

CORPORATE LAW

Delaware Cases Contain Surprises On Fee Advancement Bylaws

ABSTRACTED FROM: *The Right Protection: More On Advancement And Indemnification*
BY: John Mark Zeberkiewicz and Blake Rohrbacher, Richards Layton & Finger, Wilmington DE
Review of Securities & Commodities Regulation, Vol. 41, No. 21, Pgs. 283-287

Planning ahead could be a stroke of genius. Three recent opinions from the Delaware chancery court contain interesting surprises on the reach of bylaws that indemnify directors and officers and advance fees and expenses incurred when defending suits for breaches of fiduciary duty. In *Schoon v. Troy Corp.*, a director resigned, write attorneys John Mark Zeberkiewicz and Blake Rohrbacher. The board then deleted the word “former” from its bylaw’s designation of directors entitled to advancement and sued that director. The court denied the director’s request for advancement, based on a 1992 holding that a board cannot retroactively eliminate vested advancement rights but that vesting occurs only when the company files a pleading. *Schoon* implies that, unless the company considers a suit prior to the bylaw amendment, those rights do not vest automatically. To forestall problems, directors and officers could insist on bylaw language providing that no amendment may diminish their rights in regard to acts or omissions occurring before the amendment or could demand a side agreement specifying their rights.

Amendments are par for the course. *Underbrink v. Warrior Energy Services Corp.* raised the converse question: May the board pass a compulsory-advancement bylaw that applies retroactively? Deferring to the board, the *Underbrink* court declared the bylaw valid under the business-judgment rule. The court stated that the issue of a breach of the board’s fiduciary duty arises—thereby triggering the stricter entire-fairness rule—only if the board permits advancement of fees and expenses with respect to “particular litigation.” Thus, the

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authors suggest, a board should not be overly anxious about incurring liability for amending a bylaw to grant itself advancement rights, including retroactive ones, if its actions satisfy the business-judgment rule and relate to the costs of future lawsuits in general, rather than a specific lawsuit.

Wording might handicap companies. In *Zaman v. Amedeo Holdings*, individuals were sued for their actions as corporate agents, not directors or officers. The bylaw required the company to indemnify agents “to the fullest extent permitted by applicable law.” Section 145(c) of the General Corporation Law gives indemnification rights to directors and officers who mount successful defenses but excludes agents. Section 145(a) requires agents to have acted in good faith, and the court found that they had waived their Section 145(a) rights. Nevertheless, the court held that the bylaw supersedes both sections and requires indemnification. The holding effectively gives the company the burden of proving that those seeking indemnification or advancement have no such rights. In view of this holding, the authors advise companies to review the bylaws, ensuring that they grant only the rights intended and removing *Zaman*-style wording.

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SECURITIES ENFORCEMENT & FRAUD

Regulators Seek To Protect Retirees From Securities Fraud

Abstracted from: *There's No Such Thing As A Free Lunch: Recent Regulatory Initiatives Regarding Sales To Seniors*

By: Ivan Knauer and Michele Zarychta

Pepper Hamilton, Washington DC (IK) and Philadelphia PA (MZ)

Securities Regulation Law Journal, Vol. 36, No. 4, Pgs. 304-316

Regulators face off against firms. Now approaching retirement, baby boomers are increasingly becoming the victims of aggressive and deceptive marketing by financial-services firms, securities litigators Ivan Knauer and Michele Zarychta warn. In response, the SEC, the Financial Industry Regulatory Authority (FINRA), and the North American Securities Administrators Association (NASAA) have teamed up to protect older investors through education, investigation of improper sales techniques, and vigorous enforcement of securities laws. FINRA has publicized several regulatory campaigns and has advertised online tools it offers to protect seniors' assets. It also issued a regulatory notice that reminds firms of their duties to seniors under the securities laws and summarizes best practices. Mindful of NASD Rule 2310, which requires securities salespeople to reasonably believe that investments they suggest will suit the particular individual or institutional client, regulators have concentrated on investments that are especially dangerous for seniors, such as those that cannot be rapidly liquidated.

