

SARBANES-OXLEY

Whistleblowers Need Stronger Incentive Than An Inadequate Shield

ABSTRACTED FROM: *Beyond Protection: Invigorating Incentives For Sarbanes-Oxley Corporate And Securities Fraud Whistleblowers*
BY: Prof. Geoffrey Christopher Rapp, University of Toledo College of Law
Boston University Law Review, Vol. 87, No. 1, Pgs. 91-156

No pot of gold for whistleblowers. The Sarbanes-Oxley Act gives employees of public companies meager incentive to reveal corporate and securities fraud, even though it has criminalized retaliation, whether by firing, demoting, threatening, or otherwise discriminating against whistleblowers. Law professor Geoffrey Christopher Rapp lists several reasons why whistleblowers rarely find a pot of gold at the end of their journey. Whistleblowers are allowed (after exhausting administrative remedies) to sue in federal court for reinstatement, back pay plus interest, and reimbursement of litigation expenses (e.g., expert-witness fees and, if reasonable, attorney fees), albeit not for punitive damages; but the likelihood of success seems minimal. The Act requires companies to set up channels for addressing employees' open or anonymous criticisms about suspicious accounting practices, but it does not specify the type (the SEC has pressed for ombudsmen or in-house inspectors general); but companies evade the requirement's goal by establishing yet failing to operate the communication channel. Another potential incentive for whistleblowers comes from a 1998 statute that gives the SEC discretion to pay a reward of up to 10% of the penalty imposed on anyone guilty of insider trading; but the SEC has seldom done so.

Losing their money and their minds. The incentives for exposing fraud do not outweigh the strong disincentives, the author fears. Despite Sarbanes-Oxley's anti-retaliation provisions, for example,

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whistleblowers could lose their jobs if their revelations destroy their companies. Even when the company survives, they face on-the-job ostracism, which is as unpleasant as retaliation but probably legal and—even if illegal—very hard to prove. Some experience psychological strain whether from self-doubt over the validity of their suspicions, frustration over dealing with federal officials, or feelings of having abandoned their peer group. Such strain too often estranges the whistleblower from his or her family. Sarbanes-Oxley cannot prevent other employers from blacklisting whistleblowers, most of whom never find new jobs in their fields. Nor can the statute shield whistleblowers from liability for violating confidentiality agreements, which employers increasingly demand, and fiduciary duties of loyalty and obedience under state law.

Share-the-wealth model. In the author's view, the federal False Claims Act offers a roadmap for how to make the advantages of whistleblowing outweigh the disadvantages. Now applicable mostly in the procurement and health-care areas, the Act makes it illegal to knowingly present a false or fraudulent claim for payment to the federal government. A private citizen can sue on the government's behalf and, if successful, receive a bounty of 15%-30% of the government's damages caused by the violation. (The government may take over the suit or move to dismiss it.) With the average bounty exceeding \$1 million, the False Claims Act provides ample incentive for private whistleblowers to bring suits and talented attorneys to litigate them. There are more suits brought every year under this statute than private securities suits, even though the market capitalization of US companies dwarfs the value of federal government contracts. The False Claims Act also saves the government substantial litigation costs and brings crucial information to light.

Entice plaintiffs with riches. One method of offering bounties to Sarbanes-Oxley whistleblowers, the author suggests, is to use a state's false-claim statute, which almost all the states have. While the majority contain only anti-retaliation protections, many also have bounty provisions, which usually imitate the FCA. Some bounty provisions are limited to health-care fraud, but others are not. When a state agency purchases shares of a public company, the seller—whether the issuer or a shareholder selling in the open market—makes a claim upon the state for the share price. If the seller makes a false statement (or a material omission) constituting a securities-law violation before the sale, that is a false claim upon which a whistleblower might base a suit and seek a bounty under the state law. The author's second method would not increase the SEC's workload: amend an obscure Sarbanes-Oxley provision that now permits the SEC to pay an investor who was harmed by fraud the monetary civil penalties and disgorgement-order proceeds resulting from an enforcement action. A simple amendment would entitle whistleblowers to a percentage of those funds.

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GLOBAL MARKETS

The View From Germany: Sarbanes-Oxley Is Too Burdensome

ABSTRACTED FROM: *How Has SOX Affected Foreign Private Issuers?*

BY: Joern Schlimm, KPMG, Frankfurt, Germany

Strategic Finance, November 2007, Pgs. 49-53

An international headache. Two sections of the Sarbanes-Oxley Act leave foreign multinationals in a quandary about how to comply and even whether to list in the United States, reports Germany-based management advisor Joern Schlimm. Before Sarbanes-Oxley, the SEC frequently granted exemptions to foreign private issuers, recognizing that the laws and practices governing that foreign entity differed from those in the United States. Exemptions are no longer the custom. The reach of Sarbanes-Oxley crosses all borders, however, and foreign issuers listing in America must comply with its requirements.

