

BOWNE**DIGEST FOR CORPORATE
& SECURITIES LAWYERS**

ABSTRACTS OF INSIGHTFUL CURRENT ARTICLES FROM LEGAL PERIODICALS

FINANCIAL REPORTING & ACCOUNTING**SEC Enforcement Of Accounting Requirements: A Review Of The Year And A Half Of Living Dangerously**

By John Sturc and Sara Kropf
Gibson Dunn & Crutcher, Washington, DC
Securities Reporter
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Overview: *Flags the SEC staff's current concern with allegedly fraudulent accounting practices. Identifies subject areas, issues, recent enforcement actions, and publicity positions. Analyzes developments in the context of the last decade, and suggests procedures to minimize or contain risks.*

On the warpath. Recent public statements and enforcement initiatives by the SEC focus attention on accounting practices the agency questions, as well as on broader concerns involving the concept of materiality and the structure of the accounting profession. Specifically the key accounting areas include writedowns, reserves, the timing of revenue recognition, and excessive restructuring charges. The Commission has apparently renewed its interest in "qualitative materiality" as a counter to the issuers' neglect of minor irregularities. It has hinted at imposing structural changes in the relationship between the accounting firm's auditing and consulting roles.

Accounting practice initiatives. Several recent enforcement actions, such as *ABS Industries* and

Computone, have involved business practices, such as bill-and-hold and informal ordering, that are designed to recognize revenue before a transaction has solidified. In November 1999, the SEC promulgated SAB 101, which identifies four principal factors in determining the finality of a transaction for revenue recognition purposes: formality, delivery of goods or services, determinable price, and collectibility. Other enforcement actions have challenged accounting practices—such as whether to capitalize or expense items like advertising and corporate acquisition costs, and the establishment of reserves—which traditionally have been left to the accountant's discretion.

Qualitative materiality redux. In some of the current enforcement actions, as in the late 1998 filing against W.R. Grace, the SEC deliberately omitted any allegation of materiality with respect to the financial statements as a whole. Reinforced by its August 1999 amendment to SAB 99, which dealt with the materiality criteria, the SEC has de-emphasized numerical materiality and focuses instead on qualitative factors. These include how the challenged financial disclosure affected earnings trends, the issuer's response to securities analysts' predictions, regulatory compliance issues, loan and contract compliance, and management compensation. SAB 99 also considers intentional misstatements as being material per se, on the theory that they reflect on the management's integrity.

Auditor independence. In public statements and in incidental remarks filed in otherwise-conventional enforcement actions, SEC staff and commissioners have suggested that increasing revenues from consulting and other nonauditing activities of accounting firms may compromise the auditor's integrity and independence. Actions against PricewaterhouseCoopers and KPMG Peat Marwick have not so far yielded judicial findings to this effect, but the Commission has nevertheless suggested either direct regulation or enhanced disclosure of these relationships. Recent cases have also tended to draw in corporate officials farther down the chain of command than before, including officers of subsidiaries. Even computer personnel have been named in

IN THIS ISSUE

FINANCIAL REPORTING & ACCOUNTING	1
• SEC Enforcement Of Accounting Requirements	
• Earnings Management: Swept Away?	
• Financial Reporting For International Joint Ventures	
M&A	4
• Applying The New M&A Filing Rules	
• How To Succeed In Selling Your Business	
SECURITIES OFFERINGS	5
• What To Do Now That Our Offering Has Aborted?	
EXECUTIVES & DIRECTORS	6
• Delaware Cases Affecting Executive Compensation	
• Dual Role Of Non-Executive Directors	
INDEX JANUARY-JUNE 2000	8

actions. Issuers should be even more cautious when adopting novel, “judgmental” accounting practices. Involving an independent auditor earlier and seeking approval may be the wiser approach.

Earnings Management: Swept Away?

By Neil Lang and Mark Perlow

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Review of Securities & Commodities Regulation

Vol. 33, No. 11, Pgs. 123-133

Overview: *Examines cases initiated by the SEC in late 1999 as part of a sweep against financial reporting fraud. Notes that many involve traditional forms of fraud, but the SEC is including a broader set of people in its scrutiny. Reveals that the Commission is beginning to address issues peculiar to the so-called New Economy.*

Climate of manipulation. On September 23, 1999, the SEC filed enforcement actions against 15 companies and individuals, charging them with fraud in their accounting and reporting of financial results. These enforcement actions were part of the SEC’s coordinated assault on financial reporting fraud. The sweep came exactly one year after the SEC chairman had publicly raised concerns about an erosion in financial reports’ quality, based on a climate of earnings management. In this climate, company management manipulates results to meet the expectations of Wall Street analysts, who in turn seek guidance from management for their estimates. The chairman had focused on five particular accounting gimmicks: taking a large, one-time restructuring charge; writing off large portions of acquisition costs as in-process research and development; using “cookie-jar” reserves to smooth earnings reports; misusing the concept of materiality to cover financial misstatements; and manipulating revenue recognition.

