CORPORATE GOVERNANCE:
HOW TO STAY OUT OF TROUBLE, POST SARBANES-OXLEY

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I. Background

A. Sarbanes-Oxley was a reaction to corporate scandals and lack of investor confidence.

1. Enron/Arthur Andersen

2. Worldcom

3. Health South

B. Sarbanes-Oxley is a combination of:

1. Sarbanes-Oxley Act of 2002 (H.R. 3763)

2. Pending and final rules of the Public Company and Accounting Oversight Board (PCAOB)

3. Pending and final rules of the SEC

4. Studies by the GAO and others that may result in new laws and/or new rules.

C. Violations of Sarbanes-Oxley are considered violations of the Securities and Exchange Act of 1934.

D. New Crimes Statutes and Enhanced Penalties:

1. False Certification of 10k's and 10Q's by CEO and CFO.

    a. 10 years if knowingly, 20 if willfully.

    b. Must reflect true financial condition of company (in all material aspects).

2. Maximum fine of $5,000,000 and maximum prison sentence of 20 years for CEO's and CFO's that willfully certify a financial statement knowing that it is inconsistent with the sections of the Act.

3. New Securities Fraud Crime

    Knowingly defraud or attempt to defraud another in connection with sale of securities.

4. Maintaining Papers Crime

    a. Keep all audit papers for 5 years or go to jail for 10.

    b. If registered, audit firm keeps them for 7 years or go to jail for 20.

5. Whistleblowing

    Up to 10 years in jail if supervisor knowingly takes any harmful action:

        i. (that interferes with employee's livelihood).

ii. With the intent to retaliate against him.

iii. When employee has provided truthful information to law enforcement of possible commission of federal offense.

E. Act applies to "issuers:"

1. As defined in section 3 of the Securities and Exchange Act of 1934 and;

2. Any public company or company that plans an IPO;

3. Companies with more than $10 million in assets and whose securities are held by more than 500 owners;

4. Public accounting firms that perform audits for "issuers";

5. Plus, there may be special rules and/or rule effective dates for:

a. Investment companies

b. Foreign private issuers

II. Public Company Accounting Oversight Board

A. Established by Sarbanes-Oxley

B. Organized as a nonprofit agency – not as a government agency

C. Responsibilities:

1. Register and inspect public accounting firms.

2. Establish standards for public accounting firms.

3. Enforce compliance with the act and rules of the Board.

4. Investigate firms and impose sanctions.

III. Corporate Responsibility Under Act

A. Public Company Audit Committees

1. Responsibility to appoint, compensate and oversee the public accounting firm that performs the audit to the audit committee.

2. Companies that are not compliant with SEC audit committee requirements are subject to delisting.

3. Audit committee is responsible for oversight of auditors including the resolution of disagreements between management and auditors.

4. Audit committees must set up procedures to receive and address "whistleblower" complaints.

5. Employees and others may take concerns directly to the audit committee.

6. Audit Committee members are required to be independent and a disclosure is required in proxy statements.

B. CEOs and CFOs must:

1. Certify with respect to the accuracy and completeness of annual and quarterly reports, including the financial statements, and must make required disclosures about:

a. Fraud

b. Significant deficiencies and material weaknesses, and significant changes in internal controls; and

c. Evaluation of the effectiveness of the disclosure controls and procedures.

2. Take responsibility for disclosure controls, including:

a. Establishing and maintaining system of disclosure controls and procedures so CEO and CFO can:

i. Supervise and review periodic evaluations of the disclosure system and

ii. Report results to security holders.

b. Effectiveness of disclosure controls and procedures must be assessed within 90 days prior to filing dates of quarterly and annual reports.

c. Failure to maintain adequate disclosure controls and procedures may result in SEC action even if it doesn't lead to flawed financial statements.

C. Corporate officers must also be aware of the following effects of Sarbanes Oxley:

1. Makes it unlawful to fraudulently influence, coerce, or mislead an auditor.

2. Prohibits loans to officers and directors. (See VI. Compensation Committees and Executive Compensation).

3. Provides for the forfeiture of certain compensation following the issuance of a "non-compliant" financial document. (See VI. Compensation Committees and Executive Compensation).

4. Provides the SEC with greater flexibility to remove management or board members.

5. Blocks insider trading during pension fund blackout periods.

6. Requires attorneys to report evidence of material violations.

7. Provides that disgorged profits will benefit victims.

IV. Enhanced Disclosure Requirements

A. Overview

1. Requires disclosure of material off balance sheet arrangements.

2. Establishes standards for reporting non-GAAP financial information.

3. Requires earlier disclosure of equity transactions by directors, officers and other insiders.

4. Requires management to establish and maintain adequate internal controls and procedures for financial reporting.

5. Requires disclosure of a code of ethics for senior financial officers.

6. Requires companies to disclose whether at least one of the audit committee members is an audit committee financial expert.

