RESPONSIBILITIES OF M&A PROFESSIONALS AFTER THE SARBANES-OXLEY AND DODD-FRANK ACTS

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RESPONSIBILITIES OF M&A PROFESSIONALS AFTER THE SARBANES-OXLEY AND DODD-FRANK ACTS

By

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The responsibilities of in-house counsel and other attorneys for both public and private companies are significantly influenced by the Sarbanes-Oxley Act of 2002 (*"SOX"*)[1] and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*").[2]

SOX was the "tough new corporate fraud bill" trumpeted by the politicians and in the media as a response to the corporate scandals and as a means to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. Among other things, SOX amended the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*). Although SOX does have some specific provisions, and generally establishes some important public policy changes, it has been implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (*"SEC"*) and the Public Company Accounting Oversight Board (*"PCAOB"*), which have impacted auditing standards and have increased scrutiny on auditors' independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies,[3] its principles are being applied by the marketplace to privately held companies[4] and nonprofit entities.[5]

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1 *See* Byron F. Egan, *Major Themes of the Sarbanes-Oxley Act*, 42 TEX. J. BUS. L. 339 (Winter 2008), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186, and Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act* , 41 Tex. J. of Bus. L. 131 (Fall 2005).

2 H.R. 4173, 111th Cong. (2nd Sess. 2010). *See* **Appendix A**. *See also* J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank* (2010), George Mason University Law and Economics Research Paper No. 10-37, *available at* http://ssrn.com/abstract_id=1655482.

3 SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act (*"reporting companies"*) or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, *"public companies"* or *"issuers"*). Some of the SOX provisions apply only to companies listed on a national securities exchange (*"listed companies"*), such as the New

York Stock Exchange (*"NYSE"*) or the NASDAQ Stock Market (*"NASDAQ"*) (the national securities exchanges and NASDAQ are referred to collectively as *"SROs"*), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. *See* Standards Relating to Listed Company Audit Committees, 1933 Act Release No. 33-8220, 1934 Ac Release No. 47,654, 79 SEC Docket 2876 (April 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOX generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB). "*Small business issuer*" is defined in 1934 Act Rule 0-10(a) as an issuer (other than an investment company) that had total assets of $5 million or less on the last day of its most recent fiscal year, except that for the purposes of determining eligibility to use Forms 10-KSB and 10-QSB that term is defined in 1934 Act Rule as a United States ("*U.S.*") or Canadian issuer with neither annual revenues nor "*public float*" (aggregate market value of its outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more. SEC Registration and Reporting General, 17 C.F.R. § 240.12b-2 (2010). Some of the rules adopted under SOX apply more quickly to larger companies that are defined as "*accelerated filers"* under 1934 Act Rule 12b-2 (generally issuers with a public common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter that have been reporting companies for at least 12 months). *Id*.

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the *"1940 Act"*) and (ii) public companies domiciled outside of the United States of America (the *"U.S."*) (*"foreign companies"*). Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as: (i) more than 50% of the issuer's outstanding voting securities are <u>not</u> directly or indirectly held of record by U.S. residents; (ii) the majority of the executive officers or directors are <u>not</u> U.S. citizens or residents; (iii) more than 50% of the issuer's assets are <u>not</u> located in the U.S.; and (iv) the issuer's business is <u>not</u> administered principally in the U.S.

Companies that file periodic reports with the SEC solely to comply with covenants under debt instruments, to facilitate sales of securities under Rule 144 or for other corporate purposes (*"voluntary filers"*), rather than pursuant to statutory or regulatory requirements to make such filings, are not issuers and generally are not required to comply with most of the corporate governance provisions of SOX. The SEC's rules and forms implementing SOX that require disclosure in periodic reports filed with the SEC apply to voluntary filers by virtue of the fact that voluntary filers are contractually required to file periodic reports in the form prescribed by the rules and regulations of the SEC. The SEC appears to be making a distinction in its rules between governance requirements under the Act (which tend to apply only to statutory "*issuers*") and disclosure requirements (which tend to apply to all companies filing reports under the 1934 Act).

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX §§ 802 and 1102 make it a crime for any person to alter, destroy, mutilate or conceal a record or document so as to (x) impede, obstruct or influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding, 18 U.S.C. § 1519 (Supp. 2010); 18 U.S.C. § 1512 (2000 & Supp. 2010); (ii) SOX § 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense, 18 U.S.C. § 1513 (2000 & Supp. 2010); and (iii) SOX § 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 (*"ERISA"*). 29 U.S.C. § 1131 (Supp. 2010). These three provisions are applicable to private and nonprofit entities as well as public companies.

[4] Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both inside and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

Further, in providing such information to auditors, the provider must comply with the requirements of Section 303 of SOX (*"SOX § 303"*) and expanded Rule 13b2-2[6] under the 1934 Act adopted pursuant to SOX § 303 (collectively, the *"SOX § 303 Requirements"*). The SOX § 303 Requirements specifically prohibit officers and directors, and "persons acting under [their] direction," from coercing, manipulating, misleading or fraudulently influencing (collectively referred to herein as *"improperly influencing"*) an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading. Since attorneys and other mergers and acquisitions (*"M&A"*) professionals representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, they are subject to the SOX § 303 Requirements.

In addition, the requirements of SOX § 307 are specifically applicable to attorneys. The SEC rules under SOX § 307 generally provide that, in the event that an attorney has "credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur," the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer to the issuer's

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their affairs as if they were subject to SOX. *See* Mark Peters, Jin-Kyu Koh and Jeffrey Belisle, *Private Companies Toe the SOX Line*, Mergers & Acquisitions (Oct. 2005 at 34-36); Joseph Kubarek, *Sarbanes-Oxley Raises the Bar for Private Companies*, NACD-Directors Monthly (June 2004 at 19-20); Peter H. Ehrenberg and Anthony O. Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, 6 No. 7 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 12 at12–13 (2002).

5 *See* Sheri Qualters, *Nonprofits Scramble Under New Scrutiny*, The National Law Journal (September 3, 2007); BoardSource, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (2003); Richard Merli, *Sarbanes-Oxley Rules Seeping Into Not-for-Profit Hospitals*, KPMG Insider (Dec. 15, 2004), which can be found at http://www.kpmginsights.com/display_analysis_print_nobuttons.asp?content_id=512552.

6 Improper Influence on Conduct of Audits, 1934 Act Release No. 34-47890, 80 S.E.C. Docket 770 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm. *See infra* notes 374-377 and related text.

chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer's board of directors or an appropriate committee thereof.[7]

The SOX § 303 Requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX § 303 Requirements, however, should not be viewed as repudiating or supplanting the grand compromise or treaty reached in 1976 between the lawyers and the accountants that is reflected in the American Bar Association (*"ABA"*) Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information (the *"ABA Statement"*),[8] which was intended to facilitate lawyers' provision of information to auditors regarding client loss contingencies in connection with the preparation and examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.[9] Auditors rely upon the letters provided by their clients' counsel regarding loss contingencies (*"Response Letters"*) as they examine and report upon client financial statements. This gives the Response Letters a significant role in financial disclosure processes. Malpractice and other claims against attorneys can result from Response Letters and other statements to auditors regarding loss contingencies, particularly when a prediction is made regarding the likelihood of an unfavorable outcome or the amount or range of loss in the event of an unfavorable outcome. A lawyer who prepares a Response Letter in accordance with the ABA Statement, however, should not be considered to have misled or otherwise improperly influenced an auditor as the letter typically states that it was prepared in accordance with the ABA Statement and is prepared in response to a request letter that also should conform to the ABA Statement.

While not denying the right of lawyers to rely on the ABA Statement in actions taken in conformity with the ABA Statement, SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of "gatekeepers" or "sentries of the marketplace" whose responsibilities include "ensuring that our markets are clean."[10] These SEC actions do, however, affect the role of the lawyer in dealing with clients, auditors, M&A professionals and others.[11]

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7 *Cf.* Implementation of Standards of Professional Conduct for Attorneys, 1933 Act Release No. 33-8185, 79 S.E.C. Docket 1351 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm. *See infra* notes 406-433 and related text.

8 *Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities and Exchange Commission*, 31 BUS. LAW. 543 (Apr. 1976).

9 See **Appendix B** Attorney Client Privilege and Work Product Doctrine in the Corporate Context.

10 Stephen M. Cutler, Director, SEC Div. of Enforcement, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Speech at the UCLA School of Law (Sept. 20, 2004) (in which the point was made that SOX attempts to protect investors from a repeat of the scandals that led to its enactment by regulating "[t]he sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management") *available at* http://www.sec.gov/news/speech/spch092004smc.htm. Speeches by SEC members or staff are the

I.
PRESSURE ON AUDITORS TO DETECT CORPORATE FRAUD

GAAS. Generally acceptable auditing standards (*"GAAS"*) recognize that auditors have particular responsibilities with respect to the discovery of corporate fraud during an audit. The auditor has a responsibility to plan and to perform financial statement audits in order to obtain "reasonable assurance" about whether the financial statements are free of material misstatement, whether caused by error or fraud.[12]

Accounting Standards Board Statement (*"SAS"*) No. 99 (*"SAS 99"*) establishes guidance to help auditors to fulfill that responsibility with respect to fraud.[13] In the allocation of responsibilities between auditors and their clients, "it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud."[14] In connection with its audit of financial statements in accordance with GAAS, the auditor's "interest" is in obtaining

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expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

11 *See infra* notes 374-377, notes 406-433, and related text.

12 CODIFICATION OF AUDITING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1 (Am. Inst. of Certified Pub. Accountants); *see also* RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR, Statement on Auditing Standards No. 1, § 110.02 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00110.PDF, and Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Federal Register No. 27 6847, 6849 (February 9, 2006), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1189.pdf, wherein five federal agencies supervising financial institutions stated that they "believe that including an indemnification or limitation of liability provision for the client's knowing misrepresentations, willful misconduct, or fraudulent behavior in an Audit engagement letter may not be viewed as consistent with the auditor's duty and obligation to comply with auditing standards."

13 CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99, § 316 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF.

14 *Id*. SAS No. 99 superseded SAS No. 82, also entitled, *Consideration of Fraud in a Financial Statement Audit*. *Id*. SAS 82 provided that "[t]he auditor has a responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82, § 316 (Am. Inst. of Certified Pub. Accountants). This standard, however, expressly disavowed any per se obligation on auditors to uncover all instances of corporate fraud; indeed, SAS 82 recognized that a properly performed and executed audit may fail to detect fraud. *Id*. As it explained: "[a]n auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Because of (a) the concealment aspects of fraudulent activity, including the fact that fraud often involves collusion or falsified documentation, and (b) the need to apply professional judgment in the identification and evaluation of fraud risk factors and other conditions, even a properly planned and performed audit may not detect a material misstatement resulting from fraud." *Id*.

evidential matter regarding intentional acts that "result in a material misstatement of the financial statements."[15]

Thus, the auditor, in exercising the required professional skepticism when planning and performing the audit, is to consider whether the presence of certain "risk factors" indicate the possible presence of fraud and, if risks of fraudulent, material misstatement are identified, consider the impact of this finding on the audit report and whether reportable conditions relating to the company's internal controls exist and should be communicated to the company or its audit committee.[16] An auditor's obligations to gather evidential matter to satisfy itself regarding the presence of fraud includes making inquiries "about the existence or suspicion of fraud" to any appropriate personnel within the company, and SAS 99 suggests that the auditor "may wish to direct these inquiries" to the company's inside legal counsel.[17]

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[15] CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 99, § 316 (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF.

[16] *Id*. at §§ 316.05, 316.12, 316.31, 316.80.

[17] *Id*. at §§ 316.24–25. Other guidance found in GAAS suggests that an auditor may wish to obtain evidential matter through company counsel. In regard to an auditor's obligations regarding loss contingencies for litigation, claims and assessments pursuant to FAS 5, GAAS states that the "opinion of legal counsel on specific tax issues that he is asked to address and to which he has devoted substantive attention . . . can be useful to the auditor in forming his own opinion." *See* EVIDENTIAL MATTER: AUDITING INTERPRETATIONS OF SECTION 326, Statement on Auditing Standards No. 31, § 9326.19 (Am. Inst. of Certified Pub. Accountants) (warning further that "it is not appropriate for the auditor to rely solely on such legal opinion" in conducting the audit regarding these issues).