Marketeers are skating on thin ice. One of FINRA's regulatory campaigns scrutinizes the growing tendency for financial firms and salespeople to employ titles—such as “senior specialist”—that falsely imply proficiency in counseling senior investors. Doing so might violate NASD and NYSE rules, as well as federal and state securities laws. The SEC and NASAA have joined in this scrutiny, along with a second FINRA campaign to stop deceptive techniques at broker-dealers' so-called free lunch seminars. According to the regulators' September 2007 report, issued after examining more than 100 seminars, common problems include sales literature with lies and exaggerations concerning investments' safety, liquidity, and

returns; concealment of conflicts of interest; and investment suggestions not appropriate for seniors. Of the firms examined, 78% got deficiency letters, and 23% could face further investigation or action by regulators. In addition, the authors note, FINRA sent out an investor alert about the seminars.

Compliance is the goal. Financial firms should follow guidelines to ensure compliance with the securities rules on counseling senior investors. Recommend only products suitable for seniors in salespeople's own families, advise the authors. Put policies and procedures in writing, and make sure all employees abide by them; know each client's needs and limitations (e.g., diminished capacity or reluctance to use the Internet); avoid inappropriate investments (such as variable annuities); make sure the client comprehends the suggested investments and the methods for eluding deceptive marketing schemes; and do not use "senior specialist" or similar titles. Free lunch seminars require another set of compliance guidelines. For example, put policies and procedures in writing; consolidate review of sales and advertising literature; start the review well before the seminars; make sure the literature discloses sponsorship; properly monitor seminars (for example, with random attendance by managers); supervise communications with investors; hold yearly compliance training; and do not use testimonials. Compliance also requires knowing about the latest rules and regulatory actions. The websites of FINRA, the NASAA, and the SEC can help compliance professionals stay current.

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GLOBAL MARKETS

US, UK, And Australian Regulators Address Short-Selling Concerns

ABSTRACTED FROM: *Short Selling And Securities Lending In The Midst Of Falling And Volatile Markets*
BY: Prof. Paul Ali, Melbourne Law School and RiskMetrics Group, Melbourne, Australia
Journal of International Banking Law & Regulation, Vol. 24, No. 1, Pgs. 1-12

Selling short-selling short. The practice of selling securities short has angered regulators and market participants worldwide for centuries (laws in Holland barred short selling in 1610). Nevertheless, short-selling provides necessary and useful information to the market and, according to Australian law professor and consultant Paul Ali, may not produce the downward pressure on prices that its detractors claim. Short-selling does present one difficulty for the market: when it is a *naked short sale*—where the seller places sell orders for shares not yet owned, later making open-market purchases to fill the gap—it is invisible to the market until consummation.

Loan a misnomer. Invisibility is less of a concern in *covered short sales*, where the seller arranges a loan of equivalent shares, whether previously or simultaneously, usually collateralized by cash or other property. The seller then commits to sell the borrowed shares to a third party and redeems the shares from the lender, paying either with equivalent shares or from the collateral. In any event, the author asserts, the term "loan" is a misnomer, as the short-seller must obtain title to the shares before selling them; and the "redemption" is merely a repurchase of the collateral with independently acquired shares or an offset against the deposited property.

Naked not in fashion. The SEC's prudish attitude toward naked short sales is reflected in Regulation SHO. It requires that before a broker can accept a sale order where the seller does not have the shares to

sell, the broker must have “reasonable grounds,” founded on the seller’s credible assurances or the known liquidity of the subject shares, that the seller will be able to borrow or otherwise obtain shares to cover the sale before settlement. Since the financial crises began in late 2008, the SEC went further, temporarily prohibiting any short selling of designated financial firms, penalizing brokers who fail to produce the shares needed to settle a short sale, and imposing disclosure obligations on fund managers describing their short positions. Unlike the American regulators, securities regulators in the United Kingdom had no rules prohibiting or specifically regulating naked short sales. In September 2008, however, the Financial Services Authority barred naked short sales in designated financial companies until January 2010 and required disclosure of large short positions overhanging from the prior period. Australia has taken an intermediate position, generally prohibiting naked short sales unless the shares trade in a liquid market as certified by the Australian Securities Exchange, a position also effectively abrogated in September 2008 when the Exchange revoked all permissions.

Run for cover. In contrast to the hostility shown to naked short selling, regulators’ approaches to covered short sales have been relatively benign. Regulation SHO explicitly exempts covered short sales, and covered sales do not fall within the terms of the UK Financial Services Authority’s prohibitions. Australia has achieved a similar result in a more roundabout way, claims the author. The Australian Securities and Investments Commission established particularized exemptions to the general rule (as enunciated in Australia’s Companies Act) that a seller at the time of sale must have a clear right to transfer title to the buyer. The relevant exception permits “borrowing” arrangements that can settle within three days after the sale order and also requires disclosure. The worldwide financial crisis led to a bewildering series of orders and counter-orders from the ASIC, imposing, then lifting, then re-instating restrictions on short sales of financial stocks. When the dust settles, Australia may be back in harmony with the United States and the United Kingdom on letting covered short sales ride.