7. Requires rapid disclosure of changes in financial condition.

B. Management Assessment of Internal Controls

1. Will require management to establish and maintain adequate internal controls and procedures for financial reporting.

2. Beginning with annual reports filed after June 15, 2004 (for accelerated filers) and April 15, 2005 (other filers), each annual report must include a statement:

a. Describing management's responsibility for internal controls and procedures for financial reporting.

b. Documenting management's assessment of the effectiveness of the controls and financial reporting procedures.

c. Incorporating the independent auditor's review of management's assessment of internal controls and financial reporting procedures.

C. SEC release defines internal controls and procedures for financial reporting as controls that provide reasonable assurances that:

1. Transactions are properly authorized.

2. Assets are safeguarded against unauthorized or improper use.

3. Transactions are properly recorded to permit the preparation of financial statement that is presented consistent with GAAP.

D. To meet the assessment requirement, management must select a suitable recognized framework for assessing the effectiveness of internal controls.

V. Attorney Ethical Issues and Considerations (Reporting Up)

A. Overview: Section 307 of Sarbanes Oxley

1. The SEC has issued rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issue. These rules became effective on August 5, 2003.

2. Mandates that attorneys report evidence of material violations of securities law, or breaches of fiduciary duty or similar violations, to the chief legal officer or CEO.

3. If the reporting attorney does not believe the response is appropriate, he or she must "report up" to the board, to the audit committee, or to another board committee comprised solely of outside directors.

B. Rules Apply to:

1. Attorneys

2. Representing an issuer – meaning there must be an attorney client relationship.

3. Appearing and Practicing before the SEC – This should be interpreted very broadly, and covers any situation where there is a nexus between the attorney's representation and the SEC. For example, an attorney having notice that a document for which he is providing legal advice will be filed with the SEC (even as an exhibit).

C. What triggers the obligation to reporting up?

1. There must be credible evidence of:

a. Material Violation of U.S. Federal or State Securities Laws

b. Material Breach of a Fiduciary Duty

c. Similar Material Violation of any U.S. Federal or State Law

2. Evidence must be credible.

3. Violation must be material.

D. Up the Ladder Reporting

1. In the above context and upon discovery of credible evidence of a material violation, an attorney must report such evidence to:

a. Report first to the Chief Legal Officer/CEO of the issuer

b. Obligations of the Chief Legal Officer

i. Determine whether the material violation has occurred, is occurring, or is about to occur.

ii. If there is no material violation, he must notify the reporting attorney and advise him the basis for the decision.

iii. Unless CLO reasonably believes that no material violation has occurred, is occurring or is about to occur, he must take reasonable steps to cause the

issuer to adopt an appropriate response and must advise the reporting attorney of that response.

iv. As an alternative, the CLO may report to a QLCC.

c. Response from CLO/CEO

i. If a reporting attorney receives an "appropriate response" from the CLO/CEO, he or she has no further reporting obligations.

ii. If, however, a reporting attorney believes that the response of the CLO/CEO was not appropriate, the reporting attorney must present the evidence of the material violation to the Audit Committee, a Qualified Legal Compliance Committee, or the full board of directors.

d. Report to Audit Committee, QLCC or Board

i. If the Audit Committee or Board provides an appropriate response to the reporting attorney, he or she has no further obligations.

ii. If the Audit Committee or the Board does not provide an appropriate response, the reporting attorney should indicate that he or she disagrees

with such response. However, unless the "noisy withdrawal" proposals become effective, the reporting attorney has no further obligations.

iii. If report is made to the QLCC, the reporting attorney has no further obligations under any circumstances.

E. Appropriate Response to Reporting Attorney

1. No violation

2. Company has taken appropriate remedial measures

3. Company conducts investigation followed by appropriate remedial measures or an assertion of a colorable defense.

F. Special Considerations

1. Supervising/Subordinate Attorneys

a. An attorney who has decided to report to a QLCC or to his supervisory attorney has fulfilled his obligations and need not evaluate the response.

b. A subordinate attorney is protected by reporting up to a supervisory attorney. (This is consistent with ABA Model Rule of Professional Conduct 5.2(b), Responsibilities of a Subordinate Lawyer).