Severe brunt of regulations. Adding Sarbanes-Oxley to the regulations of their home countries imposes another layer of compliance on foreign issuers. Two sections seem most troublesome, indicates the author. Section 302 requires senior executives to certify that they have reviewed the appropriateness of financial statements and find them satisfactory, holding the executive personally liable for inaccuracies. Section 404 charges management with implementing effective internal controls for financial reporting. To add to the cost and complexity of double regulation, many foreign issuers have multiple locations and highly decentralized operations, interfering with the ability to effectively implement uniform internal controls. Some issuers find that the higher costs associated with being a cross-border public company outweigh the benefits and decide to delist; others, like German automobile maker Porsche, have put their multinational listing plans on hold. Small and mid-sized public companies feel the most severe brunt of regulation because they often lack the resources and staff power for compliance.

Detractors and supporters. Sarbanes-Oxley supporters in Germany view the Act as an opportunity to enhance financial reporting and disclosure, the author observes, and to make executives more accountable to shareholders. Proponents believe a dose of additional regulation may help loosen the hold of German banks, which often own major stakes in public companies and have been accused of exerting their influence in ways that hinder global competitiveness. By attracting domestic and international investors, regulations that encourage equity investment might sharply reduce the banks' influence over corporate policy. Critics argue that Sarbanes-Oxley imposes a costly, unnecessary burden and disregards the differences in foreign corporate governance, structure, and financing mechanisms. Many European companies use a decentralized management system, which makes it difficult to hold one person responsible for financial reports. Opponents also note that, unlike American companies which rely heavily on the US stock market for financing, foreign companies frequently resort to bank loans and thus have less need to manage earnings.

Finding the way to harmonize. The SEC has responded to such concerns by extending compliance deadlines, agreeing to consider the exemption of European companies from some requirements, and making delisting easier. Despite these efforts, many foreign issuers find that the cost outweighs the benefits of US listing and have turned to Europe's markets instead. Others are still willing to bear the burdens associated with an American listing to gain access to the world's most liquid market. More companies may make that choice if the SEC smoothes the way by considering national differences in legislation, financing, and corporate structure. The author notes that several US regulatory bodies are

already working with regulators in the European Union to come to a resolution, and more international cooperation appears likely in the future. A long-term solution may well encompass an international framework for financial reporting that takes into account the differences between corporate practices and economies around the world.

Abstracted from *Strategic Finance*, published by Institute of Management Accountants, 10 Paragon Drive, Montvale, NJ 07645. To subscribe, call (800) 638-4427 x1547; or visit www.strategicfinancemag.com. **Editor's Note:** The SEC is easing the burden on foreign issuers by accepting financial statements prepared under the International Financial Reporting Standards (IFRS), starting March 4, 2008. See SEC Release Nos. 33-8879 and 34-57026 at www.sec.gov/rules/final/2007/33-8879.pdf.

FINANCIAL REPORTING, TAXATION & ACCOUNTING

Step Transaction Doctrine In Reorganizations Still Alive, Thriving, And Confusing

ABSTRACTED FROM: *Not Your Father's Step Transaction Doctrine*

BY: Robert Wood, Wood & Porter, San Francisco, CA

M&A Tax Report, Vol. 16, No. 5, Pgs. 1-4

Step doctrine waxes and wanes. Within the IRS and Congress, concern over the step transaction doctrine ebbs and flows, notes tax attorney Robert Wood. The doctrine (which, broadly stated, integrates all the steps in a corporate transaction to determine its true nature—and thus its proper tax treatment) is typically applied in corporate reorganizations, although it has other applications. Occasionally the IRS waves its step-transaction magic wand and creates a reorganization out of multiple transactions that were not originally intended as such; at other times, the IRS pulls apart deals that were planned as reorganizations and denies that treatment. The IRS and the courts often look at a reorganization to see if the parties' desired result could have been accomplished only after all the steps transpired. If not, the deal could be deemed taxable or certain elements of the deal could be so treated.

