters will be liable under Section 11.

- Second, investors have become extraordinarily skittish about financial reporting issues, and nothing can send a company’s stock plunging faster than allegations of SEC staff inquiries into the company’s accounting or announcements of earnings restatements. The market tends to assume that if management is playing games with the numbers, then the company’s prospects for success must be worse—perhaps much worse—than the market has assumed.

- Third, interim financial statements and other unaudited financial information are not expertized. It is difficult to understand interim financial statements without close examination of the audited financial statements. Any deficiencies in the audited or interim financial statements are likely to render misleading at least some of the disclosure in the prospectus outside the financial statements, e.g., MD&A.

- Fourth, financial statement analysis plays a major role in an underwriter’s decision to underwrite an issuer’s securities in the first place, in marketing the securities to customers and in comparing the issuer’s performance to the performance of other companies for pricing purposes. Liability aside, an underwriter will not want to risk embarrassment and reputational damage because it failed to understand the issuer’s accounting.

Preparing for Financial Statement Due Diligence

It is not necessary to be trained as an accountant in order to perform effective due diligence on financial statements. Experience in reviewing financial statements certainly helps, but as in other areas effective financial statement due diligence is principally a matter of preparation, focus and common sense. Accounting expertise is not required to form conclusions as to whether financial statements are too old, whether additional statements need to be filed or whether MD&A disclosures are responsive to the SEC’s requirements.

Underwriters and their counsel should therefore prepare for financial statement due diligence as carefully as they would for due diligence in regard to any other part of the offering document. In particular, they should use their commitment committee process—whether or not a take-down is imminent—to review the issuer’s financial statements (along with its MD&A and risk factors) to identify “red flags” such as:

- is the company’s financial situation deteriorating?
- is the industry in trouble?
- is the industry’s accounting under fire from the SEC, regulators or others?
- does the issuer’s choice of accounting principles compare unfavorably to its peer companies?
- are the issuer’s identified “critical accounting estimates” inconsistent with those of peer companies?
- have there been recent changes in the issuer’s accounting policies or
principles?
- Is management under pressure to “make the number” or to meet Street expectations?
- What operating measures are investors focusing on: net earnings, operating earnings, EBITDA or some other performance measure?
- Are new accounting principles on the way that might have an adverse impact?
- Any recent change in auditors?
- Any “non-gaap financial measures” and, if so, are they inconsistent with those of peer companies?
- Any internal credit downgrades by potential lead underwriters (don’t be put off by Chinese Wall concerns)?

Meeting Focused on Financial Statement Due Diligence

Depending on the degree of their familiarity with a company, underwriters can no longer afford to confine their due diligence to a conference call with the chief financial officer—more often, an assistant treasurer—lasting 30 minutes or less. (John Shad, the chairman of the SEC at the time, predicted at the beginning of shelf registration that due diligence calls prior to takedowns would eventually degenerate into dialogues between junior people at underwriters and still more junior people at issuers.) If meetings are logistically impossible, video conferences should be arranged with the participation of underwriter representatives such as bankers and counsel (and, where possible, analysts) to engage in a dialogue with company representatives such as senior financial reporting staff and a member of the audit committee and a representative of the company’s outside accountants. The purpose of the dialogue should be to identify “red flags” by asking questions such as:

- What is the composition of the audit committee? What are the qualifications of its members? Does it carry out the responsibilities assigned to it in its charter? What resources are available? How often does it meet? What records are kept of its meetings?
- What is the relationship among the audit committee, the chief financial officer and the internal audit department? Who determines internal audit’s budget and priorities?
- What is the size of the outside accountant’s audit team, and what are the experience and qualifications of its members? Have they received all information requested? Are there any independence issues? Have all services been approved by the audit committee?
- Are the Sarbanes-Oxley certifications by the chief executive and financial officers facially sufficient? What is the process by which they become comfortable in making such certifications?
- What is the condition of the issuer’s disclosure controls and procedures and its internal control over financial reporting? What standards have been applied for distinguishing significant deficiencies from material weaknesses? What deficiencies and weaknesses have been identified?

The obvious purpose of this dialogue is that it is a serious red flag if the company’s own gatekeepers are not doing their job or are doing it carelessly. In this connection, while the underwriters and counsel should be familiar with the issuer’s SEC filings, it is not a sufficient response for the issuer to dismiss the underwriters’ inquiries with a reference to “go read the filings.”

In addition, the following subjects should be covered:

- When did the SEC staff last review the company’s 1934 Act reports? What comments did it make? Any comments still unresolved? Has the company complied with all undertakings to make changes in future?
- Has the PCAOB inspected any of the company’s audited financial statements?

At least annually, prospective underwriters and the company should engage in a review of the financial statements and the related disclosure.

\[3\] Warren Buffett is reported to have said that “managers that always promise to ‘make the number’ will at some point be tempted to make up the number.” Obviously, this is the exception rather than the rule, but it is important to know what temptations management is living with.

\[4\] Analysts can make a valuable contribution to due diligence, but their ability to do so has been compromised by Regulation FD (which may require a company to impose a lengthy confidentiality obligation as a condition for speaking to analysts) and by the “global settlement,” which permits analysts to advise on the accuracy of disclosure documents but only outside the presence of investment banking representatives. The SEC should revisit Regulation FD and the global settlement and consider what can be done to permit analysts to make a more effective contribution to due diligence.

\[5\] Note the allegations in the WorldCom class action complaint regarding the WorldCom audit committee, e.g., that it met three to five hours a year, kept poor or no records of meetings, did not understand Arthur Andersen’s audit approach and permitted the chief financial officer to “dominate” the internal audit department.
A member of the outside auditor’s team should be present for this discussion. It is likely that the following topics will deserve particular attention:

- revenue recognition policies
- derivatives and market risk (who audits VaR?)
- non-gaap financial measures
- segment disclosure
- related party transactions
- off-balance sheet entities and exposures
- goodwill and other impairment issues
- lease accounting
- environmental
- product liability
- indications of operational risk
- pension assumptions
- stock options
- restructuring reserves
- loss contingency reserves
- non-recurring items
- discontinued operations

The company’s MD&A is not expertized, but WorldCom should lead companies to request more frequently that their outside accountants perform an attestation of MD&A pursuant to SSAE 8. Whether or not this is done, underwriters should consider whether the MD&A appears:

- to reflect that management had taken a “fresh look,” as suggested by the SEC,
- to focus sufficiently on key variables or indicators,
- to identify known material trends and uncertainties,
- to tie in to the risk factors set forth in the offering document, and
- to be based on all information available to management.

Underwriters and their counsel should also be alert for potential tax issues,6 indications of operational risk7 and accounting for self-insurance activity (e.g., for worker’s compensation claims).

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Thinking Outside the Box

When underwriting firms pay out $6 billion in damages to settle class actions arising out of public offerings of $17 billion of an issuer’s securities, it is time to ask what can be done to prevent such situations from arising in the future.

A more diligent search for “red flags,” as described above, is surely one appropriate response. Asking the SEC for “safe harbors” for shelf underwritings has gone nowhere in the past and is not likely to succeed at any time in the near future.

Some additional steps that underwriters might take include the following:

Enlisting Allies

Unfortunately, due diligence too often resembles the directors, underwriters and accountants—all of whom share a common purpose—hunkering down in their silos and letting their respective liability concerns get in the way of effective cooperation and an optimum investigation.

It is understandable that directors are worried about the allegations in the WorldCom complaint about the audit committee’s poor performance and whether they can rely on their own audit committee. They are also obviously concerned that the WorldCom directors were prepared to settle Section 11 claims in part by funds from their own pockets.

Perhaps it is time to consider whether audit committees can actually benefit from participating with the underwriters in a joint due diligence effort, e.g., by:

- having one or more representatives present at due diligence meetings
- encouraging the company’s auditors to cooperate in due diligence
- ensuring that auditor reports to the audit committee are made available to underwriters.

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Directors might also want to consider asking the audit committee to have a role in selecting issuer’s counsel in public offerings and to have the issuer’s “negative assurance” or “Rule 10b-5” letter addressed to the audit committee or to the full board in addition to the underwriters.

Accountants also have more to gain than lose from cooperating with underwriters and their counsel in the due diligence effort, but this will not happen without audit committee encouragement. Clearly, the accounting profession has been rightly concerned in many cases that “no one is doing due diligence except the auditors.” If this changes as here proposed, the profession’s long-term interest may be better served by active participation rather than arm’s length passivity.

**Due Diligence by Syndicate Members**

It has become customary in recent years for syndicate members to defer to the lead underwriters for due diligence purposes. Where this is the case, a reasonable investigation by the leads will benefit the syndicate members for Section 11 purposes. On the other hand, anything less than a reasonable investigation will mean that the syndicate members have no due diligence defense. As WorldCom shows, syndicate members sink or swim according to the quality of the leads’ due diligence.

Underwriters should consider bringing back the due diligence meeting. As conducted many years ago, this was a meeting at which the issuer and the lead underwriters made a presentation to the entire underwriting syndicate, the members of which had an opportunity to ask questions of management and the leads. Over time, the due diligence meeting evolved into the roadshow at which management made a presentation to investors—a much different exercise.

The lead underwriters might describe at such a meeting their efforts to identify red flags and the responsive disclosure in the prospectus. In addition to a presentation, the company’s audit committee might be invited to make a presentation, and the company’s auditor might be asked to describe the contents of the comfort letter. Underwriters’ counsel might be asked to describe the overall due diligence effort.

Syndicate members should also consider documenting any independent due diligence, e.g., presentation to and minutes of their commitment committee and obtaining their analyst’s views about the investment merits of the issuer’s securities and the reliability of its public reports.

An ancillary benefit of independent due diligence by syndicate members is that plaintiffs’ lawyers have a harder time if they have to litigate the reasonableness of each underwriter’s due diligence as opposed to focusing only on the leads’ due diligence.

**Documentation**

Many underwriters have reduced the degree to which they document their due diligence. Some years ago, there was an approach known as the “complete file” approach where the underwriters kept evidence of their due diligence. This required someone to search through the file at the conclusion of an offering to make sure that it was complete and did not inadvertently contain unanswered questions, unresolved red flags or unflattering references to management.

The complete file approach was quite a logistical challenge for most underwriters. Under the bare bones approach, which is probably the current majority approach, the file consists of the basic documents filed with the SEC, the closing documents and any retail sales memorandum prepared for use by the sales force. It may also consist of memoranda prepared by underwriters’ counsel. The bare bones approach did not work well for the WorldCom underwriters because the Judge in her opinion appears to have taken an adverse inference from the fact that there was no written evidence of due diligence except two memoranda prepared by underwriter’s counsel.

It may be time for the pendulum to start swinging the other way. If the focus of the underwriters’ effort is to engage in a process designed to identify red flags, it stands to reason every red flag identified should then be addressed in terms of why the underwriters are still willing to proceed. Such a process should logically be documented.

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8. See, e.g., Kronfeld v. Trans World Airlines, Inc., 832 F.2d 726, 736 (2d Cir. 1987) (investment banking associate’s notes held to constitute evidence that reorganization was a “live” option and to raise issues of fact sufficient to reverse grant of summary judgment).
Institutional Buyer Beware: Recent Decisions Reinforce Narrow Range of Remedies Available to QIBs in Rule 144A Offerings

BY RANDALL W. BODNER AND PETER L. WELSH

Rule 144A private placements have become a favored mechanism for cost-effectively and timely placing securities, particularly high-yield and asset-backed securities, in the capital markets. Rule 144A provides generally that securities sold to "Qualified Institutional Buyers" ("QIBs")—typically institutional investors with more than $100 million to invest—will not be deemed to have been sold in a public offering under the Securities Act of 1933. Rule 144A offers involve the private placement to a QIB or QIBs of securities through a quasi-underwriter, known as an "initial purchaser." Rule 144A offerings are often followed shortly thereafter by a registered exchange offering, known as an "A/B exchange," involving the issuance of registered securities which are exchanged for the privately placed 144A securities. Rule 144A offerings have grown enormously in popularity since Rule 144A was issued in 1990. Roughly two-thirds to three-quarters of high-yield offerings are now accomplished by a Rule 144A private placement, often followed by an A/B exchange.

In releasing Rule 144A, the Securities and Exchange Commission recognized that "certain institutions can fend for themselves and, therefore, offers and sales to such institutions do not involve a public offering." In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig. v. Cucuzza, 271 F. Supp. 2d 1007 (E.D. Mich. 2003) (quoting SEC Rel. No. 33-6806, 1988 SEC LEXIS 2104, *51 (Oct. 25, 1988)). The question arises, however: What tools are available to QIBs in the event that they wish to fend for themselves through litigation?

Recent judicial decisions have largely reinforced the limited rights and remedies available to QIBs who may have been misled in a Rule 144A offering. In particular, several recent decisions strongly suggest that buyers in a private placement under Rule 144A are left with little more than Rule 10b-5 (along with its onerous pleading requirements) and state law causes of action, in the event that they are misled by a private placement offering memorandum. Yet, in three recent decisions, courts have permitted QIBs to survive a motion to dismiss on the theory that an ostensible private placement under 144A was, in reality, a public offering and that, as a consequence, a private right of action potentially exists under the '33 Act for misstatements made in a purported 144A offering memorandum. The law in this area nonetheless still remains largely a cautionary tale for QIBs.

144A Offerings and Liability Under the Federal Securities Laws.

For purposes of liability in connection with a Rule 144A resale and A/B exchange, both the Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (the "33 Act"), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "34 Act"), are relevant. All things being equal, and given a choice, a QIB/plaintiff would prefer to make a claim for defective disclosure in a 144A or A/B exchange transaction under the '33 Act because of the lower standard of proof required to establish a violation for defective disclosure. While the '33 Act imposes liability for defective disclosures on the basis of near strict liability in certain circumstances and mere negligence in others, transactions to which the '33 Act applies are relatively limited. The '34 Act, on the other hand, has wider applicability and generally encompasses a broader array of defendants. Because claims under this statute are based on fraud and require proof of scienter, however, the '34 Act erects a higher hurdle of both pleading a claim and proving a violation.

Liability Under the Securities Act of 1933

Section 11. A Rule 144A resale does not involve the preparation or filing of a registration statement, and there should, therefore, be no liability under Section 11 of the Securities Act for misstatements contained in a 144A offering memorandum. Section 11 covers only de-

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fective disclosures made in a "registration statement." See 15 U.S.C. § 77k. While a Rule 14A A offering memorandum often looks like the prospectus, portions of a registration statement, the offering memorandum is nevertheless not a "registration statement" within the meaning of the Securities Act. See In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 430 (S.D.N.Y. 2001); see also In re Worldcom Sec. Litig. 294 F. Supp. 2d 431, 456 (S.D.N.Y 2003) ("plaintiffs admit they can bring no Section 11 claim based on the December 2000 Offering because it was exempt from registration requirements other than as a private placement"). In re Safety-Kleen Corp. Bondholders Litig., C.A. 3:00-1145-17 Order (March 27, 2002).

This lack of any Section 11 liability in connection with a 14A A resale sale sharply with the disclosure law as it applies to an underwritten public offering of high-yield debt. The market and the participants; the pricing and the discounts, the format and the substance of the disclosure may be the same in a 14A A resale and underwritten public offering, but Section 11 liability in all likelihood attaches only to the underwritten public offering and not to the Rule 14A A resale.

The A/B exchange, on the other hand, does involve a registration statement and, as a consequence, an issuer would, if it repeated an offering memorandum's defective disclosures in the registration statement or made new defective disclosures, likely have Section 11 "strict liability" for the misstatements contained in the A/B exchange offering materials. 15 U.S.C. § 77k. So, too, an issuer's directors and officers would have liability, subject to the statute's due diligence defense. Id. But, ordinarily, the investment bank/initial purchaser that helped prepare the Rule 14A A offering memorandum does not participate in any way in the A/B exchange, and it is consequently unlikely that the initial purchaser would have Section 11 liability for defects in the A/B exchange registration statement. See In re Livent, 151 F. Supp. 2d at 432 ("Therefore, this court concludes that § 11 liability for securities purchased pursuant to a registration statement does not apply to initial purchasers of unregistered securities who were not directly involved in the preparation of the registration statement or in the subsequent exchange for registered securities of unregistered securities that the initial purchasers no longer held."); see also Letter from David M. Becker, General Counsel, Securities and Exchange Commission, to Honorable Joseph M. Anderson dated Aug. 9, 2001, as amicus curiae, In re Safety-Kleen Bondholders Litig., C.A. 3:00-1145-17(D.S.C.) (the "Safety-Kleen Letter").

If liability can be established, Section 11 provides for the recovery of the "amount paid" for the B securities, less the value or price of the B securities either on the day of suit or when sold. 15 U.S.C. § 77k. The inquiry then shifts to the "amount paid" by a QIB for the B securities at the time of the A/B exchange. A court could take the position that what was "paid" for the B security was an A security, the value of which necessarily tracks that of the B security. This view of the A/B exchange effectively would eliminate any recovery of damages, since virtually by definition the "amount paid" (i.e., the A security) equals what was received (i.e., the B security). The United States District Court for the District of Columbia in the Safety-Kleen bondholder litigation came to this very conclusion regarding the possible damages arising out of an A/B exchange transaction. In re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 2 ("no [Section 11] damages can be demonstrated because the transaction involves two sets of identical bonds").

Alternatively, it is possible—but not likely—that a court would integrate the A/B exchange with the 14A A resale to find that a 14A A resale is essentially the start of a public offering of securities and that damages from the A/B exchange may, therefore, be calculated by reference to the "amount paid" for the A securities in the original Rule 14A A resale. Cf. In re Livent, 151 F. Supp. 2d at 431-32; but see Safety-Kleen Letter at ¶11 ff. ("We do not agree that because the Rule 14A A offering contemplated a subsequent registered exchange offering, those who participated in the Rule 14A A offering were underwriters in that exchange offer."). Viewed from

2 Specifically, Section 11 provides as follows: "(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;
(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
(3) every officer who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement . . . ; and

(5) every underwriter with respect to such security."

3 It is conceivable—though, as discussed below, unlikely—that a court might integrate the 14A A resale with the follow-on A/B exchange and impose Section 11 liability on participants involved in any phase of the entire integrated transaction. Cf. In re Livent, 151 F. Supp. 2d at 431-32; but see Safety-Kleen Letter at ¶11 and 12.

4 With respect to damages, Section 11 provides generally as follows: "The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before such suit was brought, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable."