2. QLCC

a. Issuer may establish a QLCC consisting of at least one member of the audit committee and at least two other independent directors.

b. QLCC must:

i. Have written procedures.

ii. Be authorized by the Board to initiate an investigation conducted by the CLO or outside counsel.

iii. Be authorized to recommend that the issuer implement responsive actions.

iv. Have the authority and responsibility to take other appropriate action, including notifying the SEC in the event that the issuer fails to implement a recommended response.

v. Most issuers have not established a QLCC at this time. This, however, may change if the noisy withdrawal proposal becomes effective.

3. Revealing Confidential Information

a. An attorney *may* reveal confidential information to:

i. Prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests of investors;

ii. To prevent the issuer from committing perjury or an act that is likely to perpetuate fraud upon the Commission; or

iii. To rectify the consequences of a material violation by the issuer in furtherance of which the attorney's services were used.

G. Noisy withdrawal – still under consideration by SEC

1. Would require a company, under certain circumstances, to disclose a lawyer's decision to withdraw as company's counsel.

2. Under one version favored by one of the five SEC commissioners, if a company failed to disclose an attorney withdrawal, the attorney himself would be required to inform the SEC that he was withdrawing for "professional consideration(s)."

3. Under an alternative version of this rule, an attorney would be required to withdraw, under certain circumstances, but would not have to notify the SEC of his withdrawal and would not have to disavow any filings.

4. Either version would be in addition to the "reporting up" provisions discussed earlier.

5. The problem is these proposed rules interfere with attorney-client relationships, State Bar Associations and American Bar Association's codes of conduct.

VI. Compensation Committees and Executive Compensation

A. Prohibition of Loans to Directors and Officers.

Section 402 of the Sarbanes-Oxley Act contains a broad prohibition against a company directly or indirectly extending, maintaining, arranging or renewing a personal loan for any director or executive officer. While existing loans or extensions of credit outstanding at the effective date of the prohibition will not be subject to the provisions of the Act, no material modification to such loans or extensions of credit may be made. The legislation did not contain a definition of "personal loan" and no guidance from the Securities and Exchange Commission has been issued with respect to what is and is not covered by the term "personal loan". Among the practices which may be covered are split-dollar insurance policies, broker-assisted cashless option exercises, indemnification expense advances, cash advances for anticipated business expenses, and participant loans from 401(k) plans. As part of its oversight responsibility, the compensation committee should understand how the company is complying with this statutory mandate.

B. Recapture of Incentive Compensation.

Section 304 of the Sarbanes-Oxley Act requires that a CEO and CFO disgorge any bonus or other incentive-based or equity-based compensation or trading profits they receive during a 12 month period after the company is required to restate its financial statements as a result of "misconduct". In addition to assuring compliance with this statutory provision, the compensation committee may consider whether to adopt a broader use of "recapture" policies to recover bonus or other incentive-based award when a person has participated in conduct which adversely affects in a material way corporate performance.

C. Disney Decision – Breach of Fiduciary Duty of Good Faith.

1. Chief Justice Veasey's comments foreshadow the possibility that Delaware courts could find a breach of good faith for executive compensation decisions. In the recent case *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. May 28, 2003), a Delaware court for the first time recognized a claim for breach of the duty of good faith in connection with a compensation matter. In this case, Chancellor William Chandler denied a motion to dismiss an allegation that the directors of the Walt Disney Company failed to exercise good faith when determining the compensation for former Disney President, Michael Ovitz. The Chancellor found that because the complaint raised a reasonable

doubt that the decision to compensate Ovitz was made in good faith.

2. This shareholder derivative litigation arose out of Disney's $140,000,000 severance payment to Ovitz and the complaint alleged that the outside directors failed to obtain basic information about the Ovitz' contract and then permitted Michael Eisner, the CEO, to unilaterally arrange for termination benefits beyond those he was contractually entitled to. According to the complaint, the draft employment agreements were not presented to the compensation committee and the committee did not ask any questions about the potential compensation or retain a compensation expert for guidance. Both the compensation committee and the board allegedly met for less than one hour before approving the contract. The court noted if the board had taken the time or effort to review the company's options with respect to Ovitz' termination, perhaps with the assistance of expert advisors, the business judgment rule might well have protected the decision. The decision points out the importance of an informed judgment and a process utilizing expert advice.