Old wine in new bottles. The enforcement actions generally attacked traditional financial fraud activities. Covered in the sweep were improper revenue recognition, falsification of assets, or blatantly improper accounting adjustments. The revenue recognition cases involve false shipments and invoices, secret side letters guaranteeing a right of return, conditional sales charac-

terized as final, backdated agreements, and extended reporting periods. Two of the defendant companies had falsified assets by altering aged accounts receivable to make them appear current. One target had falsified inventory accounts and another had altered equipment figures. Two companies carried on their books assets that they did not own or had grossly overvalued. Significantly, in only one case did the SEC allege that the company was motivated by a desire to meet analysts’ expectations. The SEC did, however, bring two actions in 1999 against companies for misusing the concept of materiality to manage earnings.

A personal charge. As part of its effort to foster a cultural change in the financial community, the SEC filed actions against corporate officers personally as part of the sweep. The SEC named the current or former CEO as a defendant in 11 of the 15 actions. For example, as part of its action against KnowledgeWare Inc. for parking inventory with resellers (with a right not to pay), the SEC charged CEO Fran Tarkington with fraud, alleging that he had known about and directed the practice. The SEC is also pursuing persons who are not directly involved in the financial reporting process—spreading its net both wider and deeper into the corporate structure. It brought enforcement actions against three KnowledgeWare vice presidents of sales and a district sales manager, each of whom had granted unconditional rights of return through secret side agreements.

Casting a wider net. In *SEC v. Computone Corp.*, alleging the company had recognized revenue from transactions where the customer had never placed an order or for products never shipped, the SEC charged the CEO, CFO, former CAO, two VPs of sales, sales director, and sales manager. In each instance, it did not allege that the officer had a central role in the financial reporting process, but rather that each had engaged in misconduct, resulting in the fraudulent reporting. The SEC has even brought actions against third parties. In the *Model Imperial* case, the SEC brought a cease-and-desist action against the company’s vendor, alleging that it had provided false invoices. In *Sunrise Medical*, the SEC filed against an outside information systems consultant who helped the company to manipulate its

accounting software. The SEC's willingness to examine the reasonably foreseeable effects of an individual's actions, combined with its recent emphasis on qualitative factors in materiality analysis, will expand the scope of the individuals who may face SEC scrutiny.

Customize for the New Economy. Increasingly, corporate financial value comprises intangibles, such as intellectual capital, intellectual property, software, and websites. These New Economy assets compel companies to use more judgment in accounting and may create more opportunities for fraud. The SEC's May 2000 case against AOL typifies the difficulty in applying existing accounting principles to new business models. AOL distributed software disks to prospective customers, accounting for the cost as an asset (which it amortized) rather than an immediate expense. The SEC charged that this violates the rule against capitalizing direct response advertising costs unless the company has a history of obtaining customers and net revenue in excess of the costs. Agreeing to take a \$385 million charge against earnings, AOL paid a \$3.5 million civil penalty. The SEC has asked the FASB to address other accounting practices common to Internet-based companies, particularly accounting for barter transactions and booking revenues for sales of products made through another company's website. Because the market appears to value dot.com revenues more than profits, the SEC is concerned that these practices may inflate the company's revenues and seeks to tighten the standards.

Financial Reporting For International Joint Ventures

By Stephen Sayer, Richards Butler, London, England; and Graham Ackery (ret.)