<u>Accountant Duties Under 1934 Act Section 10A</u>. Section 10A of the 1934 Act,[18]

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[18] 15 U.S.C. § 78j-1. The relevant portion of Section 10A of the 1934 Act was modeled after SAS 53, the predecessor to SAS 82, and provides as follows:

> **Sec. 10A. Audit requirements (Sec. 78j–1)**
>
> (a) *In general*. Each audit required pursuant to this title of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
>
> (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
>
> (2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
>
> (3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.
>
> (b) *Required response to audit discoveries*.
>
> (1) *Investigation and report to management*. If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—
>
> (A)(i) determine whether it is likely that an illegal act has occurred; and
>
> (ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
>
> (B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.
>
> (2) *Response to failure to take remedial action*. If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such accountant, the registered public accounting firm concludes that—
>
> (A) the illegal act has a material effect on the financial statements of the issuer;
>
> (B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement;

the registered public accounting firm shall, as soon as practicable, directly report its conclusions to the board of directors.

(3) *Notice to Commission; response to failure to notify*. An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period, the registered public accounting firm shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) *Report after resignation*. If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

(c) *Auditor liability limitation*. No registered public accounting firm shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rule promulgated pursuant thereto.

(d) *Civil penalties in cease-and-desist proceedings*. If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that a registered public accounting firm has willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the registered public accounting firm and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 21B.

(e) *Preservation of existing authority*. Except as provided in subsection (d), nothing in this section shall be held to limit or otherwise affect the authority of the Commission under this title.

(f) *Definitions*. As used in this section, the term “illegal act” means an act or omission that violates any law, or any rule or regulation having the force of law. As used in this section, the term “issuer” means an issuer (as defined in section 3), the securities of which are registered under section 12, or that is required to file reports pursuant to section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

which was added by the Private Securities Litigation Reform Act of 1995 (*"PSLRA"*),[19] created additional reporting obligations for auditors with regard to fraud that had not existed prior to that time. Like GAAS, Section 10A requires auditors to employ procedures, in accordance with GAAS, designed to provide "reasonable assurance of detecting illegal acts" that would have a direct and material effect on the financial statements. In addition, however, Section 10A requires auditors to report evidence of fraud up the corporate ladder to management and to the audit committee under certain circumstances. Section 10A further requires that the auditor report not only up, but *out* to the SEC if – after investigation of evidence of an illegal act uncovered during an audit – the auditor determines that (1) the audit committee or board is adequately informed of the illegal act, (2) the illegal act has a material effect on the financial statements, (3) the illegal act has not been appropriately remediated, and (4) as a result, the auditor will be required to issue a qualified audit opinion or resign.[20] The creation of the "illegal act" requirement of Section 10A exposed auditors to potential administrative proceedings based not only on alleged deficiencies in their audits or reviews of financial statements, but also on allegations that they have taken insufficient steps to satisfy these reporting requirements.

SEC Enforcement Actions. Under SEC Rule 102(e)(1)(ii), the SEC may sanction accountants for "improper professional conduct."[21] Administrative and enforcement actions

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[19] Section 10A is the part of the 1934 Act entitled "Audit Requirements" and predates SOX; Section 10A was added to the 1934 Act on December 22, 1995 as part of the PSLRA: Title III – Auditor Disclosure of Corporate Fraud. When Congress passed SOX, it tacked on the SOX requirements to the preexisting illegal act requirements from the PSLRA.

[20] 15 U.S.C. § 78j-1. Section 10A requires (in plain English) that if an auditor becomes aware of anything indicating that an illegal act has or may have occurred at one of her public clients, her firm must: inform the appropriate level of management and the audit committee of the issue; conclude whether there has been an illegal act that has a material effect on the financials; conclude whether the company has taken timely and appropriate remedial action; and report the client to the SEC if the client fails to take timely and appropriate remedial action.

[21] SEC Rule 102(e)(1)(iv) defines improper professional conduct as follows:

> "(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
>
> (B) Either of the following two types of negligent conduct:
>
> (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
>
> (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission."

Securities and Exchange Commission Rules, 17 C.F.R. § 201.102 (2010). SEC Rule 102(e)(1)(iv) History: Section (iv) was added to the Rule in 1998 to address the D.C. Circuit's concerns – as expressed in *Checkosky v. S.E.C.*, 23 F.3d 452 (D.C. Cir. 1994) (hereinafter *Checkosky* I) and *Checkosky v. S.E.C.*, 139 F.3d 221 (D.C. Cir. 1998) (hereinafter *Checkosky* II) – about the lack of clarity in the term "improper professional conduct." *Marrie v. S.E.C.*, 374 F.3d 1196, 1198 (D.C. Cir. 2004) ("we begin with the

filed in recent years reflect enhanced scrutiny of the work of auditors who failed to catch fraud by their clients or to take sufficient steps to satisfy Section 10A.[22] When he was Director of the

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observation that in the amended Rule 102(e), the Commission has cured the defects identified in Checkosky I and II").

[22] *See In the Matter of Deloitte & Touche LLP, Steven H. Barry, CPA, and Karen T. Baker, CPA*, Admin. Proc. File No. 3-11911, Accounting and Auditing Enforcement Release No. 2238 (April 26, 2005), which can be found at http://www.sec.gov/litigation/admin/34-51607.pdf (action against Deloitte and personnel in connection with audit of the financial statements of Just for Feet, Inc. which (i) improperly recognized as income the value of advertising support from suppliers rather than as a reduction of merchandise cost which GAAP required and sometimes before all conditions precedent to its entitlement to the support had been satisfied and (ii) failed to provide adequate reserves for obsolete inventory; although Just for Feet was regarded as a high risk client which was run by an autocrat, interpreted accounting standards aggressively and had presented issues in prior audits, the SEC found Deloitte's audit processes did not insist on proper vendor confirmations (some of which were found to be ambiguous or incomplete and some of which contained vendor misstatements); Deloitte was fined $375,000 and the individuals were prohibited from practicing before the SEC)); *In the Matter of Deloitte & Touche LLP*, Admin. Proc. File No. 3-11910, Accounting and Auditing Enforcement Release No. 2237 (April 26, 2005), which can be found at http://www.sec.gov/litigation/admin/34-51606.pdf (action against Deloitte for failure to detect a massive fraud in audits of Adelphia Communications Corporation although Adelphia was regarded a very high risk because of management dominated by Rigas family without compensating controls, management tendency to interpret accounting standards aggressively and frequent disputes with auditors, transactions with unaudited affiliated parties (some of which posed form over substance questions) and high capital requirements and debt levels (some obligations were classified as guarantees even though documents showed Adelphia was jointly and severally liable with related party borrowers and the financial condition of some borrowers made it probable under FAS 5 that Adelphia would have to pay the debt), Deloitte failed to detect Adelphia's fraud, failed to tailor its audit approach to the risks in violation of GAAS, and issued an unqualified opinion on Adelphia's financial statements while it knew or should have known that Adelphia: (a) failed to record all co-borrowing debt on its balance sheet or otherwise disclose that a portion had been excluded; (b) failed to disclose significant related party transactions by improperly netting related party payables and receivables; and (c) overstated its stockholders' equity by $375 million; in settling the SEC action, Deloitte (i) paid $25 million into a disgorgement fund to be distributed to defrauded investors pursuant to a plan to be established pursuant to SOX § 308(a) and court approval and (ii) undertook to establish specified policies and procedures to detect and report fraud pursuant to Section 10A); *In the Matter of KPMG LLP,* Admin. Proc. File No. 3-11905, Accounting and Auditing Enforcement Release No. 2234 (April 19, 2005), which can be found at http://www.sec.gov/litigation/admin/34-51574.pdf (action against KPMG regarding revenue recognition issues in accounting for leases in audits of financial statements of Xerox Corporation and failing to report Xerox's failures to comply with GAAP under Section 10A; in settlement KPMG agreed to (i) avoid circumstances where a client may improperly influence the firm's assignment of engagement partners; (ii) create additional lines of communication within the firm to allow KPMG professionals to raise issues, which they may believe have not been adequately addressed at the engagement team level, to a more senior level within the firm, and establish "Whistle-blower" channels of communication; (iii) ensure that KPMG has policies and procedures designed to provide reasonable assurance that workpapers prepared in connection with the audits of the financial statements of public companies include documentation of significant consultations with KPMG's Department of Professional Practice, firm specialists or others within or without the firm; (iv) provide training to its audit professionals concerning evaluation of audit evidence in a situation involving period-ending material adjustments by management to a company's original accounting system entries; and (v) disseminate to all audit professionals, and incorporate in its training for new audit professionals, requirements that auditors of public company clients at least annually reassess a client's justification for client accounting practices which are not in accordance with GAAP and assess the materiality of such departures; *In the Matter of PricewaterhouseCoopers LLP*, Admin. Proc. File No. 3-11483, Accounting and Auditing Enforcement Release No. 2008 (May 11, 2004) (action against PwC in connection with audit of the Warnaco Group's

SEC Division of Enforcement, Stephen Cutler called auditors "the sentries of the marketplace," and said that the SEC was focusing on auditing firm responsibility for audits in the hope that "accounting firms will take an even greater role in ensuring that individual auditors are properly discharging their special and critical gatekeeping role.[23]

PCAOB. Besides the SEC's Enforcement Division, the auditors' newest regulator has put the industry on notice of its expectations with respect to fraud. The PCAOB was established under SOX § 101 to inspect, investigate and discipline auditors conducting public company audits.[24] In an August 2, 2004 interview, PCAOB Chairman William McDonough stated his view as to the auditor's *obligation* to detect client fraud:

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financial statements from 1998 for failure to correctly characterize the cause of an inventory overstatement as resulting from internal control deficiencies as opposed to changed accounting rules, as misrepresented by Warnaco in a press release); *In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. File No. 3-11377, Accounting and Auditing Enforcement Release No. 1945 (Jan. 20, 2004) (administrative proceeding against Grant Thornton for aiding and abetting fraud and violating Section 10A by failing to obtain sufficient audit evidence despite "red flags" that client failed to disclose material related party transactions; *In the Matter of Richard P. Scalzo, CPA*, Admin. Proc. File No. 3-11212, Accounting and Auditing Enforcement Release No. 1839 (Aug. 13, 2003) (auditor permanently barred from public practice based on audits of Tyco between 1997 and 2001 in which he became aware of facts that put him on notice regarding the integrity of Tyco's management but failed to perform additional audit procedures or reevaluate his risk assessment); *In the Matter of Warren Martin, CPA*, Admin. Proc. File No. 3-11211, Accounting and Auditing Enforcement Release No. 1835 (Aug. 8, 2003) (auditor suspended from public practice for two years for undue reliance upon management representations regarding the interpretation of contracts, thereby ignoring "unambiguous contractual language" that affected revenue recognition and led to a $66 million restatement); *In the Matter of Phillip G. Hirsch, CPA*, Admin. Proc. File No. 3-11133, Accounting and Auditing Enforcement Release No. 1788 (May 22, 2003) (suspending PwC auditor for one year in settlement of allegations that he did not ensure that sufficient audit procedures were conducted in light of PwC's risk of fraud assessment and that he placed undue reliance on management representations despite awareness of evidence "from which he should have realized further audit work was required."); *SEC v. KPMG*, Civil Action No. 02-cv-0671 (S.D.N.Y. January 29, 2003), Accounting and Auditing Enforcement Release No. 1709 (seeking civil injunction against KPMG and disgorgement of fees and civil penalties in connection with the firm's audit of Xerox based on allegation that auditors had evidence of manipulation of financial results and failed to ask Xerox to justify departures from GAAP); *In Matter of Barbara Horvath, CPA*, Admin. Proc. File No. 3-10665, Accounting and Auditing Enforcement Release No. 1483 (Dec. 27, 2001) (a Deloitte & Touche auditor for placing reliance on management representations as her principal source of audit evidence for the company's capitalization of expenses which, it turned out, were fraudulent).

[23] Speech entitled "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" by Stephen M. Cutler, then Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at http://www.sec.gov/news/speech/spch092004smc.htm. Speeches by SEC members or staff are the expressions of the speakers themselves, and are not to be construed as representations of the Commission itself.

[24] SOX §§ 101-105, 15 U.S.C. §§ 7211-15. History: SOX § 105 granted the PCAOB broad investigative and disciplinary authority over registered firms and those firms' partners, principals, and employees. On September 29, 2003 the PCAOB adopted Rules on Investigations and Adjudications in PCAOB Release No. 2003-015, which on May 14, 2004 the SEC approved 1934 Act Release No. 34-49704. In *Free Enterprise Fund v. Public Company Accounting Oversight Board*, D.D.C., No. 06 Civ. 00217 (September 1, 2006), the constitutionality of the PCAOB was challenged on grounds that PCAOB's existence violates

> We have a very clear view that it *is* their job [to detect fraud]. If we see fraud that wasn't detected and should have been, we will be very big on the tough and not so [big] on the love. … [A]uditors [need to] understand that, with relatively few exceptions, they should find it. To me, the relatively few exceptions are those cases where you would have some extremely dedicated, capable crooks. In most cases, though, the crooks either are not that smart or they don't cover their tracks that well.[25]

Under SOX and the PCAOB's implementing regulations, *any* violation of laws, rules or policies by individual auditors or firms detected during inspections of selected audit and review engagements is to be identified in a written report and may be handed over to the SEC or other regulatory authorities and become the subject of further investigation and disciplinary proceedings.[26] The PCAOB has stated that inspections will assess compliance at all levels – *i.e.*, actions, omissions, policies and behavior patterns "from the senior partners to the line accountants."[27] The inspections will allow the PCAOB, in its own words, to "apply pressure to improve a firm's audit practices."[28]

All of these factors -- the evolution of the law regarding auditors' obligations with respect to client fraud, the SEC's enforcement actions in recent years, and the introduction of the PCAOB's expectations into the equation -- indicate that auditors will continue to feel pressure to increase their role in monitoring and finding inappropriate corporate accounting behavior.