D. "Spinning" – Allocation of IPO Shares to Directors

1. *In re Ebay, Inc. S'holders Litig.*, No. C.A. 19988-NC, 2004 WL 253521 (Del. Ch. Feb. 11, 2004) concerns a derivative action

brought by shareholders of eBay, Inc. against certain directors and officers of eBay. Goldman Sachs was retained by eBay in connection with eBay's IPO, a subsequent secondary offering, and other significant transactions. The plaintiffs alleged that the defendants breached their fiduciary duty by accepting allocations of shares of various IPO offerings from Goldman Sachs. At the time, such allocations were often very lucrative due to the active IPO market. IPO stock often doubled or tripled during the first day of trading, allowing those receiving allocations to quickly sell the shares at a substantial profit (a practice known as "Flipping" or "Spinning"). The plaintiffs allege that "Goldman Sachs bribed certain eBay insiders, using the currency of highly profitable investment opportunities – opportunities that should have been offered to, or provided for the benefit of eBay rather than the favored insiders." *Id.* at *1.

2. The defendants moved to dismiss the action based on, among other things, plaintiff's failure to state a claim because the IPO allocations did not constitute usurping a corporate opportunity. The defendants argued that the allocations "were 'collateral investment opportunities' that arose by virtue of the inside directors' status as wealthy individuals." *Id.* at *4. They also

argued that such transactions were not corporate opportunities because they were not a part of eBay's normal line of business. *Id.*

3. The Court found that IPO transactions were corporate opportunities because eBay regularly invested in equity and debt securities as part of its cash management and had the financial ability to capitalize on the IPO allocations had they been offered to eBay. *Id.* The Court did not view its holding as preventing officers or directors from capitalizing on all advantageous investment opportunities. The Court noted that this situation was unique in that the opportunity came from the Company's investment banking firm and placed the defendants in a conflict of interest. The Court also determined that even if such opportunities were not corporate opportunities, accepting them still may constitute a breach of the fiduciary duty of loyalty, which required the defendants to account for personal profits or transactions involving the company. The court held that the allegations gave rise to a reasonable inference that the IPO allocations were commissions or gratuities from Goldman Sachs for eBay's business that rightfully belonged to eBay. The court also refused to dismiss Goldman Sachs based on the Court's belief that the plaintiffs had adequately stated a claim that Goldman Sachs aided and abetted defendants' breach of fiduciary duties.

4. This holding is important for several reasons. First, it clearly condemns the practice of "spinning" when it involves an investment banking firm and insiders of a company that retains the investment banking firm. Second, the decision expands the potential danger for directors with respect to breach of fiduciary duty claims in areas other than "spinning." A director or officer should carefully evaluate any personal transaction with any entity or person that is engaged in business with his or her company, such transactions may constitute corporate opportunities even though they may not ordinarily be considered to be within the company's normal line of business. Moreover, such transactions may be viewed as inappropriate commissions or gratuities given in exchange for the company's business.

VII. **Potential Impact of Enron-Related Ruling on Liability of Secondary Actors in Securities Markets**.

A. The opinion issued by Judge Melinda Harmon in December 2002, in the *Newby* consolidated class action case ("*Newby*") in the U.S. District Court for the Southern District of Texas (01-CV-3624) appears to have established a new and broader standard for liability under Section 10(b) of the Securities Exchange Act. *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp.2d 549 (S.D. Tex. 2002).

B. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439 (1994), the Supreme Court overruled prior case law and held that there can be no civil liability for aiding and abetting under Section 10(b) of the Securities Exchange Act. Although Congress has since passed legislation allowing the Securities and Exchange Commission ("SEC") to bring enforcement actions against parties for aiding and abetting liability under Section 10(b), federal courts have generally followed the *Central Bank* ruling in precluding private litigants from maintaining such actions. The *Central Bank* decision, however, does not protect secondary actors from liability as primary violators under the Section 10(b). *Central Bank* has left to the lower courts the task of determining when the conduct of a secondary actor subjects it to primary liability. In general, courts have adopted one of two tests in making the distinction – the "bright line" test and the "substantial participation" test. The "bright line" test holds a secondary actor primarily liable if the secondary actor both makes a material misrepresentation and the misrepresentation is attributed to the specific actor at the time of public dissemination. Under the "substantial participation" test, on the other hand, courts have found primary liability where there is "substantial participation or intricate involvement" of the secondary actor in the preparation of fraudulent statements.