5 The SEC's position in its Safety-Kleen Letter comports with the SEC's established position on A/B exchanges gener-
this perspective, for example, a court could determine the "amount paid" for the B securities based either on the original purchase price of the A securities or the value of the A securities in the PORTAL Market at the time of the A/B exchange. The Safety-Kleen court, for one, specifically rejected this approach. In re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 2.

Section 12(a)(2) and the 144A Offering Memorandum. Section 12(a)(2) imposes liability for material misstatements in a "prospectus" or related "oral communication." Until mid-1995, securities counsel for institutional high-yield purchasers, as well as the SEC and other practitioners, had thought that a Rule 144A offering memorandum might be considered a "prospectus" within the meaning of Section 12(a)(2). See, e.g., Safety-Kleen Letter at ¶ 9. But, in 1995, the Supreme Court, in Gustafson v. Allied Corp., Inc., 513 U.S. 561 (1995), made clear that Section 12(a)(2) applies only to a prospectus issued in a transaction registered or required to be registered under the '33 Act and to oral communications directly associated with that prospectus, as expressed in the Exxon Capital and Morgan Stanley No-Action Letters and their progeny. See Exxon Capital Holding Corp., SEC No-Action Letter (May 13, 1988); Morgan Stanley & Co. No-Action Letter (June 5, 1991). As General Counsel Becker indicated in the Safety-Kleen Letter, the consequences of integrating the Rule 144A resale with the 144A offering memorandum would be to greatly diminish the usefulness of Rule 144A: "The consequences of accepting plaintiffs' integration argument would be significant, as two-step transactions similar to the one at issue in this case account for the majority of registered high-yield bond offerings and a significant portion of all initial public offerings." Id.; see also In re Liewent, 151 F. Supp. 2d at 431-32 ("To import underwriter liability for entities that serve as initial purchasers prior to an Exxon Capital Exchange would render Rule 144A ineffective for a very substantial number of securities transactions and defeat the capital market financing objectives the Rule 144A exemption was designed to achieve, a fact which undoubtedly would have been known and addressed by the promulgation of Rule 144A if such a major exception was intended.").

Section 12(a)(2) provides as follows: "Any person who: (1) offers or sells a security in violation of section 5, or (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (4) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." Id. at 569-70. Moreover, "the word 'prospectus' is a term of art referring to a document that describes a public offering of securities by an issuer or controlling shareholder." Id. at 584. While this reasoning of Section 12(a)(2) has been roundly criticized by commentators, it has been widely followed by the lower federal courts so as to preclude claims arising out of transactions previously thought to fall within the scope of Section 12(a)(2). See e.g. Laser Mortgage Mgmt., Inc. v. Asset Securities Corp., No. 00 Civ. 8100 (NRB) 2001 WL 102407 (S.D.N.Y).

Because Rule 144A resales do not involve the registered public offering of securities, there is likely no liability under Section 12(a)(2) for misstatements contained in a 144A offering memorandum. In re Worldcom Sec. Litig., 294 F. Supp. 2d at 455-56; In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig., 271 F. Supp. 2d at 1028-29; AIG Global Securities Lending v. Banc of America Securities LLC, 254 F. Supp. 2d 373, 388-89 (S.D.N.Y. 2003). In re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 3.

'Public' Private Placements. Recent decisions, however, have questioned whether or not a Rule 144A private placement might nonetheless be considered a public offering within the meaning of Gustafson. In AAL High Yield Bond Fund v. Ruttenberg, C.A. No. 00-C-1404-S (Oct. 1, 2001) (hereinafter "Ruttenberg"), the court refused to dismiss a claim under Section 12(a)(2) arising out of a 144A resale, holding that:

The line between public offerings and private placements is neither well-defined nor easily decipherable. Even after Gustafson, this distinction remains hotly debated by the plaintiffs' and defendants' bars, and has not been entirely resolved by the courts. Ultimately the question is one of fact and demands an inquiry into factors such as the marketing strategies employed, the scope of the Offering and the sophistication of the offerees. The 'private placement' argument as a bar to Plaintiffs' entitlement to present evidence on this claim is rejected.

Id. at 15-16.

Likewise, the court in Steed Finance LDC v. Nomura Securities Int'l, Inc., 00 Civ. 8058 (NRB), 2001 WL 1111508, *1, *6 (S.D.N.Y.), refused to dismiss a complaint alleging (i) that a private placement nevertheless constituted a public offering of securities; and (ii) that a simultaneous public offering should be integrated with a private placement (under Section 4(2)) and the entire transaction considered a registered public offering for Section 12(a)(2) purposes. On the first point, the court stated that "[a]lthough it appears unlikely that the Pri-
private Certificates at issue were sold in a manner constituting a public offering, we can, of course, form no conclusions at this stage." Id. On the second point, the court stated, "[i]mportant, whether the alleged simultaneous public and private offerings may be considered a single integrated offering is likewise unsuitable for resolution at this stage." Id. (citing cases); but cf. Safety-Kleen Letter at ¶ 11-16.10

More recently, the court presiding over the Enron securities litigation refused to dismiss a § 12(a)(2) count based on alleged misstatements in a 144A offering memorandum. See In re Enron Corp. Sec., Derivative & "ERISA" Litig., 310 F. Supp. 2d, 819, 861-866 (S.D. Tex. 2004). In Enron, the court held that "what constitutes a public offering turns on a number of factors and requires a fact-specific analysis on a case by case basis." Id. at 862. The court then pointed to several factors concerning the offering in question that "brought it within the letter of Rule 144A. Id. The Court, however, refused to dismiss because the offering appeared to fall within the ambit of Rule 144A, it was necessarily a private placement foreclosing Section 12(a)(2) liability: "[t]he law is not clear as to whether an offering memorandum that is not exempt under § 4(2) but that fails under Rule 144A or Regulation S is necessarily a private offering." Enron raises the prospect that a QIB could avoid early dismissal of a '33 Act claim alleging misrepresentations in the 144A offering memorandum by challenging whether a 144A sale was in fact a bona fide private placement under Section 4(2) of the '33 Act.

The holdings in Ruttenberg, Steed Financial and Enron appear to overlook the importance placed by Gustafson on the relationship between a '33 Act "prospect," on the one hand, and the registration statement, on the other hand. Gustafson evidently requires a prospectus and a registered public offering before Section 12(a)(2) comes into play. See Gustafson, 513 U.S. at 568-69.11 Unless the transaction at issue involves a prospectus, understood as "a document that, absent an overriding exemption [under Section 3], must include the information contained in the registration statement," Section 12(a)(2) is likely not applicable under Gustafson.12 Because a Rule 144A resale does not involve a transaction registered under the '33 Act, Section 12(a)(2) does not apply to any defective disclosures that may be made in the offering memorandum or any oral communications associated therewith. Cf. Id.

Section 12(a)(2) and the A/B Exchange. The application of Section 12(a)(2) in the context of an A/B exchange is more complicated. Although we are not aware of any case so holding, there is a significant possibility that Section 12(a)(2) would apply to the prospectus issued in an A/B Exchange notwithstanding that an A/B exchange is not itself a public offering. Cf. Gustafson, 513 U.S. at 568-69. The prospectus in the typical A/B exchange is intended to be a disclosure document to facilitate the resale of the securities and "contain(s) the information contained in the registration statement." Gustafson, 513 U.S. at 568-69. Consequently, an issuer that repeats defective disclosures from the offering memorandum or introduces new defective disclosures in the A/B exchange prospectus is at significant risk of Section 12(a)(2) liability.13 Cf. In re Livent, 151 F. Supp. 2d at 432.

Section 12(a)(2) provides for liability only on the part of one who "offers or sells a security." 15 U.S.C. § 77i(a)(2). This restriction has been applied to limit liability only to those who actually sold or offered to sell securities.

Gustafson, at 568-69 ("[w]hatever else 'prospectus' may mean, the term is confined to a document that, absent an overriding exemption, must include the information contained in the registration statement."); see also Id. at 583 ("It will be recalled that as to private transactions, such as the Alloyd purchase, there will never have been a registration statement: if § 12(2) liability were imposed here, it would cover transactions not within the contemplated reach of the statute."); Id. at 583 ("Nothing in the legislative history, moreover, suggests Congress intended to create two types of prospectuses, a formal prospectus required to comply with both § 8 and § 10(b), and a second, less formal prospectus, to which only § 12 would be applicable.").

Section 12(a)(2) also imposes liability for misstatements contained in an "oral communication." See 15 U.S.C. § 77i(2). The law is well settled, however, that the term "oral communication" in Section 12(a)(2) applies only to oral communications that relate to a statutory prospectus. See Gustafson, 513 U.S. at 567.

There is an argument under Gustafson that Section 12(a)(2) would not apply to the A/B exchange, since the exchange was not a sale to the public even though a '33 Act prospectus was used in the exchange. Gustafson dealt with whether representations made in connection with a stock purchase agreement between two private parties exposed the selling party to liability under Section 12(a)(2), 513 U.S. at 564-65, a factual setting quite different from that present in an A/B exchange. The Supreme Court's decision is not entirely consistent in its reasoning, at times describing the "defective oral question" as whether the contract at issue was a "prospectus," id. at 568, while at other times phrasing the key inquiry in terms of whether the transaction was a "public offering" using a prospectus. Id. at 583.

In an A/B exchange, a prospectus under the '33 Act is used, but not in connection with a "public offering" per se. Instead, the prospectus is used to facilitate an exchange of securities in which unregistered "securities are exchanged for the registered and tradable "B" securities. Thus, the impact of Gustafson on this specific transaction is not clear.

10 Along similar lines, the SEC has argued that the circumstances of the transaction at issue in Gustafson were quite distinct from the circumstances of the typical 144A resale, and have raised the possibility that the Supreme Court might, therefore, find a Rule 144A offering memorandum to be sufficiently akin to a statutory prospectus to give rise to liability under Section 12(a)(2). As General Counsel Becker noted in the Safety-Kleen Letter:

There are significant differences between the Rule 144A transaction ... and the private transaction that was held not to be subject to Section 12(a)(2) in Gustafson. The sale in Gustafson was indisputably a private one in which three shareholders sold their stock to a single corporate buyer, pursuant to a negotiated contract. ... [T]he offering memorandum in the [the Safety Kleen] Rule 144A offering was an important part of the entire transaction, and it was understood by all parties that the memorandum would likely form the basis for the registration statement and prospectus in the subsequent [A/B] exchange offer. Perhaps in light of the factual distinctions between [the Safety-Kleen] 144A resale and Gustafson, the Supreme Court might have accepted plaintiffs' theory in this case that the offering memorandum was a prospectus.


11 The court in Ruttenberg quotes Gustafson for the following "principle": "[l]iability imposed by § 12(a)(2) has nothing to do with the fact of registration, but rather with 'whether a prospectus is a document soliciting the public to purchase securities from the issuer.' " Ruttenberg at 12; compare

SECURITIES REGULATION & LAW REPORT  ISSN 0037-0665
the security or to one who was “directly involved in the actual solicitation of a securities purchase.” See Pinter v. Dahl, 486 U.S. 644, n. 21 (1988). It is, accordingly, unlikely that an initial purchaser would face liability under Section 12(a)(2) because a 14A A initial purchaser is rarely, if ever, a “seller” in the A/B exchange. The result might be different, however, if it could be shown that the initial purchaser was directly involved in the solicitation efforts leading up to the A/B exchange. See In re Livent, 151 F. Supp. 2d at 432 (“CIBC may stand in a very different position from PaineWebber and Furman Selz because the Noteholders indicate in their opposition memorandum that CIBC sold not directly to them.”); cf. Pinter, 486 U.S. at 643-46. In the typical A/B exchange, the “seller” of the B securities is the issuer. A QIB acquiring B securities issued based on a prospectus containing a material misstatement would most likely be able to proceed against the issuer under Section 12(a)(2) to the extent the issuer’s prospectus for the “B” exchange contained a material misstatement or omission in connection with the offering of a security. As with the Section 11 claim, moreover, a QIB would not have to plead or prove that the issuer/seller acted intentionally or with recklessness. See 15 U.S.C. § 77j(a)(2).

Upon establishing liability, the remedy available under Section 12(a)(2) would depend upon whether the QIB/plaintiff still owned the B securities. If the QIB had already sold the B securities, the QIB essentially would be entitled to recover the price it paid for the securities, less the price received when the securities were sold. As with the Section 11 damages discussed above, it is not clear how a court would determine exactly what a QIB would be entitled to receive as damages in this situation. In other words, a court would need to determine what the “price” was for the B securities, facing all the uncertainties discussed above. See In re Safety-Kleen Bondholders Litig., C.A. No. 3:00 1145-17 at 2 (holding that under Section 11, “no damages can be demonstrated because the transaction involves two sets of identical bonds”).

If, on the other hand, the QIB/plaintiff still held the B securities in question, it would only be entitled to rescission under the terms of the statute. 15 U.S.C. § 77j(a)(2). Such a rescissionary remedy, however, could prove hollow if “rescission” were applied formally to the A/B exchange: The QIB would merely be entitled to the return of the restricted A securities. Accordingly, if the QIB brought a claim under Section 12(a)(2) while still holding the B securities, it would have to argue that the court should, in essence, look back to the 14A A resale and rescind that part of the overall transaction as well. Only in that way, by recovering the amount originally paid for the A securities, would the QIB obtain effective relief. The case law in this specific area has not been well developed, and it is difficult to predict whether any such “look back” argument for damages would hold sway with the courts. What discussion of this general approach is found in the relevant authorities is not encouraging for QIB/plaintiffs. See In re Safety-Kleen Bondholders Litig., C.A. No. 3:00 1145-17 at 2; In re Livent, 151 F. Supp. 2d at 430-32.

14A A Offerings and Liability Under the Exchange Act Section 10(b), along with Rule 10b-5 promulgated by the SEC, imposes liability where (1) a defendant has made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading; (2) the defendant acted with an intent to defraud; (3) the plaintiff relied on the misstatement; and (4) the plaintiff was injured as a result. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Any person who actually “uses or employs” a manipulative or fraudulent device in connection with the purchase or sale of securities is liable for a violation of the ’34 Act. In this way, the ’34 Act does not restrict who may be held liable as do Sections 11 and 12(a)(2) of the ’33 Act.

Of course, while Section 10(b) does not restrict the field of potential defendants to narrowly drawn categories as does the ’33 Act, its reach does not extend to those who merely aided or abetted someone else in connection with a Section 10(b) violation. See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (rejecting “aiding and abetting” liability under Section 10(b)). To be liable, a defendant must have itself actually engaged in the prohibited conduct. See, e.g., In re Enron Corp. Sec. Litig., C.A. No. H-01-3624, 2002 WL 31854963, *1, *16-1-24 (S.D. Tex. Dec. 20, 2002). Moreover, the standard for liability under Section 10(b) is substantially higher than that required under the ’33 Act. In addition to proving the alleged fraudulent elements of fraud and reliance, a plaintiff must meet the heightened pleading standards of Fed. R. Civ. P. 9(b) requiring the plaintiff to describe the alleged fraud in the complaint with “particularity.” 15 U.S.C. § 78u-4(b)(1).

The difficulties inherent in bringing a claim under Section 10(b) were further increased when Congress passed the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 (the “Reform Act”), which imposed stricter pleading requirements for claims under 10(b) during the pendency of motions to dismiss, and provided for certain “safe harbors” for forward-looking statements. See, e.g., 15 U.S.C. §§ 78u-4 and 78u-5. The practical effect of these amendments has been to erect an even higher hurdle for asserting a ’34 Act claim and to slow or possibly preclude pursuing

14 Specifically, Section 10(b) provides as follows: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

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discovery to support such a claim. These additional factors simply underscore the attractiveness of asserting claims under the '33 Act when possible.18

If a plaintiff/purchaser establishes a violation of Section 10(b), it is entitled to recover its damages caused by the violation. Although the '33 Act itself is silent as to the appropriate measure of damages for a violation of Section 10(b), it is likely that a plaintiff will be able to recover "the excess of what he paid over the value of what he got." Levine v. Seilman, Inc., 439 F.2d 328, 329 (2d Cir. 1971); see also Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1447 (11th Cir. 1997) (same). In other words, the plaintiff can recover the difference between the price paid for the security and the true value of the security on the day of purchase "but for" the fraud.

144A Offerings and Liability Under Blue Sky Laws and Common Law

When facing an actual situation of defective disclosure in connection with a Rule 144A resale and an A/B exchange, it is not sufficient to analyze the matter only under the federal securities laws. There is an entire separate body of law—state law—that may provide an attractive avenue for recovery for such defective disclosures. See Northwestern Mutual Life Ins. Co. v. Banc of America Securities, LLC, 254 F. Supp. 2d 390, 392-93 (S.D.N.Y. 2003). Moreover, the threshold for establishing liability is often lower under state "blue sky" anti-fraud/civil liability provisions as compared with rights of action under federal law. For example, state blue sky statutes typically do not require proof of either scienter or reliance.16 The common law count of negligent misrepresentation might provide a similarly effective vehicle for pursuing claims in the 144A context. Additionally, a monetary recovery, enhanced by multiple damages and attorney fees, may also be available under relevant state consumer protection laws. Cf. Twin Fires Investment LLC v. Morgan Stanley Dean Witter & Co., C.A. No. 00-00751-F. 2002 WL 31875204 (Mass. Super.) (applying Massachusetts's Ch. 93A to a securities transaction).

State blue sky laws are not often used, or even seriously considered, in connection with defective disclosure claims brought by class action plaintiffs' attorneys. Ordinarily, the lawyers representing the plaintiffs in such actions have an incentive to "recruit" the largest class of "victims" possible in order to drive up the amount that can be recovered in settlement. There is a significant limitation on the availability of a state law cause of action in the class action context, however. The Securities Litigation Uniform Standards Act, 15 U.S.C. § 78bb(f) ("SLUSA"), provides for the removal of state court securities class actions to federal court and abolishes state law causes of action in securities fraud [class action] cases involving securities covered by the federal statutes. See In re Liven, 151 F. Supp. 2d at 442. As a result, these plaintiffs' lawyers are not inclined to look to state laws that require less in the way of individualized proof in order to prevail. However, an institutional investor or even a handful of institutional investors who find that they were misled in the 144A resale might find it economical to avail themselves, without running afoul of SLUSA, of state blue sky anti-fraud provisions in a non-class action against the issuer and initial purchaser. See Northwestern Mutual Life Ins. Co., 254 F. Supp. 2d at 392. Remedies under state law should, in any event, always be considered by a wronged QIB.