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the appointments clause, the general separation of powers principle and the non-delegation doctrine of the U.S. Constitution. The SEC and U.S. Department of Justice filed briefs supporting the constitutionality of the PCAOB. *See* 38 BNA Sec. Reg. & Law Rept. No. 37 at 1573 (September 18, 2006). On August 22, 2008, in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. 2008), *cert. granted*, 77 U.S.L.W. 3632 (U.S. May 18, 2009) (No. 08-861), the U.S. Court of Appeals for the District of Columbia upheld SOX and the creation of the PCAOB as constitutional holding that the PCAOB does not encroach upon the appointments clause, separation of powers principles or the non-delegation doctrines of the U.S. Constitution.

25 *The Enforcer*, CFO.com (Aug. 1, 2004), (emphasis added), *available at* http://www.cfo.com/printable/article.cfm/3015411/c_3046616?f=options.

26 When the PCAOB believes that an act, practice or omission by a registered firm or individual auditor may violate SOX, PCAOB rules or other professional standards or any securities law or regulation pertaining to audit reports or to the duties of accountants, the PCAOB may open an investigation. *See* PCAOB R. 5101. Such an investigation can lead to disciplinary proceedings, exposing the offending auditor or firm to penalties ranging from compulsory training and mandated quality control procedures to heavy civil fines and temporary or permanent suspension from audit practice.

27 Steven Berger, *PCAOB—Beyond The First Year*, MONDAY BUSINESS BRIEFING (July 15, 2004), *available at* 2004 WL 69983842.

28 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, ANNUAL REPORT, FISCAL YEAR 2003, at 4 (2004), *available at* http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2003.pdf.

II.
AUDITOR INDEPENDENCE; NON-AUDIT SERVICES (SOX TITLE II)

SOX amended the 1934 Act to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with an audit and requires audit committee pre-approval for other non-audit services. On January 28, 2003, the SEC issued Release No. 33-8183, adopting rules to implement SOX Title II (the *"Title II Release"* and the *"Title II Rules"*).[29] These rules are applicable to all public companies regardless of size.[30]

Prohibited Non-Audit Services. SOX § 201 and the related Title II Rules prohibit a registered public accounting firm from providing to a public company, contemporaneously with the audit, the following non-audit services:[31]

(1) bookkeeping[32] or other services related to the accounting records or financial statements[33] of the audit client;

(2) financial information systems design and implementation;[34]

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29 Strengthening the Commission's Requirements Regarding Auditor Independence, 1933 Act Release No. 8183, 1934 Act Release No. 47,265, 68 Fed. Reg. 6006 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm [hereinafter the *"Title II Release"*].

30 *Id.*

31 SOX § 201, *amending* 15 U.S.C.A. § 78j-1(g)-(h) (West Supp. 2010) [hereinafter *"SOX § 201"*].

32 17 C.F.R. § 210.2-01(c)(4)(i) (2010). The Title II Rules utilize a definition of bookkeeping or other services which focuses on the provision of services involving: (1) maintaining or preparing the audit client's accounting records; (2) preparing financial statements that are filed with the SEC or the information that forms the basis of financial statements filed with the SEC; or (3) preparing or originating source data underlying the audit client's financial statements.

33 In the Title II Release, the SEC noted that an accountant's independence would be impaired where the accountant prepared an issuer's statutory financial statements if those statements form the basis of the financial statements that are filed with the SEC. Under these circumstances, an accountant or accounting firm who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP financial statements.

34 17 C.F.R. § 210.2-01(c)(4)(ii) (2010). The SEC's Title II Rules prohibit an accounting firm from providing any service related to the audit client's information system unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. These rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

In the SEC's view, designing, implementing, or operating systems affecting the financial statements may place the accountant in a management role, or result in the accountant auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by that accountant. For example, if an auditor designs or installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on his or her

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;[35]

(4) actuarial services;[36]

(5) internal audit outsourcing services;[37]

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firm's own work. Investors may perceive that the accountant would be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or installed.

However, this prohibition does not preclude the accountant from evaluating the internal controls of a system as it is being designed, implemented, or operated either as part of an audit or attest service or making recommendations to management. Likewise, the accountant would not be precluded from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.

[35] 17 C.F.R. § 210.2-01(c)(4)(iii) (2010). Under Title II Rules, appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. These services include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction.

The Title II Rules do not prohibit an accounting firm from providing such services for non-financial reporting purposes (*e.g.*, transfer pricing studies, cost segregation studies, and other tax-only valuations). Also, the rules do not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client's financial statements. In those instances, the accountant will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit.

[36] 17 C.F.R. § 210.2-01(c)(4)(iv) (2010). The SEC believes that when the accountant provides actuarial services for the client, he or she is placed in a position of auditing his or her own work. Accordingly, the Title II Rules prohibit an accountant from providing to an audit client any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. It is permissible, however, to advise the client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations, while it is not appropriate for the accountant to provide the actuarial valuations for the audit client. Further, the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities.

[37] 17 C.F.R. § 210.2-01(c)(4)(v) (2010). The Title II Rules prohibit the accountant from providing to the audit client internal audit outsourcing services. This prohibition includes any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

(6) management functions[38] or human resources;[39]

(7) broker or dealer, investment adviser, or investment banking services;[40]

While conducting the audit in accordance with generally accepted auditing standards (*"GAAS"*), or when providing attest services related to internal controls, the auditor evaluates the company's internal controls and, as a result, may make recommendations for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, does not constitute an internal audit outsourcing engagement.

Along those lines, the prohibition on "outsourcing" does not preclude engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not, in substance, the outsourcing of the internal audit function. For example, the company may engage the accountant, subject to the audit committee pre-approval requirements, to conduct "agreed-upon procedures" engagements related to the company's internal controls, since management takes responsibility for the scope and assertions in those engagements. The prohibition also does not preclude the accountant from performing operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

[38] 17 C.F.R. § 210.2-01(c)(4)(vi) (2010). The Title II Rules prohibit the accountant from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. The SEC believes, however, that services in connection with the assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an accountant's independence. Accountants must gain an understanding of their audit clients' systems of internal controls when conducting an audit in accordance with GAAS. With this insight, accountants often become involved in diagnosing, assessing, and recommending to audit committees and management ways in which their audit clients' internal controls can be improved or strengthened. The resulting improvements in the audit clients' controls not only result in improved financial reporting to investors but also can facilitate the performance of high quality audits. As a result, the Title II Rules allow accountants to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls.

Designing and implementing internal accounting and risk management controls is fundamentally different from obtaining an understanding of the controls and testing the operation of the controls, which is an integral part of any audit of a company's financial statements. Likewise, design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements in the internal accounting and risk management controls of an audit client (which is permissible, if pre-approved by the audit committee).

[39] 17 C.F.R. § 210.2-01(c)(4)(vii) (2010). The Title II Rules provide that an accountant's independence is impaired with respect to an audit client when the accountant searches for or seeks out prospective candidates for managerial, executive, or director positions; acts as negotiator on the audit client's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment; or undertakes reference checks of prospective candidates. Under the Title II Rules, an accountant's independence also is impaired when the accountant engages in psychological testing on behalf of the audit client, other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

[40] 17 C.F.R. § 210.2-01(c)(4)(viii) (2010). The SEC considers selling–directly or indirectly–an audit client's securities to be incompatible with the accountant's responsibility of assuring the public that the company's financial condition is fairly presented. When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit

(8) legal services[41] and expert services unrelated to the audit;[42]

With respect to other non-audit services, SOX § 201 states that "A registered public accounting firm may engage in any non-audit service, *including tax services*, that is not

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client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended.

[41] 17 C.F.R. § 210.2-01(c)(4)(ix) (2010). A lawyer's core professional obligation is to advance clients' interests. An individual cannot be both a zealous legal advocate for management or the client company and maintain the objectivity and impartiality that are necessary for an audit. Thus, under the Title II Rules, an accountant is prohibited from providing to an audit client any service that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

[42] 17 C.F.R. § 210.2-01(c)(4)(x) (2010). The Title II Rules prohibit an accountant from providing expert opinions or other services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation, or regulatory or administrative investigations or proceedings. For example, under this rule, an auditor's independence would be impaired if the auditor were engaged to provide forensic accounting services to the audit client's legal representative in connection with the defense of an investigation by the SEC's Division of Enforcement. Additionally, an accountant's independence would be impaired if the audit client's legal counsel, in order to acquire the requisite expertise, engaged the accountant to provide such services in connection with any litigation, proceeding, or investigation.

The Title II Rules do not, however, preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact-finding engagements. These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client. The involvement by the accountant in this capacity generally requires performing procedures that are consistent with, but more detailed or more comprehensive than, those required by generally accepted auditing standards (*"GAAS"*). Performing such procedures is consistent with the role of the independent auditor and could improve audit quality. If, subsequent to the completion of such an engagement, a proceeding or investigation is initiated, the accountant may allow its work product to be utilized by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, but may provide factual accounts or testimony about the work performed.

Accordingly, the Title II Rules do not prohibit an accountant from assisting the audit committee in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety. For example, if the audit committee is concerned about the accuracy of the inventory accounts at a subsidiary, it may engage the auditor to conduct a thorough inspection and analysis of those accounts, the physical inventory at the subsidiary, and related matters without impairing the auditor's independence.

Recognizing that auditors have obligations under SOX and GAAS to search for fraud that is material to an issuer's financial statements and to make sure the audit committee and others are informed of their findings, the Title II Rules permit auditors to conduct these procedures whether they become aware of a potential illegal act as a result of audit, review, or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system. Should litigation arise or an investigation commence during the time that the auditors are conducting such procedures, the SEC would not deem the completion of these procedures to be prohibited expert services so long as the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

described in any of paragraphs (1) through (9) [listed above] . . . for an audit client, only if the activity is approved in advance by the audit committee of the issuer[.]"[43] There has been considerable debate regarding whether an accountant's provision of tax services for an audit client can impair the accountant's independence.[44]

The Title II Release reiterates the SEC's long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence, and states that accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to the normal audit committee pre-approval requirements.[45]

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43 SOX § 201, *supra* note 31 (emphasis added).

44 *See* Title II Release, *supra* note 29, at 6016.

45 With respect to accounting firm-developed income tax preparation software, the Staff commented in response to Questions 18 and 19:

Question 18

Q: Some accounting firms have developed their own proprietary income tax preparation software. The software is used to facilitate the preparation of company income tax returns for various tax jurisdictions. Can an accounting firm license or sell its proprietary income tax preparation software to an audit client?

A: Licensing or selling income tax preparation software to an audit client would be subject to audit committee pre-approval requirements for permissible tax services. To the extent that the audit client's audit committee pre-approves the acquisition of the income tax preparation software from the accounting firm, it would be permissible for the accounting firm to license or sell its income tax preparation software to an audit client, so long as the functionality is, indeed, limited to preparation of returns for filing of tax returns. If the software performs additional functions, each function should be evaluated for its potential effect on the auditor's independence (see Question 19).

Question 19

Q: Some accounting firms have developed software modules which extend the functionality of the proprietary income tax preparation software. One of the additional software modules that has been developed by some firms takes the information used in preparing the tax return and generates some or all of the information needed to prepare the tax accrual and disclosures related to income taxes that will appear in the company's financial statements. Can the accounting firm license or sell this type of module to an audit client either concurrently with or subsequent to the licensing or sale of its income tax preparation software?

A: No. Since the purpose of the module is to develop the information needed to prepare a significant element of the company's financial statements, licensing or selling the module to an audit client would constitute the design and implementation of a financial information system, which is a prohibited non-audit service. It should be noted that the prohibition exists whether or not the module is integrated with, linked to, feeds the company's general ledger system, or otherwise prepares entries on behalf of the audit client (even if those entries are required to be manually recorded by client personnel). The output of the module aggregates source data or generates information that can be significant to the company's financial statements taken as a whole.

