

**FINANCIAL REPORTING, TAXATION & ACCOUNTING****Think Like A Plaintiff To Minimize Fallout From Corporate Accounting Fraud**ABSTRACTED FROM: *How To Identify, Prevent, And Investigate Accounting Fraud*BY: Jennifer Brannen, Michelle Reed, and Ashley Vinson, Akin Gump Strauss Hauer & Feld, Austin, TX
Wall Street Lawyer, Vol. 8, No. 11, Pgs. 1, 3-8

Overview: Looks through plaintiffs' eyes to tag the warning signs for "cooked" corporate books. Advises companies on how to use these red flags to construct their prevention programs. Suggests some responses, if all else fails and a financial restatement ensues, to minimize the regulatory and publicity fallout.

Buried debt and bogus income. While everyone pays lip service to the proposition that declining corporate results do not themselves bespeak fraud, securities litigators Jennifer Brannen, Michelle Reed, and Ashley Vinson point out that any downturn invites the attention of would-be plaintiffs. Five key areas, according to the plaintiffs' securities bar, can hold red flags for fraudulent accounting practices: (1) *expense deferral*, whether by postponing recognition or capitalizing an operating expense, with or without mysterious changes in reserves; (2) *bogus revenue*, revenue bookings without any apparent substantive transactions supporting them; (3) *premature revenue*, booking revenues where buyers have rights of return and other rights that could later reverse the result; (4) *buried debt*, liabilities removed from the books through guarantees and special-purpose entities; and (5) *miscellaneous frauds*, such as mysteriously obtuse footnotes. A financial restatement virtually guarantees a lawsuit, so an impending restatement, the authors warn, should automatically trigger an intense internal review. The company should try to spot any fraud and ascertain that it can verify all its financial reporting.

Beware the enemy within. Very frequently, the authors report, plaintiffs obtain their initial information from disgruntled sources within the company. These tipsters can reveal whether management, for example, has stressed quarterly targets at the expense of careful reporting processes. Such an emphasis could lead to various fraudulent practices, such as false sales bookings and inventory manipulation. In addition, plaintiffs can obtain indications of transactions between related parties by carefully scrutinizing the financial footnotes in annual and quarterly required reports. Self-dealing and non-arm's-length transactions present fertile ground for fraud complaints.

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Editor's Note: Because of the vacation publishing schedule, the July and August issues of the *Bowne Digest For Corporate & Securities Lawyers* are shortened. The full-length newsletter will return in September 2005.

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Apply an ounce of prevention. To avoid the conditions that yield fraudulent practices, begin with a balanced attitude and close relationships, the authors advise, both within the company and with key outside advisors such as auditors and investment bankers. A strong audit committee, an unwavering ethical tone from management, a powerful ethics policy, and continual education at all levels of management form the backbone of a proper fraud prevention program. Communicating the leadership's serious commitment to compliance is paramount. The prime player in managing these relationships and in keeping the focus on the prevention policy is the audit committee. Nevertheless, all the directors and executives should familiarize themselves with key accounting requirements affecting the company, as well as with typical accounting frauds.

Do not panic. The authors offer practical steps companies can take to minimize the temptations to fraud. Since pressure to meet quarterly sales targets can invite corner-cutting, for example, put sales staff on quarters different from the company's fiscal quarters. Internal audits should always compare the requested accounting treatment with the underlying substance of a transaction, looking beyond their legal form. Document the underlying evidence in support of management's assessment that the internal controls are effective. On the other hand, the authors caution, the company often waives its attorney/client privilege during an internal investigation. Doing reports orally—whether to the board, to the investigating committee, or even to the SEC—may eliminate the creation of a discoverable paper trail for private plaintiffs. Should a financial restatement prove inevitable, boards are wise to consult with securities litigation counsel before drafting the press release.