Four critical factors usually considered. The IRS and the courts typically apply four factors in assessing whether the step doctrine should be imposed. First, the author instructs, examine whether the steps in a corporate transaction are dependent on each other; if they are not, each step may be viewed as a separate deal. Second (and, historically, most important to the courts), assess whether there is a binding commitment for each of the steps. Third is the amount of time that has elapsed between the various steps. The greater the lapse of time between the steps, the more difficult it is to argue that they are interdependent. Conversely, the shorter the intervals between the steps, the more likely it is that they will be viewed as parts of an integrated plan. Finally, consider the intention of the parties, in what the author terms the "end result" test, which reviews whether the deal could have succeeded only with each and every one of the steps taken to achieve the result.

Not always the key to success. Despite the emphasis by the courts and the IRS on the four factors, they are not always applied consistently as a group or in equal measure with each other. Occasionally, one factor will be given primacy or another may garner little attention. Some cases have required a business purpose for each step and have ignored the step doctrine. The author points to the *Esmark* case from 1988, in which the IRS wanted to apply the step doctrine but the tax court focused primarily on whether there were any steps that should have been ignored. The *Esmark* court found that just because

the final deal was the cheapest in tax dollars due, no route was any more direct than the steps taken by the Esmark dealmakers.

Ruling causes confusion. In an IRS revenue ruling in 2001, confusion reigned in a deal involving some two-step stock acquisitions. Steps were integrated under a reorganization structure but did not result in the parent acquiring control of the target, when all was said and done. Despite the fact that such control is normally required for tax-free treatment, the ruling concluded that the deal satisfied the tax-free reorganization rules. The author points out that the steps in the deal were not interdependent, yet the IRS still applied the step doctrine, a confusing result, to say the least. Practitioners need to stay on top of the cases coming before the IRS and the courts before sounding the step doctrine's death knell.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Using *Disney* To Address Cronyism And A Failure Of Good Faith

ABSTRACTED FROM: *Disney, Good Faith, And Structural Bias*

BY: Prof. Claire Hill and Prof. Brett McDonnell, University of Minnesota Law School

Journal of Corporation Law, Vol. 32, No. 4, Pgs. 833-864

Greed in the House of Mouse. By now, perhaps everyone knows the tale about how Michael Ovitz received \$140 million in termination compensation after a rocky 14 months as Disney's president. The controversy has generated a seemingly endless court battle. Law professors Claire Hill and Brett McDonnell think that, while probably right in exonerating the Disney board, the Delaware courts wasted a chance to clarify the fiduciary duty owed by directors with close personal and professional ties to officers (known as "structural bias"). Judges traditionally divide cases on fiduciary duty into the categories of loyalty and care. When directors, officers, or controlling stockholders engage in self-dealing, courts cite the duty of loyalty and scrutinize the transaction, presuming its invalidity but letting the defendants try to validate it. When self-dealing is not a factor, courts cite the duty of care and examine the transaction much less closely, presuming its validity under the business-judgment rule but letting the plaintiffs try to rebut that presumption. Some transactions do not involve self-dealing (e.g., takeovers) but could still strongly tempt directors to favor their own interests over the corporation's. For these, Delaware courts have created several intermediate standards of review and, in the several *Disney* decisions, identify—but do not clarify—another duty: the duty of good faith.

Disney directors were sheepish but not in breach. The stockholders sued Disney CEO Michael Eisner (who brought Ovitz in as the second-in-command and negotiated his contract), Ovitz himself, and the directors. The suit alleged that the defendants had breached their fiduciary duties in negotiating Ovitz's contract and permitting him to leave but not declaring that the firing was for good cause. Ovitz and Eisner were close friends, the authors explain, and Eisner dominated the board, whose members included Eisner's personal attorney, his architect, and his children's school principal. Although these circumstances call the board's disinterestedness and independence into question, the Delaware courts decided they do not show self-dealing that breaches the duty of loyalty. Most of the directors barely looked at or discussed Ovitz's contract, but the standard of care is very loose and the court could not conclude that they had breached their duty of care.

Structural bias is hard to ferret out. The *Disney* decisions epitomize the problematic case of officers' and directors' cronyism, or structural bias, against which the duties of loyalty and care cannot defend. Instances of self-interest are much more widespread but more attenuated than the self-dealing transactions that do trigger the duty of loyalty. Boards might, for example, give officers the same deference and lavish compensation that the directors would expect if the tables were turned. Another structural-bias example from the authors is the CEO's selection of director/nominees who already are or might become the executive's friend. Officers and directors mix socially and so share social attitudes. All of these factors tend to weaken directors' critical faculties, prejudicing them against stockholders' interests and in favor of management's frequently divergent interests. Determinations of this structural bias, which lacks a generally accepted definition, are extremely fact-sensitive.

