

SECURITIES REGULATION & DISCLOSURE

Construing The Meaningful Cautionary Statement Defense: When “Or” Means “And”

ABSTRACTED FROM: *Cleaning The Murky Safe Harbor For Forward-Looking Statements: An Inquiry Into Whether Actual Knowledge Of Falsity Precludes The Meaningful Cautionary Statement Defense*

BY: Allan Horwich, Schiff Hardin, Chicago IL; and Northwestern University

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A word leaves confusion in its wake. A grammatical disagreement is preventing a consistent interpretation of the safe harbor in the 1995 Private Securities Litigation Reform Act, which covers public companies’ forward-looking statements. The safe harbor is available in any 1934 Act private suit based on a false written or oral statement of a material fact (or a misleading omission of a material fact) in a projection, corporate lawyer and law lecturer Allan Horwich explains, provided the defendant can meet either of two conditions. First, the projection must have been identified as such and been either immaterial or “accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially.” Second, whoever made the projection—whether an executive or someone having that executive’s permission—must not have had actual knowledge that it was false or misleading. The statute joins the two conditions with the word “or,” but despite the arguable clarity, not all courts have given “or” its common meaning.

Did Congress wave off knowing lies? The Conference Committee Report on the statute indicated Congress’s intent that the two conditions be independent and that the safe harbor therefore protects someone who can satisfy either one. In the debate on the report, however, some senators expressed their concern that satisfaction of the first condition would render actual knowledge of a projection’s falsity irrelevant. For example, one senator said that this was the first time the federal securities laws had protected fraudulent statements. Defending the bill, another senator said that the safe harbor was not “a

IN THIS ISSUE

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SECURITIES REGULATION & DISCLOSURE

1

- Construing The Meaningful Cautionary Statement Defense: When “Or” Means “And”

GLOBAL MARKETS

2

- Before Foreign Acquisitions, Check FCPA Compliance

CORPORATE GOVERNANCE & DIRECTORS’ DUTIES

4

- Bank Boards Need To Reassess Priorities And Expand The Number Of Seats

license to lie.” The House debate mirrored these divergent views. Over the president’s veto, the author notes, the version of the bill in the report passed.

The case law has crosscurrents. Courts’ constructions of the safe harbor have varied greatly. Numerous cases treat the second condition as irrelevant, disregarding claims and even proof of the defendant’s actual knowledge of the projection’s falsity, if the first condition is met. Some judges indicated they were reluctant to decide as they did, the author points out, but felt compelled to do so by the statute’s wording. Declining to address the wording question, other courts have held that the defendant’s actual knowledge of falsity nullifies satisfaction of the first condition. Still others try to blend the two conditions: they declare that actual knowledge bars the court from finding the defendant’s cautionary statements were sufficient (and therefore were meeting the first condition), unless those statements revealed the actual knowledge of falsity.

The statute is not hard to fathom. In the author’s view, the job of a judge is not to second-guess Congress but to determine what it meant when it worded the safe harbor as it did. The judge should then fulfill Congress’s obvious intention to augment the protection of public companies’ forward-looking statements. Accordingly, judges should give the words their plain meaning and find that the two conditions (as well as the alternative for immaterial statements in the first condition) are independent. The report of the congressional conference committee unequivocally supports this construction. The concern voiced by some senators and representatives—that the plain meaning creates “a license to lie”—is a policy matter for Congress, not the courts, to settle.

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GLOBAL MARKETS

Before Foreign Acquisitions, Check FCPA Compliance

ABSTRACTED FROM: *FCPA Due Diligence In Acquisitions*

BY: Rebekah Poston, David Saltzman, and Gregory Bates

Squire Sanders & Dempsey, Miami FL (RP and GB) and Palo Alto CA (DS)

Review of Securities & Commodities Regulation, Vol. 43, No. 2, Pgs. 13-30

Covered state-owned entities. Sophisticated dealmakers and compliance professionals understand the provisions of the USA PATRIOT Act against money laundering, but not many realize the rigorous due diligence mandated by the Foreign Corrupt Practices Act (FCPA) for overseas M&A. Persons working in private industry may be considered “foreign officials” under the FCPA, advise attorneys Rebekah Poston, David Saltzman, and Gregory Bates, if the organization in which they work could be considered a “foreign government instrumentality” or state-owned entity. Certain factors determine whether the employing entity would be viewed as such: what percentage of ownership, voting rights, and degree of control is held by a foreign (non-US) government; whether the employees of the entity have the rights of those holding governmental positions; and how the home country characterizes the entity. The analysis should also consider whether the entity was formed primarily to serve the public good and whether the home country would prosecute bribery of the entity’s employees as public corruption.

Using a consultant. Companies often hire consultants to assist in overcoming the regulatory hurdles when operating in a foreign country. Because the US Department of Justice has brought FCPA suits based on the actions of consultants, due diligence before hiring one is critical to assessing whether the consulting firm might violate the FCPA. The authors suggest that executives question a consultant's understanding of the FCPA requirements and the antibribery laws of the home country. Examine the backgrounds of the consultant's principals and owners to determine if anyone could be considered a foreign official. Ask whether the consultant has a code of conduct and internal controls. Ascertain if the consultant is usually paid a success fee (which might encourage the use of inappropriate means to obtain the desired result for a client). Use public information to learn about past problems involving the consultant. Negotiate appropriate representations and warranties in the consultant's contract, including: assurances of compliance with the FCPA; specified obligations if the consultant discovers an FCPA violation; the right to audit the consultant's books; and the right to withhold payment for violations. The contract should also require the consultant to provide annual certification that tracks the language of the statute, stating that it has not made any unlawful payment to induce a foreign official to act. Refuse to enter into unusual payment arrangements, such as paying third parties for the consultant's services.