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SECURITIES ENFORCEMENT & FRAUD

D&O Insurance Not A Perfect Shield From Sarbanes-Oxley Liability

ABSTRACTED FROM: *Blowing Whistles And Climbing Ladders:
The Hidden Insurance Issues Behind Sarbanes-Oxley*

BY: John Tanner and David Howard

McGriff Seibels & Williams, Birmingham, AL (JT); Arnall Golden Gregory, Atlanta, GA (DH)

ACC Docket, Vol. 23, No. 4, Pgs. 32-51

Overview: *Warns of Sarbanes-Oxley liabilities that D&O policies might not cover. Points out the special problems of SEC investigations, policy rescission, whistleblowers, and coverage for in-house legal staff. Suggests negotiation strategies to improve coverage.*

Maximize coverage to defend against the SEC. In-house counsel need to make sure that their employer's D&O insurance policy maximizes coverage for all the potential liabilities arising under the Sarbanes-Oxley Act. The statute increases the risk of formal and informal investigations by the SEC, attorneys John Tanner and David Howard advise, but D&O policies do not cover informal investigations and certainly not the fines or penalties that might result. Many policies explicitly cover only insured individuals who are named or subpoenaed in a formal investigation and not the corporate entity itself. Counsel should negotiate for coverage of the potentially huge costs—even with an informal investigation—of answering information requests and asserting a defense. Some insurers use narrow definitions of policy claims or sublimits for investigative costs to restrict their exposure.

Resisting rescission. By requiring public companies' CEOs and CFOs to certify all quarterly and annual reports, Sarbanes-Oxley increases the risk that D&O insurers will rescind coverage. If insurers incorporate these certified reports into the policy's definition of *application* and if companies must subsequently restate a financial statement, insurers can argue that the initial certified quarterly or

annual report was a false certification, thereby justifying rescission. To reduce this risk, companies can purchase unrescindable coverage for non-indemnifiable claims against individual insureds. The authors would also try to strengthen the severability clause that protects innocent insureds (i.e., those who do not certify) against rescission. If certifications from lower-level employees support those of the CEO and CFO, counsel should ascertain whether entity coverage extends to these employees and also consider indemnifying them.

Parrying whistleblowers' blows. Another hidden pitfall the authors raise is the cost of whistleblowers. Employees have dramatically increased their complaints of corporate fraud or SEC violations since enactment of Sarbanes-Oxley, which protects whistleblowers against reprisals. Contending that these complaints constitute informal investigations, insurers usually refuse coverage. Should a lawsuit alleging reprisal follow, insurers still deny coverage—even when the company has entity coverage for *securities claims*—if the insurer defines that term as only claims brought by shareholders. While policies are more likely to cover whistleblowers' claims alleging reprisals by insured directors and officers, insured-vs.-insured exclusions apply when the whistleblowers are also insured individuals. Upon request, many D&O insurers limit this exclusion with an exception for ex-employees' lawsuits claiming wrongful termination. Separate employment-practices liability insurance for whistleblowing claims is also available.

Looking out for number one. In-house attorneys themselves need protection. The movement to make attorneys the guardians of the investing public has resulted in expanded liability exposure, the authors warn. The sources are varied: Sarbanes-Oxley's up-the-ladder reporting requirements for corporate malfeasance; bankruptcy law (for collusion with corporate insiders); Rule 10b-5; and several theories of indirect malpractice (e.g., negligent misrepresentation in opinion letters). Indemnification of in-house attorneys could be subject to the directors' discretion, yet mandatory indemnification offers no protection when companies become insolvent. Standard D&O policies provide limited coverage, at best, even when they include entity coverage and named in-house counsel as insureds. The best protection comes from carrying a separate, specific policy. These professional liability policies have a liability limit distinct from the D&O figures. They cover in-house counsel for non-indemnifiable claims and the company for indemnified claims. Designed to solve the unique problems faced by in-house legal staff, some of these policies explicitly cover claims resulting from the up-the-ladder reporting requirements.

Abstracted from *ACC Docket*, published by Association of Corporate Counsel, 1025 Connecticut Ave. NW, Suite 200, Washington, DC 20036-5425. To subscribe, call (202) 293-4103; or visit www.acca.com/docket/subscribe.php. **Editor's Note:** Another article on handling whistleblowers is "Accommodating Would-Be Whistleblowers" by Paul Sweeney, *Financial Executive*, March 2005, Pgs. 26-28.