In view of the legal burdens facing QIBs under the '33 Act, Section 10(b) may well be the only federal securities remedy available for alleged misstatements in an offering memorandum. Thus, after dismissing a Section 11 and Section 12(a)(2) count for the reasons discussed herein, the Court in the Safety-Kleen litigation allowed the QIB plaintiffs to proceed on their claims under Section 10(b) and Rule 10b-5. In re Safety-Kleen Bondholders Litig., C.A. No. 3:00-1145-17 at 3.

The Uniform Securities Act of 1956, which has been adopted by a number of states, holds civilly liable anyone "who offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." See e.g. Mass. Gen. Laws, Ch. 110A, § 410(a)(2).
the exclusion for communications in connection with a registered securities offering is
available only in respect of capital formation transactions for the account of the issuer
and registered offerings that are both an issuer capital formation transaction and a selling
security holder offering (unless the issuer's participation is intended for the purpose of
evading Regulation FD), and only if the disclosures are made in the following types of
communications:

- a registration statement filed under the Securities Act, including a prospectus
  contained in the filing;
- a free writing prospectus used after filing the registration statement for the
  offering or a free writing prospectus accompanied or preceded by the final
  prospectus after the registration statement is effective;
- a preliminary or final prospectus;
- a pre-filing notice permitted by Securities Act Rule 135;
- a post-filing communication permitted by Securities Act Rule 134; or
- an oral communication made in connection with a registered offering after filing a
  registration statement for an offering under the Securities Act.

Communications not contained in the list above, such as the publication of
regularly released factual business information, are subject to Regulation FD even if they
take place during a registered securities offering.

F. Liability Considerations

Under the Securities Act, purchasers of an issuer's securities in a
registered offering have private rights of action under Securities Act Section 11 for
materially deficient disclosure in registration statements and under Securities Act
Section 12(a)(2) for materially false or misleading statements in prospectuses and oral

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99 Section 11 liability exists for untrue statements of material facts or omissions of material facts required
to be included in a registration statement or necessary to make the statements in the registration
statement not misleading at the time the registration statement became effective.

100 Sellers have potential liability to purchasers under Section 12(a)(2) for offers or sales by means of a
prospectus or oral communication that includes an untrue statement of material fact or omits to state a
material fact necessary in order to make the statements made, based on the circumstances under which
they were made, not misleading.

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communications. Other potential sources of private or governmental liability include the anti-fraud provisions of the federal securities laws, including Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder.

In the proposing release, the SEC first issued an important interpretation that Securities Act Sections 12(a)(2) and 17(a)(2) require that information conveyed to an investor regarding an issuer and the securities being sold in an offering be materially accurate and not misleading at the time of the contract of sale, when the investor makes his or her investment decision. The adopting release reaffirms this interpretation and the Reforms codify it as new Securities Act Rule 159. The Reforms also introduce reforms designed to rationalize the application of liability under Securities Act Section 11 in shelf offerings and non-shelf offerings and to clarify that the issuer is a "seller" for purposes of Section 12(a)(2) in connection with firm commitment underwritings. In addition, the SEC in the adopting release discusses its due diligence interpretation contained in Rule 176. These interpretations and rules are discussed below.

As a result of the Reforms, all free writing prospectuses subject the user (but generally not others) to potential disclosure liability under the same provisions as applied prior to the Reforms to oral offers and statutory prospectuses, including Section 12(a)(2), but will not be deemed to be part of a registration statement and thus will not be subject to Section 11 liability. Written communications not constituting prospectuses, including research reports and Rule 134 notices, will not be subject to Securities Act Section 12(a)(2) prospectus liability, but will remain subject to the antifraud provisions of the federal securities laws, such as Exchange Act Section 10(b) and Rule 10b-5 thereunder.

1. Section 12(a)(2) and Section 17(a)(2) Liability at the Time of Sale

The SEC notes that both an investor's investment decision and the sale of securities to the investor generally occur before the final prospectus is available and required to be delivered under the Securities Act. To address this timing discrepancy, the
SEC issued in the proposing release an interpretation of Sections 12(a)(2) and 17(a)(2). Under the SEC’s interpretation, those statutory provisions do not require that oral statements or the prospectus or other communications contain all information called for under the SEC’s line-item disclosure rules or otherwise contain all material information. However, the SEC interprets those statutory provisions to require that information conveyed to an investor regarding an issuer and the securities being sold be materially accurate and not misleading at the time of the contract of sale, when investors make their investment decisions, as opposed to a later time such as the time of delivery of a final prospectus.101

Pursuant to this interpretation, for purposes of determining whether at the time of sale a prospectus or oral statement includes a material misstatement or materially misleading statement, only the information then “conveyed” to the investor may be considered, and information “conveyed” to the investor after the time of sale, including by way of modifications or corrections to previously conveyed information, will not be

101 The SEC clarifies in the adopting release that its interpretation is not intended to affect any rights currently existing at any time other than the time of the contract of sale. See Rel. No. 33-8591, supra note 1, at n.394. Pursuant to the SEC’s interpretation, the time of contract of sale can be the time the purchaser either enters into the contract (including by virtue of acceptance by the seller of an offer to purchase) or, if there is no contract, completes the sale.

Under the SEC’s interpretation, the time of contract of sale is not strictly a question of state law. The SEC cautions that while state law contract principles are significant with regard to contract formation, and it is not aware of any current significant conflicts between state contract law and federal law regarding the elements of formation of a contract, a contract of sale under the federal securities laws may occur before there is an unconditional bilateral contract under state law (for example, when a purchaser has taken all actions necessary to be bound but a seller’s obligation remains conditional under state law), and if significant conflicts were to arise, the SEC may take appropriate action. The SEC also notes that federal law governs any waiver of a right or claim arising under the federal securities laws and, therefore, a contract of sale may not contain provisions that operate to waive a purchaser’s substantive rights under the federal securities laws and any such provision would be void. See Rel. No. 33-8591, supra note 1, at paragraph referencing n.409. For example, the SEC indicates that the following provisions would be impermissible waivers: (1) a contractual term that provides that a purchaser is deemed to have read or have constructive or actual knowledge of information or documents; (2) a provision stating that a purchaser who has access to information is charged with knowledge of that information for purposes of Section 12(a)(2); (3) a provision to the effect that the seller is deemed to have communicated information to the purchaser; and (4) a non-conditional contract that moves the time of sale forward to a different time. See id. at n.414 and paragraphs referencing nn.414 and 415.
taken into account. Whether or not information has been “conveyed” to an investor by the time of sale is a facts and circumstances determination. Information may be conveyed orally, through a free writing prospectus, by Exchange Act filing with the SEC or by other means reasonably designed to convey the information to investors. Filing with the SEC does not automatically result in that information being conveyed, however.

The SEC explains in the adopting release that its interpretation and new rule do not affect the ability of the seller and the purchaser to consider subsequently provided facts or disclosure and, among other actions, terminate the contract of sale and enter into a new contract of sale with respect to the offered securities, in each case by mutual agreement. In such a case, for purposes of the SEC’s interpretation and Securities Act Rule 159, the time of the contract of sale to that purchaser will be the time of the new contract of sale.¹⁰² However, because any such agreement could result in extinguishment of a right to damages under the old contract of sale, the SEC indicates that any new contract of sale will conflict with federal law unless:

- the investor is provided adequate disclosure of the contractual arrangement;
- the investor is provided with adequate disclosure of its rights under the existing contract at the time termination is sought;
- the investor is provided with adequate disclosure of the new information that the seller seeks to convey; and
- the investor is provided with a meaningful ability to elect to terminate or not terminate the prior contract and to elect to enter into or not enter into the new contract.

Similarly, the Reforms provide that information contained in a document that is deemed part of or incorporated by reference into a registration statement or prospectus:

- would modify or supersede the information contained in the registration statement or prospectus; but

¹⁰² See Rel. No. 33-8591, supra note 1, at n.398.
• would not modify or supersede any information conveyed to an investor at the
time of sale for purposes of determining the information conveyed to an investor
at or prior to that time.103

While the SEC interpretation and new rule reflect existing best practices,
they may cause a formalization of procedures to convey recent developments and pricing
information to investors prior to sale that in some cases would represent a “speed bump”
in the offering process. These matters are discussed in part III.A.5 on pages 27-28.

2. Application of Section 11 Liability in the Shelf Offering Context

The Reforms deem information contained in prospectus supplements to be
part of and included in the registration statement retroactively for purposes of
Securities Act Section 11 liability, but not for Section 12(a)(2) liability, as discussed in
the previous section:

• For a prospectus supplement filed other than in connection with a shelf takedown,
  all information contained in that prospectus supplement will be deemed part of
  and included in the registration statement as of the date the prospectus supplement
  is first used.104

• For a prospectus supplement filed in connection with a shelf takedown, all
  information in that prospectus supplement will be deemed part of and included in
  the registration statement for Section 11 purposes as of the earlier of the date it is
  first used or the time of the first contract of sale of securities in the offering to
  which the prospectus supplement relates.

The Reforms also establish a new effective date for takedowns from a
shelf registration statement for Section 11 liability purposes for the issuer and
underwriters for the takedown as the earlier of the date the prospectus supplement is first
used or the first contract of sale.105 The effective date for Section 11 liability of directors,

103 See Securities Act Rules 412 and 430B.
104 See Securities Act Rule 430C. The SEC reiterates its position that the date of first use is the date that
the prospectus supplement is first available to the managing underwriter, syndicate member or
prospective purchaser. See Rel. No. 33-8591, supra note 1, at n.462. Rule 430C applies to all issuers.
105 The effect of the Reforms generally is to move the effective date for the issuer to the same date as for
underwriters for takedowns from shelf registration statements. The new effective date would not be
considered the filing of a new registration statement for purposes of assessing eligibility to use certain
(footnote continued on next page)
signing officers, auditors and other experts remains unchanged as the date of the filing of the registration statement or, if more recent, the date of filing of the annual report containing audited financial statements on Form 10-K or 20-F.

As noted, the Reforms do not change the Section 11 effective date for auditors that provided a consent in an existing registration statement for use of their report on previously issued financial statements or previous reports on management’s assessment of internal control over financial reporting. By limiting the new liability effective date to issuers and underwriters, the Reforms avoid potential issues that issuers and other offering participants might encounter if forced to obtain new auditor consents at the time of each takedown.

3. Issuer as Seller

In order to resolve what it calls “unwarranted uncertainty” as to whether an issuer has prospectus liability on the prospectus and other issuer information in connection with a registered offering using a firm commitment underwriting, the Reforms adopt a new interpretive rule to establish that, for purposes of Section 12(a)(2), a “seller” includes the issuer in respect of the prospectus and any other communications made by the issuer to purchasers in the initial distribution regardless of the underwriting method used to sell the issuer’s securities. The rule specifically identifies as covered communications:

- any preliminary prospectus or prospectus supplement relating to the offering;

(footnote continued)

registration forms. That determination would remain, as before the Reforms, to be made at the time of filing the annual audited financial statements included in the registration statement, which is typically filing of the annual report on Form 10-K or 20-F.

106 Certain court decisions have held that in a firm commitment underwriting, issuers are not ordinarily liable under Section 12(a)(2) because the public does not purchase from the issuer directly and on the theory that suing the issuer would be “an attempt to recover against the seller’s seller.” See, e.g., Rosenzweig v. Azurix Corp., 332 F.3d 854 (5th Cir. 2003); Lone Star Ladies Investment Club v. Schlotzsky’s, Inc., 238 F.3d 363 (5th Cir. 2001).

107 See Securities Act Rule 159A(a).
• any free writing prospectus prepared by or on behalf of the issuer;\textsuperscript{108} and
• material information about the issuer or its securities provided by or on behalf of
  the issuer and included in any other free writing prospectus.\textsuperscript{109}

4. Due Diligence Standards

In the proposing release, the SEC requested comment as to whether it
should reevaluate the factors discussed in Securities Act Rule 176 regarding what due
diligence practices constitute a “reasonable investigation” under Securities Act
Section 11. Commenters urged the SEC to reintroduce its Aircraft Carrier proposal to
amend Rule 176 so that it also applies to the “reasonable care” standard under
Securities Act Section 12(a)(2), but the SEC has determined not to propose any
modifications to Rule 176 at this time. In response to comments, however, the SEC did
reaffirm its view that Section 11 requires a more diligent investigation than
Section 12(a)(2), and clarified its view that any practices or factors that would be
considered favorably under Section 11 (including pursuant to Rule 176) will be
considered as favorably under the reasonable care standard of Section 12(a)(2).

* * *

\textsuperscript{108} In the case of an issuer that is an open-end management investment company, any profile provided
pursuant to Securities Act Rule 498 is also included.

\textsuperscript{109} In the case of an issuer that is a registered investment company or business development company,
information in any advertisements pursuant to Securities Act Rule 482 is also included.
SECTION 16 SHORT-SWING TRADING:
SELECTED PRACTICAL ISSUES AND
PITFALLS TO AVOID

I. MOVING "IN-AND-OUT" OF INSIDER
STATUS

A. OFFICERS AND DIRECTORS

1. Officers and directors who are not otherwise
insiders are generally not liable for transactions
occurring prior to becoming an officer or director.
Accordingly, transactions effected during the
six-month period prior to becoming an officer or
director generally will not be matched with
transactions that occur after becoming an officer
or director to determine Section 16(b) short-swing
profit liability.

2. Transactions effected after termination of officer
or director status are subject to Section 16(b) if
executed within six months of an opposite way
transaction (e.g., sale/purchase or purchase/sale)
that occurred while the individual was an officer
or director. The date the officer or director loses
his or her insider status may therefore be critical.

For Section 16 purposes, "officer" status is based
upon a person's functional responsibilities, not his
or her title. Therefore, if an officer resigns or is
terminated from his or her position but continues
to have the same functional responsibilities and
access to insider information, he or she may
continue to be an "officer" for Section 16(b)
purposes. Consequently, transactions following
the resignation but preceding actual departure in some cases may be subject to Section 16(b). A complete severance of access to insider information after resignation or termination and prior to departure can help avoid Section 16(b) liability. Documentation of such severance would be prudent.

B. 10% SHAREHOLDERS

A person who is subject to Section 16(b) only because he or she is a greater than 10% shareholder is only liable for transactions occurring while he or she is such a shareholder. Thus, the purchase that creates the 10% shareholder status is not subject to Section 16(b), while the sale that causes the loss of such status is subject to Section 16(b).

II. INITIAL PUBLIC OFFERING

A. OFFICERS AND DIRECTORS

1. Transactions by an officer or director during the six months preceding the company becoming a Section 12 registrant can result in Section 16(b) liability. A transaction preceding an initial public offering ("IPO") can therefore be matched with a post-IPO transaction or sale by the officer or director in the IPO if the transactions occur within a six-month period. To avoid unexpected liability, officers and directors should be timely notified of the timing of the IPO and the associated potential short-swing profit liability.

B. 10% SHAREHOLDER

Unlike officers and directors, transactions effected by 10% shareholders prior to an IPO are not subject to Section 16(b) and cannot be matched with transactions occurring after the IPO, even though such transactions occur within a six-month period.

III. EXEMPTIONS FROM SECTION 16(b)

A. GRANTS, AWARDS, AND OTHER ACQUISITIONS

1. Under Rule 16b-3, grants, awards or other acquisitions by an officer or director of securities from the issuer will be exempt if any of the following three conditions is met:

   a). The issuer's board of directors or committee of two or more "Non-Employee Directors"
approves the grant, award or other acquisition in advance. A "Non-Employee Director" is defined as a person who (i) is not currently an officer or employee of the issuer or a parent or subsidiary, (ii) does not receive compensation of more than $60,000 per year for services except as a director and (iii) does not otherwise have transactions or business relationships with the issuer that are required to be disclosed under the proxy rules. A disclosed transaction or relationship which terminates before a director's service as a Non-Employee Director begins will not bar the director from acting as a Non-Employee Director. However, if a current or currently contemplated transaction or relationship with a director will require disclosure in a future filing, such director will no longer be eligible to serve as a Non-Employee Director. Loss of Non-Employee Director eligibility will not cause retroactive loss of a Rule 16b-3 exemption for a transaction previously approved by the director while serving as a Non-Employee Director. (ABA No Action Letter, December 20, 1996).

A committee of two or more "Non-Employee Directors" may consist of (i) a subcommittee, composed solely of two or more Non-Employee Directors of a committee of the board of directors or (ii) a committee of the board of directors which, following abstention or recusal of all members who are not Non-Employee Directors, is composed solely of two or more Non-Employee Directors. (American Society of Corporate


b). The issuer's shareholders approve the acquisition in advance or ratify it not later than the date of the next annual meeting of shareholders following the transaction.

c). The director or officer holds the securities acquired for six months or, in the case of a derivative security (such as a stock option), at least six months elapse between the date of acquisition of the derivative security and the date of disposition of the underlying security.

B. TAX-CONDITIONED PLANS

1. In addition to the three alternative exemptions described above for acquisitions of securities by officers and directors, Rule 16b-3 exempts most routine transactions under plans that satisfy specified provisions of the Internal Revenue Code of 1986 ("IRC"), such as thrift plans, stock purchase plans and excess benefit plans, without needing to satisfy additional conditions. In that regard, Rule 16b-3 will broadly exempt from Section 16(b) liability any transactions in a "Tax-Conditioned Plan" (i.e., a "Qualified Plan," "Excess Benefit Plan" or "Stock Purchase Plan") other than "Discretionary Transactions." "Qualified Plan" is defined broadly to include: (i) an employee benefit plan that satisfies the broad-based coverage and participation requirements of IRC §§ 410 and 401(a)(26). "Excess Benefit Plan" is defined as any employee benefit plan operated in conjunction with a Qualified Plan that provides only the benefits that
would have been provided under the Qualified Plan but for the benefit and contribution limitations of IRC §§ 401(a)(17), 415 and similar IRC benefit and contribution limitations. However, there are certain types of supplemental plans operated in conjunction with a Qualified Plan that do not constitute Excess Benefit Plans (ABA No Action Letter, February 10, 1999, superseding American Express Company, February 26, 1997). A "Stock Purchase Plan" is defined as any employee benefit plan that satisfies the coverage and participation standards of IRC §§ 423(b)(3) and 423(b)(5) or § 410.