C. Judge Harmon, in her December 19, 2002 opinion in the *Newby* action, resolved the motions to dismiss of the Secondary Actor Defendants by

applying neither the "bright line" test nor the "substantial participation" test. Instead Judge Harmon applied a standard proposed by the Securities and Exchange Commission in an *amicus curiae* brief filed in connection with the *Newby* motions, referred to as the "creator" test. The "creator" test subjects a secondary party to primary liability when the party, acting alone or with others, and with the requisite scienter, creates a misrepresentation on which investors rely. Under this test, secondary actors such as lawyers, accountants, banks, and underwriters may be found liable as primary violators for writing "misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." Additionally, Judge Harmon established a more extensive standard for liability by adopting a rather broad view of the term "manipulative or deceptive device or contrivance." The ruling, if adopted by other courts, has the potential to significantly broaden the class of actors and categories of conduct that will give rise to Section 10(b) liability. Judge Harmon's ruling and future rulings in the Enron case will likely have a great effect on securities law enforcement and the manner in which investment banks, law firms and accountants deal with their corporate clients.

VIII. SEC Enforcement - Merrill Lynch Avoids Criminal Charges

A. Able to escape much of the fallout from the Enron debacle, despite its involvement in transactions designed to artificially increase Enron's reported profits for year-end 1999.

B. Avoided criminal prosecution via deal with the Department of Justice/SEC requiring full disclosure of information and documentation related to the 1999 transactions with Enron.

C. Terms of deal required Merrill Lynch to adopt new policies and procedures relating to the integrity of client and counterparty financial statements and year end transactions, as well as retaining an independent auditing firm and attorney to review and monitor the implementation and compliance with these policies.

D. Merrill Lynch's full compliance and cooperation with DOJ and the SEC has allowed Merrill Lynch to survive, despite its involvement with Enron.

IX. Corporate Cooperation

A. The El Paso CFTC Order.

B. Excerpts from the Order:

1. Prior to the Division . . . discovering violative conduct, EPME initiated an internal investigation by hiring an independent law firm to conduct a timely investigation.

2. EPME voluntarily provided Commission staff with interview reports of current and former EPME traders and analyzed and compiled trading data.

3. Finally, after uncovering the violative conduct, El Paso decided to cease trading operations and the employees responsible for the activities referenced above are no longer with the Company.

4. Result: Absent that cooperation, the commission likely would have imposed a more severe sanction.

X. **Insider Trading**

A. General Rules

1. The Law

a. Insider trading occurs when a person who is aware of non-public material information is involved in a securities transaction.

b. Material information is generally defined as information that could affect a company's stock price. Such information may include:

i. Information regarding a possible tender offer.

ii. The declaration of a merger.

iii. A positive earnings announcement.

iv. An announcement regarding a new company discovery, such as a new drug or new mineral finds.

v. An upcoming buy recommendation by a financial analyst.

vi. An upcoming appearance in a financial news article.

vii. A soon to be announced dividend payment.

c. Wrongfulness is presumed from the disclosure of the non-public information.

d. Insider trading may result in severe penalties, including civil penalties, punitive awards and criminal prosecution.

2. Who are the insiders?

a. Someone who, by virtue of his or her relationship with the issuer, is privy to information that has not been released to the public at large. Aside from the obvious, the following are also considered insiders:

i. Family members of directors and officers.

ii. Underwriters

iii. Lawyers

iv. Accountants

v. Consultants

b. Insider liability can extend to "temporary insiders," such as financial printers.

c. If a person is an insider, they are expected to honor their fiduciary duty to the company and its shareholders by keeping non-public information confidential.

3. Third-party "tippee" liability

a. A tipper is a person who has revealed inside information in breach of his or her duty of trust or confidence to the issuer's shareholders.

b. Tipper need not be a "true" insider, such as a director, officer or lawyer. Tipper may be a temporary insider.

c. A tippee is a person who knowingly uses inside information in order to make a trade.

d. The tipper need not have a belief that the tippee (or subsequent tippee) would trade. Wrongfulness is presumed.

e. In order for a tippee to be held liable, there must have been some benefit to the tipper in making the tip. The tipper's benefit, however, need not be tangible. A gift of information to a friend or relative satisfies this requirement.

f. Subsequent tippees can create a "chain" of liability, if the breach of trust and confidence is passed down the line. One example of liability involved the passing of information from husband to wife, then from the wife to a third party.

g. There is a trend in case law narrowing the breadth of tippee liability.

h. Both a tipper and a tippee can be held liable for insider trading under certain circumstances.

4. Tattle-Tales

a. SEC is permitted to offer “bounties” to persons who provide information leading to the imposition of civil penalties upon an insider.

b. With minor exceptions, any person who provides such information may be paid a bounty.