Payments for travel, gifts, entertainment, and grease. FCPA violations often stem from the payment of travel and entertainment expenses. The FCPA contains an affirmative defense for bona fide business expenditures paid to foreign officials if they are directly related to promoting or understanding the company's products. A second defense covers gifts of value that are made pursuant to the laws of the foreign official's country. To avoid issues under the FCPA, the authors advise companies not to provide a stipend and instead to pay service providers directly. Reasonable entertainment is permissible if the main purpose of the trip is business. Expenses for extended travel beyond the business portion of the trip and expenses of spouses or friends should not be covered since they are not related to any business purpose. If, after due diligence, a company has reason to believe a violation of the FCPA may have occurred, it is obligated to investigate further. Even small payments to low-level officials may violate the FCPA. Facilitation payments (often called "grease") are permissible if they facilitate a routine, nondiscretionary governmental action. However, if paid regularly, over time, and always to the same foreign official, a payment will probably be construed as an improper bribe.

Accounting issues. The FCPA requires companies to keep books and records that fairly and accurately reflect business transactions. The books and records must be prepared in accordance with generally accepted accounting principles. These rules apply to all of a company's expenditures, the authors emphasize, not just those that would be considered material. Account separately for gifts, entertainment expenditures, and facilitation payments. The company must also maintain a system of internal controls to ensure that transactions are executed in accordance with management's authorization and are recorded as required to prepare financial statements in accordance with GAAP. Recorded assets should be compared with actual assets and actions taken with respect to any differences. The board (or the audit committee) should oversee the development of the internal controls. Test policies and procedures from time to time, and make changes if necessary.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Bank Boards Need To Reassess Priorities And Expand The Number Of Seats

ABSTRACTED FROM: *Boardroom Burdens*

BY: Michael Sisk

US Banker, Vol. 120, No. 4, Pgs. 26-29

Directors out of control. Even the most casual observer of the financial services sector is aware of turmoil in the banking industry. Government-sponsored bailouts, bank failures at an all-time high, and ever more onerous loan restrictions for the average consumer all overhang the industry, Michael Sisk observes. Many institutions, to the dismay of long-time shareholders, have reduced or eliminated their dividends, yet bank executives continue to receive generous salaries and healthy bonuses. Despite the weak capital structures and sub-par earnings, it looks like business as usual to critics who complain that the directors are exercising little or no control.

Bank boardroom no longer a cushy seat. Bank directors are caught between the Scylla of regulators seeking more caution and politicians demanding more oversight and increased lending, and the Charybdis of furious shareholders watching their investments all but disappear. At the same time, the directors are being held more accountable for the mistakes of management and more responsible for strategic planning. The process of rebuilding public trust will be a slow and painful one, but it must begin as soon as possible. The author suggests five issues that bank boards should make top priorities: board composition, compensation, liability, risk management, and termination. A tough stance on compensation policies would be a good place to begin. Directors must also become more conversant with accounting, finance, risk management, and regulation.

Bigger boards, less pay. Industry observers note that there has been little turnover in boards in recent years, and too many banks lack outside directors with experience in financial services. According to surveys, big banks have fewer directors (12 on average) than nonbank corporations (14 on average) and pay them 33% less than companies in other industries. The average compensation—\$209,000—is too low for the job that needs to be done, which includes providing an active, substantive check on management. Such disparate groups as the Treasury Department and bank shareholders have pressured major banks to change their boards. Bank of America, the country's largest bank, has increased its percentage of outside directors with financial experience to 38%, up from 11% in 2009 (although, the author notes, Citigroup shrank its board from 17 members to 15). Banks are also retooling compensation policies, trying to maintain a balance between rewarding excellence and discouraging excessive risk-taking. Prior metrics for determining executive compensation—such as return on equity or assets and earnings per share—still matter, but they are now joined by capital levels and credit quality. Banks are also adjusting bonuses to discourage executives from grabbing immediate gains that result in long-term negative effects on the institution. Adjustments include converting cash bonuses to deferred stock and instituting clawbacks that recoup bonuses relying on excess risk.

Risk is an important consideration. The author urges bank boards to inaugurate a healthier risk culture, create more effective reporting structures to oversee management, and invest in the technology that would enable directors to quantify and analyze enterprise risk. Industry insiders are considering various responses to the excessive risk that US banks took during the current and past financial crises. Some boards have appointed an experienced chief risk officer. In terms of personal exposure, board

members need to consider indemnification for potential penalties (most of which result from bad loans failing) beyond those covered by standard D&O insurance. Directors could invest in a policy that would cover their portion of a civil penalty. Finally, the author advises, directors should assess their own skills and contributions to the board. If these are not a match with the rest of the board and with the institution's management and its policies, it might be time to resign. The American Association of Bank Directors offers questionnaires for board nominees and members to use in evaluating their skills and qualifications as a director.

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