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CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Independent Boards, Not Congress, Should Control Runaway Executive Pay

ABSTRACTED FROM: *Can't Cap Corporate Greed: Unintended Consequences Of Trying To Control Executive Compensation Through The Tax Code*
BY: Ryan Miske

Minnesota Law Review, Vol. 88, No. 6, Pgs. 1673-1696

Overview: *Examines the tax code sections that Congress has enacted in its efforts to rein in excessive executive compensation. Argues that these provisions are ineffective and that the only real cure for runaway corporate compensation is truly independent directors.*

Congress charges into the breach. With \$188 million in annual compensation, former NYSE head Richard Grasso is just one more illustration in the growing controversy over excessive executive compensation. Over the last two decades, Congress has enacted three amendments to the Internal Revenue Code intended to corral excessive compensation. The only IRC provision that had directly addressed executive pay was Section 162(a)(1), which limits a company's deduction to "reasonable" employee compensation. As Ryan Miske observes, this section was never meant to control public companies' executive compensation practices. It was aimed at stopping closely held corporations from artificially increasing compensation instead of paying out profits in the form of (nondeductible) dividends. The recent scandals and political pressure that produced Sarbanes-Oxley reforms will lead Congress to consider additional tax provisions to control executive compensation. Unfortunately, the existing provisions have not accomplished their intended purpose and have yielded some unfortunate, unintended consequences.

Intended and unintended consequences. Section 280G, enacted in 1984, prohibits corporations from deducting golden-parachute payments (i.e., compensation contingent on a change in control) that exceed three times the executive's average annual compensation over the previous five years. A companion item, Section 4999, requires the recipient of the excess parachute payment to pay a 20% excise tax. A payment is not excessive if the company can prove, by clear and convincing evidence, that it was "reasonable." Congress intended to remove elements of personal enrichment from the takeover decision matrix. It also wanted to discourage companies from offering huge executive contracts that would entrench management and artificially raise the price of a corporate takeover. Unfortunately, the author recognizes, Section 280G has instead led to three unintended results: (1) executive severance contracts have rapidly increased to the new "standard" of three times annual base pay; (2) severance arrangements now include a tax gross-up—giving the executive additional money to cover the excise tax—which keeps the executive whole while costing the company much more; and (3) some companies write executive severance agreements as "best net" deals, paying the greater of either the full payment, subject to excise tax, or a lesser payment, pegged at just under the excise tax trigger.

Meet that goal. Under Section 162(m), enacted in 1993, companies cannot deduct the compensation paid to any executive in excess of \$1 million annually, unless as part of a performance-based plan. The compensation must be based on the achievement of pre-established, objective goals designed by a compensation committee comprising independent directors and approved by the shareholders. Before it makes the payment, the committee must certify in writing that the performance goals were met. Unfortunately, in the author's view, many important corporate goals, such as employee morale or public image, are not conducive to objective measurement and not easily incorporated into a pre-established, objective performance. The simplest way to comply with the performance requirements is with stock options, which, by their nature, are performance-based. If granted at mar-

ket value, options comply with the requirements of Section 162(m), without the need for written certification that pre-set goals have been met. Companies therefore overemphasize stock options as an executive compensation tool, and executives, for their part, focus on short-term, stock-price-driving goals, at the expense of building long-term value.

Independence is the only cure. The author asserts that the best curb on excessive executive pay is to ensure the independence of the compensation committee. Congress will then not need to micromanage executive compensation through the tax code. An independent director would not be willing to circumvent the tax code's incentives by providing executives with the same excessive compensation at an even higher cost to the corporation. The independent board committee would instead engage in true arms'-length bargaining with executives. The states, which are traditionally the guardians of corporate law, should enact legislation requiring all companies to establish compensation committees entirely of independent directors. If the states do not do so, the author suggests that shareholders try to amend the corporate charter to require an independent compensation committee. Directors who are truly independent should be free from formal business ties with the company, other than their board seats, and should be free from informal social ties as well.

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How Acquiring Directors Can Use Experts To Ward Off Trouble

ABSTRACTED FROM: *Advising The Board Of Directors In Acquiring A Business*

BY: Stewart Landefeld, S. Paul Sassalos, and Ryan Arai, Perkins Coie, Seattle, WA

Insights: Corporate & Securities Law Advisor, Vol. 19, No. 3, Pgs. 13-19

Overview: *Examines the legal risks to the acquiring company's directors when undertaking a corporate acquisition. Reviews a 2000 seminal decision on the duty of care. Discusses the advantages of obtaining a fairness opinion, and provides guidance on how to use the opinion.*

Buyer still beware. Courts traditionally judge a board's decision to acquire another company under the business-judgment rule, which provides great deference to a informed decision made by directors without conflicts. Acquisitions can, however, pose significant risks for the acquiror. Attorneys Stewart Landefeld, S. Paul Sassalos, and Ryan Arai point out that if the deal does not succeed, the directors are subject to litigation. When plaintiffs can prove that the directors violated their duties of care or loyalty, the court will apply not the business-judgment rule but the entire-fairness rule. The court reviewing a transaction under the latter rule will examine more than the substantive result; it will also consider the process that the board followed, the structure and negotiation of the transaction, and the disclosures made to the shareholders.