International Company & Commercial Law Review
Vol. 11, No. 5, Pgs. 176-183

Overview: *Travels through the accounting and legal complexities of an international joint venture. Explores issues that arise when the venture must reflect its accounts on both its own books and those of its joint venturers, focusing on British law and standards.*

Different countries, different forms. The financial accounts of a joint venture can take many forms, and the choice becomes more complex when the venturers are from different countries. Each jurisdiction's standards may conflict on the legal, currency choice, accounting, taxation, and reporting requirements. In most countries, companies must present a true and fair view of their financial condition, pursuant to local accounting practices; unfortunately, no international

GAAP exists. The joint venture agreement should specify the presentation of management accounts, audited accounts, auditors' appointments, and other financial practices, each of which is reflected on the enterprise's books. The venture's legal form will, in part, dictate many of the decisions. For example, British law recognizes four basic venture forms: a partially owned subsidiary, whose dominant parent retains the majority of the voting rights and the power to appoint or remove directors; an associate, in which venturers have significant (but not controlling) influence; a contractual arrangement, which is not a separate entity but merely a joint business operation; and a true joint venture, created by two or more parties as a jointly controlled, separate entity.

Local requirements. If a separate entity, the joint enterprise must comply with local accounting practices and domestic corporate and partnership law. In most Western countries, the company must assert that its financial statements were prepared in accordance with local standards or explain why not. Even subsidiaries must do so (although subs and joint ventures may also have to prepare financials in accordance with the parent's national accounting standards, so they can be consolidated). Reports must be audited by an independent auditor in accordance with local standards. For a sub or associate, the parent usually relies on its own auditors; for a joint venture, the parties must agree on the auditor's appointment. Using either party's auditor might create a conflict of interest, but often joint auditors—one leading and the other reviewing the work for accuracy—will suffice.

Assuming a duty and a liability. The directors assume a legal duty by having financial reports prepared—and the auditors by certifying their accuracy. They expose themselves to liability because present and potential investors, lenders, and trade creditors rely on the financials. Current investors may use the statements not only to evaluate the investment, but also to prepare their own financial reports. Potential investors may base their investment decision on the financials. Lenders usually require a parent's guarantee of a joint venture's debt, but they may seek access to the joint enterprise's audited financials as well. Even trade creditors might seek comfort on the venture's creditworthiness, although they often leave the task to an independent credit agency. The tax authorities frequently need the financials as support for the returns of the joint venture and the individual venturers. Finally, the joint venturers will need the statements to consolidate the venture's accounts with their own (when it is structured as a separate entity).

Consolidation. The exact method of consolidation depends on the enterprise's nature. The subsidiary's entire assets and liabilities are reflected in the parent's consolidated accounts, subject to showing the minority's interest. Each parent accounts for its interest in an associate by using the equity method, which values the interests based on the associate's accounts rather than the investors' capital. Each parent includes in its own accounts its share of the profits (losses), not just the dividends received, and its share of the associate's assets in the parent's own assets account. This accounting also applies to a true joint venture, but each venturer also discloses its share of the venture's turnover as a separate item in the profit-and-loss account. On its balance sheet, each venturer analyzes net assets. Current account balances between the venturer and the enterprise are not eliminated but are included as current assets or liabilities.

M&A

Applying The New M&A Filing Rules

By Stephen Glover and James Moloney
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M&A Lawyer
Vol. 4, No. 3, Pgs. 11-23

Overview: *Compares prior law with the new safe harbors available for statements made by acquirors and targets about planned mergers and acquisitions. Applies the SEC rules to various communications commonly made by parties to business combination transactions.*

1933 Act safe harbors. Acquirors and targets often wish to communicate with stockholders about a planned transaction. Under prior law, companies were concerned that issuing a press release before filing a registration statement for any newly offered shares would be considered an offer to sell the securities and thus violate 1933 Act Section 5. Under new law, effective in January 2000, safe harbors now exist to alleviate these concerns. Rule 165 under the 1933 Act allows companies to make public statements concerning potential transactions without violating Section 5, as long as the issuer files written communications with the SEC and contain a legend advising investors to review the complete offering documents filed with the SEC. Most documents filed under Rule 165 will be deemed prospectuses, subject to liability under 1933 Act Section 12 if they contain material misstatements or omissions.

Safety in proxy and tender offer rules. A communication to shareholders in a stock-for-stock transaction could be considered a proxy solicitation. Before the new SEC rules took effect, such solicitation was prohibited before the issuer had delivered a definitive proxy statement to the stockholders. Under new 1934 Act Rule 14a-12, an acquiror or target can communicate with security holders before providing the proxy statement if it files the communication with the SEC no later than the date on which the communication is first published. The material must include a legend advising stockholders to read the definitive proxy statement, must list the participants in the solicitation (which, at a minimum, means the directors), and must describe the participants' interests in the transaction. Without the new safe harbors under the tender offer rules, bidders could not make public statements about the deal until they had prepared and were ready to disseminate all the required materials. The bidder is now protected under the new rules if it files the written communication with the SEC on the date of first use and includes the legend reminding stockholders to review the tender offer statement.