Office of SEC Chief Accountant Application of the January 2003 Rules on Auditor Independence; Frequently Asked Questions, *at* http://www.sec.gov/info/accountants/ocafaqaudind080703.htm (August 13, 2003) [hereinafter *"Auditor Independence FAQ"*].

Additionally, the Title II Rules require issuers to disclose the amount of fees paid to the accounting firm for tax services.[46]

The Title II Release further comments that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair auditor independence and that audit committees and accountants should understand that providing certain tax services to an audit client could impair the independence of the accountant.[47] Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims.[48] In addition, audit committees are cautioned to scrutinize carefully the retention of an accountant in a tax-avoidance transaction initially recommended by the accountant, the tax treatment of which may be dicey.[49]

The SEC's principles of independence with respect to non-audit services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management; (2) an auditor cannot audit his or her own work; and (3) an auditor cannot serve in an advocacy role for his or her client.[50] The PCAOB has adopted rules which have been approved by the SEC[51] and amplify on these independence principals as follows:

- No Contingent Fees (PCAOB Rule 3521): An auditor would not be independent if it entered into a contingent fee arrangement, directly or indirectly with an audit client. A "contingent fee" would include any fee established for the sale of a product or the performance of a service pursuant to an arrangement in which no fee would be charged unless, or the amount thereof is dependent upon, a specified finding or result is attained.

- No Aggressive Tax Transaction (PCAOB Rule 3522): An auditor is prohibited from providing any non-audit services to an audit client related to the marketing, planning or opining in favor of the tax treatment of any transaction that (i) is a listed transaction (defined in Treasury Regulations § 1.6011-4(b)(2) as a transaction substantially similar to those identified therein as tax avoidance transactions), (ii) is a confidential transaction (defined in Treasury Regulations § 1.6011-4(b)(3)(ii) as a transaction on which disclosure

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46 Title II Release, *supra* note 29, at 6017.

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.* at 6010.

51 Public Company Accounting Oversight Board; Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules, 1934 Act Release No. 34-53677 (April 19, 2006), *available at* http://www.sec.gov/rules/pcaob/2006/34-53677.pdf; PCAOB Release No. 2005-014 (July 26, 2005).

limitations are imposed to protect the advisor's tax strategies) or (iii) would be considered an aggressive tax position transaction (i.e., a transaction a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws).

- Tax Services for Management (PCAOB Rule 3523): An audit firm may not provide any tax service to any individual who performs a financial reporting oversight role for an audit client, or an immediate family member of such an individual, unless such individual is in that role solely as a member of the issuer's board of directors.

- Audit Committee Pre-approval of Tax Services (PCAOB Rule 3524): In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm is required to (a) describe, in writing, to the audit committee of the issuer (i) the scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the accounting firm and the audit client, relating to the service; and (ii) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service; (b) discuss with the audit committee of the issuer the potential effects of the services on the independence of the accounting firm; and (c) document the substance of its discussion with the audit committee of the issuer.

Audit Committee Pre-Approval of All Audit and Non-Audit Services. SOX § 202 requires audit committee pre-approval of all auditing services (including providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of state law) and all non-audit services provided by the auditor.[52] The audit committee may delegate the pre-approval responsibility to a subcommittee of one or more independent directors.[53] There is a de minimis exception with respect to the provision of non-audit services for an issuer if (i) the aggregate amount constitutes not more than five percent of the total amount paid to the auditor during the fiscal year in which the non-audit services are provided; (ii) such services were not recognized as non-audit services by the issuer at the time of the engagement; and (iii) such services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or

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[52] SOX § 202, *amending* 15 U.S.C.A. § 78j-1(i) (West Supp. 2010) [hereinafter "SOX § 202"]. The audit committee of a parent company may serve as the audit committee of the parent company and the wholly-owned subsidiaries. In this situation, the subsidiary's disclosure should include the pre-approval policies and procedures of the subsidiary and, also should include the pre-approval policies and procedures of the parent company. *See* Auditor Independence FAQ, *supra* note 45, at Question 20.

[53] SOX § 202, *supra* note 52.

more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee.[54]

The Title II Release recognizes that management has historically retained the accounting firm, negotiated the audit fee, and contracted with the accounting firm for other services, but the Release comments that SOX § 202 changes that practice by requiring audit committees to pre-approve the services – both audit and permitted non-audit – of the accounting firm.[55] The SEC believes that the SOX § 202 change may both facilitate communications among the board of directors, management, internal auditors, and independent accountants, and enhance auditor independence from management by vesting in the audit committee the power and responsibility of appointing, compensating, and overseeing the work of the independent accountants.[56]

The Title II Rules require that the audit committee pre-approve all permissible non-audit services and all audit, review, or attest engagements required under the securities laws.[57] Specifically, the rules require that before the accountant is engaged by the issuer or its subsidiaries to render the service, the engagement is:

- Approved by the issuer's audit committee; or
- Entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer, provided the policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and such policies and procedures do not include delegation of the audit committee's responsibilities to management.[58]

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[54] *Id.*

[55] Title II Release, *supra* note 29, at 6022.

[56] *Id.*

[57] *Id.*

[58] Title II Release, *supra* note 29, at 6022. The SEC Chief Accountant has commented that pre-approval policies may not be based on monetary limits and must be detailed enough for the audit committee to know precisely what services are being pre-approved and the impact thereof on auditor independence. *See* Auditor Independence FAQ, *supra* note 45. Under Questions 22, 23, and 24 the Staff wrote:

Question 22

Q: The Commission's rules require the audit committee to pre-approve all services provided by the independent auditor. In doing so, the audit committee can pre-approve services using pre-approval policies and procedures. Can the audit committee use monetary limits as the basis for establishing its pre-approval policies and procedures?

A: The Commission's rules include three requirements that must be followed in the audit committee's use of pre-approval through policies and procedures. First, the policies and procedures must be detailed as to the particular services to be provided. Second, the audit committee must be informed about each service. Third, the policies and procedures cannot result in the delegation of the audit committee's authority to

The Title II Rules recognize audit services to be broader than those services required to perform an audit pursuant to GAAS.[59] For example, SOX § 202 identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.[60]

Furthermore under the Title II Rules, audit services also would include services performed to fulfill the accountant's responsibility under GAAS.[61] For example, in some situations, a tax partner may be involved in reviewing the tax accrual that appears in the company's financial statements as part of the audit process. Consultation with "national office" or other technical reviewers to reach an audit judgment also constitutes an audit service.

In contrast, where an issuer is evaluating a proposed transaction and asks the independent accountant to evaluate the accounting for the proposed transaction, those services would not be considered to be audit services.

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management. Pre-approval policies and procedures that do not comply with all three of these requirements are in contravention of the Commission's rules. Therefore, monetary limits cannot be the only basis for the pre-approval policies and procedures. The establishment of monetary limits would not, alone, constitute policies that are detailed as to the particular services to be provided and would not, alone, ensure that the audit committee would be informed about each service.

Question 23

Q: Can the audit committee's pre-approval policies and procedures provide for broad, categorical approvals (e.g., tax compliance services)?

A: No. The Commission's rules require that the pre-approval policies be detailed as to the particular services to be provided. Use of broad, categorical approvals would not meet the requirement that the policies must be detailed as to the particular services to be provided.

Question 24

Q: How detailed do the pre-approval policies need to be?

A: The determination of the appropriate level of detail for the pre-approval policies will differ depending upon the facts and circumstances of the issuer. However, a key requirement is that the policies cannot result in a delegation of the audit committee's responsibility to management. As such, if a member of management is called upon to make a judgment as to whether a proposed service fits within the pre-approved services, then the pre-approval policy would not be sufficiently detailed as to the particular services to be provided. Similarly, pre-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. For example, if the audit committee is presented with a schedule or cover sheet describing services to be pre-approved, that schedule or cover sheet must be accompanied by detailed back-up documentation regarding the specific services to be provided.

[59] Title II Release, *supra* note 29, at 6022.

[60] *Id*.

[61] *Id*. at 6030.

Although the audit committee must pre-approve all services, SOX § 202 permits the audit committee to establish policies and procedures for pre-approval "provided they are detailed as to the particular service and designed to safeguard the continued independence of the accountant."[62] For example, SOX § 202 allows for one or more audit committee members who are independent directors to pre-approve the service. Decisions made by the designated audit committee members must be reported to the full audit committee at each of its scheduled meetings.[63]

Like SOX § 202, the Title II Rules include a de minimis exception which waives the pre-approval requirements for non-audit services provided that: (1) all such services do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (2) the services were not recognized as non-audit services at the time of the engagement; and (3) the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives.[64] The audit committee's policies for pre-approval of services should be disclosed in the issuer's Form 10-K annual reports.

Until the adoption of the Title II Rules, proxy disclosure rules required that an issuer disclose, for the most recent fiscal year, the professional fees paid for both audit and non-audit services to its principal independent accountant. As a result of the requirements of SOX and partly in response to public comment received by the SEC on proxy disclosure requirements since their adoption in 2000, the Title II Rules now require issuers to report fees spent on: (1) Audit Fees; (2) Audit-Related Fees; (3) Tax Fees; and (4) All Other Fees.[65] Additionally, other than for the audit category, the issuer is required to describe, in qualitative terms, the types of services provided under the remaining three categories.[66] This information is now required for

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62 *Id*. at 6022.

63 *Id*.

64 *Id*. at 6023.

65 Previously, issuers were required to disclose only "Audit Fees," "Financial Systems Design and Implementation Fees," and "All Other Fees."

66 To provide guidance to issuers in making the required audit fee disclosures, the SEC has provided some guidance as to fee disclosures. Auditor Independence FAQ, *supra* note 45. The Staff responded to questions 30, 31, and 32 as follows:

Question 30

Q: What fee disclosure category is appropriate for professional fees in connection with an audit of the financial statements of a carve-out entity in anticipation of a subsequent divestiture?

A: The release establishes a new category, "Audit-Related Fees," which enables registrants to present the audit fee relationship with the principal accountant in a more transparent fashion. In general, "Audit-Related Fees" are assurance and related services (*e.g.*, due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services related to financial

the two most recent years, and must be provided either in the issuer's proxy statement or its Form 10-K annual report.[67]

As noted above, the issuer must provide disclosure of the audit committee's pre-approval policies and procedures. Additionally, to the extent that the audit committee has applied the de minimis exception, the issuer must disclose the percentage of the total fees paid to the independent accountant where the de minimis exception was used.[68] This information should be provided by category.[69]

The information must be included in an issuer's Form 10-K annual report.[70] However, because the SEC views the information as relevant to a decision to vote for a particular director or to elect, approve, or ratify the choice of an independent public accountant, the SEC is also requiring that the disclosure discussed above be included in an issuer's proxy statement. Since

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reporting that are not required by statute or regulation and consultation concerning financial accounting and reporting standards. Fees for the above services would be disclosed under "Audit-Related Fees."

Question 31

Q: Would fees paid to the audit firm for operational audit services be included in "Audit-Related Fees"?

A: No. "Audit-Related Fees" are fees for assurance and related services by the principal accountant that are traditionally performed by the principal accountant and which are "reasonably related to the performance of the **audit or review of the registrant's financial statements.**" Operational audits would not be related to the audit or review of the financial statements and, therefore, the fees for these services should be included in "All Other Fees." As required by the rules, the registrant would need to include a narrative description of the services included in the "All Other Fees" category.

Question 32

Q: The Commission's new independence rules require companies to disclose fees paid to the principal auditor in four categories ("audit", "audit-related', "tax", and "all other") for the two most recent years. Previously, companies were required to disclose fees paid to the principal auditor in three categories and only for the most recent year. When are the new fee disclosure requirements effective?

A: The release text indicates that the new disclosure requirements are effective for periodic annual filings and proxy or information statement filings for the first fiscal year **ending after December 15, 2003.** Thus, the new disclosure requirements are not mandatory until the calendar-year 2003 periodic annual filings are made in 2004. However, the release text also indicates that "we encourage issuers . . . to adopt these disclosure provisions earlier." Thus, companies may, but are not required, to provide the new disclosures for proxies and other periodic annual filings that are made prior to the effective date for the new disclosures.

67 Title II Release*, supra* note 29, at 6031.

68 *Id*.

69 *Id*.

70 *Id*.

the information is included in Part III of annual reports on From 10-K, domestic companies are able to incorporate the required disclosures from the proxy or information statement into the annual report on Form 10-K.