B. Blackout periods and Restricted Stock Sales

1. Sarbanes-Oxley Section 306(a) Proposed Blackout Rules

a. Prohibit directors and executive officers from directly or indirectly purchasing, selling, or otherwise transferring equity securities during a blackout period under a company pension plan.

b. Blackout period is defined as a period of more than three consecutive business days during which the ability to purchase, sell, or otherwise transfer an interest in any equity security of the issuer held in an individual account plan maintained by the issuer is suspended with respect to at least 50% of the participants or beneficiaries of such plans. Blackout periods do not include:

i. Regularly scheduled periods in which participants and beneficiaries may not purchase or transfer securities if such period is incorporated into the individual account plan, and

ii. Disclosed to employees before, or within 20 days after, they become participants or as party of a subsequent amendment and

iii. Any suspension is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries by reason of merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor of an acquired or divested entity.

c. Acquired in Connection with Service Employment

i. The aforementioned trading prohibitions are limited to securities acquired in connection with the director or executive officer's employment.

ii. Would include any securities acquired through grants and awards under employee stock option, restricted stock, and other equity compensation plans.

(1) Securities acquired outside of an individual's service as a director or executive officer would not technically be covered, however:

(2) As a practical matter, directors and executive officers should refrain from making any trades during blackout periods because the proposed rules establish an *irrebuttable presumption* that any securities sold during blackout periods were acquired in connection with service or employment.

iii. Exemptions from the above trading rules include:

(1) Acquisitions of securities under dividend or interest reinvestment plans;

(2) Purchases or sales of securities pursuant to a contract, instruction, or written plan that satisfies conditions set out in Exchange Act Rule 10b5-1(c).

(3) Purchases pursuant to certain "tax conditioned" plans (such as Section 401(k) plans), other than discretionary transactions; and

(4) Stock splits, stock dividends, and rights granted to all shareholders.

iv. Penalties for noncompliance

(1) Issuer or security holder of the issuer may bring action to recover profit.

(2) SEC enforcement action including possible injunctive actions, cease and desist proceedings and all other remedies available to the SEC to redress violations of the Exchange Act.

(3) Under appropriate circumstances, criminal penalties.

v. Notice Requirements

(1) Require an issuer to notify affected directors and officers at least 15 calendar days in advance of blackout periods.

(2) Above requirement may be excused where there are unforeseeable events.

(3) In addition, company must file a notice of the blackout on Form 8-K within two business days of plan administrator giving notice of the blackout or, if earlier, actual knowledge of the blackout.

C. Section 16 Restricted Stock Sales

1. Section 16 seeks to deter insiders from benefiting from trading on a company's securities on the basis of insider information.

a. A director will be deemed the beneficial owner of securities for purposes of this section if the director has or shares voting or disposition power with respect to such securities, or can acquire such power within 60 days.

b. Beneficial ownership can mean a direct or indirect pecuniary interest in the subject securities through any

contact, arrangement, understanding, relationship or otherwise (including family, partnerships, corporations and trusts).

2. Section 16 requires insiders to return to the company any "profits" made on "short-swing" transactions in company securities.

3. This law is unforgiving in that the liability of an insider for short-swing profits *does not* depend on the actual possession or use of inside information.

4. Requirements

   a. Directors of a public company must file an initial report of the director's ownership of equity securities of the company within 10 days after becoming a director (or prior to effectiveness of the company's IPO, if a director at that time) and;

   b. Report subsequent changes in beneficial ownership of equity and derivative securities of the company. Such reports must be filed within two business days of the transaction.

5. Exemptions from Section 16 include transactions that essentially represent compensation, such as:

a. Option grants

b. Stock awards

c. Other acquisitions from the issuer if one of the following is satisfied:

i. Transaction is approved in advance by full Board of Directors or by committee of the Board composed solely of two or more non-employee directors;

ii. The transaction is approved in advance by the stockholders, or ratified no later than the next annual meeting of stockholders; or

iii. There is a contractual six-month holding period following the date of the grant, award or acquisition.

d. Bona fide gifts of stock and transfers of stock for estate-planning purposes are also exempt.

6. What constitutes a violation of Section 16?

a. A purchase and sale of company securities (including derivative securities) within less than six months.

b. Exercise of an in-or-at-the-money derivative security is exempt from Section 16 because it is deemed to be merely

a change from indirect to direct beneficial ownership of the underlying stock.

7. Measure of damages and penalties

a. "Any profit realized by" director, regardless of actual profit and regardless of the order of the trades is the amount to be paid to the company under Section 16(b).

b. Chronological order of sales and purchases does not matter in determining damages.

c. Right to recovery belongs to company.

d. Additionally, directors and officers that violate Section 16 may be subject to penalties under the anti-fraud and anti-manipulative provisions of the Exchange Act and rules and regulations promulgated thereunder.