2. Employee thrift and stock purchase plans often permit a participant to choose one of several funds in which to invest (e.g., an issuer stock fund, a money market fund, a bond fund or an indexed fund). Plan participants typically are permitted to transfer assets from one fund to another and often have the right to withdraw their investments in cash from a fund containing equity securities of the issuer. These discretionary plan transactions involving an issuer's securities are defined under Rule 16b-3 as "Discretionary Transactions." However, the SEC staff has indicated that the term "Discretionary Transactions" does not cover elections to participate in a Tax-Conditioned Plan or election to change the level of (or termination of voluntary contributions to) a Tax-Conditioned Plan. Under Rule 16b-3, Discretionary Transactions are not automatically exempt as is the case for other transactions in Tax-Conditioned Plans. However, a Discretionary Transaction, including the switching of assets into or out of an issuer stock fund or withdrawing cash from an issuer stock fund regardless of whether or not the

Discretionary Transaction is effected pursuant to a Tax-Conditioned Plan, will be exempt if the election by the officer or director to effect the Discretionary Transaction is made at least six months following any "opposite way" (a disposition in the case of an acquisition or an acquisition in the case of a disposition) election made under the plan in question or any other plan of the issuer. The definition of "Discretionary Transaction" excludes transactions that are incident to death, disability, termination of employment or diversification elections required under ERISA.

C. DISPOSITIONS TO THE ISSUER

1. Rule 16b-3 provides that any transaction (other than a Discretionary Transaction) involving a disposition of an equity security to the issuer would be exempt from Section 16(b) liability if the disposition is approved in advance by the board of directors, by a committee of two or more Non-Employee Directors or by the shareholders (ratification by shareholders will not be sufficient). If the terms of a subsequent transaction involving the disposition of securities to the issuer are provided for in the transaction as initially approved (such as the delivery to the issuer of shares in payment of the exercise price of a previously approved option providing for that form of payment of the exercise price or the withholding of shares to pay the exercise price or tax withholding obligations in connection with a previously approved option that contained those provisions), the subsequent transaction does not require further specific approval.
2. If the disposition is a Discretionary Transaction, to be exempt the transaction must satisfy the Rule 16b-3 conditions, specifically applicable to Discretionary Transactions as described above. The specific terms of the disposition, including price, will require prior approval of either the full board, the committee of Non-Employee Directors or shareholders. If shareholder approval is to be relied upon, both the proxy card and the proxy statement should provide that a vote in favor of the transaction also constitutes approval of the disposition of the equity securities to the issuer in connection with the transaction.

3. This exemption will cover delivery (or withholding) of shares to the issuer to exercise an option or pay withholding taxes in connection with the exercise of an option or the vesting of restricted stock. In the context of a merger, Rule 16b-3 would exempt the disposition of issuer equity securities (including derivative securities) solely to the issuer, provided the conditions of the rule are satisfied. See Section IV below.

4. Transactions with a majority-owned subsidiary (more than 50% of whose outstanding securities representing the right to elect directors is owned by the subsidiary’s issuer-parent), or a benefit plan sponsored by such a majority-owned subsidiary, are considered to be transactions with the issuer-parent and are eligible for exemption under Rule 16b-3. (ABA No Action Letter, February 10, 1999).

5. Transactions between the issuer and certain parties related to an officer or director with an indirect pecuniary interest (i.e. beneficial ownership interest in a partnership or corporation, interest held by a family member or by a trust), are exempt under Rule 16b-3. In order to satisfy the approval conditions of Rules 16b-3 (d) and (e) and apply those rules to the transactions, the approval must specify the extent of the officer's or director's indirect interest in the transaction, and that the approval is granted for purposes of making the transaction exempt under Rule 16b-3. (ABA No Action Letter, February 10, 1999).

IV. MERGERS

A. OFFICERS AND DIRECTORS; DISPOSITIONS TO, AND ACQUISITIONS FROM, THE ISSUER

1. The conversion or cancellation of securities in connection with a merger (both the disposition of target securities and the acquisition of acquirer securities) by an officer or director is eligible for exemption from Section 16(b). (Skadden, Arps, Slate, Meagher & Flom LLP, No Action Letter, January 12, 1999).

2. The conversion in a merger of target equity securities (including derivative securities) by officers and directors of the target are eligible for the Rule 16b-3(e) exemption whether the disposition is a conversion, exchange, or cancellation of the target securities for equity, debt or cash. Each such transaction constitutes a disposition to the issuer of target-issuer securities and is exempt so long as the conversion or cancellation occurs simultaneously or immediately before the merger and certain approval procedures are followed by the target. Such dispositions are exempt regardless of how
such securities were acquired (employee benefit plan, open market or otherwise). Payment of consideration directly to the target equity holders by the acquirer will not change the result. In addition, time of payment does not affect the result.

3. The acquisition of acquirer-issuer securities (including derivative securities) by officers and directors of the acquirer (including those employees and directors of the target who become officers and or directors of the acquirer before, or at the time of, the merger) through the conversion of target-issuer equity securities, constitutes an acquisition from the acquirer-issuer and is also eligible for exemption under Rule 16b-3(d) if certain approval procedures are followed by the acquirer.

4. Approval conditions of Rule 16b-3(e) dispositions and Rule 16b-3(d) acquisitions may be satisfied only by the target and acquirer, respectively. Approval conditions must be satisfied at the same time or following approval of the merger by the respective boards of directors but before consummation of the merger. Approval given by the board of directors or by a committee of Non-Employee Directors, must specify (i) the name of each officer or director, (ii) the number of securities to be acquired or disposed of for each named person, (iii) where derivative securities are acquired, the material terms of such securities, and (iv) that approval is granted for purposes of exempting the transaction under Rule 16b-3.

5. Persons who will become officers or directors of the acquirer as a result of the merger need not have attained insider status with respect to the acquirer at or prior to the time of board or committee approval in order for the acquisition of acquirer securities to be exempt under Rule 16b-3(d) where either (i) target securities are converted into acquirer securities in the merger, or (ii) the acquirer board or committee, prior to the merger, grants acquirer securities to such insiders, effective upon consummation of the merger. In neither case does the grant of approval adversely affect the acquirer's ability to subsequently determine that a new insider has not in fact become an officer or director of the acquirer.

B. 10% SHAREHOLDERS

1. Unlike officers and directors, there are no specific rules exempting 10% shareholders in transactions relating to mergers (except if a shareholder, as a result of the merger, becomes a 10% shareholder of the acquiring company's stock, then such acquisition is not subject to Section 16(b)). Therefore, the exchange of securities in connection with such transactions can be matched with another transaction within a six-month period to determine Section 16(b) liability. Any transaction relating to a merger that causes a shareholder to become a 10% shareholder is exempt.

2. Transactions relating to friendly mergers with non-affiliates may be exempt if the exchange was involuntary and not vulnerable to abuse. The test for this exemption is based upon potential and not actual abuse. The insider must therefore go beyond a showing of no actual abuse and show that given his or her individual situation there was no possibility of abuse. Although the courts have
not provided clear criteria for making this determination, generally the insider must show that he or she had no ability to control the circumstances and timing of the transaction relating to the merger and had no access to inside information. Insiders who are involved in activities relating to the merger may find it difficult to make such a showing.

3. Transactions by 10% shareholders in connection with a defensive merger may also be exempt from Section 16(b) liability if the insider can show that he or she had no active participation in the transaction and, thus, had no influence or control over the merger.
Publications

Jones Day Commentaries

Merger Agreement Representations Take on a Life of Their Own
United States

July 2005
Lyle G. Ganske, James P. Dougherty

The Securities and Exchange Commission recently provided guidance concerning potential liability under Exchange Act Rules 10b-5 and 14a-9 in connection with misstatements and omissions contained in merger agreements and other agreements filed with the Commission. This guidance has been the subject of much debate among mergers and acquisitions practitioners because the federal securities laws require issuers to include a summary description of the merger agreement, including the representations and warranties, in the merger proxy distributed to shareholders. In mergers where target company shareholders receive consideration consisting in whole or in part of securities registered under the Securities Act, the merger agreement is also required to be incorporated by reference into the merger proxy. In addition, it is customary practice for issuers in public merger transactions to include a copy of the merger agreement in the merger proxy distributed to shareholders. This is one of several customary practices in connection with public merger transactions that are being reconsidered as a result of the Commission's newly articulated position.

On March 1, 2005, the Commission issued a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (the "Report")\(^1\) in connection with the settlement of an enforcement action against Titan Corporation.\(^2\) The Commission's complaint alleged that Titan violated the Foreign Corrupt Practices Act of 1977, as amended (the "FCPA"), in connection with various payments made to the election campaign of the incumbent president of Benin, Africa. Without admitting or denying the allegations in the complaint, Titan consented to the entry of a final judgment permanently enjoining it from violating the FCPA and requiring it to pay fines and penalties in excess of $15 million in the aggregate.

The Commission issued the Report to "provide guidance concerning potential liability under Exchange Act Sections 10(b) and 14(a), and Rule 10b-5 and 14a-9 thereunder, for publication of false or misleading material disclosures regarding material contractual provisions such as representations." Many mergers and acquisitions practitioners believe such "guidance" is an attempt by the Commission to promulgate a broad new interpretation of the federal securities laws outside of the Commission's normal rulemaking process. In the Report, the Commission asserted that issuers may have liability for misstatements and omissions contained in merger agreements and other agreements filed with, or incorporated by reference into filings made with, the Commission.\(^3\) Although this Commentary focuses on the Report's application to mergers and acquisitions, it is important to note that the Report purports to be applicable to any agreement filed with the Commission or incorporated by reference into an issuer's '34 Act filings including, for example, Form 8-Ks.

The Report addresses a number of public disclosures made by Titan following the execution of a merger agreement (the "Merger Agreement") on September 15, 2003, pursuant to which Titan was to be acquired by Lockheed Martin.\(^4\) In the Merger Agreement, Titan represented to Lockheed Martin that:

To the knowledge of the Company, neither the Company nor any of its Subsidiaries, nor any director, officer, agent or employee of the Company or any of its Subsidiaries, has . . . taken any action which would cause the Company or any of its Subsidiaries to be in violation of the Foreign Corrupt Practices Act of 1977, as amended, or any applicable law of similar effect.

Unlike some of Titan's other representations in the Merger Agreement, the foregoing FCPA representation was not qualified by reference to a disclosure schedule exception. The FCPA representation was summarized in the merger proxy filed with the Commission and distributed to Titan's shareholders, which included a copy of the Merger Agreement. The Report notes that the Merger Agreement and the merger proxy were amended at various times following the announcement of the proposed merger and public


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disclosure of the possible FCPA violation, but that this representation was not amended. These amendments were primarily due to Commission and Department of Justice investigations of potential Titan violations of the FCPA and disclosed Titan's potential FCPA problems. Public disclosure of these developments was also made in a number of Titan's press releases that were referred to in the definitive merger proxy. In addition, the definitive merger proxy contained an extensive discussion of the possible FCPA violations. While acknowledging that Titan’s shareholders are not beneficiaries of Titan’s FCPA representation, or any other representation in the Merger Agreement, the Commission maintained that the “inclusion of the FCPA representation in a disclosure document filed with the Commission, whether by incorporation by reference or other inclusion, constitutes a disclosure to investors.” Consequently, when making a disclosure, issuers must consider whether additional disclosure is necessary to put the information disclosed “into context.” Issuers “cannot avoid this disclosure obligation simply because the information published was contained in an agreement or other document not prepared as a disclosure document.” The Commission further stated that:

Depending on the context in which the disclosure is made (including the significance of the representation or other contractual provision and the total mix of information available to the investor), a reasonable investor could conclude that the statements made in the representation describe the actual state of affairs and the information could be material. Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988) (“materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information”). In such a situation, where a document containing such a representation is disclosed, if additional material facts exist, such as those contradicting or qualifying the disclosure of the original representation (for example, knowledge by the senior officers of the company that the facts described in the representation are not true), omission of which makes that disclosure misleading, a company would also be required to disclose those facts. This is particularly true when an issuer knows of new information before the original proxy statement, or amendments, are published. Where the failure to make such disclosure is negligent, an issuer would violate Section 14(a) of the Exchange Act and Rule 14a-9 thereunder, and where the failure involved scienter, the issuer would also violate Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Although the Commission believes the “Report is not intended to change the way issuers engage in merger, or other contractual, negotiations . . . or to suggest . . . that provisions such as representations and covenants in such agreements are binding on or intended to benefit persons other than parties thereto,” mergers and acquisitions practitioners are counseling clients to take certain cautionary measures as a result of the Report. The Commission’s pronouncement that a reasonable investor could conclude that statements made in a merger agreement representation describe the actual state of affairs of an issuer is inconsistent with the widely held view of practitioners that investors recognize that merger agreements contain many standard or boilerplate provisions that speak as of a particular point in time and are often qualified by reference to separate disclosure schedules and materiality thresholds, including “material adverse change” or “material adverse effect” standards. While representations and warranties are not provided for the benefit of investors, when issuers have knowledge of material facts that are reasonably likely to give rise to a party’s ability to terminate a merger agreement, disclosure of those material facts is warranted. As a practical matter, however, such facts would likely lead to some form of disclosure absent a representation or warranty being made as to these particular facts.

Issuers and their counsel should consider implementing one or more of the following measures in order to mitigate potential disclosure violations of the variety identified in the Report:

**Include Disclaimer Language.** Issuers should consider including disclosures in the merger proxy that put the summary of the merger agreement representations and warranties in context for investors who may not understand the nuances of the relationship among representations and warranties, disclosure schedules, materiality qualifications, closing conditions, and termination rights. Clear, prominent disclosures may satisfy the Commission’s concern that investors could mistakenly rely on merger representations summarized in, or included in merger agreements attached to, merger proxies as statements as to the actual state of affairs of an issuer. The following is an example of such general cautionary language:

*The merger agreement has been included with this document to provide you additional information regarding its terms. The merger agreement sets forth the contractual rights of [Acquirer] and [Target] but is not intended to be a source of factual, business, or operational information about either party. That kind of information can be found elsewhere in this document and in other filings. Each of us makes with the SEC, which are available without charge at the SEC’s website (www.sec.gov) and as described in "Where You Can Find More Information."*
As a stockholder, you are not a third party beneficiary of the merger agreement and therefore you may not directly enforce any of its terms and conditions. The representations and warranties in the merger agreement are qualified by information each of us filed with the SEC prior to the date of the merger agreement, as well as by disclosure letters each of us delivered to the other prior to signing the merger agreement. The disclosure letters contain or refer to information that has been included in our prior public filings made with the SEC and may also include other non-public information. The disclosure letters have not been made public because, among other things, they include confidential or proprietary information. The parties believe, however, that all information material to a stockholder’s decision to approve the merger is included in or incorporated into this document.

You should also be aware that none of the representations or warranties has any legal effect among the parties to the merger agreement after the effective time of the merger, nor will the parties to the merger agreement be able to assert the inaccuracy of the representations and warranties as a basis for refusing to close the transaction unless all such inaccuracies as a whole would reasonably be expected to have or result in, individually or in the aggregate, a material adverse effect on the party that made the representations and warranties.

Notwithstanding such disclaimer language, the Commission has reiterated the fact that additional disclosures may be warranted if there is an identified problem or material fact that would render a disclosure misleading. Issuers should also be aware that the Commission has not taken a formal position on the use or scope of this or any other cautionary language in response to the Report. In fact, during a recent mergers and acquisitions discussion panel, Brian Breheny, Chief of the Office of Mergers and Acquisitions at the Commission, indicated that he is not recommending that issuers include general cautionary language in filings but that such language "could potentially be appropriate." He also indicated that the issue of general cautionary language in this context is an area the Commission will further consider.

Ensure Material Information Is Disclosed. The vast majority of issuers and practitioners are likely to continue the customary practice of excluding disclosure schedules from public filings.6 Issuers generally rely on Item 601(b)(2) of Regulation S-K as the basis for excluding disclosure schedules from filings. This practice makes sense, given the fact that disclosure schedules are often one of the final documents prepared during the negotiation of a merger agreement and are not prepared with a view toward public disclosure.7 Information material to an investor’s investment decision contained in a disclosure schedule should be disclosed to investors. Rather than filing the disclosure schedules, the practical way to shield an issuer from claims of misleading or inadequate disclosure is to file excerpts or summaries of those schedules containing material information that should be disclosed. Issuers and practitioners should carefully review and analyze the disclosure schedules to ensure that investors are provided all material information relevant to making an investment decision.

Qualify All Representations. Current market practice regarding reference to disclosure schedules in merger representations varies with some representations, or portions thereof, qualified by reference to a disclosure schedule while other representations are not qualified by reference to the disclosure schedules.8 Issuers should consider adding a blanket provision in the lead-in paragraph to the representations and warranties section of the merger agreement providing that all of the representations and warranties are qualified by reference to the disclosure schedules and the issuer’s SEC filings. Within the disclosure schedules, specific disclosures could be attributed to the particular representations to which they relate so as to preserve the current practice of specific disclosures qualifying individual representations or a group of representations.9

Exclude the Merger Agreement from the Merger Proxy Distribution. It is customary practice to include the merger agreement as an annex to the merger proxy distributed to shareholders. The effectiveness of discontinuing this practice is likely to be of limited utility for two main reasons. First, at the American Bar Association’s 2005 Spring Meeting, Alan Beller, director of the Division of Corporation Finance at the Commission, indicated that he believes it is counterproductive to cease the practice of attaching merger agreements to merger proxies. Second, the Report purports to cover situations where merger agreements, or filings containing merger agreements, are incorporated by reference into merger proxies or other ‘34 Act filings. As a result of recent amendments to Form 8-K, which expanded the category of contracts issuers are required to publicly file, an issuer’s decision to exclude the merger agreement from the merger proxy distribution is not an effective solution to the disclosure concerns raised in the Report because the merger agreement will be required to be filed as an exhibit to the issuer’s Form 8-K.10 Accordingly, inclusion of cautionary disclosure language in connection with the filing of a merger agreement or other material agreement as an exhibit to an issuer’s Form 8-K or any other ‘34 Act filing should be considered even if that filing is not incorporated by reference to the merger.
proxy.

The Report serves as an important reminder that issuers and practitioners should carefully review and analyze the disclosure schedules to ensure that investors are provided all material information relevant to making an investment decision.

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**Endnotes**

1. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on potential Exchange Act Section 10(b) and Section 14(a) liability. Release No. 51283 (March 1, 2005).

2. Section 21(a) of the Exchange Act authorizes the Commission to investigate "whether any person has violated, is violating, or is about to violate" the federal securities laws. "The Commission is authorized . . . to publish information concerning such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary and proper to aid in the enforcement of" the federal securities laws.