From elephantine compensation to pet charities. The authors offer a solution: courts could adapt the fiduciary duty of good faith to address structural bias. To make a prima facie showing that the directors' decision lacked good faith (thus rebutting the presumption of the business-judgment rule), plaintiffs would have to establish two elements. First, structural bias likely prejudiced the directors against the corporation's interests and in favor of their own, the officers', or controlling stockholders' adverse interests. Second, the directors were grossly negligent in reaching their decision. The stronger the first element is, the weaker the second element could be. If the plaintiffs succeed, the defendants could then try to rebut the inference of bad faith. This approach goes beyond Delaware case law but is consistent with the *Disney* holdings and with Delaware law on good faith. It could apply to executive compensation, management's self-interested transactions, M&A deals, demands on directors in derivative suits, and donations to management's pet charities. It would not lead to liability in the *Disney* litigation or in many other cases but, by warning that the Delaware courts regard structural bias as a basis for liability, might encourage directors to put the corporation's interests before their own.

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Shining A Light On Phantom Owners Avoids Trouble

ABSTRACTED FROM: *Who Owns Your Stock?*

BY: Kate O'Sullivan

CFO, October 2007, Pgs. 60-65

Stumping shareholder relations. It's nine o'clock. Do you know where your shareholders are? Of course not, but CFOs ought to know who their shareholders are, and how to contact them. Portfolio managers are not complying with reporting obligations, leaving issuers in the dark. Section 13(f) of the 1934 Act requires investment managers with more than \$100 million in portfolio assets to report their positions to the SEC within 45 days of a quarter's end. Nowadays, Kate O'Sullivan finds, this rule is honored mostly in the breach. While some managers fly under the radar by buying and selling prior to the quarterly reporting date, others just ignore the requirement and hope that an understaffed SEC will not find them. In fact, the law has no penalty for missing the filing deadline (and thus gives little incentive to comply). Perhaps the most egregious example of noncompliance was reported by an IR officer who discovered four years of unfiled Form 13F reports in a back office at his company. Given the cavalier attitude towards regulations displayed by investment managers, most executives cannot communicate with the company's major shareholders. This can have disastrous consequences if there are issues of control or if shareholder activists are targeting the company.

Why be shy? Noncompliers cite many valid (to them) reasons for their lack of reporting, including the need to protect their investment strategies from copycats and from investors who are attempting to affect share price. Those who are determined to remain anonymous can petition the SEC to keep from

publishing their filings. Short-term investors are particularly sensitive to publicity, because they operate with thin margins for quick gains. They are not in a sharing mode and decidedly do not want management to shadow them. Despite these obstacles, a recent study cited by the author shows that CFOs are committed to learning as much as they can about their shareholder base. Most faithfully scan the SEC filings. Others, some 53% of those surveyed, subscribe to various ownership tracking or stock surveillance services, or they purchase lists of non-objecting beneficial owners (NOBOs) from database companies. Despite these efforts, which can cost upwards of \$60,000 per year, only 29% of the executives surveyed feel that the data obtained are accurate.

We really want to know you. Many executives devise their own methods of tracking shareholders in an effort to know who the major shareholders are and to communicate with them regularly. Some executives speak with high-profile investors weekly to help them understand the company's business. The CFO of one clothing manufacturer regularly canvasses his shareholders but, despite his best efforts, can identify only half of them. However, communications with that portion influenced the company to significantly increase its dividend. For companies concerned that their policies may be attracting activist or hostile investors, lack of knowledge can pose a particular danger. Just a few large trades can move a shareholder base from pro-management to neutral or hostile, and even a tiny stake can be leveraged, the author reminds. For example, one shareholder/activist gained a seat on the board of tax preparer H&R Block with an initial position of less than 2%. Since shareholders must report positions of 5% or more, this activist was flying under the radar until he joined forces with other shareholders. Most CFOs agree that the SEC needs to be more vigilant by decreasing the reporting deadlines and then enforcing them. Observers suggest a monthly reporting schedule, but that seems unlikely.

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SECURITIES REGULATION & DISCLOSURE

Exemptions Under Rule 145 Based More On No-Action Letters Than Policy

ABSTRACTED FROM: *A Study On Rule 145 Of The Securities Act Of 1933:
How To Provide Clarity And Predictability In Rule 145 Transactions*

BY: Kab Lae Kim, Esq.