Abstracted from *Journal of International Banking Law & Regulation*, published by Sweet & Maxwell, 100 Avenue Road, London NW3 3PF, England. To subscribe, call 44(0)12 6438-8560; or visit www.sweetandmaxwell.co.uk. **Editor’s Note:** The Australian Securities and Investment Commission continues to extend its prohibition of covered short-selling. For the extension announced on March 5, 2009, and lasting until May 31, 2009, see www.iht.com/articles/2009/03/05/business/short.php. The SEC is considering similar action; read www.boston.com/business/articles/2009/03/10/uptick_rule_may_return_market_changes_seen/. The action the SEC has already taken on short-selling is the subject of “The Bad And The Ugly Of Recent SEC Short-Sale Regulation” by Simon Lorne, *Wall Street Lawyer*, Vol. 12, No. 12, Pgs. 1, 4-9.

Culture And Language Impediments To IFRS Universality

ABSTRACTED FROM: *IFRS: Beyond The Standards*

BY: Prof. George Tsakumis, Prof. David Campbell, and Prof. Timothy Doupnik

Drexel University (GT and DC); University of South Carolina (TD)

Journal of Accountancy, Vol. 207, No. 2, Pgs. 34-39

The IFRS footprint for America. As nations move toward a common set of financial reporting principles, some significant players, including the United States and Japan, are slowly converging their domestic accounting standards with the International Financial Reporting Standards. Moving along that pathway, the SEC in 2007 stopped requiring foreign issuers with ties to the US markets to provide reconciliation from IFRS to US GAAP. The SEC then released a road map that leads to the United States adopting IFRS by 2014. The map includes several benchmarks for standard setters to use in determining whether the global business community is making strides to provide consistent reporting standards across the globe. [*Editor’s Note:* See www.sec.gov/rules/proposed/2008/33-8982.pdf for the road map.] The goal of IFRS has always been to provide comparability of financial information among all international companies. Based on research by accounting professors George Tsakumis, David

Campbell, and Timothy Doupnik, two impediments stand in the way of accomplishing that goal: culture and language.

Cultural values impact accounting interpretations. Research suggests that cultural differences may cause accountants in the various IFRS jurisdictions to measure accounting values differently, especially when it comes to conservatism and secrecy. Following a study that surveyed over 100,000 multinational employees, the authors theorize that the accounting convention of conservatism is stronger in those countries that have higher *uncertainty avoidance* and lower *individualism*. These traits also trend toward higher levels of *secrecy*. Since judgment is required in a principles-based system such as IFRS, these differences in culture may impact the interpretation of accounting rules. For example, the authors consider it 74% probable that American auditors would recognize a certain construction loss, while German auditors interpret the criterion and see only a 66% likelihood. Similarly, 84% of US accountants would disclose a lawsuit liability; just 56% of their Greek counterparts would disclose it. These findings reflect how cultural differences result in differing judgments when interpreting the accounting principles.

Translation may cause lack of comparability. The official language of the International Accounting Standards Board (and the IASB's international reporting standards) is English. Pronouncements and regulations are translated into the working languages of 40 other reporting countries. Canadian researchers studied the translation of probability terms. Despite a foundation that was created to take responsibility for these translations and despite the oversight review committees, the authors demonstrate that problems persist. One example is the term "remote," since some languages do not have a word with the same meaning. Many expressions have nuances, creating translation difficulties that can lead to different interpretations of the universal standards. The authors recommend that global accountants become more culturally aware and familiar with potential biases of others (as well as their own). Language discrepancies could be better resolved by using back-translation, a process by which an English text is translated into the second language and then independently back into English.

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Editor's Note: For another article on IFRS, see "The SEC Goes International" by Jack Ciesielski and Thomas Weirich, *Strategic Finance*, Vol. 90, No. 6, Pgs. 32-37.