Communications with investors. The new rules do not require companies to file a copy of every communication they make while negotiating and completing a business combination transaction. Information concerning the company's ordinary course of business need not be filed. Clearly, the company's initial press release announcing the transaction and any follow-up press releases concerning the transaction should be filed. To comply with the safe harbor requirements, a company must file only written communications provided to persons who are not parties to the transaction, although "written" may include any audio or videotape of a conference call with analysts or investors that is available for future playback. In presentations to analysts and investors, if the company uses a script or a prepared set of questions and answers, these written materials probably should be filed. A speech delivered once may not require filing unless copies of it are handed out. Slides presented during a road show should be filed. The SEC staff has encouraged companies to file any merger-related materials delivered to employees, because employees are frequently investors as well.

Communications with third parties. An issuer generally needs to provide information about the proposed transaction to lenders, rating agencies, customers, suppliers, and other outside parties. The SEC staff has stated that information provided to banks about an impending merger need not be filed as long as the information is confidential and the bank is not an investor being

encouraged to approve the transaction. Similarly, materials provided to rating agencies are not filed because the agencies are not making an investment decision concerning the securities. Companies generally have not filed copies of communications sent to suppliers or customers, asserting that the communications do not contain new information and are unlikely to become public. Filings made with other governmental agencies do not need to be filed with the SEC unless they contain information that is material and not previously included in SEC filings.

And The Factory Goes To...: How To Succeed In Selling Your Business Without Really Trying (Too Hard)

By Fredric Tannenbaum, Gould & Ratner, Chicago, IL
Business Law Today
July/August 2000, Pgs. 23-28

Overview: *Outlines the roles of the advisory team for sellers of private companies. Advises on steps before, during, and after the sale that will insure a smooth transaction. Considers practicalities such as the mechanics of due diligence and ways to retain or remove key employees. Highlights common judgmental errors that contribute to suboptimal results.*

The advisory team. Selling a privately held business to the seller's best advantage requires considerable planning and methodology, to which a proper advisory team can contribute greatly. An investment banker can suggest a supportable range of expected values for the business, prepare the offering memorandum, advise on sale methods that will optimize value realization (for example, auctions, direct contacts, exclusive dealing), and help prequalify potential buyers. The accountant is essential in evaluating and, if necessary, recasting the seller's financial statements into proper form, as well as in advising on tax implications. The lawyer will review the offering memorandum, evaluate the structure of competing offers, supervise the due diligence process, draft documentation (including confidentiality and employment agreements), obtain consents, and generally supervise the corporate housekeeping and cleaning up of contingent obligations.

Keeping the sale process smooth. Sellers should be tidy and efficient in providing potential buyers with all relevant information to inform their due diligence needs. Creating a segregated "data room" with indexed files is often quite helpful. Exercise caution, however, to avoid merely fueling pseudo-buyers' competitive curiosity. Phase disclosures to flush out fakers. Properly timed disclosure to employees by both seller and buyer will

also preserve value in the business. Couple this, where necessary, with retention bonuses and other devices either to retain employees after the closing or keep them motivated until the closing. Recasting the financial statements to reflect normal public company practices and values may be essential in assisting buyers' evaluation. Factors to monitor include unusual payroll practices and related-party transactions to accommodate the owners' families; inventory levels; asset capitalization or expensing; and special depreciation schedules, employed for tax minimization purposes.

Errors and omissions. Several common errors by sellers contribute to less-than-satisfactory sale prices and transaction experiences. Among these are being too impatient to close, erring in timing when to announce the sale to employees, retaining related employees and minority shareholders, and failing to assess the buyer's financial condition properly. Affirmative steps can foreclose embarrassing and expensive postclosing confrontations with the buyer. Make sure to disclose all material information, collect all necessary third-party consents, clarify the postclosing obligations of buyer and seller, and fully understand all the seller's representations and warranties. The seller should protect its postclosing interests by ensuring that the buyer cannot manipulate the criteria for any earnout payments and by inserting liability caps and warranty-survival limits into the P&S agreement.

SECURITIES OFFERINGS

What Can We Do Now That Our Public Offering Has Aborted?