3. Although the Report is devoted almost exclusively to a discussion of disclosure-related issues, notably it does not allege a violation by Titan of Sections 10(b) or 14(a) of the Exchange Act or Rules 10b-5 and 14a-9 thereunder, and the Commission did not charge Titan with such violations. In fact, the Report was issued after the merger proxy had received a full review by the staff of the Commission.

4. Lockheed subsequently terminated the Merger Agreement in June 2004 based on Titan’s failure to satisfy certain conditions in the Merger Agreement relating to FCPA matters. See Lockheed Martin Corporation’s Form 8-K filed with the Commission on June 28, 2004.

5. Material facts affecting the valuation of the combined company in a stock merger are another example where disclosure would be warranted.

6. Item 601(b) of Regulation S-K describes each category of document listed in the exhibit tables. The following is the text of Item 601(b)(2): "Plan of acquisition, disposition, reorganization, readjustment, succession, liquidation or arrangement - Any material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation or arrangement and any amendments thereto described in the statement or report. Schedules (or similar attachments) to these exhibits shall not be filed unless such schedules contain information which is material to an investment decision and which is not otherwise disclosed in the agreement or the disclosure document. The plan filed shall contain a list briefly identifying the contents of all omitted schedules, together with an agreement to furnish supplemental a copy of any omitted schedule to the Commission upon request."

7. Disclosure schedules are nevertheless extremely important documents. Although often relegated to the most junior members of the deal team, one need look no further than *IBP, Inc. v. Tyson Foods, Inc.*,
789 A.2d 14 (Del. Ch. 2001) (concluding that the merger agreement, including the related disclosure schedules, specifically allocated certain risks to Tyson and that these risks cannot serve as a basis for Tyson to terminate the merger agreement), for a reminder of the importance of disclosure schedules.

8. In the Merger Agreement, Titan's representations were not uniformly qualified by reference to the disclosure schedules. In particular, the FCPA representation was not qualified by reference to the disclosure schedules. Based upon the reasoning outlined in the Report, the failure to qualify a representation by reference to an issuer's SEC filings and the disclosure schedules could lead an investor to believe that the particular representation is a statement as to the actual state of affairs of the issuer.

9. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), severely limits a buyer's ability to rely on disclosure schedules in this manner. Buyers would be well advised to assume that any disclosure in the schedules qualifies all of the seller's representations and warranties.

10. As previously noted, in a stock merger, the merger agreement is also required to be incorporated by reference into the merger proxy.
plaint. Judge Chesney in overruling the objections of defendants to the Magistrate Judge’s Order did so as she could find “no error in, and is in accord with Magistrate Judge James’ conclusion that plaintiffs have not violated Rule 11 and, consequently, the imposition of Rule 11 sanctions is not warranted.”

This is not necessarily the end of the matter as the Rule 10b-5 (but not Section 11) claims were dismissed with prejudice. See § 3:16. Judge James noted in her order that “the sanctions issue under Rule 11 normally will be determined at the end of the litigation.” Further, under the PSLRA, on final adjudication of any private action there has to be a mandatory review to determine whether Rule 11 has been violated and, mandatory sanctions imposed if a violation is found.

Notwithstanding the significant number of instances in which courts have granted a motion to dismiss with respect to complaints including allegations based in part on confidential witnesses, the author has found it difficult to locate proceedings of this character in which sanctions were considered under the foregoing PSLRA provisions. This in part is probably attributable to the fact defendants often appeal the granting of the motion to dismiss and it takes the case a long time to reach what a court regards as a final adjudication. The author did find one relatively early case arising under the PSLRA involving a complaint with allegations based on several confidential witnesses. The decision in the case coincidentally was by Judge Chesney and she granted the motion to dismiss the third amended complaint with prejudice. A footnote at the end of the opinion reflects compliance with the PSLRA mandatory review requirement, stating: “Pursuant to 15 U.S.C. § 78u-4(c)(1), the Court has conducted an independent review of the record, and is satisfied that there is no cause for sanctions pursuant to Rule 11(b) of the Federal Rules of Civil Procedure.”

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27 See In re Exodus Communications, Inc. Sec. Litig., N.D. Cal. 01CV00266 (Jan. 7, 2005), Docket Entry No. 225.


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PART V.
PLEADING FRAUD-ON-THE-MARKET UNDER ATTACK

§ 3:24 Research reports of analysts and the fraud-on-the-market doctrine

The multi-faceted WorldCom case\(^1\) poses a number of issues, but we focus only on those relating to the analyst defendants, one of which may provide a safe haven for analysts. The basic facts as to at least some of the officer defendants are well known and overwhelming. The defendants included Salomon Smith Barney, Inc. (SSB), Citigroup Inc., and Jack Grubman (hereinafter the analyst defendants). The complaint, among other things, in a separate count alleged a 10b-5 violation by SSB and Grubman, based on Grubman’s research reports and pled a controlling persons claim against SSB and Citigroup based on the same reports. The district court regarded as particularly relevant what it referred to as a quid pro quo arrangement between SSB and WorldCom under which SSB and Grubman would issue positive analyst research reports about WorldCom in exchange for WorldCom’s investment banking business. Judge Cote concluded that the allegations were sufficient to allege that the reports were false and misleading and scienter alleged with sufficient particularity for failure to disclose the “quid pro” arrangement. She also concluded that the allegations sufficiently alleged that Grubman was aware as a result of his unusually close arrangement with the company of the fact that the financial statements had capitalized expenditures and were false and misleading. In a subsequent proceeding in which Judge Cote certified the class, the analyst defendants argued that a class could not be certified as “the presumption of reliance should not apply here because the market had been aware for years that ‘sell-side analysts had perceived conflicts of interest arising from investment banking relationships,’ and because SSB disclosed its investment banking relationship with WorldCom in the disclaimer that accompanied each analyst report.”\(^2\) The court rejected this argument, stating, “[n]othing in the press

\(^1\) In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392 (S.D.N.Y. 2003).

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reports or in the boiler-plate disclaimer on which they rely provides notice to the public of the quid pro quo relationship detailed in the Amended Complaint." In what, however, may be the most significant aspect of the case vis-à-vis the analyst defendants, Judge Cote also rejected the contention that the fraud-on-the-market presumption was not applicable as market professionals do not rely on recommendations of analysts such as Grubman and that since reliance differs as to each investor a class action is not appropriate. The Second Circuit granted interlocutory review with respect to the fraud-on-the-market issue, stating: "That question is whether a district court may certify a class in a suit against a research analyst and his employer, based on the fraud-on-the-market doctrine, without a finding that the analyst’s opinions affected the market prices of the relevant securities. . . . Although the fraud-on-the-market doctrine clearly applies to statements made by issuers, as in Basic, we have never addressed whether it also applies to reports by analysts."4

How the Second Circuit resolves this issue when it is considered, if considered, is of tremendous significance. If the presumption does not apply, the implication is that a class action is inappropriate as the reliance issue will vary with each potential member of the class. The Commission filed an amicus brief arguing "that applying the presumption to analysts is consistent both with economic studies showing the market effect of analyst reports and with their very purpose — providing information on which to base investment decisions."5 The Second Circuit on May 7, 2004 issued its opinion supporting its prior order to review the issue and on May 11, 2004 the parties announced that Citigroup had entered into an agreement with the plaintiffs to settle all claims against it for $2.65 billion.6 On July 16, 2004, Judge Cote entered an order preliminarily approving the settlement and directing that notice of the proposed settlement be given to members of the class and setting the hearing on the settlement for November 5, 2004.7 Although the Second Circuit did not resolve the issue, its opinion provides much fodder for district courts to use in the meantime in insisting on being convinced at the class certification stage that the analyst’s recommendation in question actually impacted the price of the security.

The Second Circuit held with respect to Citigroup that its petition for interlocutory review of Judge Cote’s “implies a legal question about which there is a compelling need for immediate resolution.” The question that needed resolution “is whether a district court may certify a class in a suit against a research analyst and his employer, based on the fraud-on-the-market doctrine, without a finding that the analyst’s opinions affected the market prices of the relevant securities.” The court had actually granted the petition several months earlier, but was writing it opinion to explain why it had granted the petition. The court had to strive hard to do so because it needed to distinguish an earlier Second Circuit case in which the court had declined to grant interlocutory review of a district court decision applying fraud-on-the-market in a different context.8 In doing so, in many respects it went beyond merely rationalizing why it is an appropriate issue for interlocutory review. Citigroup argued that in order to certify a class action Rule 23(b)(3) requires a “finding” that questions of fact or law common to members of the class predominate over those affecting individual members of the class. The court without expressly accepting this argument comes close to drawing a distinction between a motion to dismiss and a motion to certify the proceeding as a class action. It did so by noting that Judge Cote in certifying the Citigroup class action “applied the fraud-on-the-market doctrine to an analyst’s expression of opinion as opposed to an issuer’s statement of fact.

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3 Id.


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7 The terms of the settlement including links to Judge Cote’s Order preliminarily approving the settlement and to the Memorandum of Agreement covering the settlement are available at http://www.worldcomlitigation.com/html/citissettlement.html.

8 Hevesi v. Citigroup Inc., 366 F.3d 70, 77 (2d Cir. 2004).

9 Id.

10 In re Sumitomo Copper Litig., 262 F.3d 134 (2d Cir. 2001).
In so doing, Judge Cote declined to ‘wade into the battle of the experts’ as to the existence of a causal link between Grubman’s analyst reports and movements in the price of WorldCom securities; instead, Judge Cote credited the plaintiffs’ allegation that Grubman’s statements of opinion changed the prices of WorldCom securities during the Class Period.” To Judge Cote, in the court’s view, “applied the fraud-on-the-market doctrine in a novel context [FN6] without identifying a causal link between the statements at issue and the price of securities.” At footnote 6, the court referred to district courts that had applied fraud-on-the-market to analysts’ reports at the motion to dismiss stage, but noted that none had done so previously at the class certification stage. The court immediately added, “on motions to dismiss, of course, courts are required to assume the truth of well-pleaded allegations, including allegations that an analyst’s misrepresentations affected the market price of securities.”

The court via footnote backed off a little from its statement that Judge Cote merely accepted the allegations that the analyst’s misrepresentations affected the price of the securities. The court noted she also took into account the analyst’s (Jack Grubman’s) $20 million annual salary, highly favorable reports, and that “it comports with both common sense and probability to apply the presumption here.” As to which the court remarked, “Judge Cote did not state what standard of proof, if any, the plaintiffs were required to meet at the class certification stage with respect to the Basic presumption.” The court professed that it was not deciding “what evidentiary showing, if any, the plaintiffs must make at the class certification stage in order to benefit from the Basic presumption in an action against research analysts and their employers.” Citigroup defendants had “offered a substantial legal argument in support of their position,” and “the District Court’s extension of the fraud-on-the-market doctrine in the instant case is closely connected to its certification decision, because, in order to recover from the Citigroup Defendants, each class member will have to prove reliance on one or more of Grubman’s statements of opinion—either individually or with the benefit of the Basic presumption.” The issue is “also significant, because the application of the fraud-on-the-market doctrine to opinions expressed by research analysts would extend the potentially coercive effect of securities class actions to a new group of corporate and individual defendants—namely, to research analysts and their employers.” Ironically, in view of the fact that the case vis-à-vis Citigroup is in the process of settlement, the court added as a reason for granting interlocutory review that it otherwise was likely to escape effective review after final judgment. The court noted in this regard with supporting quotations from other Second Circuit court opinions that class certification places inordinate pressure on defendants to settle. Hence, absent interlocutory review in this matter if the class certification were allowed to proceed without review the matter likely would be settled and the issue would not reach the circuit court for review.

Although the Second Circuit merely granted leave in Citigroup to file an interlocutory appeal, the court said enough about the issue for Judge Rakoff to rely on it, perhaps justifiably, to hold in the context of a motion to certify the action as a class action “that the ‘fraud-on-the-market’ doctrine applies in a case premised on a securities analyst’s false and fraudulent opinions or recommendations only where the plaintiff can make a showing that the analyst’s statements materially impacted the market price in a reasonably quantifiable respect.” Judge Rakoff was influenced by what the Second Circuit said in Citigroup to the extent he forgot what he said with respect to fraud-on-the-market in denying defendants’ motion to dismiss. He quoted Basic as holding “that where there has been a misrepresentation to the securities marketplace, a rebuttable presumption arises that investors who purchased or sold securities in an

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14 Hevesi v. Citigroup Inc., 366 F.3d 70, 78 n.5 (2d Cir. 2004).
15 Hevesi v. Citigroup Inc. 366 F.3d 70, 79 (2d Cir. 2004).
17 Hevesi v. Citigroup Inc., 366 F.3d 70, 80 (2d Cir. 2004).
18 Hevesi v. Citigroup Inc., 366 F.3d 70, 80-81 (2d Cir. 2004).
efficient market relied upon the misrepresentation.” He then noted, “Lehman’s initial response is to claim the Basic presumption is inapplicable to research reports.” To which he responded, “[b]ut as Judge Cote noted in rejecting a similar argument in In re WorldCom Inc. Sec. Litig., 219 F.R.D. 267, 299-300 (S.D.N.Y. 2003), ‘defendants cite no legal authority to support this remarkable assertion’ and for good reason, for it ‘comports with both common sense and probability to apply the presumption here.’ This Court agrees, and therefore declines to exempt the research reports here in question—whose very purpose was to advise Lehman’s readers to buy stock in a company, RealNetworks, for which Lehman also acted as investment banker, see Complaint, ¶ 2—from the reach of the fraud-on-the-market presumption.”20 This, of course, was on a motion to dismiss and as suggested in Citigroup certification as a class action may be a different proposition.

“Common sense and probability,” apparently are not enough at the class certification stage, as in that context Judge Rakoff opined “the plaintiff must adduce admissible evidence that facially meets the aforementioned standard, i.e., that makes a prima facie showing that the analyst’s statements alleged to be false or fraudulent materially and measurably impacted the market price of the security to which the statements relate.”21 Lehman had acted as co-manager of the underwriting of the common stock of RealNetworks in June of 1999. Stanek, a Lehman analyst, had written 13 reports relating to RealNetworks during the class period all of which rated it as a 1, which under Lehman’s 1 to 5 rating system was its highest recommendation. As a result of an SEC investigation it became known that in emails, dated July 18, 2000, Stanek advised an institutional investor that “[RealNetworks] has to be short bigtime.” The institutional investor replied on July 19, 2000, saying “nice call on [RealNetworks] . . . I mean all the upside from crappy ad business . . . why aren’t people jumping up and down saying this sucked? ? ? . . . Nice call on your part anyhow.” Stanek replied in turn that “we bank these guys so I always have to cut the benefit of the doubt.” In another email, written in January 2001, Stanek stated that “if it’s in my group it’s a short.” In his opinion denying the motion to dismiss, Judge Rakoff referred to “the stark difference between what Stanek was effectively recommending to readers of his reports, i.e., ‘buy,’ and what he was effectively recommending to preferred customers in his emails, i.e., ‘sell’.”22 In fact, he was recommending more than that to his preferred customers—to short big time.

On their motion to certify as a class action, plaintiffs in Judge Rakoff’s view failed to establish by admissible evidence that the allegedly false statements materially impacted the price of the security. Judge Rakoff viewed it from the perspective of what the difference might have made on the market between a buy and sell recommendations when other analysts where recommending a buy. Given the 1-to-5 rating system of Lehman, the analyst’s true opinion would appear to have been more than the difference from a buy to a sell; more like the difference between a 1 and a 5. The “evidence” offered by plaintiff consisted of some brochures that Lehman at one time put out concerning the expertise of Stanek, which Judge Rakoff referred to as “puffing” that didn’t establish much in terms of Stanek’s influence on the market. Plaintiffs also presented expert testimony based on a somewhat dated study and other assumptions of the expert as to the impact of a change in an analyst’s rating on the market. Judge Rakoff regarded the testimony so irrelevant as to be inadmissible under Daubert23 because the studies and assumptions were based on the impact on the market of a change in the rating when all the analysts changed their recommendations. Plaintiffs had failed to “survive the ‘rigorous analysis’ that is required for class certification.”24 Defendants argued that plaintiffs could not satisfy the Rule 23(b) requirements of “numerousness,” “commonality,” and “typicality,” and the court in effect agreed.

Judge Lynch in a very similar case involving a different investment banking firm and its research analysts disagreed with Judge Rakoff as to the significance to be attached to Hevesi and applying fraud-on-the-

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market in determining whether class certification was appropriate. To Judge Lynch "Hevesi has only one holding: that the application of the Basic presumption to analyst statements at the class certification stage presents 'legal question about which there is a compelling need for immediate resolution.' That holding merely underscores the unresolved nature of the question, rather than directing the necessary result, as defendants assert." To require plaintiff to establish prima facie fraud-on-the-market at the class certification stage is to decide the case on the merits at that stage. Although it would be easier if plaintiff disclaimed any assertion of individual reliance, which plaintiff refused to do, the appropriate test at the class certification stage is whether plaintiff presented what would be a colorable argument for purpose of a summary judgment motion or at trial that fraud-on-the-market was appropriate in this case. Judge Lynch concluded as follows:

Here, plaintiffs have demonstrated that they will be able to make a colorable presentation at summary judgment or trial as to the propriety of applying the fraud-on-the-market theory in this case. Defendants vigorously contest this argument, and the evidence in support of it, but it is clear that both plaintiffs' presentation and defendants' rebuttal will apply equally to the entire plaintiff class, and that the legal and factual issues raised by the controversy will be common ones. The elements of the fraud-on-the-market theory will form the core of plaintiffs' presentation to a factfinder on reliance, and that factfinder will conclude either that the class as a whole is entitled to the Basic presumption or that it is not. Thus, the existence of this dispute, however heated, does not demonstrate that individual issues will predominate over common ones.