XI. **Foreign Corrupt Practices Act**

A. Applicability

1. Companies with securities registered with the Securities and Exchange Commission pursuant to Section 13 of the Exchange Act and companies required to file reports pursuant to Section 15(d) of the Exchange Act (collectively "Issuers") – note that under this definition, Issuers can be foreign as well as domestic entities;

2. U.S. citizens, nationals and residents; and

3. Business entities organized under the laws of the U.S. or any state.[1]

4. The 1998 Amendments extended applicability of the Act to foreign persons and entities that commit any act in furtherance of a prohibited payment while in the territory of the U.S. Territory is construed broadly to include, e.g., a U.S. airliner flying over Europe.[2]

B. Elements of Prohibited Foreign Corrupt Practices:

1. Use of instrumentality of interstate commerce, OR if defendant is a U.S. person or entity, action taken beyond the U.S. regardless of use of instrumentality of interstate commerce;

2. Payment, authorizing payment, or offering to pay, or giving, authorizing a gift, or offering to give anything of value;

3. To any foreign official[3], any foreign political party, any foreign political candidate, any public international organization, or any person, with actual knowledge, conscious disregard, or willful

[1] Applicability also extends to shareholders, officers, directors, employees and agents acting on behalf of such a business entity, to those who conspire to violate the FCPA and to those who aid and abet the violation of the FCPA.

[2] A Department of Justice official suggested that an action abroad, such as an email, that triggered an action in the U.S. could be sufficient to meet this jurisdictional requirement. However, this approach would be akin to the "instrumentality of interstate commerce" test that was rejected when the 1998 Amendments were enacted.

[3] Foreign official is an expansive term defined to include officers or employees of a foreign government, department or agency or instrumentality thereof, including government controlled businesses (whether controlled by majority or control block ownership or otherwise) and possibly even government paid informants.

blindness that such person will act as a conduit for otherwise prohibited payments or gifts or purposes forbidden by the Act;

4. If the purpose of the payment is the "corrupt" one of getting the recipient to act or refrain from acting to influence any act or decision by the recipient or to induce the recipient to use his influence or to secure any improper advantage (evil motive or purpose, misuse of office, quid pro quo);

5. To assist in obtaining or retaining business or in directing business to any particular person.

C. Accounting Requirements:

1. Specific requirements as to record keeping and internal controls are applicable only to Issuers. However, because a foreign entity can fall under the definition of "Issuer" (see XI.A1. above), these requirements are not limited solely to U.S. entities.

2. Moreover, an Issuer is responsible for the compliance of its majority-owned (i.e., 50% or more) subsidiaries – both domestic and foreign -- with the record keeping and internal control requirements. Issuers are put in the difficult position that violations of these requirements by a majority-owned subsidiary either (a) are crimes of the Issuer due to the Issuer's knowledge, or (b) make the U.S. parent's financial statements and discussion

thereof inadequate due to failure to disclose and discuss such payments.

3. When an Issuer holds 50% or less voting control of a domestic or foreign subsidiary, the Issuer must exert a good faith effort, to the extent reasonable under the circumstances, to cause the subsidiary to follow the record keeping and internal control requirements. Circumstances in light of which the reasonableness of the effort is measured include the relative degree of the Issuer's ownership of the subsidiary, and the laws and practices governing the business operations of the country in which the subsidiary is located.

D. Exceptions / Affirmative Defenses:

1. Written Local Law. There is an exception to the Act for payments permitted by the local, foreign law, if such law is written.

2. Grease / Facilitating Payments. There is an exception for grease payments or payments that are made with the intent to get the foreign official or government to act in its routine governmental capacity to do something it is already supposed to be doing such as issuing a visa, providing police protection, delivering the mail, processing work orders, issuing a permit or document to qualify to do business in the country, scheduling inspections, or providing utilities. This exception appears to apply only for payments made to procure routine, nondiscretionary functions or services. The

typical example of a facilitating payment is a modest payment to a customs official to speed up the processing of entry papers. In at least one case, a payment of $50,000 to an official to secure timely payment of an undisputed debt of the Dominican Republic was found to be "an unlawful payment to induce an official to use his influence to obtain or retain business" even though the debt was due and owing. The collection of money validly owing is considered part of "obtaining or retaining business."

3. Promotion Expenditures. There is an exception for reasonable bona fide expenditures incurred by or on behalf of the foreign official and directly related to the promotion, demonstration or explanation of products or services or the execution or performance of a contract with a foreign government or agency. For example, a vendor paying for foreign official's trip from Singapore to Missouri to tour a factory and look at heavy equipment for sale is permissible, but not if the trip includes a two week, expense-paid side stay in Tahiti. In one case, a defendant company agreed to a permanent injunction, to pay a $400,000 fine and to initiate an intensive compliance program after advancing an Egyptian official a per diem, upgrading him to first class and paying for his spouse and children to visit the U.S.