By Stanley Keller, Palmer & Dodge, Boston, MA
Insights: Corporate & Securities Law Advisor
Vol. 14, No. 7, Pgs. 3-6

Overview: *Examines the issues involved in privately raising money after a failed public offering. Explores the available alternatives and the factors to be considered when structuring the private offering.*

Avoiding integration. If a company begins the process of offering securities publicly and is unable to complete the journey, it often must resort to raising funds privately. It must then be careful when structuring the private offering, to avoid integration with the aborted public offering. If integrated, the solicitation used in the public offering will violate the private offering exemption requirements. To achieve the necessary separation,

the company could sell a different security. It may sell equity in the private transaction only to qualified institutional buyers (“QIBs”) and a few other large institutional buyers. To qualify the offering under Regulation D, the issuer must wait six months from the withdrawal of the registration statement before offering securities privately. It may also be able to sell shares offshore under Regulation S.

Consider the facts. Counsel will need to consider the facts of a particular private offering to determine whether it would be integrated with the prior public offering. First review the sophistication of the private investors and their prior connection, if any, with the issuer. Assess the level of marketing activity undertaken in the aborted public offering, and consider whether the registration statement filed in connection with the public offering has been withdrawn. Any differences between the equity offered privately and the security that was publicly offered should be evaluated. Finally, look at how much time has elapsed since the end of the public offering. Each of these considerations will weigh for or against viewing the offerings as integrated.

The type of investors. As outlined in the SEC’s 1990 *Black Box* no-action letter, the issuer could sell securities privately to QIBs after an aborted public offering without waiting and without withdrawing the registration statement if the public offering had not been marketed and if the other requirements of a private offering were met. Should general marketing activity have taken place, the private offering might still be permissible if the private investors have a preexisting relationship with the company. When the investors in the private offering are institutional investors who are not QIBs as set forth in *Black Box*, the registration statement should be terminated. Let at least 30 days elapse before the private offering. If the investors are not all accredited, the company might be required to wait six months before making the private offering in order to comply with Regulation D.

The securities being sold. The public and private offerings are less likely to be integrated if a different security is sold in the second offering. Preferred stock immediately convertible into common would not constitute a different security. However, if the preferred is not convertible for a certain period of time, the security may be considered different than the underlying common stock that had been offered in the withdrawn public offering. Even if the preferred stock is not convertible for a relatively long period of time, a sale to nonaccredited investors would be problematic if made soon after the registration statement’s termination.

EXECUTIVES & DIRECTORS

Net Envy And Delaware Law: Recent Delaware Decisions Affecting Executive Compensation

By Peter Ladig, Richards Layton & Finger, Wilmington, DE
Corporate Governance Advisor
Vol. 8, No. 3, Pgs. 5-14

Overview: Surveys recent Delaware cases on conflicts between stockholders and directors over options plans and executive employment contracts. Provides guidelines by which directors can protect themselves.

When directors compensate themselves. Four recent Delaware cases deal with stockholders’ challenges to directors’ development, approval, and activation of option plans and employment contracts for executives. *In re 3Com Corp. Shareholders Litigation* concerned a stockholders’ suit to invalidate the directors’ grants of stock options to themselves. The Court of Chancery reviewed the grants under the business-judgment rule, rather than the entire-fairness standard applicable to an “interested transaction,” because the stockholders had approved the option plan. Accordingly, the plaintiff/shareholders could prevail only by proving corporate waste. A waste claim, the court said, could not succeed merely by alleging that the company had received inadequate (as opposed to no) consideration for the option grants. Nor was the court persuaded by a precedent in which waste was found in the grants of options with a smaller present value per director.

What the plan permits. In *Sanders v. Wang*, the stockholders challenged option grants by a directors’ compensation committee to directors who were also key executives. Under the option plan, which the stockholders had approved, some of the grants were contingent upon the stock reaching certain price targets. The plan specifically permitted the committee to adjust the price targets to account for stock splits, but it was silent on adjusting the number of options subject to grant. After three splits, the compensation committee adjusted both. Although the plan gave the committee the power to interpret the plan, the chancery court held that the committee could not adjust the number of options and thereby change the plan’s substantive terms. *Wagner v. Selinger* held that directors did not commit waste by entering into a separation agreement with a departing CEO who already had an employment agreement, even though the newer agreement gave greater benefits. Because the CEO had given some additional consider-

ation, the chancery court refused to question the directors' decisionmaking process or even to determine if the consideration had been adequate.