Audit Partner Rotation. SOX § 203 mandates rotation every five years of both the lead audit partner working for the audit client and the audit partner responsible for reviewing the audit,[71] but does not require rotation of registered public accounting firms, although the PCAOB may end up requiring such rotation.[72] The Title II Rules expand SOX § 203 by requiring not only that both the lead and the concurring partners rotate after five years, but that they also are subject to a five-year time-out period after the rotation.[73] Further, the Title II Rules require rotation after seven years, with a two year post-rotation time-out, for other partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee (together with the lead and concurring partner, *"audit partners"*).[74] The mandatory audit partner rotation does not extend to less important partners on the audit engagement teams, specialty partners, and national office partners.[75]

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71 SOX § 203, *amending* 15 U.S.C.A. 78j-1(j) (West Supp. 2010) [hereinafter "SOX § 203"]; *Id*. at 6017.

72 Title II Release, *supra* note 29 at 6018.

73 *Id*.

74 Tax and other partners are deemed "audit partners" under this definition if they are "relationship partners" with a high degree of contact with the issuer's management or audit committee. *See* Auditor Independence FAQ, *supra* note 45. In response to questions 10 and 11 the Staff commented:

Question 10

Q: Generally, a tax or other specialty partner is not included within the definition of "audit partner." Are there circumstances where a tax or other specialty partner would be included within the definition of "audit partner"? If so, what are the consequences?

A: The term "audit partner" is significant in that it establishes the partners who are subject to the partner rotation requirements and the partner compensation requirements. The discussion of "audit partner" in the release text states: "the term audit partner would include the 'lead' and 'concurring' partners, partners such as 'relationship' partners who serve the client at the issuer or parent level." "Relationship" partners have a high level of contact with management and the audit committee of the issuer. Therefore, a tax or other specialty partner who serves as the "relationship" partner would be included within the scope of the definition of "audit partner."

Question 11

Q: What are the rotation requirements for the "relationship" partner who is not the "lead" or "concurring" partner?

A: As discussed in question 10, the "relationship" partner meets the definition of an "audit partner" and, therefore, is subject to the partner rotation requirements. "Lead" and "concurring" partners are required to rotate off an engagement after a maximum of five years in either capacity and, upon rotation, must be off the engagement for five years. Other "audit partners" are subject to rotation after seven years on the

The rotation requirements applicable to the lead partner are effective for the first fiscal year ending after the effective date of the Title II Rules.[76] Furthermore, in determining when the lead partner must rotate, time served in the capacity of lead partner prior to the effective date of these rules is included.[77] For example, for a lead partner serving a calendar year audit client, if 2006 was that partner's fifth year as lead partner for that audit client, the partner would be able to complete the current year's audit but must rotate off for the 2007 engagement.

Auditor Reports to Audit Committees. SOX § 204 requires auditor reports to audit committees regarding (a) all critical accounting policies and practices to be used and (b) all alternative treatments of financial information within generally accepted accounting principles for financial reporting in the U.S. (*"GAAP"*) that have been discussed with management.[78] In response to SOX § 204, the SEC amended Regulation S-X to require each registered public accounting firm that audits an issuer's financial statements to report, prior to the filing of such report with the SEC, to the issuer's audit committee: (1) all critical accounting policies and practices used by the issuer;[79] (2) all alternative accounting treatments of financial information

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engagement and must be off the engagement for two years. A "relationship" partner who is not the "lead" or "concurring" partner would, therefore, be subject to the seven years of service, two years time out rotation requirement.

75 Title II Release, *supra* note 29, at 6019-20.

76 *Id*. at 6021.

77 *Id*.

78 SOX § 204, *amending* 15 U.S.C.A. § 78j-1(k) (West Supp. 2010) [hereinafter *"SOX § 204"*]; *Id*. at 6007. The Financial Accounting Standards Board (*"FASB"*) has codified its accounting standards under a unified format known as the FASB Accounting Standards Codification (the *"FASB Codification"*) which replaces prior accounting pronouncements as GAAP for financial statements for periods ending after September 15, 2009. Financial Accounting Standards Board, Accounting Standards Codification, http://asc.fasb.org/ (last visited Dec. 22, 2009). The FASB has stated that the FASB Codification does not change GAAP. See Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (June 2009), available at http://www.fasb.org/st/#fas168, and Press Release, Fin. Accounting Standards Bd., FASB Accounting Standards Codification Launches Today (July 1, 2009), http://www.fasb.org/jsp/FASB/Page/SearchNews?filter_year=2009. *See* Committee on Audit Responses, ABA Section of Business Law, *Statement on the Effect of the FASB Codification on Audit Response Letters*, 65 Bus. Law. 491 (Feb. 2010).

79 In December 2001, the SEC issued cautionary advice regarding each issuer disclosing in the Management's Discussion and Analysis section of its Form 10-K annual report those accounting policies that management believes are most critical to the preparation of the issuer's financial statements. Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies, 1933 Act Release No. 8040, 1934 Act Release No. 45,149, 66 Fed. Reg. 65,013 (December 17, 2001), *available at* http://www.sec.gov/rules/other/33-8040.htm [hereinafter the *"December 2001 Cautionary Guidance"*]. The December 2001 Cautionary Guidance indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm;[80] and (3) other material written communications between the accounting firm and management of the issuer.[81]

Reference should be made to the December 2001 Cautionary Guidance to determine the types of matters that should be communicated to the audit committee under the Title II Rules. While there is no requirement that the discussions follow a specific form or manner, the Title II Release expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the Guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, it is anticipated that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

80 Title II Release, *supra* note 29, at 6027. The Title II Rules require communication, either orally or in writing, by accountants to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm, including recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

Communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the accountants should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not, in the accountant's view, the preferred method, the reasons why the accountant's preferred method was not selected by management also should be discussed.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS, and should include the impact of management's judgments and accounting estimates, as well as the accountant's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies should include the range of alternatives available under GAAP that were discussed by management and the accountants along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change also should be communicated. If the accounting policy selected is not the accountant's preferred policy, then the SEC expects the discussions to include the reasons why the accountant considered one policy to be preferred but that policy was not selected by management.

81 *Id*. at 6029. Examples of additional written communications that the Title II Release expects will be considered material to an issuer include:

- Management representation letter;
- Reports on observations and recommendations on internal controls;
- Schedule of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any;

In describing the role and responsibilities of the audit committee, the Title II Release includes the following quotation from Warren Buffett:

> Their function . . . is to hold the auditor's feet to the fire. And, I suggest . . . the audit committee ask [questions] of the auditors [including]: if the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and non-material differences. If the auditor would have done anything differently than management, then explanations should be made of management's argument and the auditor's response.[82]

Prohibited Employment Relationships. SOX § 206 prohibits a registered public accounting firm from performing audit services for a public company if the issuer's chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer had been employed by such firm and participated in any capacity in the audit of that issuer during the one year period preceding the audit initiation date.[83]

To implement SOX § 206, the Title II Rules require that when the lead partner, the concurring partner, or any other member of the audit engagement team who provides more than ten hours of audit, review, or attest services for the issuer accepts a position with the issuer in "a financial reporting oversight role" within the one year period[84] preceding the commencement of audit procedures for the year that included employment by the issuer of the former member of the audit engagement team, the accounting firm is not independent with respect to that issuer.[85] The Title II Rules cover employment in any "financial reporting oversight role," which would

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- Engagement letter; and
- Independence letter.

[82] *Id*. at 6027 (quoting Warren Buffett, Comments During SEC "Roundtable Discussion on Financial Disclose and Auditor Oversight" (Mar. 4, 2002)).

[83] SOX § 206, *amending* 15 U.S.C.A. § 78j-1(l) (West Supp. 2010) [hereinafter *"SOX § 206"*].

[84] Title II Release, *supra* note 29, at 6008. Under the Title II Rules, the accounting firm must have completed one annual audit subsequent to when an individual was a member of the audit engagement team before the individual would be eligible for employment by the issuer.

[85] *Id.* at 6009. While the employment prohibition applies broadly to members of the audit engagement team, there are accommodations for certain unique situations. For example, in a situation where an individual complied fully with the rule and, subsequent to his or her beginning employment with an issuer, the issuer merged with or was acquired by another entity resulting in he or she becoming a person in a financial reporting oversight role of the combined entity and the combined entity being audited by the individual's previous employer, unless the employment was taken in contemplation of the combination, and, as long as the audit committee is aware of this conflict, the audit firm would continue to be independent under the Title II Rules.

encompass any individual who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information that are included in SEC filings and is not limited to the four named positions in SOX § 206 (chief executive officer, controller, chief financial officer and chief accounting officer).[86]

Prohibited Compensation. The Title II Rules provide that "an accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review, or attest services."[87] The Title II Rules do not preclude an audit partner from sharing in the overall firm profits.[88] Non-audit partners can be compensated for selling their respective areas of expertise.[89] The Title II Release suggests that an audit committee may wish to ascertain the audit firm's compensation policies regarding senior staff members, as well as partners, when pre-approving non-audit services.

III.
CORPORATE RESPONSIBILITY (SOX TITLE III)

Audit Committees. SOX § 301 requires the SEC to issue rules that will effectively prohibit the listing of an issuer's stock unless the audit committee complies with certain enhanced requirements that seek to break what is perceived as the direct link between management and the auditors.[90] Under SOX § 301, audit committees for listed companies must take charge of the audit, including appointing, compensating, and overseeing the auditors, as well as resolve disputes on accounting matters between auditors and management.[91] Although

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86 SOX § 206, *supra* note 83.

87 Title II Release, supra note 29, at 6025.

88 *Id.*

89 *Id.*

90 SOX § 301, *amending* 15 U.S.C.A. § 78j-1(m) (West Supp. 2010) [hereinafter *"SOX § 301"*].

91 *Id*. Under Section 3(a)(58) of the 1934 Act as added by SOX Section 205, the term "*audit committee*" is defined as:

(A) A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of **overseeing** the accounting the financial reporting **processes** of the issuer and **audits** of the issuer; and

(B) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

SOX § 205, *amending* Section 3(a) of the 1934 Act, 15 U.S.C.A. § 78c (West Supp. 2010) (emphasis added).

Under this statutory definition of audit committee, the responsibility of the audit committee members is one of "oversight," not management or doing, of "processes" and "audits." The audit committee role is one of

the audit committee must control the audit of a listed company, the financial statements remain the responsibility of management, as evidenced by the required civil certification of all Forms 10-K and 10-Q in SOX § 302 and criminal certification in SOX § 906. Audit committees must also establish procedures to ensure that their members are independent, and they must hear and act on employee complaints regarding questionable accounting or auditing matters. These rules are the complement to the restrictions on registered accounting firms' activities in SOX § 201, and are considered an important step in ensuring auditor independence and preserving the integrity of the audit process.

On April 9, 2003, the SEC issued Release No. 33-8220 to implement SOX § 301.[92] The SOX § 301 Rule requires that each national stock exchange, including NASDAQ, must adopt rules conditioning the listing of any securities of an issuer upon the issuer being in compliance with the standards specified in the SOX § 301, which may be summarized as follows:

- *Oversight*—The audit committee must have direct responsibility for the appointment, compensation, and oversight of the work (including the resolution of disagreements between management and the auditors regarding financial reporting) of any registered public accounting firm employed to perform audit services, and the auditors must report directly to the audit committee.

- *Independence*—The audit committee members must be independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees: (i) accept any consulting, advisory, or other compensation, directly or indirectly, from the issuer or (ii) be an officer or other affiliate of the issuer.

- *Procedures to Receive Complaints*—The audit committee is responsible for establishing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer (*"whistleblowers"*) of concerns regarding questionable accounting or auditing matters.

- *Funding and Authority*—The audit committee must have the authority to hire independent counsel and other advisers to carry out its duties, and the issuer must provide for funding, as the audit committee may determine, for payment of compensation of the issuer's auditor and of any advisors that the audit committee engages.[93]

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understanding and monitoring processes and procedures, rather than supervising the preparation of financial statements.

[92] Standards Relating to Listed Company Audit Committees, 1933 Act Release No. 8220, 1934 Act Release No. 47,654, 68 Fed. Reg. 18,788 (April 16, 2003), *available at* www.sec.gov/rules/final/33-8220.htm [hereinafter the *"SOX § 301 Release"*].

[93] *Id*. Noncompliance would result in delisting, although the SRO rules must provide procedures to permit issuers an opportunity to cure defects that would otherwise result in delisting.

A self-regulatory organization (*"SRO"*) may adopt additional listing standards regarding audit committees as long as the standards are consistent with SOX and the SEC SOX § 301 Rule.

Additional analysis regarding the SOX § 301 Rule follows:

Audit Committee Member Independence. To be "independent" and thus eligible to serve on an issuer's audit committee, (i) audit committee members may not, directly or indirectly, accept any consulting, advisory or other compensatory fee from the issuer or a subsidiary of the issuer, other than in the member's capacity as a member of the board of directors and any board committee (this prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments; indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a general partner, managing member, executive officer or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial, or other advisory services or any similar services to the issuer or any subsidiary; receipt of fixed retirement plan or deferred compensation is not prohibited)[94] and (ii) a member of the audit committee of an issuer may not be an "affiliated person" of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee (subject to the safe harbor described below).[95]

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[94] SOX § 301 Release, *supra* note 92. The SOX § 301 Rule restricts only current relationships and does not extend to a "look back" period before appointment to the audit committee, although SRO rules may do so.