SECURITIES REGULATION & DISCLOSURE

Tips From The SEC On Using Corporate Websites For Disclosure

ABSTRACTED FROM: *Using Corporate Websites For Regulation FD-Compliant Disclosures: Recommended Best Practices*

BY: Steven Bochner and Evan Kastner

Wilson Sonsini Goodrich & Rosati, Palo Alto CA (SB) and Austin TX (EK)

Wall Street Lawyer, Vol. 13, No. 1, Pgs. 1, 4-10

The SEC untangles the web. Although many companies have used their websites to ensure that information disclosed privately is quickly available to the public, as required by Regulation FD, the release adopting the regulation left it unclear whether website posting can substitute for traditional print releases. Reflecting comments and operating experience since Regulation FD was first issued in 2000, the SEC

followed up with Release 34-58288 in August 2008. It touches on a wide range of administrative points, attorneys Steven Bochner and Evan Kastner explain, such as: determining when posted materials become public for purposes of Reg. FD; how disclosure controls apply to materials on the issuer's website; what liability the company has for third-party information to which its website links.

When website information is public. Unless stock exchange rules require otherwise (as the NYSE does), if a company normally uses its website to disseminate information to investors, has notified investors and the press to watch the site, makes linking to the information easy, and keeps the site updated, it may direct investors to the sites by notice rather than by distributing a traditional press release. The information need not, unless other SEC rules require it, be in a specifically printer-friendly format. Release 34-58288 does not provide any safe-harbor assurances, the authors remind, but it does give factors to evaluate, including a time period for posting the information that is adequate considering the type of information, its complexity, and the issuer's general communication practices; the need to alert the public that the information is available, plus where and how to get it; and the time needed to digest the information.

Website liabilities in context. The release reaffirms that information posted on company websites is as much subject to Rule 10b-5 and other antifraud requirements as any other written material, but it clarifies certain points. For example, refreshing or re-accessing a webpage does not constitute republication of that information. If the company wants to declare a particular page "historical" so it can disclaim any duty to update, the page should be tagged and moved to an archive or other segregated web section. The authors point out, however, that if the issuer's jurisdiction imposes a duty to update information, nothing in the SEC release abrogates that duty. Only information posted to the website in substitution for a formal 1934 Act report needs to figure in the company's disclosures and certifications pertaining to its disclosure control processes. The release also contains pointers to avoid liability when linking to third-party sites, including commonly used devices such as exit statements and explanations of the link, then counsels against linking only to favorable commentary on the company. Although the release encourages the use of blogs and other discussion forums, the authors caution against using these forums as a subterfuge to propagate misleading information by company personnel pretending to write in their individual capacities.

Best practices. The authors derive from the release and their own experience a set of best practices for companies wishing to use websites to distribute public information. For example, prominently promote the corporate URL in SEC filings and press releases, along with the items listed in the release, to notify the public and press to use the company's website for current information; and undertake this process at least one fiscal quarter ahead of using the site for Reg. FD purposes. Tout the site to the general and financial press, with a stated start date, and coordinate this with other means of notifying the public, such as RSS feeds and blogs, while making sure that the site itself can handle the increased traffic. With respect to the waiting period to consider posted material to be public, and when applying internal insider-trading prohibitions and disclosure review processes, companies should be as conservative as they are for material disseminated in the conventional printed form. Distance the company from third-party sites for liability purposes, but also review all such sites to ensure they contain no material misstatements or omissions.

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FINANCIAL REPORTING, TAXATION & ACCOUNTING**Changed Rule On Timing Of Deferred Compensation Now In Full Effect**

ABSTRACTED FROM: *Section 409A And Payments Of Deferred Compensation In Connection With A Corporate Transaction*

BY: Daniel Hogans, Morgan Lewis & Bockius, Washington DC

Tax Management Compensation Planning Journal, Vol. 36, No. 11, Pgs. 258-264

Compensation planning just got trickier. Companies have long had fairly wide latitude in timing the distribution of taxable deferred compensation such as severances, bonuses, equity compensation, and post-employment benefits. Beginning in 2009, however, that latitude will be severely constricted because IRC Section 409A and its regulations take full and final effect. The rule impacts the conditions under which companies may accelerate or defer payments as well as which payments they can restructure or delay. Generally, it prohibits the discretionary acceleration of payment of a deferred amount, explains attorney Daniel Hogans. Section 409A, which is effective for certain types of compensation deferred on or after December 31, 2005, became fully operational on January 1, 2009. The restrictions bring a new set of complications to compensation planning and, in many cases, present considerable hurdles for those seeking to mold compensation arrangements to a company's needs and circumstances.