§ 3:25 The broader attack on fraud-on-the-market

During the Supreme Court's 2003-2004 term, it denied a petition for certiorari filed by America West Holdings, seeking review of the question whether the majority of the Ninth Circuit panel erred in applying the fraud-on-the-market presumption in a situation in which defendants contended (and plaintiffs disputed) the alleged misrepresentation had no impact on the market price of the security. Both the majority and the dissent in the Ninth Circuit discussed the issue in the context of materiality. The majority rejected any bright line rule that required the market to immediately react to the market price when America West disclosed the problems that it was encountering with the Federal Aviation Administration (FAA) and the settlement it had reached with the FAA. The majority of the panel purporting to rely on Basic argued "[t]he market is subject to distortions that prevent the ideal of 'a free and open public market' from occurring. As recognized by the Supreme Court, these distortions may not be corrected immediately." The court noted that Basic in crafting the fraud-on-the-market presumption stated, "we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in the market price." It may be significant that there was more, for as the majority added, "[m]oreover, although America West's disclosures of the settlement agreement had no immediate effect on the market price, its stock price dropped 31% on September 3, 1998 when the full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed to the market. This reaction, even if slightly delayed, further supports a finding of materiality. This is particularly true because Plaintiffs offer a

2 No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003).
3 No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 934 n.2 (9th Cir. 2003), quoting from Basic, Inc. v. Levinson, 485 U.S. 224, 248 n.28 (1988).
reason for the delay, i.e., America West continued to reassure analysts that the settlement agreement and compliance therewith would not have noticeable economic effects on the company."\(^4\) The dissent cited three disclosures of the FAA problem—(1) an initial disclosure by the *Wall Street Journal* on June 22, 1998; (2) America West’s announcement of July 14, 2004 of its settlement with the FAA; and (3) publication by America West Weekly on July 20, 1998 of key terms of the settlement. The first two were followed by slight increases in the market price of the stock and the third resulted in the stock closing down 3/8ths from 28-3/4 to 28 3/8. "The market’s collective yawn to the allegedly material news," in the view of the dissenting member of the panel, "is fatal to plaintiffs’ ability to successfully establish the reliance element of their cause of action when their complaint is founded upon a ‘fraud-on-the-market’ theory."\(^5\)

The Fourth Circuit has held that in a proceeding to certify a class that the court can not rely on plaintiff’s assertion that the security (stock of a community bank) traded in an efficient market, but must “take a ‘close look’ at relevant matters, conduct a ‘rigorous analysis,’ and make findings in determining whether the plaintiffs have demonstrated that the requirements of Rule 23(b)(3) have been satisfied.”\(^6\) Further, although the fact that the price of the stock dropped significantly in value after the Office of the Comptroller of the Currency closed the bank "reflects the assimilation of market information at its grossest level, that single piece of information, standing alone, does not represent adequate evidence that the plaintiffs in this case purchased their shares of Keystone stock in an efficient market." In the court’s view, "to determine whether a security trades on an efficient market, a court should consider factors such as, among others, whether the security is actively traded, the volume of trades, and the extent to which it is followed by market professionals."\(^7\) Although the court remanded the case to the district court to make the determination, it referenced a number of negative factors that raised "a serious question about whether plaintiffs in this case could demonstrate that they purchased their shares on a market sufficiently efficient to act as a surrogate for reliance." During part of the class period (April 19 to September 1) the stock was not listed on any market and thereafter traded only on the OTC Bulletin Board and in the pink-sheets. During the entire class period there were only 244 trades or an average of 2.5 trades a day and on some days the spread between the bid and ask price was nearly 30 percent. The court said of this, "[i]f the district court were to take such facts into account, it would have been faced with formidable evidence that the generally accepted criteria for an efficient market might not have been satisfied during the period from April to September 1999."\(^8\)

The Fifth Circuit held in *Zonagen* that the Supreme Court in *Basic* made it clear "that the presumption of reliance may be rebutted by [a]ny showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff."\(^9\) The Supreme Court in *Basic* gave as an example the situation in which the market-makers knew the representation was false, "and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone."\(^10\) The Fifth Circuit turned the example into a generalization that the link would be severed by "a showing that ‘the market price would not have been affected by’ the alleged ‘misrepresentations,’ as in such a case ‘the basis for finding that the fraud had been transmitted through market price would be gone.’"\(^11\) This led the

\(^4\) No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 935 (9th Cir. 2003).

\(^5\) No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 947 (9th Cir. 2003).

\(^6\) Gariety v. Grant Thornton LLP, 368 F.3d 356, 359 (4th Cir. 2004).

\(^7\) Gariety v. Grant Thornton LLP, 368 F.3d 356, 368 (4th Cir. 2004).

\(^8\) *Id.*

\(^9\) Gariety v. Grant Thornton LLP, 368 F.3d 356, 364 (4th Cir. 2004).

\(^10\) *Id.*


\(^12\) *Basic* v. Levinson, 485 U.S. 224, 248 (1988).

\(^13\) Nathenson v. Zonagen, Inc., 267 F.3d 400, 414 (5th Cir. 2001).
court to conclude “that a fraud-on-the-market theory may not be the basis for recovery in respect to an alleged misrepresentation which does not affect the market price of the security in question.”14 Plaintiff alleged in detail the nature of the market in which the security was traded suggesting it was an efficient market, but the price of the stock went down after the alleged misrepresentations and increased after disclosure of the negative news that was the basis for alleging the representations were false. Since there was no allegation that the alleged misrepresentations affected the price of the stock, the court concluded “that the district court properly determined that those May 9 and 16, 1996, representations were not actionable under a fraud-on-the-market theory.”15

The Fifth Circuit subsequently in Crossroads Systems read Zonagen to hold “plaintiffs could not show that the price of Zonagen’s stock was actually affected by the allegedly false statements, either by showing an increase in price following the allegedly false positive statements or a corresponding decrease in price following the revelation of the misleading nature of these statements. As such, the plaintiffs were not entitled to the fraud-on-the-market presumption of reliance.”16 The Fifth Circuit in Crossroads Systems applied this learning to the granting by a district court of a summary judgment for the defendant with respect to representations made during the class period (January 25, 2000, and August 24, 2000) concerning the company’s third generation line of storage routers for computer networks.17 With one exception discussed below, the plaintiff did not make any allegation that the price of the stock went up after the alleged misrepresentations. The company made two announcements that included negative news on July 27, 2000 and on August 24, 2000 and the price of the stock dropped after both. The July 27, 2000 bad news included that earnings for the third quarter would be disappointing, a problem had been encountered with the interoperability of the routers, which was being corrected, that one large customer would not be order-

19 Id.
tions, because “confirmatory information has already been digested by the market and will not cause a change in stock price.”21 Plaintiffs alleged misrepresentations made on 15 different occasions. The Fifth Circuit ruled out ten of them as being confirmatory of what was represented previously. The five non-confirmatory statements all related to the interoperability of its new line of routers. The July 27 statements disclosed that the company was having a problem with the interoperability of the new generation routers. The plaintiffs therefore had shown that the alleged misrepresentation and the disclosure leading to a drop in price of the stock were related. But plaintiffs have an additional problem, the July 27 announcement referred to several other problems (reduced third quarter earnings, large customer’s inventory imbalance, other customer transitioning out of the product) that could have had a negative impact. The one related problem—a temporary glitch in technology—is a common occurrence and the least serious of the problems disclosed. The court opined: “In order for the plaintiffs to trigger the reliance presumption they must demonstrate the likelihood that the 27 July 2000 interoperability statements played a significant role in the decline in stock price. The plaintiffs have not done so, either in their Complaint or through their expert, Dr. Hakala. In the face of the more serious negative statements unrelated to interoperability and without any explanation by the plaintiffs, we conclude that a fact finder could not find that the news regarding temporary interoperability problems played a significant role in the decline in price following the 27 July 2000 statement. For these reasons, the statements regarding the interoperability of Crossroads’ routers cannot form the basis for a fraud-on-the-market claim.”22 Plaintiffs pointed to several other representations alleged to be false relating to the storage router, but the court held fraud-on-the-market inapplicable as to them as none of the alleged problems alleged to underlie these representations were acknowledged in the July 27 announcement.

There was another aspect to the case. Plaintiffs alleged that a number of representations made relating to the company’s financial situation were false or misleading. Those statements that related to the first and second quarter of the year, however, did not relate to the bad news disclosed in the July 27 announcement, which referred only to its expected third quarter results. Plaintiffs had not passed the related test necessary to rely on the drop in price after the July 27 announcement. There were also representations made relating to the expectations for the third quarter. Here, plaintiffs passed the related test—“because the 27 July 2000 release clearly concerned a significant revenue shortfall for Crossroads’ third fiscal quarter, the plaintiffs have shown the requisite link between the 27 July 2000 negative information and the earlier statements.”23 But have they shown that it was more likely than not that a significant drop in price was attributable to that information rather than the other bad news included in the announcement? Plaintiff had produced no evidence that it did; nonetheless, “unlike the news of temporary interoperability problems, we are persuaded the news that a company’s revenue will be 66% below estimates satisfies the plaintiffs’ burden. News that a company’s earnings will be two-thirds short of analysts’ estimates is the type of negative information most likely to cause a sharp decline in stock price. For these reasons, we find that Crossroads’s statements [relating to the third quarter expectations] may form the basis for the plaintiffs’ fraud-on-the-market claim.”24

The plaintiffs on August 24, 2000 released their financial results for the third quarter and the price of the company’s stock dropped from $12.62 to $9.00. The court, however, did not regard the disclosure in that release as a basis for applying fraud-on-the-market not because the drop in price was not significant but because the release was confirmatory of what it had disclosed in the July 27 release with respect to third quarter earnings; hence, plaintiff had to rely on the July 27 release. This made no difference in context since the court had already concluded that fraud-on-the-market was applicable to the representations made about expectations as to the third quarter based on the information included in the July 27 release and its impact on the market price of the stock. If it had not reached the conclusion that the July 27 disclosure had a significant impact on the market price because of the other negative news, the August

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24 Id.
24 release should have confirmed that conclusion. It is also conflicts with the court’s view that confirmatory statements do not impact the market price of a security. Interestingly, however, the price of the stock after that decline was still well above the price ($5.00) to which it had dropped after the July 27 release, demonstrating, perhaps, how inexact a science is at play in attributing market movements to disclosure of particular company related information.

There was one alleged misrepresentation as to which plaintiff could allege it resulted in an increase in market price. The company announced on February 7, 2000 an agreement with Hitachi Data Systems to resell Crossroad’s older generation router worldwide. The price of the stock went from $109.75 to $163.25 within two days. The announcement also referred to “the unique interoperability of feature of Crossroad’s storage routers.” It was this aspect of the announcement that plaintiffs apparently alleged was false and misleading, but in making the allegation the complaint referred by number to the newer generation router. The court treated the allegation as relating to the newer generation router as that was what was considered by the district court. The company had made similar representations relating to the newer generation router on January 25, 2004. The court viewed the February 7, 2000 representation as a confirmation of what it had said on January 25, 2004 and, therefore, it was not that representation that caused the price of the stock to rise. Since the misrepresentation allegations did not pertain to the Hitachi Data Systems agreement as such, the increase in price of the stock could not be the basis for relying on fraud-on-the-market.

The defendants’ petition for certiorari in America West Holdings purports to summarize the differences among the circuit courts of appeals as to fraud-on-the-market and the need to allege the impact of the alleged misrepresentations on the market price. The petition asserted that the majority in the Ninth Circuit held “that the materiality and reliance elements of a Section 10(b) claim invoking the ‘fraud-on-the-market’ theory . . . can be satisfied when the disclosure of the alleged misrepresentations


had no impact on the defendant issuer’s stock price.” This as discussed above may be an oversimplification of what the Ninth Circuit held and the Supreme Court refused to review. The petition asserts that the Eighth Circuit also regards the test whether a reasonable investor would have regarded the misrepresentation or omission as material as sufficient to “to invoke the fraud-on-the-market theory and assume that the misrepresentations inflated the stock’s price.” On the other hand, the petition argued “the First, Third, Fourth and Fifth Circuits determine materiality and reliance in fraud-on-the-market cases based on market reaction. This is qualified slightly; ‘the Third and Fifth in particular, hold that market reaction is dispositive.” Reference is made to the Third Circuit’s opinion in Burlington Coat Factory and the court’s statement “[i]n the context of an ‘efficient’ market, the concept of materiality translates into information that alters the price of the firm’s stock.” The Fifth Circuit in Zonagen, the petition notes, agreed that the test is whether “the complained of misrepresentation or omission . . . actually affected the market price of the stock.” The Fifth Circuit regarded it as a matter of reliance rather than materiality, stating: “[I]t is more appropriate in such cases to relate this requirement to reliance rather than to materiality.” The “rubric of materiality or reliance” aside, the Fifth Circuit made it clear “where the facts properly considered by the district court reflect that the information in question did not affect the price of the stock then the district court may properly deny fraud-on-the-market based recovery.”

26 Petition for certiorari, id., quoting from Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 830 (8th Cir. 2003).
27 Petition for certiorari, id., quoting from In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997).
29 Id.

Richard A. Rosen

Under the Private Securities Litigation Reform Act ("PSLRA" or "Reform Act"), an issuer’s forward-looking statement or projection does not give rise to securities law liability if: (1) the statement is identified as forward-looking and accompanied by meaningful cautionary language; or (2) the statement is immaterial; or (3) plaintiffs fail to establish that defendants had actual knowledge of the falsity of the statement.1

There have been sixteen court of appeals decisions about the safe harbor since the enactment of the PSLRA, the majority of which were issued over the past year and a half. Since the safe harbor’s passage, there have also been well over 150 district court opinions, over thirty of which have come down since April 2003.2 Of all the district court and court of appeals decisions in the last nineteen months, only one decision was not in the context of a motion to dismiss.3

The PSLRA was designed in part to facilitate dismissal at the pleading stage, and thereby to avoid the necessity of burdensome and lengthy inquiry into a defendant’s state of mind, if the issuer could show that any potentially misleading forward-looking statements had been accompanied by meaningful cautionary language.4 This goal, however, is under threat by two emerging lines of cases. Of most recent concern to issuers is Asher v. Baxter International, Inc.,5 a Seventh Circuit decision which, if read too broadly, raises the question whether a court may ever determine the adequacy of cautionary language at the pleading stage. There is also an emerging circuit split on whether the safe harbor protects an issuer that made predictions accompanied by adequate cautionary language, even if the defendant made the predictions knowing they were false or had no reasonable basis. A review of the cases decided in the last year and a half reveals, in addition, that case law remains inconsistent on whether statements that contain both factual and forward-looking elements can be afforded protection under the safe harbor, on whether cautionary language must literally "accompany" the predictions or may be incorporated by reference to another document, and on what constitutes immaterial "puffery" and when it is appropriate to decide that question.

I. Meaningful Cautionary Language

A. Does Asher Close the Safe Harbor? A recent decision from the U.S. Court of Appeals for the Seventh Circuit has caused many to fear that public companies will no longer be able to seek refuge in the safe harbor.6 Since the enactment of the statute, issuers have been


2 The court of appeals and district court opinions are listed in Appendix A to this article. The earlier court cases are all cited in my “Safe Harbor for Forward-Looking Statements in the Courts: A Scorecard in the Courts From January 2002 Through April 2003” and “Safe Harbor for Forward-Looking Statements in the Courts: A Year 2001 Scorecard” articles.


4 The House Conference Report explains: The use of the words ‘meaningful’ and ‘important factors’ are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.


5 377 F.3d 727 (7th Cir. 2004).
willing to make more forward-looking disclosures with some confidence that, should they be sued, they have a reasonable likelihood of obtaining a dismissal at the pleading stage so long as the predictions were accompanied by meaningful cautionary language identifying "important factors that could cause actual results to differ materially from those in the forward-looking statement." Indeed, although plaintiff buyers continue to assert claims for such statements, they are generally regarded by practitioners on the plaintiffs' side as relatively weak.

This may be about to change. In Asher, 5 the Seventh Circuit raises the question whether a court may ever determine the adequacy of cautionary language at the pleading stage. 6 The plaintiff in Asher alleged that Baxter International, a medical manufacturer, made positive projections about revenue growth without disclosing various internal and external risk factors. Although the lower court found Baxter's long and relatively company-specific list of warnings to be adequate, 7 the Seventh Circuit reversed and remanded, writing, "[t]here is no reason to think—at least, no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery—that the items mentioned in Baxter's cautionary language were those thought at the time to be the (or any of the) 'important' sources of variance." 8

The court appears to be shifting the safe harbor inquiry from whether the cautionary language identified "some important risks" to whether the language fully reflected what the issuers actually knew when they made the predictions. This interpretation is in acute tension with the language of the statute, which requires issuers only to identify "important factors that could cause actual results to differ materially from those in the forward-looking statement." 9 Shifting the focus from whether the identified factors provided adequate notice of risk—an objective inquiry that can often be determined at the pleading stage—to an inquiry into what issuers knew when they made predictions seems to preclude pre-discovery dismissal. Taken to its logical extreme, the Asher court's formulation would require an inquiry into exactly what the issuers knew or should have known at the time of the forward-looking statements.

Asher need not be the end of the world, however, for four reasons. First, the analysis should only come into play when the issuer failed to identify the risk that actually materialized. Second, the issuer in Asher failed to update its cautionary language in the face of changing risks—a circumstance that weighed heavily with the court. Third, much of the balance of the Asher decision is not consistent with the conclusion that the safe harbor is never available at the pleading stage, even in the Seventh Circuit. Finally, Asher is not the law in all circuits; this is a critical issue of great importance that seems ripe for Supreme Court review.

First, Baxter failed to identify the risks that actually materialized. Though the court emphasizes that it is not necessary to do so, 10 issuers must at least provide buyers of the very circumstance that eventually causes a negative outcome certainly should be sufficient to place forward-looking statements within the safe harbor. 11 After all, it would be irrelevant to the outcome of the case if it turned out that management subjectively knew of material undisclosed risks that never in fact came to pass. Thus,

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7 377 F.3d 727 (7th Cir. 2004).

8 See id. See also Ong v. Sears, Roebuck & Co., No. 03 C 4142, 2004 U.S. Dist. LEXIS 10425, at *105-06 (N.D. Ill. Sept. 24, 2004) (applying Asher v. Baxter Int'l, Inc.); In re Humane, Inc. Sec. Litig., No. C 03-2954 SI, 2004 U.S. Dist. LEXIS 15382, at *15 (N.D. Cal. July 30, 2004) ("To the extent that a statement is forward-looking and is not based on the most accurate information available to defendants, it would not be protected by the general safe harbor provision. The Court cannot conclude at this early stage whether defendants relied on the most accurate information or whether they failed to discuss negative information, as alleged by plaintiffs."). In New Jersey v. Sprint Corp., No. 03-20710(JWL), 2004 U.S. Dist. LEXIS 17765 (N.D. Kan. Sept. 3, 2004), the Northern District of Kansas applied Asher to find that plaintiffs adequately pled actual knowledge, the second prong of the safe harbor. Id. at *9 ("[s]ince the application of the law is not relevant to the current inquiry, which concerns the first prong of the safe harbor, adequate cautionary language.")