[95] SOX § 301, *supra* note 90; SOX § 301 Release, *supra* note 92. In the SOX § 301 Release, the SEC commented:

> [W]e are defining the terms "affiliate" and "affiliated person" consistent with our other definitions of these terms under the securities laws, such as in Exchange Act Rule 12b-2 and Securities Act Rule 144, with an additional safe harbor. We are defining "affiliate" of, or a person "affiliated" with, a specified person, to mean "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." We are defining the term "control" consistent with our other definitions of this term under the Exchange Act as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."
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> . . .
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> Our definition of "affiliated person" for non-investment companies, like our existing definitions of this term for these issuers, requires a factual determination based on a consideration of all relevant facts and circumstances. To facilitate the analysis on facts and circumstances where we are presumptively comfortable, we are adopting a safe harbor for that aspect of the definition of "affiliated person," with minor modifications from the original proposal. Under the safe harbor as adopted, a person who is not an executive officer or a shareholder owning 10% or more of any class of voting equity securities of a specified person will be deemed not to control such specified person. * * * We have clarified * * * that the ownership prong should be based on ownership of any class of voting equity securities, instead of any class of equity securities.

Since it is difficult to determine whether someone controls the issuer, the SOX § 301 Rule creates a safe harbor regarding whether someone is an "affiliated person" for purposes of meeting the audit committee independence requirement. Under the safe harbor, a person who is not an executive officer, director, or 10% shareholder of the issuer would be deemed not to control the issuer. A person who is ineligible to rely on the safe harbor, but believes that he or she does not control an issuer, still could rely on a facts and circumstances analysis. This test is similar to the test used for determining insider status under § 16 of the 1934 Act.[96]

The SEC has authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. Because companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the SOX § 301 Rule provides an exception for non-investment company issuers that requires only one fully independent member at the time of the effectiveness of an issuer's initial registration

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> The safe harbor is designed to identify a group of those that are not affiliates so as to provide comfort to those individuals or entities that no additional facts and circumstances analysis is necessary. It only creates a safe harbor position for non-affiliate status. Failing to meet the 10% ownership threshold has no bearing on whether a particular person is an affiliate based on an evaluation of all facts and circumstances. A director who is not an executive officer but beneficially owns more than 10% of the issuer's voting equity could be determined to be not an affiliate under a facts and circumstances analysis of control.
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> . . .
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> [C]alculations of beneficial ownership are to be made consistent with Exchange Act Rule 13d-3.
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> The proposed rules would have deemed a director, executive officer, partner, member, principal or designee of an affiliate to be an affiliate. * * * Under the final rule, only executive officers, directors that are also employees of an affiliate, general partners and managing members of an affiliate will be deemed to be affiliates. The limitation on directors will exclude outside directors of an affiliate from the automatic designation.
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> . . .
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> For issuers that are investment companies, we are adopting, as proposed, the requirement that a member of the audit committee of an investment company may not be an "interested person" of the investment company, as defined in Section 2(a)(19) of the Investment Company Act.

SOX § 301 Release, *supra* note 92, at 18,793-94.

[96] 17 C.F.R. § 240.12b-2 (2010).

statement under the 1933 Act or the 1934 Act, a majority of independent members within 90 days, and a fully independent audit committee within one year.[97]

For companies that operate through subsidiaries, the composition of the boards of the parent company and subsidiaries are sometimes similar, given the control structure between the parent and the subsidiaries. If an audit committee member of the parent is otherwise independent, merely serving on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent for purposes of the subsidiary except for the member's seat on the parent's board. Therefore, the SOX § 301 Rule exempts from the "affiliated person" requirement a committee member that sits on the board of directors of both a parent and a direct or indirect subsidiary or other affiliate, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary or affiliate, including the receipt of only "ordinary-course" compensation for serving as a member of the board of directors, audit committee, or any other board committee of the parent, subsidiary, or affiliate.[98] Any issuer taking advantage of any of the exceptions described above would have to disclose that fact.

Responsibilities Relating to Registered Accounting Firms. The SOX § 301 Release states that one of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. It is the SEC's view that the auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. Therefore, under the SOX § 301 Rule, the audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of the independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review ,or attest services for the issuer, and the independent auditor would have to report directly to the audit committee.[99] The oversight responsibilities contemplated include the authority to retain the outside auditor, which would include the power not to retain (or to terminate) the outside auditor.[100] The SEC states in the SOX § 301 Release that, in connection with the oversight responsibilities contemplated, the audit committee would need to have ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor.[101] In this

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97 SOX § 301 Release, *supra* note 92.

98 *Id*.

99 SOX § 301, *supra* note 90; *Id*. The SOX § 301 Release proposes to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor because 1940 Act Section 32(a) already requires that independent auditors of registered investment companies be selected by majority vote of the disinterested directors.

100 SOX § 301; SOX § 301 Release, *supra* note 92.

101 SOX § 301 Release, *supra* note 92.

regard, the requirement would reinforce the requirement in SOX § 202 that auditing and non-auditing services be pre-approved by the audit committee.[102]

The requirement will not affect any requirement under a company's governing law or documents or other home country requirements that require shareholders to elect, approve or ratify the selection of the issuer's auditor.[103] The requirement instead relates to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. However, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer must be responsible for making the recommendation or nomination.[104]

Procedures for Handling "Whistleblower" Complaints. The SOX § 301 Release states that because the audit committee is dependent to a degree on the information provided to it by management and internal outside auditors, it is important for the committee to cultivate open and effective channels of information. In order to ensure that these channels remain open, the SOX § 301 Release provides that the audit committee must establish procedures for:

- The receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters, and
- The confidential, anonymous submission by employees of the issuer concerns regarding questionable accounting or auditing matters.[105]

The SEC has not mandated specific procedures that the audit committee must establish. Each audit committee is encouraged to develop procedures that work best, consistent with its company's individual circumstances.

Authority to Engage Advisors. The SOX § 301 Release notes that to perform its role effectively, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.[106] The SOX § 301 Rule specifically requires an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.[107]

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102 *See* SOX § 202, *supra* note 52.

103 SOX § 301 Release, *supra* note 92, at 18,797.

104 *Id.*

105 *Id.* at 18,798; *cf.* SOX § 806, *infra* notes 368-372 and related text.

106 *Id.*

107 *Id.*

Funding. The SOX § 301 Rule requires the issuer to provide for appropriate funding, as determined by the audit committee, for payment of compensation:

- To any registered public accounting firm engaged for the purpose of rendering or issuing an audit report [or related work] or performing other audit, review or attest services for the listed issuer; and

- To any advisors employed by the audit committee.[108]

This rule is designed to prevent the audit committee's effectiveness from being compromised by its dependence on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent.

Trading Markets Affected. SOX § 301 by its terms applies to all stock exchanges and NASDAQ, and, to the extent that their listing standards do not already comply with the proposals, they will be required to issue or modify their rules, subject to SEC review, to conform their listing standards.[109] The SOX § 301 Rule does not preclude stock exchanges and NASDAQ from adopting additional listing standards regarding audit committees, as long as they are consistent with the SOX § 301 Release. [110]

The OTC Bulletin Board, the Pink Sheets and the Yellow Sheets will not be affected by the proposed requirements in the SOX § 301 Release. [111] Therefore, issuers whose securities are quoted on these interdealer quotation systems similarly would not be affected, unless their securities also are listed on an exchange or NASDAQ.[112]

Issuers and Securities Affected. SOX § 301 prohibits the listing of "any security" of an issuer that does not meet the SOX standards for audit committees.[113] Therefore, the proposed SOX § 301 rules apply not just to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities and other types of listed securities.[114] The

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108 *Id*. At 18,799.

109 SOX § 301 Release, *supra* note 92, at 18,799; *see also* New York Stock Exchange and National Association of Securities Dealer Order Approving Proposed Rule Changes, 1934 Act Release 34-48475 (Nov. 4, 2003) available at http://www.sec.gov/rules/sro/34-48475.htm.

110 *Id*.

111 *Id*. at 18,800.

112 *Id*.

113 *Id*.

114 *Id*.

SOX § 301 Rule applies to foreign companies as well as domestic issuers, subject to certain exceptions.[115]

Small Businesses. SOX § 301 makes no distinction based on an issuer's size, except that small business issuers are given until July 31, 2005, to comply with the SOX audit committee requirements.[116]

Investment Companies. The SOX § 301 Rule covers closed-end investment companies and exchange-traded, open-end investment companies, but excludes exchange-traded unit investment trusts from the proposed SOX § 301 requirements.[117]

Determining Compliance with Standards. SOX § 301 does not establish specific mechanisms for a national securities exchange or NASDAQ to ensure that issuers comply with the standards on an ongoing basis. SROs are required to comply with SEC rules pertaining to SROs and to enforce their own rules, including rules that govern listing requirements and affect their listed issuers. The SOX § 301 Release directs the SROs to require a listed issuer to notify the applicable SRO promptly after an executive officer of an issuer becomes aware of any material noncompliance by the listed issuer with the requirements.[118]

Opportunity to Cure Defects. The SOX § 301 Rule specifies that the SRO rules must provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition of the continued listing of the issuer's securities as a result of its failure to meet the SRO audit committee standards before the imposition of such a prohibition.[119] The SRO rules may provide that an audit committee member who ceases to be independent for reasons outside his control may, with notice by the issuer to the SRO, remain on the audit committee until the earlier of (i) the next annual meeting of shareholders or (ii) the first anniversary of the event which caused him not to be independent.[120]

Audit Committee Charters. Issuers should review their audit committee charters and amend them to comply with the SOX § 301 Rule and any applicable SRO rules.[121]

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[115] *See infra* notes 513-523 and related text.

[116] SOX § 301 Release, *supra* note 92, at 18,790.

[117] *Id*. at 18,797.

[118] *Id*. at 18,805.

[119] *Id.* at 18,806.

[120] *Id*.

[121] *Id*. at 18,808.

Disclosure Changes Regarding Audit Committees

- Disclosure Regarding Exemptions. Because exemptions from the rules adopted in the SOX § 301 Release would distinguish certain issuers from most other listed issuers, the exempted issuers would need to disclose their reliance on an exemption and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the proposed rules.[122] Such disclosure would need to appear in, or be incorporated by reference into, (i) annual reports filed with the SEC and (ii) proxy statements or information statements for shareholders' meetings at which elections for directors are held.[123]

- Identification of the Audit Committee in Annual Reports. Currently, an issuer subject to the SEC proxy rules is required to disclose in its proxy statement or information statement, if action is to be taken with respect to the election of directors, whether the issuer has a standing audit committee, the names of each committee member, the number of committee meetings held by the audit committee during the last fiscal year, and the functions performed by the committee.[124] The SOX § 301 Release requires disclosure of the members of the audit committee to be included or incorporated by reference in the listed issuer's annual report.[125] Also, since in the absence of an audit committee the entire board of directors will be considered to be the audit committee, the SEC requires a listed issuer that has not separately designated or has chosen not to separately designate an audit committee to disclose that the entire board of directors is acting as the issuer's audit committee.[126]

- Updates to Existing Audit Committee Disclosure. A listed issuer will be required to disclose whether the members of its audit committee are independent using the definition of independence for audit committee members included in the applicable listing standards.[127] Non-listed issuers that have separately designated audit committees would still be required to disclose whether their audit committee members were independent, but in determining whether a member was independent, non-listed issuers would be allowed to choose any definition for audit committee member independence of a national securities exchange or national securities association that has been approved by the SEC.[128]

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122 SOX § 301 Release, *supra* note 92, at 18,806.

123 *Id*.

124 *Id*. at 18,807.

125 *Id*.

126 *Id*.

127 *Id*. at 18,808.

128 SOX § 301 Release, *supra* note 92, at 18,808.

CEO/CFO Certifications. SOX contains two separate certification requirements, which are applicable to all public companies, regardless of size, and are in addition to the one-time certification requirement which the SEC imposed on the CEOs and CFOs of the 947 largest public companies pursuant to a June 27, 2002, investigative order.[129]

SOX § 906 Certification. SOX § 906 amended Federal criminal law to require the CEO and CFO to furnish a written certification with each SEC periodic report filed containing financial statements certifying that the financial statements and the disclosures therein fairly present, in all material aspects, the operations and financial condition of the issuer.[130] The required form of the SOX § 906 certification follows:[131]

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the __________ Report of _______________ (the "Company") on Form 10-__ for the period ending __________ as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, _________________, Chief [Executive] [Financial] Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ ______________________________________

____
Chief [Executive] [Financial] Officer
[Date]

The criminal penalties applicable to a false SOX § 906 certification are (1) 20 years in prison for a willful violation; and (2) ten years for a reckless and knowing violation.[132] The § 906 certification requirement was effective July 30, 2002, and was not predicated on any SEC rulemaking.