4. Nominal, Customary Gift. A gift of nominal value provided to a foreign official as a courtesy, token of regard, or expression of

gratitude, in accordance with the customs of the foreign country, generally lacks the quid pro quo element of a prohibited action. Product samples of low value would be permitted under the above described exemption for bona fide expenditures directly related to the promotion, demonstration or explanation of products. Gifts should be low in value and should be unequivocally customary in the foreign country and appropriate for the occasion. There is no specific statutory basis for this exception, although it is generally recognized by commentators.

5. Payments to Government or Government Entity. Gifts or payments directly to the foreign government or governmental entity itself fall outside of the scope of the Act. Discounts, payments of cash or provisions of related or unrelated products or services directly to the foreign government are permitted. However, if the governmental entity is intended to be used as a conduit to funnel value to a foreign official, the action would be prohibited.

6. Government Entity as Agent or Partner. The Act does not prohibit entering into a joint venture with a foreign governmental agency nor retaining a foreign governmental entity as agent. Where there is a bona fide commercial reason for the appointment, and the relationship is structured so that there is no intent or expectation that any individual government employee will personally benefit,

the relationship will generally not raise problems under the Act. Of course, any profits or commissions payable to the entity should be paid directly to a government-owned account.

E. Remedies:

1. Criminal and Civil remedies.

2. Fines up to $2 million per violation for Issuers and domestic concerns.

3. Officers, directors and stockholders willfully violating the Act subject to fine of $100,000 and five years imprisonment.

4. Employee, agent etc. that carried out the violation subject to $100,000 fine and five years imprisonment.

5. Fines levied on officers, directors, stockholders, employees and agents may not be paid by the Issuer or domestic concern.

6. The Alternative Fines Act may increase the amount of the above described fines, up to twice the benefit sought by the defendant that made the prohibited payment.

7. The DOJ or the SEC may bring actions for civil fines and injunctions.

8. Private RICO cause of action with treble damages remedy available.

9. Suspension from doing business with the U.S. Federal government.

10. Export license ineligibility.

11. Suspension of securities and similar licenses.

12. Other federal remedies available.

F. The effect of the *United States of America vs. David K. Douglas Murphy*, the United States Court of Appeals for the Fifth Circuit, decision of February 4, 2004:

1. Factual Background

In *United States v. Kay*, the government charged David Kay and Douglas Murphy with violating the FCPA by bribing Haitian officials to understate customs duties and sales taxes on raw rice shipped for processing at their Haitian plant and eventual sale to there and elsewhere. Even though the payments were not directly linked to any "business," the government argued that the payments violated the FCPA because reduced customs duties and sales taxes will always provide the payor with an unfair advantage in obtaining or retaining business. The defendants argued that the FCPA was not implicated because the payments were not directly linked to an attempt to obtain or retain business. The district court agreed with the defendants and dismissed the indictment. According to the district court, as a matter of law, an indictment

alleging illicit payments to foreign officials for the purpose of avoiding customs duties and sales taxes were not the sort of bribes that were criminalized by the FCPA.

2. Fifth Circuit holds that FCPA not limited solely to obtaining or retaining government contracts.

3. Payments made to foreign officials need not directly relate to a specific business opportunity to violate the FCPA.

The Fifth Circuit held that Congress intended for the FCPA to apply to the type of conduct alleged in *Kay* if those payments were intended to "engender assistance in improving the business opportunities of the payor or his beneficiary, irrespective of whether that assistance be direct or indirect, and irrespective of whether it be related to administrating the law, awarding, extending, or renewing a contract, or executing or preserving an agreement."

4. Payments to lower tax burdens will not always violate the FCPA.

The remaining question in the case, as emphasized by the Fifth Circuit, is whether the bribery was intended to produce an effect that would "assist in obtaining or retaining business." Thus, the Fifth Circuit rejected the government's argument that bribes to secure lower taxes always violate the FCPA. At trial, the government would have to prove "how the tax benefit was intended to assist in obtaining or retaining business, and what was

the business or business opportunities sought to be obtained or retained?"

The *Kay* decision should be followed closely because of its potential impact regarding international payment practices. Because the *Kay* decision is one of first impression in the federal courts, it is possible that the Fifth Circuit may grant *en banc* consideration to the decision. However, until any change is made, *Kay* is the law in the Fifth Circuit and will be persuasive authority for other courts considering the same issue.