Great deference to boards. In *Brehm v. Eisner*, which concerned Michael Ovitz's departure from Disney, the Supreme Court held that a board's decision about executive compensation should receive great deference and that a board acts properly as long as it does not unconscionably or irrationally squander corporate assets. Therefore, an employment agreement does not constitute waste just because the employee would earn more by engineering a premature termination without cause than by fulfilling the contract terms. The court also refused to function as super-directors and question the board's decision not to fire the executive for cause, finding that the stockholders challenging the deal had failed to demonstrate no reasonable person in the circumstances would have decided as the board had.

Guidelines for directors. The cases show that a board has a lot of flexibility in awarding executive compensation. A board that retains and properly relies on an expert is entitled to the presumption that it used its business judgment. The business-judgment rule generally protects the board's decisions made under an employment agreement or a shareholder-approved option plan. As the severe holdings in *Sanders* and another chancery case indicate, a board should stay within the terms of a stock option plan or executive employment contract, because Delaware courts tend not to look outside the four corners for the drafter's intent. Shareholder approval of a plan or contract, while not required in Delaware, provides two advantages. First, absent waste, the business-judgment rule will protect directors' grant of options to themselves. Second, the shareholders could well be precluded from later alleging that the directors did not use due care in devising the contract or plan.

Managing And Monitoring: The Dual Role Of Non-Executive Directors On UK And US Boards

By Dr. Rita Esen

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International Company & Commercial Law Review
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Overview: *Examines the conflicting roles of directors in unitary board systems. Considers reform measures to enhance the monitoring functions of outside directors. Contrasts the Anglo-American unitary system with European two-tier directorates, and detects no inherent advantage in either.*

So much to do, so little time. In the Anglo-American structure of a unitary corporate board, all directors,

whether inside or outside directors, stand responsible for both managing the company's business and monitoring the performance and good conduct of the hired management. Outside directors, who typically hold senior positions in other corporations, have only limited time to devote to the board of their non-employer. The dual legal roles thus in practice shortchange the supervisory function, so reformers have placed great weight on encouraging these outside directors to concentrate on the oversight functions. In the UK, several self-regulatory committees have issued reports, which the London Stock Exchange has appended to its Listing Rules under the heading of The Combined Code. The LSE requires listed companies to comply with the Combined Code or explain why they do not; the New York Stock Exchange's rules achieve similar results.

Reforms focus on outside directors. The reports comprising the Combined Code recommend that public corporations have outside directors, that companies declare which outside directors are truly independent, that directors submit to at least triennial election, and that the task of nominating directors fall to a committee of outside and mostly independent directors. Other suggestions include the formal qualification and chartering of independent directors and an explicit annual board review of internal control systems. In the US, many of these reforms have already been adopted, whether through the exchanges' rules, the ALI Principles of Corporate Governance, or otherwise as a result of litigation.

Structural impediments to monitoring. All the US and UK reform efforts retain to the unitary board system. Within that system, even given its reliance on outside directors, informal forces—appointment by managers, social and professional ties between directors, and the concur-or-resign method of handling policy differences—impede the forceful exercise of monitoring functions. Even otherwise-independent directors are hamstrung by these informal influences. Another limiting factor is the control that management exercises over what information the board receives. The European-style two-tier board would, upon first examination, seem to offer an antidote to these deficiencies. A board of managers or an executive committee exercises sole control over the daily operations, while a supervisory board, consisting of outside directors, performs the monitoring functions. Because of limited powers over the executive committee and a highly inbred pool of supervisory members, however, the two-tier system has not shown any notable difference from the unitary system in controlling management, preventing abuses, or improving corporate performances.

INDEX JANUARY-JUNE 2000

Editor's Note: Back issues of the *Bowne Digest* are available online at www.bowne.com under the heading "Resources."

Audit Committees

New Audit Committee Requirements, May, p. 4
The New Audit Committee Rules, May, p. 5

Buy/Sell Agreements

Buy-Sell Agreements Developed As Estate Planning Vehicles Require Foresight And Periodic Review, March, p. 1
What Every Business Lawyer And Business Owner Should Know About Buy-Sell Agreements, March, p. 2

Closely Held Corporations

Slicing It Up, January, p. 3

Directors' Duties & Liabilities

Corporate Opportunity Doctrine And Interested Director Transactions: A Framework For Analysis In An Attempt To Restore Predictability, February, p. 5
Equity Ownership And The Duty Of Care: Convergence, Revolution, Or Evolution?, June, p. 5
Rethinking Judicial Review Of Director Care, June, p. 6
"A Delicate Interplay": Resolving The Contract And Corporate Law Tension In Mergers, June, p. 7