SOX § 302 Certification. The SEC has adopted rules pursuant to SOX § 302 requiring the CEO and CFO of each public company filing a Form 10-Q or 10-K to certify that the financial statements filed with the SEC fairly present, in all material respects, the operations

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[129] Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, SEC File No. 4-460 (June 27, 2002), *at* http://www.sec.gov/rules/other/4-460.htm.

[130] SOX § 906, 18 U.S.C.A. § 1350 (West Supp. 2010) [hereinafter *"SOX § 906"*]; Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 1933 Act Release No. 8238, 1934 Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm.

[131] SOX § 906, *supra* note 130.

[132] *Id.*

and financial condition of the issuer, as to the adequacy of the issuer's "disclosure controls and procedures" and "internal controls," and as to certain other matters.[133] The mandated CEO/CFO certification under SOX § 302 is as follows:

> I, [identify the certifying individual], certify that:
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> 1. I have reviewed this [specify report] of [identify registrant];
>
> 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
>
> 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the [registrant] as of, and for, the periods presented in this report;
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> 4. The [registrant]'s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)[134]) [and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)[135])][136] for the [registrant] and have:

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133 SOX § 302, 15 U.S.C.A. § 7241 (West Supp. 2010) [hereinafter *"SOX § 302"*]; 1933 Act Release No. 8238, *supra* note 130. Note that certain portions of the § 302 certification are not mandatory for a particular issuer until the final rules relating to Internal Controls over Financial Reporting are fully in effect for that issuer. *See infra* notes 293-**Error! Bookmark not defined.** and related text.

134 For purposes of this certification, the term "*disclosure controls and procedures*" is defined in Rule 13a-15(e) under the 1934 Act as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the 1934 Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the 1934 Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. 17 C.F.R. § 240.13a-15(e) (2010).

135 For purposes of this certification, the term "*internal control over financial reporting*" is defined in Rule 13a-15(f) and 15d-15(f) under the 1934 Act as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the [registrant], including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the [registrant]'s disclosure controls and procedures and presented in this report our conclusion about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the [registrant]'s internal control over financial reporting that occurred during the [registrant]'s most recent fiscal quarter (the [registrant]'s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the [registrant]'s internal control over financial reporting; and[137]

5. The [registrant]'s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the [registrant]'s auditors and the audit committee of the [registrant]'s board of directors (or persons performing the equivalent function):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

To implement SOX § 302's directive that the SOX § 302 certifications be "in" each periodic report, the SEC requires issuers both to (i) file the SOX § 302 certifications as an exhibit

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(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

17 C.F.R. § 240.13a-15(f); *see infra* notes 293-**Error! Bookmark not defined.** and related text.

136 The bracketed language regarding internal control is not applicable to an issuer until its first Form 10-K that is required to contain a management report on internal control over financial reporting requirements. Generally, accelerated filers were required to include a management report on internal control over financial reporting requirements in their Forms 10-K for their fiscal years ending on or after November 15, 2004, and all other domestic issuers are required to comply for their Forms 10-K for their fiscal years ending on or after July 15, 2007. *See infra* notes 293-**Error! Bookmark not defined.** and related text.

137 This certification mirrors the requirements in 1934 Act Rules 13a-15 and 15d-15 which require an issuer to establish and maintain an overall system of disclosure controls and procedures and internal control over financial reporting that is adequate to meet its 1934 Act reporting obligations. These rules are intended to complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their financial reporting obligations. In the SEC's view, "internal controls" has a meaning which both overlaps and is narrower than "disclosure controls." *See infra* notes 293-**Error! Bookmark not defined.** and related text.

to the periodic reports to which they relate[138] and (ii) furnish the SOX § 906 certifications as an exhibit to the periodic reports to which they relate.[139]

Enforcement Actions. The SEC is using the SOX certification requirements as an independent basis for enforcement action. In *SEC v. Rica Foods*, the SEC settled civil injunctive actions against a company headquartered in Costa Rica and the officers who personally signed certifications in a Form 10-K Report.[140] The predicate of the SEC action was that the officers signed their certifications and filed the Form 10-K Report despite the company's lack of a signed report of its independent auditors and material classification errors in the financial statements.[141] In *SEC v. Irving Paul David*, the SEC filed an enforcement action, and the U.S. Attorney for the Southern District of New York simultaneously announced an indictment, against a financial officer of two mutual funds for embezzling funds to which the investment companies were entitled and for filing SOX-mandated certificates that did not disclose his fraud.[142]

CEO/CFO Reimbursement to Issuer. SOX § 304 provides that, if an issuer is required to restate its financial statements owing to noncompliance with securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or incentive or equity based compensation received in the 12 months prior to the restatement and (2) any profits realized from the sale of issuer securities within the preceding 12 months.[143] The purpose of this provision is to "prevent CEOs and CFOs from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public and regulators about the poor heath of the company."[144] Because there is no relationship between the financial restatement and any

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[138] 1933 Act Release No. 8238, *supra* note 130, at 36,638.

[139] In 1933 Act Release No. 8238, the SEC noted that SOX § 906 merely requires that the SOX § 906 certifications "accompany" a periodic report to which they relate, in contrast to SOX § 302, that requires the certifications to be included "in" the periodic report. In recognition of this difference, the SEC requires issuers to "furnish," rather than "file," the SOX § 906 certifications with the SEC. Thus, the certifications would not be subject to liability under 1934 Act § 18 and would not be subject to automatic incorporation by reference to an issuer's 1933 Act registration statements, which are subject to liability under 1933 Act § 11, unless the issuer takes steps to include the certifications in a registration statement. Issuers are to submit the SOX § 906 certifications as exhibits to the periodic reports to which they relate and designate the certifications as an "Additional Exhibit" under Item 99 of Item 601(b) of Regulation S-K. *See id.*; SOX § 302, *supra* note 133; SOX § 906, *supra* note 130.

[140] *SEC v. Rica Foods et. al.*, Civil Action No. 03-22191-Civ-King (S.D. Fla. filed August 15, 2003), SEC Litigation Release No. 18,293 (August 18, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18293.htm.

[141] *Id*.

[142] *SEC v. Irving Paul David*, 03 Civ. 6305 (S.D.N.Y.) (KMW), SEC Litigation Release No. 18300 (August 1, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18300.htm.

[143] SOX § 304, 15 U.S.C.A. § 7243 (West Supp. 2010) [hereinafter *"SOX § 304"*].

[144] S. REP. NO. 107-205, at 26 (2002).

misconduct of the CEO or CFO, the CEO and CFO could conceivably be responsible for misconduct of any employee of the issuer.[145]

The SEC has asserted that the SOX § 304 "clawback" provision can force the return of incentive-based compensation by CEOs and CFOs to issuers, even when they are not personally responsible for any alleged "misconduct." In *SEC v. Jenkins*,[146] the court denied a motion to dismiss the SEC's complaint seeking an order directing the former CEO of CSK Auto Corporation to pay back to CSK over $4 million in bonuses and stock sale proceeds that Jenkins received during a period for which CSK's financial statements were later restated. The SEC did not charge Jenkins with any wrongdoing, notwithstanding that other former CSK executives have faced both civil and criminal accounting fraud charges. The *Jenkins* court rejected the argument that the SOX § 304 obligation can arise only where the "misconduct" has been committed by the CEO or CFO in question, and instead held that the triggering event is misconduct by the issuer, acting through any of its officers, agents or employees. The court noted that although the SEC did not allege that the former CEO of CSK personally was aware of the fraudulent actions of other CSK officers, the former CEO did certify pursuant to SOX § 302[147] CSK's inaccurate financial statements for the years in issue. The court linked reimbursement pursuant to SOX § 304 to certifications under SOX § 302 and internal controls mandated by SOX § 304[148] as follows:

> Section 304 provides an incentive for CEOs and CFOs to be rigorous in their creation and certification of internal controls by requiring that they reimburse additional compensation received during periods of corporate non-compliance regardless of whether or not they were aware of the misconduct giving rise to the misstated financials.[149]

In arguing against the SEC's interpretation of SOX § 304, the CEO argued that he would be entitled to indemnification under Delaware General Corporation Law (*"DGCL"*) § 145(a) if he acted in "good-faith" and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation. In response, the court in *Jenkins* wrote:

> [A]t this point, the Court need not determine the efficacy of Delaware's statutory scheme or the extent to which Delaware's statute conflicts with Section 304, [but] the existence of a state statute does not alter the meaning of the federal statute.[150]

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[145] *Id.* In *Neer v. Pelino*, 2005 WL 2434685 (E.D. Pa. Sept. 27, 2005), the court held that the disgorgement is limited to SEC action and that no new private cause of action was created by SOX § 304, etc.

[146] 2010 WL 2347020 (D. Ariz. June 9, 2010).

[147] *See supra* notes 129-142 and related text.

[148] *See supra* notes 293-**Error! Bookmark not defined.** and related text.

[149] *Jenkins*, 2010 WL 2347020 at 4.

[150] *Jenkins*, 2010 WL 2347020 at 5.

D&O Bars. SOX § 305 authorizes a court to prohibit a violator of certain SEC rules from serving as an officer or director of an issuer if the person's conduct demonstrates unfitness to serve (the pre-SOX standard was "substantial unfitness").[151]

Insider Trading Freeze During Plan Blackout. SOX § 306 prohibits any director or executive officer of an issuer of any equity security from, directly or indirectly, purchasing, selling, or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants or beneficiaries from engaging in equity securities transactions through their plan accounts, if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer.[152] Under SOX § 306, profits realized from such trades shall inure to and be recoverable by the issuer irrespective of the intent of the parties to the transaction.[153]

The Enron scandal provided impetus for SOX § 306(a) when insiders were able to liquidate their Enron stock before its price plunged, even as employees were stuck holding shares during a pension blackout period, resulting in often devastating losses in their accounts.[154] SOX § 306(a) restrictions on transactions by insiders would apply to all reporting companies, including foreign private issuers, banks and savings associations, and small business issuers.[155] The SEC was required to adopt implementing rules within 180 days of the effective date of SOX (January 26, 2003).[156]

Regulation BTR. On January 22, 2003, the SEC adopted Regulation Blackout Trading Restriction (*"Regulation BTR"*) to implement SOX § 306(a) and to prevent evasion of the statutory trading prohibition.[157] Regulation BTR incorporates a number of concepts developed under 1934 Act § 16 to take advantage of "a well-established body of rules and interpretations concerning the trading activities of corporate insiders and, as to directors and executive officers of domestic issuers, facilitate enforcement of the SOX § 306(a) trading prohibition through monitoring of the reports publicly filed by directors and executive officers pursuant to 1934 Act § 16(a).[158]

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151 SOX § 305, *modifying* 15 U.S.C.A. § 78u. (West Supp. 2010).

152 SOX § 306 (a)(1), 15 U.S.C.A. § 7244(a)(1) (West Supp. 2010) [hereinafter *"SOX § 306"*].

153 *Id*. at (a)(2)(A).

154 Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135, 150 (2004).

155 S. Rep. No. 107-205, at 27 (2002).

156 SOX § 208, 15 U.S.C.A. § 7233 (West Supp. 2010).

157 Insider Trades During Pension Fund Blackout Periods, 1934 Act Release No. 47,225, 68 Fed. Reg. 4338 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/34-47225.htm.

158 *Id*. At 4339.

Persons Subject to Trading Prohibition. SOX § 306(a) and Regulation BTR apply to the directors[159] and executive officers[160] of domestic issuers, foreign companies,[161] small business issuers[162] and, in rare instances, registered investment companies.[163]

Securities Subject to Trading Prohibition. SOX § 306(a) applies to any equity security of an issuer other than an exempt security.[164]

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159 Under Regulation BTR, the term "director" has the meaning set forth in 1934 Act §3(a)(7). *Id.* at 4339. As the SEC has previously noted, this definition reflects a functional and flexible approach to determining whether a person is a director of an entity. Improper Influence on Conduct of Audits, 1934 Act Release No. 47,890 (May. 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm. Thus, for purposes of SOX § 306(a) and Regulation BTR, an individual's title is not dispositive as to whether he or she is a director. As under 1934 Act § 16, attention must be given to the individual's underlying responsibilities or privileges with respect to the issuer and whether he or she has a significant policy-making role with the issuer. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 1934 Act Release No. 28,869, 56 Fed. Reg. 7242, at § II.A.1 (Feb. 21, 1991). An individual may hold the title "director" and yet, because he or she is not acting as such, not be deemed a director. *See* Ownership Reports and Trading by Officers, Directors and Principal Stockholders, 1934 Act Release No. 26,333, 53 Fed. Reg. 49,997, at § III.A.2 (Dec. 13, 1988).