10 Asher, 377 F.3d at 734.


12 See Asher, 377 F.3d at 734 ("The problem is not that what actually happened went unmentioned; issuers need not anticipate all sources of deviations from expectations.").

13 See e.g., Miller v. Champion Enters., Inc., 364 F.3d 660, 678 (6th Cir. 2003) (finding adequate cautionary language and noting that "[d]efendant disclosed the exact risk that occurred in this situation ... [and] is not required to detail every facet or extent of that risk to have adequately disclosed the nature of the risk.") But see Ong, No. C 4142. The U.S. Dist. LEXIS 19425, at *102-03 (rejecting defendant's argument that its warnings must have been adequate because they were "not only realistic; they actually came true").
where issuers have identified the risk that materialized, Asher, properly read, should not adversely affect the visibility of a motion to dismiss.

Second, whereas the district court found that Baxter's failure to include certain known risks was mitigated by the "substantive and sufficiently tailored" cautionary disclosures,\(^{15}\) the appellate outcome seems to have been heavily influenced by the fact that Baxter's cautionary language "remained fixed even as the risks changed."\(^{16}\) For example, the complaint alleged that there was a "sterility failure" in the spring of 2002, but "Baxter left both its forecasts and cautions as is." Also, Baxter allegedly "closed plants that were its least-cost sources of production," yet "the forecasts and cautions continued without amendment."\(^{17}\) For the court, the unchanging cautionary language was a red flag, raising "the possibility—no greater confidence is possible before discovery—that Baxter omitted important variables from the cautionary language and so made projections as more certain than internal estimates at the time warranted."\(^{18}\) Of course, even before Asher it was crucial for issuers to adopt their cautionary language to reflect any major changes in the risks their company faces.

The language of Ong v. Sears, Roebuck & Co.,\(^{19}\) the only district court case to apply Asher,\(^{20}\) similarly indicates that the defendant may have fared better had it been more current in its description of risk factors.\(^{21}\) Sears had made rosy predictions about the quality of its credit-card portfolio, cautioning that the accuracy of the predictions was subject to "changes in...delinquency and charge-off trends in the credit card receivables portfolio."\(^{22}\) The court found this language to be insufficient, writing, "[a] warning that trends could change...is not the same as a warning that the current portfolio is experiencing rising delinquencies and charge-offs due to its high-risk customers."\(^{23}\)

Third, the court's discussion in Asher includes several good points on the safe harbor that are wholly inconsistent with the notion that it is never appropriate to apply the safe harbor at the pleading stage. For example, the Court notes that, "[i]n no case is it possible to give a concrete and reliable answer [to the question of what constitutes meaningful cautionary language], the safe harbor is not 'safe.'"\(^{24}\) The opinion goes on, "[a] safe harbor matters only when the firm's disclosures (including the accompanying cautionary statements) are false or misleadingly incomplete; yet whenever that condition is satisfied, one can complain that the cautionary statement must have been inadequate. The safe harbor loses its function."\(^{25}\)

Given these inherent difficulties, the court tries to discern a standard for applying the safe harbor. Clearly, "issuers need not anticipate all sources of deviations from expectations," as that would render the safe harbor meaningless.\(^{26}\) Also, public companies need not reveal the calculations underlying predictions, as revealing this kind of confidential information might undermine the company's competitiveness, ultimately hurting shareholders.\(^{27}\)

Finally, other circuit courts have recently affirmed dismissals based on the safe harbor, applying a far more lenient standard than the Asher court.\(^{28}\) For example, in the same month as Asher, the Third Circuit affirmed a district court's dismissal based, in part, on the safe harbor. In In re Adams Family Golf Sec. Litig., the defendant, a manufacturer of custom-fit golf clubs, made forward-looking statements concerning "sanguine prospects for the golf industry and the rising popularity of the sport more generally."\(^{29}\) Plaintiffs alleged that these statements were materially misleading given that there was an oversupply of clubs in the retail market.\(^{30}\) The court found that defendant's registration statement contained adequate cautionary language that warned of "prospects of lagging demand for the company's products, competitive products from rivals, unseasonable weather patterns that could diminish the amount of golf played, and an overall decline in discretionary consumer spending." It did not concern the court that there was no warning about the oversupply specifically. Rather, the court focused on the fact that the risks identified "relate directly to the claim on which plaintiffs allegedly relied; the general representations of better business ahead were mitigated by the discussion of the several factors that could have caused poor financial results."\(^{31}\) Thus, as the statute directs, the Third Circuit focused on whether the cautionary language appropriately modified the forward-looking statement, not whether the language matched exactly with what the defendant knew at the time it made the statement.\(^{32}\) When it remains to be seen how courts in other circuits will react to the Asher decision, as of today, it stands virtually alone.\(^{33}\)

\(^{15}\) No. 02 C5608, 2003 U.S. Dist. LEXIS 12905, at *13 (N.D. Ill. July 17, 2003), rev'd by 377 F.3d 727.
\(^{16}\) 377 F.3d at 734.
\(^{17}\) Id.
\(^{18}\) Id. at 734-35.
\(^{19}\) No. 03 C 4142, 2004 U.S. Dist. LEXIS 19425 (N.D. Ill. Sept. 24, 2004).
\(^{20}\) As noted above, New Jersey v. Sprint Corp., No. 03-20710WJL, 2004 U.S. Dist. LEXIS 17765, at *36-37 (N.D. Kan. Sept. 3, 2004), cites Asher, but not in the context of determining whether cautionary language was adequate.
\(^{21}\) Ong, No. 03 C 4142, 2004 U.S. Dist. LEXIS 19425, at *102-03.
\(^{22}\) Id. at *102.
\(^{23}\) Id.
\(^{24}\) Asher, 377 F.3d at 729.
\(^{25}\) Id.
\(^{26}\) Id. at 734.
\(^{27}\) Id. at 733.
\(^{28}\) See, e.g., In re Adams Family Golf Sec. Litig., 381 F.3d 267 (3d Cir. 2004); Rombach v. Chang, 355 F.3d 164 (2d Cir. 2004).
\(^{29}\) 381 F.3d at 279.
\(^{30}\) Id.
\(^{31}\) See id.
\(^{32}\) Id.
\(^{33}\) See id.
\(^{34}\) It should be noted that the court placed this language within the safe harbor on two bases: because it was accompanied by adequate cautionary language and because it was too vague to be material. See id.
B. Specificity. Decisions are unfortunately far from uniform as to the specificity required of cautionary language.\textsuperscript{38} In \textit{In re Midway Games, Inc. Securities Litigation}, granting a motion to dismiss under the safe harbor provision, the court emphasized that cautionary language must be "sufficiently related in subject matter and strong in tone to counter the statement made."\textsuperscript{39} In this case, defendant Midway had made predictions about product release dates and growth in sales and revenue. The court found language such as "[w]e do not know when or whether we will become profitable again" to be "highly specific."\textsuperscript{40} The court emphasized that Midway's warnings "continue[d] for pages" and identified "numerous factors" that might lead to adverse outcomes, including, "variations in the level of market acceptance of our products," "delays and timing of product introductions," and "development and promotional expenses relating to the introduction of our products."\textsuperscript{41}

In \textit{Rombach v. Chang},\textsuperscript{42} the Second Circuit upheld a lower court's determination that the defendant's cautionary statements, though "formul\ae," were sufficiently meaningful.\textsuperscript{43} The language included warnings "that the company's past performance was not necessarily indicative of future results" and "that no assurance could be given that additional facilities would be readily integrated into the Company's operating structure.

The Second Circuit ruled that the language offered "a sobering picture of a company's financial condition and future plans," and therefore was protected by the safe harbor.\textsuperscript{44} On the other hand, in \textit{In re American Express Securities Litigation},\textsuperscript{45} the Southern District of New York found language that "potential deterioration in the high-yield sector ... could result in further losses," accompanying the prediction that losses on high-yield investments would go down, was inadequate because "it was not based on specific facts, and therefore was insufficiently precise."\textsuperscript{46}

In light of \textit{Asher} and other recent cases careful issuers would be wise to update their cautionary language every quarter to reflect all changes—both within the company and in the outside markets. The language must be as specific as possible. Issuers should also write cautionary language with an eye to the risk disclosures of competitors, suppliers and customers. Similarly, it is always helpful to review research reports of the analysts who follow the company. Their insights into industry-wide phenomena, and their nonpartisan view of the company and its prospects, will help to identify potential risk factors.

II. Is Actual Knowledge of Falsity a Barrier to Safe Harbor Protection?

Though the statute is clear and unambiguous on the issue, there is an emerging circuit split over the "actual knowledge" provision of the safe harbor. A literal reading of the statute provides three separate grounds for dismissing a count—the first, if its statements are forward-looking and accompanied by adequate cautionary language, the second, if the plaintiff has failed to allege that the defendant actually knew its statements were false, and the third, if the alleged misrepresentations were immaterial. Therefore, a defendant that loses on the cautionary language issue may nevertheless argue that plaintiff failed adequately to plead scienter.\textsuperscript{48} But the converse is not necessarily true. Circuits are split over whether a defendant that actually knew its statements were false or misleading at the time they were made may still avail itself of the safe harbor so long as the statements were forward-looking and accompanied by meaningful cautionary language. This split has a profound impact on how motions to dismiss get decided.

Over the past year and a half the Fifth, Sixth and Ninth Circuits have all found that the two prongs of the safe harbor provision operate totally independently of one another. For example, in \textit{Miller v. Champion Enterprises, Inc.},\textsuperscript{49} the Sixth Circuit ruled that if a statement qualifies as forward-looking and is accompanied by cautionary language, it is "protected regardless of the actual state of mind."\textsuperscript{50} In \textit{Southland Securities Corp. v. Inspire Insurance Solutions Inc.},\textsuperscript{51} the Fifth Circuit wrote, "[t]he safe harbor has two independent prongs: one focusing on the defendant's cautionary statements..."
and the other on the defendant’s state of mind.”52 Similarly, in Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. The Clorox Co.,53 the Ninth Circuit affirmed the district court’s application of the safe harbor to allegedly “knowingly false statements” because it found that the statements were accompanied by “sufficient warnings.”54

Some district courts in other circuits agree, most recently in the Northern District of Illinois, where the court noted that, “[f]or purposes of § 78u-5(c)(1)(A), proof of knowledge of the falsity of a forward-looking statement is ‘irrelevant’ when the statement is accompanied by meaningful cautionary language.”55

The First and Third Circuits, however, have rejected this reading, finding that forward-looking statements with adequate cautionary language fall within the safe harbor “unless the person making the forward-looking statements ... had actual knowledge that they were false or misleading.”56 In these circuits, then, there is no possibility for dismissal at the pleading stage where plaintiff has adequately pled scienter. Moreover, if plaintiff is able to prove scienter, the safe harbor will not apply at all, even if defendant’s predictions were couched in adequate cautionary language.

III. Is the Statement Forward-Looking?

Courts seem to have relatively little trouble determining whether a simple statement is forward-looking. Of late, this question has received less detailed attention than in the past. Courts are still sharply divided, however, on how to analyze statements with both factual and forward-looking elements.

Most courts determine whether an issuer’s statement is forward-looking simply by asking if the “the truth or falsity of the statement cannot be discerned until some point in time after the statement is made.”57 At times, however, courts will not apply even this level of analysis.58 Some statements are classically forward-looking and require little analysis because they relate to management’s expectations for the company’s future operations. For example, statements that speak of a “strategic operating plan” or indicate that management is “expecting a very good year” address future events and are prototypical forward-looking statements.59

Complications arise when the court must review a statement that contains both forward-looking and historical or present fact elements. Five years ago in Harris v. Ivax,60 the Eleventh Circuit adopted a “holistic” approach to mixed statements, rating a list of factors in the company’s disclosure documents—some containing present assessments of business conditions, others including assumptions about future events—as a single forward-looking statement.61 The court based its decision both on a close reading of the statutory language and on the practical understanding that predictions can rest on historical observations.62

Some courts seem to have taken the Ivax approach to an extreme. For example, in Baron v. Smith,63 the First Circuit dispensed with almost all analysis and simply found that the press release, which plaintiffs claimed was misleading due to material omissions, “contained forward-looking statements ... and therefore comes under the protection of the statutory safe harbor.”64

Not all courts, however, will afford safe harbor protection to factual statements intermingled with predictions. Some require that statements of present fact form the basis for forward-looking statements in order to fall within the safe harbor. In Miller v. Champion Enters.65 the Third Circuit reviewed two mixed statements that plaintiffs asserted were not forward-looking. The court determined that the phrase, “given the continuation of outstanding earnings growth and the successful implementation of our retail strategy,” included in a letter to shareholders discussing earning estimates, might fall within the safe harbor because, though not inherently forward-looking, it was “the basis for later forward looking statements.”66 However, a

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52 Id. at 371; see also Taubenhof v. Hotels.com, No. 3:03-CV-0069, at *6 (N.D. Tex. Sept. 27, 2004) (unpublished opinion) (“The Court finds these cautionary statements meaningful and that the press release is not an actionable misrepresentation, regardless of Defendants’ intent.”).
53 353 F.3d 1125 (9th Cir. 2004).
54 Id. at 1131-33.
59 Kindred Healthcare, 299 F. Supp. 2d at 737-38; see also GSC Partners CDO Fund v.Washington, 388 F.3d 228, 242 (3d Cir. (N.J.) 2004) (“[B]ecause the statement about collectability is a prediction of the likelihood of collection on change orders and claims, it is a classic forward-looking statement.”).
60 182 F.3d 799 (11th Cir. 1999).
61 Id. at 805-07.
62 See id.
63 393 F.3d 49 (1st Cir. 2004).
64 380 F.3d 49, 55 n.3 (emphasis added).
65 364 F.3d 660, 676-80 (6th Cir. 2003).
66 Id. at 677.
statement announcing that second quarter earnings per share grew thirteen percent was not protected by the safe harbor because the earnings statement was "easily separable" from the protected forward-looking statements and was not an assumption underlying them. At the other extreme from Ivanov, for some courts, any intermingling of statements of present fact with predictions removes the entire statement from safe harbor eligibility. In AOL Time Warner, the court found that a forecast about revenue growth fell outside the scope of the PSLRA safe harbor because it was "combined with statements of existing fact." Similarly, in Wagner v. Barrick Gold Corp., the court declared, "[i]t is well recognized that even when an allegedly false statement has both a forward-looking aspect and an aspect that encompasses a representation of present fact, the safe harbor provision of the PSLRA does not apply."

IV. The 'Accompaniment' Requirement

The safe harbor protects predictions "accompanied" by meaningful cautionary language, but courts differ in their interpretations of what this means. For example, while some courts will only apply the safe harbor to predictions in a press release if the release itself contains cautionary language, others have interpreted "accompany" broadly, examining cautionary language in SEC filings (even if they are not specifically referenced) to determine whether forward-looking statements fall within the safe harbor. Cautious issuers should not rely on such a broad interpretation of "accompany," but a specific reference to SEC filings may suffice. Issuers that include independent cautionary language would benefit from also referencing SEC filings, thereby adding any cautionary language in the filings to the analysis.

In GSC Partners CDO Fund v. Washington, the Third Circuit indicated that cautionary language "does not have to actually accompany the alleged misrepresentation." The court applied a "total mix" analysis taking into account cautionary language from the totality of information available. In Stavros v. Exelon Corp., the court held that cautionary language need not actually accompany the projection because "it is the total mix of information available to investors at the time of the alleged fraudulent statements that is relevant, not whether the warnings were contained in the same document." Therefore the court considered cautionary language "not only in the documents containing the forward-looking statements at issue, but also in Exelon's filings with the SEC." Specifically referencing SEC filings will make it even more likely that a court will consider their cautionary language.

A twist on the "total mix" analysis can be found in Asher. The basis for the suit was the fraud-on-the-market theory: though plaintiffs themselves had not read or heard the allegedly misleading statements, they argued that others—investors, analysts, fund managers—had, and thus that the statements affected the price, which in turn affected the plaintiffs. The court found that this theory of liability presupposes an efficient market and, just as all positive predictions reached the investors, so too did any cautionary statements. Therefore, the court found that "Baxter's cautionary language [contained in SEC filings and other documents] must be treated as if attached to every one of its oral and written statements."

V. The 'Accompaniment' Requirement and Oral Forward-Looking Statements

References to SEC filings may also protect oral forward-looking statements, such as those made in oral...

67 Id. at 679; see also id at 680; In re Blockbuster Inc. Sec. Litig., 3:03-CV-0398-M (LEAD), 2004 U.S. Dist. LEXIS 7173, at *20-21 (N.D. Tex. Apr. 26, 2004) (finding that the safe harbor does not apply to independently actionable material misrepresentations and omissions).

68 Note that the result in Miller was that plaintiffs no longer had to prove actual knowledge for liability, only recklessness. Without the protection of the safe harbor issuers are liable if plaintiffs show "an extreme departure from the standard of ordinary care." Miller, 364 F.3d at 681 (citing Mansbach v. Prescott, Ball & Turben, 588 F.2d 1017, 1025 (6th Cir. 1979)).


70 AOL, 02 Civ. 5575 (SWK), 2004 U.S. Dist. LEXIS 717, at *71 (citing In re APAC Teleservices Inc., Sec. Litig., 1999 U.S. Dist. LEXIS 17908 at *8 (S.D.N.Y. Nov. 19, 1999)).

71 Wagner, No. 03 Civ. 4302 (RMB), at *13 (citing In re Prudential Sec. Ltd. P'tnrs., Litig., 390 F. Supp. 68, 72 (S.D.N.Y. 1996) ("The doctrine of bespeaks caution provides no protection to a person who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.").

lyst meetings or conference calls. For example, in Teamsters Local v. Clorox, the Ninth Circuit found that the caveat "actual results will depend on a number of competitive and economic factors..." we refer you to our form 10K filing," sufficed to meet the safe harbor's accompaniment requirement.

If sued for fraudulent oral predictions, defendant issuers should bring all cautionary statements to the court's attention. In Friedman v. Rayovac Corp., the court refused to consider cautionary language in an SEC filing alongside an oral forward-looking statement, because the defendant issuer failed either to provide a citation to the filing, or to identify which of the cautionary language was. The court concluded, that "district courts are not required to scour the record for relevant information." Similarly, in In re QLT, Inc. Securities Litigation, the court ruled that the safe harbor does not apply to oral sales projections when the defendants fail to state that cautionary language accompanied the projections. The court "could not infer, on the basis of other instances of cautionary language QLT included, that such language had been provided in conjunction with [defendant's] statement or that it was in fact meaningful and adequate.