Rely in good faith on experts. *Ash v. McCall*, a 2000 Delaware chancery court case, illustrates how a thoughtful board should approach a corporate acquisition, the authors maintain. The deal turned sour three months after it closed, when the acquiror discovered preacquisition accounting irregularities on the part of the seller. Plaintiffs claimed that the board had breached its duty of care because it did not discover the irregularities during due diligence. The court—indicating that only the decisionmaking process, not the business result, can be attacked—dismissed the claim. The decisionmaking process withstood scrutiny because the board obtained “available critical information” before making the decision; got expert advice from the accountants and investment bankers; conducted meetings after giving good and timely notice of the deal under consideration; and diligently examined the reasons for and terms of the transaction. The court observed that if experts are selected with reasonable care, the board may rely in good faith on their review. By contrast, the board in *In re Emerging Communications*, which also relied on experts, was not insulated from liability.

Before taking the company private, the board appointed a special committee of independent directors, who, in turn, hired independent counsel and financial advisors. The process sounds sufficient, but the court found that it was not fair. All but two directors were connected with the acquiring CEO. Communications to the special committee were routed through his office, compromising confidentiality, and he withheld last-minute financial projections that reflected substantially higher growth than previous projections.

Follow good process and obtain a fairness opinion. The authors offer several guidelines to the directors of acquirors: Follow a fair, well-informed process to withstand court scrutiny. A fairness opinion, though a valuable tool, does not substitute for careful judgment. Tap any special expertise on the board when considering the transaction. Take whatever steps are necessary to assure directors have all available relevant information. Look beyond the obvious, formal conflicts, and consider subtle noneconomic ties. Be clear with management as to what role it will play and what critical decisions must be left to the board alone. As for fairness opinions, the authors suggest: Always obtain a fairness opinion if shareholders will be approving the transaction; usually obtain one if any director or senior executive has a conflict; and consider obtaining one if the acquisition is large or important, or if the target is difficult to value.

Using the advice. Once the fairness opinion is in hand, the task is not complete. The board must keenly question the experts about their opinions. Ask the expert about the assumptions used that were important to the decision; the methodology applied; what projections were used, where they came from, and what a change to the projections would mean to the quality of the transaction. To make the best use of an expert opinion, the authors urge the board to be willing to change the deal's terms based on the report. When making a decision based on an expert's opinion, review the key materials beforehand, request a bring-down opinion just before closing, and, in extraordinary circumstances, obtain a second financial opinion. Schedule at least two board meetings, to make certain that directors thoroughly consider the experts' opinions. Finally, make certain the board minutes reflect the thorough process the board followed. Capture the time and duration of the discussion, the business reasons for the transaction, and the questions raised and changes made in response to expert and board input.

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SecuritiesConnect Editor's Note: Bowne is pleased to observe that the authors of this article, Stewart M. Landefeld, S. Paul Sassalos and Ryan A. Arai, all of Perkins Coie, Seattle, WA, are also contributors to Bowne's SecuritiesConnect (TM) Library. Stewart M. Landefeld is Editor in Chief and co-author of the very popular *The Public Company Handbook: A Corporate Governance and Disclosure Guide for Directors and Executives* (Second Edition) (256 pages), by Stewart M. Landefeld, Andrew B. Moore and Katherine Ann Ludwig with other contributing authors, all of Perkins Coie LLP (Published by Bowne & Co., Inc., © 2003 Perkins Coie LLP; Design and Layout © 2003 Bowne & Co., Inc.). Messrs. Sassalos and Arai are contributing authors. The book can be downloaded at SecuritiesConnect at the following address: http://www.bowne.com/bsc/pubs_public.asp.