Six-month delay. Under Section 409A, the company must specify the timing of a deferred payment by the deadline date for deferral elections, and deferred compensation can be paid only on a specific date or schedule, upon separation of service, or as a result of disability, death, emergency, or other unforeseen events. The rule does not apply to short-term deferrals or involuntary terminations. Companies must also delay payments to specified key employees for six months from the date of separation from service. The author indicates that "separation from service" occurs when there is at least an 80% reduction in the employee's service with the employer, but not when the reduction is 50% or less. For a reduction between 50% and 80%, the specific circumstances must be considered to determine whether the six-month delay is triggered. All this presents several new administrative obligations, including the need to maintain a list of the specified key employees and to update documents and agreements to reflect this delay.

Changes in ownership, severance, and acquisitions. The author notes that Section 409A may also apply to payments triggered by a change in ownership. It includes several definitions of an "acquisition," including the purchase of more than 50% of the total voting power of the stock or more than 40% of the target's assets. While certain severance benefits fall under the 409A umbrella, a number do not. Companies have broader discretion with compensation distributed as a result of involuntary termination as well as with short-term deferrals, those that specify the employee has no legally binding right to the payment for 10 weeks after a specified date. Other exclusions from the rule include

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additional separation benefits (such as taxable health benefits payable during the post-separation COBRA period) and, under many circumstances, stock options and stock appreciation rights.

Delaying rather than accelerating. Acquirors seeking to retain key target managers generally focus on delaying payments rather than accelerating them. In the past, acquirors have been able to delay management payouts and make them contingent on certain performance goals. Now, however, the ability to structure such arrangements is severely curtailed by Section 409A, although opportunities for planning still exist through vesting schedules and other means.

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As Stocks Decline, Companies Bid Farewell To Goodwill

ABSTRACTED FROM: *Goodwill Hunting*

BY: S.L. Mintz

CFO, Vol. 25, No. 1, Pgs. 71-74

On the chopping block. Welcome to the financial crisis: many companies whose depressed stocks sell below book value are writing off goodwill to improve their balance sheets and appease regulators and shareholders. Companies that have already put goodwill on the chopping block include travel website Orbitz, Morris Publishing Company, and Griffon Corp. By early December of 2008, reports S.L. Mintz, more than one in six S&P500 companies—including well-known names such as Alcoa, International Paper, and Motorola—had joined the ranks of issuers with market capitalizations below book value. The prospect of lower cashflow increases the probability that other companies with depressed shares will join them.

Pros and cons. In the past, issuers have written off goodwill for a variety of purposes, from allowing a new CEO to get a fresh start to compensating for losses. These days, it is a logical alternative for companies seeking to adjust book values downward. Unlike depreciable assets, goodwill can remain on balance sheets indefinitely and cause an earnings drag. In a tough business climate, managers may perceive it as expendable, but observers disagree about whether writing off goodwill in response to declining stock prices is a wise move. Most financial executives believe that declining share price alone does not provide sufficient reason for a writeoff, since stock prices may not necessarily reflect corporate fundamentals. At the same time, the author acknowledges, Wall Street often does not take that view, equating market value with fair value. Keeping investments on the books at cost, as Japanese companies did two decades ago, postpones the need to address overvalued assets and may slow down recovery.

Reaction varies. Financial professionals will no doubt have concerns about the effect writing off goodwill will have on the stock price. Investors may perceive it as a fair way to eliminate visible problems such as bad receivables or other baggage; but the action could also reveal previously unknown bad news. In either case, regular communications with the shareholders can help minimize the impact, the author advises. In down markets, when significant damage has already been done to share prices, investors barely notice goodwill writeoffs. According to one study, average goodwill writeoffs in the first half of 2008, when the stock market was buoyant, trimmed stock prices by 4% on the first full trading day. Some companies saw smaller drops, while others even experienced gains. A writeoff also allows a company to close the book on massive deals with no cash impact, as Sprint did last year when it wrote down \$30 billion in goodwill from its acquisition of Nextel.

Consider other factors. The market's response is not the only concern. Companies considering a writeoff should also anticipate reaction by lenders, who may view the move as a sign of increased risk. Under some

legal contracts, a goodwill writeoff is a violation of the asset-based covenants. Decisionmakers must also look at the potential tax consequences, cautions the author. Unless the transaction that produced goodwill was completed as a taxable purchase of target assets, it may not generate any tax benefit.

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