Akron Law Review, Vol. 40, No. 1, Pgs. 131-173

Under-full sale. The SEC adopted Rule 145 in 1972 to replace its heavily criticized exemptive scheme under former Rule 133 for the receipt and resale of securities issued in mergers and other recapitalizations. While Rule 133 jurisprudence tied itself in knots over the “no-sale” doctrine, Rule 145 sought to treat such transactions as sales. It somewhat streamlined the registration process for securities whose receipt and resale were not otherwise exempt. However, Rule 145 still determines if a sale has taken place based on whether the recipient has given value for the new security—for example, by agreeing to different terms governing the new securities. Legal scholar and attorney Kab Lae Kim notes some problems under Rule 145 in defining what it covers (exempting reverse stock splits, for example) while the economic reality of a transaction probably qualifies as a material change of terms.

No clear guidance. Much of the law behind Rule 145 comes not from court decisions, rulemaking, or even policy statements, but as a result of no-action letters from SEC staff. Since these letters have very limited precedential value, practitioners cannot safely predict how the SEC will interpret Rule 145's central concepts—such as whether a sale has occurred—without input from SEC staff. As one example illustrating what the author views as SEC staff's preference for flexibility over certainty, consider the 2004 no-action letter on a reincorporation by Russell Corporation. The SEC staff applied the no-sale doctrine and agreed that the reincorporation was exempt from registration because it simply eased corporate administration. Yet more formal policy pronouncements from the SEC stress that changes in corporate domicile constitute a material change (and thus give rise to a new investment decision) if the governing law would significantly alter the shareholders' rights.

No sale and no resale. Because of the expansive definition that the SEC and courts traditionally give "underwriter" under the 1933 Act, recipients of securities in a recapitalization or merger may have registration concerns if they propose to resell the securities. While the Act's general definition of underwriter incorporates the subjective element of intent to distribute, Rule 145 (in a holdover from the days of Rule 133) ignores this point. It presumes anyone to be an underwriter who resells Rule 145 securities outside the rule, whether or not those securities were themselves registered. Affiliates (officers, directors, and major shareholders) of an acquired company may, after the acquisition, be unable to obtain information from the issuer to comply with registration requirements for the secondary sale. They may thus be trapped into selling acquired shares under Rule 144's volume and other limitations, which may impair liquidity and efficient pricing of the securities. The author questions whether any special concepts of underwriter or resale restrictions are warranted under the sale/no-sale concept underpinning Rule 145 and criticizes the inconsistencies between its resale provisions and the general statutory treatment of underwriters. Rule 145 seems an anachronism in its disregard of the disclosure system for all securities that has evolved in the 35 years since the SEC adopted it.

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When Issuers Must Disclose Outsourcing

ABSTRACTED FROM: *The Reality Of Outsourcing Agreement Disclosures: Are Public Companies Disclosing Material Deals?*

BY: Randall Parks, J. Christopher Lemons, and Ann Hammenecker
Hunton & Williams, Richmond, VA (RP and JCL), and Atlanta, GA (AH)

Insights: Corporate & Securities Law Advisor, Vol. 21, No. 10, Pgs. 8-13

Outsourcing as a material agreement. Many companies outsource major portions of once-internal operations, such as IT and manufacturing, yet few have disclosed the arrangements as material contracts in their SEC filings. Attorneys Randall Parks, J. Christopher Lemons, and Ann Hammenecker point to several sections of the annual, quarterly, and current 1934 Act disclosure forms (Forms 10-K, 10-Q, and 8-K) where these contracts might appear. For example, they could be disclosed in the risk factors, the notes to financial statements, the general business disclosures, or the Management's Discussion and Analysis section. On Form 8-K alone, two items deal with the disposition of assets (which might apply if the outsourcing company will receive company assets necessary to perform the services) and material agreements. If the outsourced service or function is essential to the company's business, it is material and should not only be disclosed in the descriptive sections but also be attached as an exhibit. Depending on the circumstances, other items in Form 8-K may apply to outsourcing agreements, including the items on significant layoffs, fixed minimum payments, and termination fees.

What to say, what to do. The authors estimate that issuers are not disclosing as much as 70% of the largest, most significant outsourcing contracts. When an outsourcing contract should be disclosed, the issuer should describe certain essential features, such as the parties, date, term, services, and price. Include any pricing adjustments, credits, offsets, or allowances under the particular conditions, the authors advise. Describe any early termination and indemnification provisions, as well as the potential impact on the company, including its staffing and capital structure. Since some of these disclosures will likely reflect forward-looking data, add the standard disclaimers. Another suggestion is to redact the filed contracts to conceal confidential information, assuming that the issuer requests and receives confidential treatment for the contract from the SEC. It is important to comply strictly with the SEC's requirements for confidential treatment, which track the disclosure exemptions under the Freedom of Information Act. Generally the SEC is hostile to confidentiality requests that cover entire documents; it prefers a more granular approach in seeking confidentiality, although this may put the issuer at odds with the outsourcing service provider.

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