Disclosure Duties

Malone v. Brincat: The Fiduciary Disclosure Duty Of Corporate Directors Under Delaware Law, March, p. 5
The Statutory Safe Harbor For Forward-Looking Statements In The Courts: A Scorecard, March, p. 6

Dissenters' Rights

The Unfairness Of Applying Lack Of Marketability Discounts To Determine Fair Value In Dissenters' Rights Cases, March, p. 7
Fair Value And Fair Price In Corporate Acquisitions, March, p. 7

Due Diligence

Due Diligence: The Overlooked Cornerstone, January, p. 6

Executive Compensation

The Effect Of Shareholder Proposals On Executive Compensation, February, p. 3
Corporate Executive Deferred Compensation: Should The Exercise Of Stock Appreciation Rights (SARs) Trigger Securities Law Liability?, February, p. 4

Global M&A

Northern Exposure: Considerations For A US Bidder Acquiring A Canadian Target, March, p. 3
What Do You Get When You Cross A Kangaroo With An American Company?, March, p. 4

Lawyers Investing In Clients

Who Wants To Be A Millionaire?, April, p. 1

Mergers & Acquisitions

Using Stock As Acquisition Consideration, January, p. 2
Qualified Plan Issues Pervading 401(k) Plan Mergers, January, p. 3
When The Seller Has Internet-Related Business, February, p. 6
Employee Benefit Issues In Corporate Mergers And Acquisitions, February, p. 7

Financial Statement Requirements For Acquisitions In Registered Public Offerings, April, p. 4
The Impact Of Technology On Acquisition Confidentiality Agreements: Doing Deals In The Internet Age, April, p. 5
All Buyouts Are Not The Same: It Can Be Different In England, May, p. 8
The SEC's New M&A Rules In Operation: What's Different?, June, p. 3
When The Tail Wags The Dog: Environmental Considerations And Strategies In Business Acquisitions, Sales And Merger Transactions, June, p. 4

No-Shop And Fiduciary-Out Clauses

No-Talk And Fiduciary-Out Provisions In Delaware After *Phelps Dodge, Capital Re* And *IXC*, May, p. 1
Understanding Fiduciary-Outs: The What And The Why Of An Anomalous Concept, May, p. 2
A Rubeophobic Delaware Counsel Marks Up Fiduciary-Out Forms, May, p. 3

Partnerships And LLCs

Employee Benefits Aspects Of Partnerships And LLCs, May, p. 3

Poison Pills

Continuing Directors Provisions: These Next Generation Shareholder Rights Plans Are Fair And Reasoned Responses To Hostile Takeover Measures, April, p. 2
Death Toll For The Dead Hand?: The Survivability Of The Dead Hand Provision In Corporate America, April, p. 3

SEC Supervisory Functions

Regulatory Supervision By The Securities And Exchange Commission: Examinations In A Disclosure-Enforcement Agency, June, p. 8

Securities Disclosure & Regulation

The Disintermediation Of Forward-Looking Disclosures, April, p. 4
Half-Truths: Protecting Mistaken Inferences By Investors And Others, May, p. 6
The Impact Of Securities Laws On Developing Companies: Would The Wright Brothers Have Gotten Off The Ground?, May, p. 7

Securities Law In Cyberspace

The SEC's Statutory Weaponry To Combat Internet Fraud, January, p. 7
State Law Amendments Make It Easier To Implement Electronic Proxy Voting, March, p. 3
The Internet And Its Challenges For The Future Of Insider Trading Regulation, June, p. 1
Securities Regulation In The Electronic Era: Private Placements And The Internet, June, p. 2

Securities Offerings

The SEC Cracks Down On Directed Share Programs, January, p. 4
The Public Offer Of Securities In The United Kingdom, January, p. 5
How Quantum, DLJ And Ziff-Davis Are Keeping On Track With "Tracking Stock," February, p. 1
Recirculation Of A Preliminary Prospectus: Statutory Basis And Analytical Techniques For Resolving Recirculation Issues, February, p. 2

Shareholder Proposals

The 1999 SEC No-Action Letters: Weakened Protection For Corporate Governance Proposals, April, p. 6

Spinoffs

Spinoffs, Fiduciary Duty, And The Law, January, p. 1