VI. The 'Identification' Requirement

A number of recent cases focus specifically on the 'identification' requirement but there remains no bright-line rule on what is sufficient language. While some courts have found that certain buzz words, such as "anticipate" or "predict" are sufficient to satisfy the identification requirement, others continue to require that issuers explicitly label even clearly forward-looking statements in order to take advantage of the safe harbor. Requiring explicit identification guards against the possibility that "investors might see or hear such statements and... not undertake the effort to read the accompanying press releases or SEC filings" that indicate such statements are forward-looking and carry risk. For example, in Southland Securities Corp. v. Insurance Solutions Inc., the Fifth Circuit determined that statements not explicitly identified as forward-looking were not protected by the safe harbor, even though the statements in substance were forward-looking. Similarly in In re Blockbuster Inc. Securities Litigation, a statement that "we think rental business will continue to grow and we think rental business will continue to grow" was not protected by the safe harbor because it was not specifically identified as forward-looking.

Identification may be accomplished through a relatively general statement and need not accompany each individual forward-looking statement within the same document. In In re Copper Mountain Securities Litigation, the court ruled that a "statement at the end of each release or filing stating that forward-looking statements in this release or report are made pursuant to the safe harbor provisions of the PSLRA are considered sufficient." The court reasoned that companies are not required to label each forward-looking statement individually because, "to saddle companies with such a duty would be impractical at best and impossible at worst." Nevertheless, the court in Copper Mountain cautioned that a total failure to identify forward-looking statements—even if such statements occurred within days of press releases and other filings that were properly identified—would disqualify statements from the protection of the safe harbor.

VII. 'Immaterial' Forward-Looking Statements

A projection is also immunized from liability under the safe harbor if it is immaterial. Four court of appeals and seven district court cases have recently dismissed claims on this ground. Others, however, have indi-

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Footnotes:
82 But see In re Skechers U.S.A., Inc. Sec. Litig., No. CV 03-0294 PA (Ex), 2004 U.S. Dist. LEXIS 12570, at *17 (C.D. Cal. May 10, 2004). In Skechers, the court ruled that when neither party provides transcripts of a conference call the court will evaluate the statement only on the basis of whether plaintiffs prove actual knowledge of falsity. The court would not make determinations as to whether statements were identified as forward-looking, were accompanied by cautionary language, or included references to the cautionary language in readily available written documents. Id. This ruling underscores the importance for issuers of keeping transcripts of conference calls. Without the transcript issuers may lose the absolute protection provided for in the first prong of the safe harbor.
83 353 F.3d 1113, 1131-32 (9th Cir. 2004).
84 Id. at 1132-33; see also In re Copper Mountain Sec. Litig., 31 F. Supp. 2d 857, 882 (N.D. Cal. 2004).
86 Id. at 989-90.
87 Id.
89 Id. at 533-34.
90 Id. at 533; see also Southland Secs. Corp. v. Inspire Ins. Solutions Inc., 365 F.3d 353, 379 (5th Cir. 2004).
92 Copper Mountain, 311 F. Supp. 2d at 882.
93 Copper Mountain, 311 F. Supp. 2d at 882.
94 365 F.3d 353.
95 Id. at 372.
97 Id. at *17.
98 311 F. Supp. 2d at 882.
99 Id.
100 Id.
101 Id.
102 Id. at 881-882.
103 In re Adama Family Golf Sec. Litig., 381 F.3d 267, 279 (3d Cir. 2004) (also finding adequate cautionary language); Rombach v. Chang, 355 F.3d 164, 174 (2d Cir. 2004); Southland Secs. Corp. v. Inspire Ins. Solutions Inc., 365 F.3d 353, 374 (9th Cir. 2004); Rosenweig v. Azurix Corp., 322 F.3d 854, 869 (5th Cir. 2003); In re QLT, Inc. Sec. Litig., 312 F. Supp. 2d 526, 532-33 (S.D.N.Y. 2004); Gavish v. Revlon, Inc., No. 00 Civ.
cated that this is a question best left to the trier of fact.\textsuperscript{103}

In Rosenzweig v. Azurix Corp.,\textsuperscript{104} the Fifth Circuit ruled that representations made in defendant’s prospectus were not actionable because “generalized, positive statements about the company’s competitive strengths, experienced management, and future prospects . . . are immaterial.”\textsuperscript{105} The court reasoned that analysts, who rely on facts in determining the price of a security, would not be misled by the prospectus because the statements were not specific enough to perpetrate fraud.\textsuperscript{106}

Courts continue to dismiss claims for immateriality when the statement in question is mere puffery or when it is a vague statement of optimism. In Rombach v. Chang,\textsuperscript{107} the Second Circuit observed that, “companies must be permitted to operate with a hopeful outlook” . . . and that “they can be expected to be confident about their ownership and the corporation that they manage.”\textsuperscript{108} In Taubenfeld v. Hotels.com,\textsuperscript{109} the court found claims that “we’re not seeing any slowing,” “we’re seeing very large increases and we expect that to continue,” and “we’re still doing incredibly well” to be “vague assertions of the condition of the company on which no reasonable investor would rely.”\textsuperscript{110} In Govish v. Revlon,\textsuperscript{111} the court found Revlon’s statements, “our program to broaden distribution of our Ultima II line is showing significant strength” and “despite the challenges we now face, we are confident that our long-term outlook remains positive and we intend to pursue the fundamental business strategy that fueled our success to date!” were “so vague, general, and hedged that they qualify for the PSLRA’s safe harbor” for immaterial “forward-looking statements.”\textsuperscript{112} More problematic, according to the court, was the statement, “the business fundamentals of our Company are strong.”\textsuperscript{113} The court ultimately found this statement to be “patently immaterial,” however, because it found that “fundamentals” referred to the strength of Revlon, a fact not alleged to be false.\textsuperscript{114}

Nevertheless, puffery arguments are not always successful for defendants. In Friedman v. Rovoyvac Corp.,\textsuperscript{115} the court cautioned that there are no buzzwords for puffery, writing, “a statement is not immaterial as a matter of law simply because the speaker prefaces it with ‘I believe’ or ‘I think.’”\textsuperscript{116} To determine whether a statement is puffery, courts will look at who is speaking, who the audience is, and what aspect of the company the speaker is addressing.\textsuperscript{117}

Of perhaps more concern to issuers is the reluctance by some courts to rule on puffery at the pleading stage. In In re Vivendi Universal, S.A. Securities Litigation,\textsuperscript{118} the court held that whether a statement is actionable, “depends on all relevant circumstances of the particular case, and is generally not an appropriate basis on which to dismiss a complaint at this stage of the action.”\textsuperscript{119} The Vivendi court also took into account the speaker’s state of mind, rejecting defendant’s argument that statements that Vivendi was “financially solid” were puffery, because plaintiffs pled sufficient facts to show that defendants could not reasonably have believed the statements when they made them.\textsuperscript{120}

VIII. The Continuing Relevance of the Pre-Reform Act Case Law

Cases decided under the pre-Reform Act “bespeaks caution” doctrine remain relevant in safe harbor cases.\textsuperscript{121} Such cases are commonly cited on the issues of whether cautionary language is sufficiently meaningful,\textsuperscript{122} or whether a statement is forward-looking or one of present fact.\textsuperscript{123} One issue where courts relied heavily on the “bespeaks caution” doctrine is the accompanies requirement. In Rombach, the Second Circuit incorporated the doctrine’s “total mix” analysis in its ma-

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\textsuperscript{103} Id. at *22.
\textsuperscript{104} 295 F. Supp. 2d 957 (W.D. Wisc. 2003).
\textsuperscript{105} Id. at 990.
\textsuperscript{106} In In re Ravisent Technologies, Inc. Securities Litigation the court found that statements such as “the very-year-over-year improvement in gross margins illustrates the growing momentum in our software and technology license business” were not mere puffery because they were made by the CEO and CFO to the general public about the financial condition of the company. No. 00-CV-1014, 2004 U.S. Dist. LEXIS 13255, at *31 (E.D. Pa. July 12, 2004).
\textsuperscript{107} No. 02 Civ. 5571 (HB), 2003 U.S. Dist. LEXIS 19431 (S.D.N.Y. Nov. 4, 2003).
\textsuperscript{108} Id. at *63. Similarly, the Ong court declined to rule on the question of materiality because “it presents a mixed question of law and fact and requires . . . determinations that are particularly appropriate for resolution by the trier of fact.” Ong v. Sears, Roebuck & Co., No. 03 C 4142, 2004 U.S. Dist. LEXIS 19425, at *105-06 (N.D. Ill. Sept. 24, 2004).
\textsuperscript{109} Videnli, No. 02 Civ. 5571 (HB), 2003 U.S. Dist. LEXIS 19431, at *62-68.
\textsuperscript{110} See In re Donald Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993).
\textsuperscript{113} Id. at *21.
\textsuperscript{114} Id.
teriality inquiry. Similarly the court in Stavros v. Exelon Corp. imported the total mix analysis from "bespeaks caution" doctrine case law and determined that courts may consider cautionary language from other available sources.

The continued relevance of the pre-Reform Act cases should not come as a surprise because the Reform Act, in many respects, codified prior, judicially developed law. In addition, because the safe harbor provision does not apply by its terms to various types of transactions, or to a number of entities, we will continue to see cases rely on earlier doctrines.

IX. Conclusion

While courts differ in their applications of the safe harbor, there is enough case law to assist counsel in advising a issuer on how to make forward-looking statements with relative safety from liability. The cautious counsel will advise clients, among other things, to update cautionary language frequently, with an eye to internal and external indicators of risk; to segregate factual statements from forward-looking ones unless the facts form the basis for the predictions; to identify forward-looking statement with appropriate vocabulary, such as "anticipate" or "predict," and a general identifying statement; and, at the very least, to refer to specific cautionary statements in SEC filings when making oral or written predictions.

Appendix A


125 266 F. Supp. 2d 833 (N.D. Ill. 2003).

126 Id. at 843-44 (citing Grossman v. Novell, Inc., 120 F.3d 1112, 1122-23 (10th Cir. 1997) ("The Tenth Circuit, however, in discussing the analogous bespeaks caution doctrine, held that cautionary language need not be contained in the same document as the projection.").

127 Transactions not covered by the safe harbor provision include initial public offerings ("IPOs"), rollups, and tender offers. See 15 U.S.C. §77z-2(b) (Supp. II 1999); see also P. Stolz Family P'ship L.P. v. Daum, 355 F.3d 82, 97-99 (2d Cir. 2004).

128 The safe harbor provision does not cover such entities as limited liability corporations ("LLCs") and partnerships. See Stols, 355 F.3d at 97-99.
PRESS RELEASE CHECKLIST

Nine questions for U.S. securities law counsel to ask before an SEC-reporting company client issues a press release.

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September 2004

1. Rule 10b-5 Liability. Is the release materially false or misleading within the meaning of Rule 10b-5?
   • Has it been reviewed by appropriate Company personnel — legal, investor relations, finance/accounting, relevant business units, etc.?
   • Has the Company complied with its disclosure controls and procedures maintained pursuant to Rule 13a-15?
   • Is the release consistent with previously disclosed information and, if not, how will the Company explain the inconsistency?

2. Forward-Looking Statements. Does the release contain a forward-looking statement?
   • Is the safe harbor under Section 21E of the 1934 Act available? Is the statement “identified as a forward-looking statement” and is it “accompanied by meaningful cautionary statements”?
   • Does the release create a duty to update the forward-looking statement — e.g., does it discuss future plans or intentions, how specific is it and what are investor expectations likely to be? See In re Time Warner Inc. Secs. Litig., 9 F.3d 259 (2d Cir. 1994); Welner v. Quaker Oats, 129 F. 3d 310 (3d Cir. 1997). Should the release disclaim a duty to update?
   • Does the release provide earnings guidance? If so, does the Company have an existing practice of providing earnings guidance and is the guidance in the release consistent with that practice (e.g., in frequency and scope)? Will the release create new expectations about future guidance? Does the release omit guidance of the kind previously given (e.g., because the outlook is disappointing)? Does the guidance involve a non-GAAP
3. **Regulation FD.** Does the release contain material, non-public information within the meaning of Regulation FD?

- If so, does the release satisfy the “public disclosure” requirement of Rule 10(e) of Regulation FD or should it also be furnished/ filed under Item 7.01/8.01 of Form 8-K (if not under Item 2.02, as discussed in 4 below)?

- Does the release contain information that has previously been or is to be disclosed in another manner (e.g., analysts meeting, press conference or industry conference)? If so, how do the timing requirements of Regulation FD (“promptly” vs. “simultaneously”) apply? See also 4 below for earnings releases.

- Does the Company maintain a shelf-registration statement and, if so, should the release be “filed” rather than “furnished” on Form 8-K so that it can be incorporated by reference into the registration statement? Should the release be incorporated in its entirety or is it desirable for certain parts of the release (e.g., “puffery” or highly sensitive forward-looking statements) not to be incorporated? If the latter, consider “furnishing” the release under Item 7.01 (or Item 2.02 for earnings releases as described in 4 below) and as an exhibit under Item 9.01, but “filing” only the appropriate parts of the release, for example by restating the substance of those parts under Item 8.01.

- Is the Company a non-U.S. issuer and, if so, does it endeavor to comply with Regulation FD voluntarily? Should the release be “furnished” or “filed” on Form 8-K?

- Should the release be submitted to the stock market(s) where the Company is listed (see, e.g., NYSE Listing Manual Section 202.05)?

4. **Earnings Releases.** Does the release disclose material information about the Company’s financial results or condition for a completed quarterly or annual fiscal period, such as a quarterly earnings release does?

- If so, the release must be included as an exhibit to a current report “furnished” or “filed” under Item 2.02 of Form 8-K.

- If the contents of the release are to be discussed in a webcast, conference call or other similar forum, does the release provide adequate notice of

5. **Non-GAAP Measures.** Does the release contain a “non-GAAP financial measure” as defined in Regulation G?

- If so, is this measure accompanied by (1) the most directly comparable financial measure under GAAP and (2) a quantitative reconciliation of the differences between the non-GAAP and GAAP measures (note limited exception for forward-looking measures)?

- Can the Company rely on the exception for non-U.S. issuers or proposed business combinations (see Rule 100 (c) and (d))?

- If the release is to be “filed” on Form 8-K, does it comply with Item 10(e) of Regulation S-K?

- Is the comparable GAAP measure presented with equal or greater prominence?

- Does the release disclose (1) the reasons why management believes the non-GAAP measure is useful to investors and (2) any other material purposes for which management uses the non-GAAP measure (see Item 10(e)(1)(i)(C) and (D))?
• Does the non-GAAP measure (other than EBIT or EBITDA) exclude cash-settled charges or liabilities from a measure of liquidity (see Item 10(e)(1)(ii)(A))? 

• Does the non-GAAP measure eliminate items identified as "non-recurring", "infrequent" or "unusual" in violation of the two-year rule (see Item 10(e)(1)(ii)(B))? 

• Does the non-GAAP measure appear on the face or in the footnotes of the Company's financial statements or any required pro-forma financial information (see Item 10(e)(1)(ii)(C) and (D))? 

• Is the non-GAAP measure titled or described using terms similar to those used for any GAAP measure (see Item 10(e)(1)(ii)(E))? 

• If the release is to be "furnished" pursuant to Item 2.02 on Form 8-K, does it include an explanation of usefulness and purpose required by Item 10(e)(1)(ii)(C) and (D) (see Instruction 2 to Item 2.02)? 

6. Securities Offerings. Is the Company offering or planning to offer (or has it recently offered) securities for sale? 

• If so, does the release constitute an “offer to sell” the securities for the purpose of Section 5 of the 1933 Act? If so, unless an exemption for the release is available, the release could result in gun-jumping (if a registration statement has not been filed) or be an illegal prospectus (after filing), or constitute “general solicitation” or “directed selling efforts” that could preclude reliance on an exemption from registration (in a private placement or Regulation S offering). 

• If an exemption for the release is necessary, does the release comply with Rule 135 (registered offering, pre-filing), Rule 134 (registered offering, post-filing), Rule 135c (unregistered offering) or Rule 135e (offshore press release of non-U.S. issuer)? 

• Does the release contain material information that should be included or incorporated in the offering document? 

7. Proxy Solicitations. Is the Company soliciting or planning to solicit proxies? 

• If so, does the release constitute a “solicitation” subject to Regulation 14A? 

8. Form 8-K Requirements. Does the release describe events or developments that trigger the reporting requirements of Form 8-K? 

• See Items 1.01 through 9.01 of Form 8-K, which require reports about various events including events involving material definitive agreements, significant asset purchases or sales, earnings releases (see 4 above), on- or off-balance sheet obligations or related triggers, exiting a business, material impairments, problems with prior financial statements, unregistered sales of equity securities and changes in officers or directors. 

• If so, will the Form 8-K include the disclosures required by the applicable item and should those disclosures be included in the release? 

• See also Instruction B.3 to Form 8-K – has the Company “previously reported” substantially the same information as required by Form 8-K, in which case no Form 8-K may be required? 

• Does the event described in the release trigger other federal securities law reporting requirements (e.g., Section 13(d) or 16(a) of 1934 Act)? 

9. Collateral Consequences. Does the release describe “crisis” or other negative events that may have collateral consequences under the federal securities laws? 

• Will the release create concerns about confidentiality – e.g., on the part of regulators conducting an investigation announced in the release? 

• An “accounting restatement” resulting from “misconduct” could require the CEO and CFO to disgorge certain compensation and trading profits under Section 304 of the Sarbanes-Oxley Act. 

• Entry of a judicial or administrative order arising from a governmental action prohibiting or finding violations of antifraud provisions of
securities laws (or prohibiting other conduct relating to securities transactions) could disqualify the Company, absent an SEC waiver:

- From relying on the safe harbors for forward-looking statements (see Section 27A of 1933 Act and Section 21E of 1934 Act).

- From relying on certain exemptions from registration under the 1933 Act for small securities offerings (see, e.g., Rule 505 of Regulation D and Rule 262 of Regulation A).

- If the company is a financial institution, from engaging in certain investment advisory, broker-dealer or commodities business and could require SRO reporting (see, e.g., Section 9(a)(2) and (b)(2) of 1940 Act; Section 203(e) of Investment Advisers Act and Rule 206(4)-3; Section 15(b)(4)(C) of 1934 Act; Section 8(a)(2)(E) of CEA; NASD By-laws Article 3, Section 3 and Rule 3070; and NYSE Rules 351 and 476).