160 Under Regulation BTR, the term "executive officer" has the same meaning as the term "officer" in 1934 Act Rule 16a-1(f), *supra* note 157.

161 *See infra* notes 529-532 and related text.

162 SOX § 306(a) does not distinguish between large and small issuers, *supra* note 152.

163 1934 Act Release No. 47,225, *supra* note 157, at 4339.

164 SOX § 306(a), *supra* note 152. Rule 100(i) of Regulation BTR defines the term "exempt security" by reference to the definition in 1934 Act § 3(a)(12). 17 C.F.R. § 245.100(i) (2010). Rule 100(f) provides that the term "equity security of the issuer" includes any equity security or derivative security relating to an issuer, whether or not issued by that issuer. 17 C.F.R. § 245.100(f). Rule 100(d) provides that the term "derivative security" has the same meaning as in 1934 Act Rule 16a-1(c), which defines the term "derivative securities" to mean

> any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security, but shall not include: (1) Rights of a pledgee of securities to sell the pledged securities; (2) Rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities; (3) Rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy the exercise price or the tax withholding consequences of receipt, exercise or vesting; (4) Interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority; (5) Interests or rights to participate in employee benefit plans of the issuer; or (6) Rights with an exercise or conversion privilege at a price that is not fixed; or (7) Options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering.

Transactions Subject to Trading Prohibition. SOX § 306(a) is interpreted to make it unlawful for a director or executive officer of an issuer of any equity security, directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer during a pension plan blackout period with respect to the equity security if the director or executive officer acquired such equity security in connection with his or her service or employment as a director or executive officer.[165]

(a) *"Acquired in Connection with Service or Employment as a Director or Executive Officer."* Regulation BTR defines the phrase "acquired such equity security in connection with service or employment as a director or executive officer" to include equity securities acquired by a director or executive officer:

- At a time when he or she was a director or executive officer under a compensatory plan, contract, authorization, or arrangement, including, but not limited to, plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit-sharing (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization, or arrangement with a parent, subsidiary or affiliate;[166]

- At a time when he or she was a director or executive officer as a result of any transaction or business relationship described in paragraph (a) or (b) of Item 404 of Regulation S-K[167] to the extent that he or she has a pecuniary interest in the equity securities;[168]

- At a time when he or she was a director or executive officer, as "directors' qualifying shares" or other securities that he or she must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers;[169]

- Prior to becoming, or while, a director or executive officer where the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer;[170] or

- Prior to becoming, or while, a director or executive officer where the equity security was received as a result of a business combination in respect of an equity security of an entity

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17 C.F.R. § 240.16a–1(c) (2010).

165 17 C.F.R. § 245.101(a) (2010).

166 17 C.F.R. § 245.100(a)(1) (2010).

167 17 C.F.R. § 229.404 (2010).

168 17 C.F.R. § 245.100(a)(2) (2010).

169 17 C.F.R. § 245.100(a)(3) (2010).

170 17 C.F.R. § 245.100(a)(4) (2010).

involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of such entity.[171]

(b) *Service or Employment Presumption*. Regulation BTR provides that any equity securities sold or otherwise transferred during a blackout period by a director or executive officer of an issuer will be considered to have been "acquired in connection with service or employment as a director or executive officer" to the extent that the director or executive officer had a pecuniary interest in such securities at the time of the transaction, unless he or she establishes that the equity securities were not "acquired in connection with service or employment as a director or executive officer."[172] To establish this defense, a director or executive officer must specifically identify the origin of the equity securities in question and demonstrate that this identification of the equity securities is consistent for all purposes related to the transaction (such as tax reporting and any applicable disclosure and reporting requirements).[173] In other words, to the extent that directors and executive officers are able to specifically identify, or trace, the source of equity securities sold or otherwise transferred during a blackout period, the transaction will not be considered to involve securities "acquired in connection with service or employment as a director or executive officer."[174]

(c) *Transitional Situations*. Equity securities acquired by an individual before he or she becomes a director or executive officer are not "acquired in connection with service or employment as a director or executive officer."[175] Thus, equity securities acquired under a compensatory plan, contract, authorization, or arrangement while an individual is an employee, but not a director or executive officer, will not be subject to SOX § 306(a) trading prohibition. However, equity securities acquired by an employee before becoming a director or executive officer will be considered "acquired in connection with service or employment as a director or executive officer" if the equity securities are part of an inducement award.[176]

In contrast, equity securities acquired by an individual in connection with service or employment as a director or executive officer before an entity becomes an "issuer" are considered "acquired in connection with service or employment as a director or executive officer" for purposes of SOX § 306(a) and Regulation BTR and are subject to the statutory trading prohibition.[177] Similarly, equity securities acquired by a director or executive officer in

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171 17 C.F.R. § 245.100(a)(5) (2010).

172 17 C.F.R. § 245.101(b) (2010).

173 *Id*.

174 *Id*.

175 17 C.F.R. § 245.100(a) (2010).

176 17 C.F.R. § 245.100(a)(4) (2010).

177 17 C.F.R. § 245.100(a) (2010).

connection with his or her service or employment as a director or executive officer of an issuer before the effective date of SOX § 306(a) are subject to that section and Regulation BTR.[178]

(d) *Exempt Transactions*. Regulation BTR exempts from the statutory trading prohibition:

- Acquisitions of equity securities under dividend or interest reinvestment plans;[179]

- Purchases or sales of equity securities pursuant to a trading arrangement that satisfies the affirmative defense conditions of 1934 Act Rule 10b5-1(c);[180]

- Purchases or sales of equity securities, other than discretionary transactions, pursuant to certain "tax-conditioned" plans;[181]

- Increases or decreases in the number of equity securities held as a result of a stock split or stock dividend applying equally to all equity securities of that class;[182]

- Compensatory grants and awards of equity securities (including options and stock appreciation rights) pursuant to a plan that, by its terms, permits directors or executive officers to receive grants or awards, provides for grants or awards to occur automatically, and specifies the terms and conditions of the grants or awards;[183]

- Exercises, conversions, or terminations of derivative securities that were not written or acquired by a director or executive officer during the blackout period in question or while aware of the actual or approximate beginning or ending dates of the blackout period, and where (i) the derivative security, by its terms, may be exercised, converted, or terminated only on a fixed date, with no discretionary provision for earlier exercise, conversion, or termination, or (ii) the derivative security is exercised, converted, or terminated by a counterparty and the director or executive officer does not exercise any influence on the counterparty with respect to whether or when to exercise, convert, or terminate the derivative security;[184]

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[178] *Id.*

[179] 17 C.F.R. § 245.101(c)(1) (2010).

[180] 17 C.F.R. § 245.101(c)(2) (2010).

[181] 17 C.F.R. § 245.101(c)(3) (2010).

[182] 17 C.F.R. § 245.101(c)(10) (2010).

[183] 17 C.F.R. § 245.101(c)(4) (2010).

[184] 17 C.F.R. § 245.101(c)(5) (2010).

- Acquisitions or dispositions of equity securities involving a *bona fide* gift or a transfer by will or the laws of descent and distribution;[185]

- Acquisitions or dispositions of equity securities pursuant to a domestic relations order;[186]

- Sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction;[187] and

- Acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture, or similar transaction occurring by operation of law.[188]

The exemption in Regulation BTR does not extend to "discretionary transactions," such as an intra-plan transfer involving an issuer equity securities fund or a cash distribution funded by a volitional disposition of an issuer equity security,[189] that occur during a blackout period.[190] However, it would cover acquisitions or dispositions of equity securities made in connection with death, disability, retirement or termination of employment, or transactions involving a diversification or distribution required by the Internal Revenue Code to be made available to plan participants because these transactions are not "discretionary transactions."[191]

Blackout Period. SOX § 306(a)(4)(A) defines the term "*blackout period*" to mean any period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all "*individual account plans*" maintained by an issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity security of the issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan.[192]

(a) *Individual Account Plan*. The Regulation BTR definition of "*individual account plan*" encompasses a variety of pension plans, including 401(k) plans, profit-sharing and savings plans, stock bonus plans, and money purchase pension plans, but excludes one-participant retirement plans and pension plans, in which participation is limited to directors of the issuer.[193]

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185 17 C.F.R. § 245.101(c)(6) (2010).

186 17 C.F.R. § 245.101(c)(7) (2010).

187 17 C.F.R. § 245.101(c)(8) (2010).

188 17 C.F.R. § 245.101(c)(9) (2010).

189 17 C.F.R. § 240.16b–3(b)(4) (2010).

190 17 C.F.R. § 245.101(c)(3) (2010).

191 17 C.F.R. § 240.16b–3(b)(4) (2010).

192 SOX § 306(a)(4)(A), *supra* note 152, at 4344.

193 17 C.F.R. § 245.100(j) (2010).

(b) *Blackout Period*. Regulation BTR defines "*blackout period*" such that, in determining whether a temporary trading suspension in issuer equity securities constitutes a "*blackout period*," the individual account plans to be considered are individual account plans maintained by an issuer that permit participants or beneficiaries located in the U.S. to acquire or hold equity securities of the issuer.[194]

(c) *Determining Participants and Beneficiaries*. Once an issuer has identified the relevant individual account plans, it must determine whether the temporary suspension of trading in its equity securities affects 50% or more of the participants or beneficiaries under these plans.[195] This is accomplished by comparing the number of participants or beneficiaries located in the U.S. who are subject to the temporary trading suspension in issuer equity securities to the number of participants or beneficiaries located in the U.S. under all individual account plans maintained by the issuer.[196] In the case of a domestic issuer, where this percentage is 50% or more, the temporary trading suspension constitutes a "blackout period," so the SOX § 306(a) trading prohibition applies to the issuer's directors and executive officers.[197]

On any day, it may be difficult for an issuer to know precisely how many participants and beneficiaries are covered by all of its individual account plans. As a result, issuers will need to apply the "50% test" on the basis of estimates. Regulation BTR contains provisions for making reasonable estimates.

(d) *Exceptions to Definition of Blackout Period*. SOX § 306(a)(4)(B) expressly excludes from the definition of the term "blackout period" two types of temporary trading suspensions:

- A regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity security of an issuer, if such period is—
  - Incorporated into the individual account plan; and
  - Timely disclosed to employees before they become participants under the individual account plan or as a subsequent amendment to the plan;[198] or

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194 17 C.F.R. § 245.100(b)(1) (2010).

195 *Id*.

196 *Id*.

197 With respect to foreign private issuers, *see infra* notes 529-532 and related text.

198 Regulation BTR provides that the requirement that the regularly scheduled period be incorporated into the individual account plan may be satisfied by including a description of the regularly scheduled trading suspension in issuer equity securities, including the suspension's frequency and duration and the plan transactions to be suspended or otherwise affected, in either the official plan documents or other documents or instruments that govern plan operations. In the latter case, these documents or instruments may include

- Any temporary trading suspension [that would otherwise be a "blackout period"] that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, in an individual account plan by reason of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor.[199]

Remedies. SOX § 306(a) contains two distinct sets of remedies: (i) a violation of the statutory trading prohibition in SOX § 306(a)(1) is treated as a violation of the 1934 Act and subject to all resulting sanctions, including SEC enforcement action, and (ii) where a director or executive officer realizes a profit from a prohibited transaction during a blackout period, SOX § 306(a)(2) permits an issuer, or a security holder of the issuer on its behalf, to bring an action to recover that profit.[200] Under the latter provision, an issuer, or a security holder on its behalf, may initiate an action only if a director or executive officer realized a profit as a result of a prohibited purchase, sale or other acquisition, or transfer of an equity security during a blackout period.[201] As under 1934 Act § 16(b), this concept of "realized profits" means that the director or executive officer must have received a direct or indirect pecuniary benefit from the transaction.[202]

To provide guidance to the courts regarding SOX § 306(a)(2) private actions against directors and executive officers who have violated the statutory trading prohibition, Regulation BTR provides that where a transaction involves a purchase, sale or other acquisition, or transfer of a listed equity security (other than a grant, exercise, conversion, or termination of a derivative security), profit is to be measured by comparing the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the average market price of the equity security calculated over the first three trading days after the

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an ERISA Section 404(c) notice or an advance notice in either the plan's summary plan description or any other official plan communication. *See* 1934 Act Release No. 47,225, *supra* note 157, at 4347.

The disclosure of the regularly scheduled trading suspension will be considered timely if the employee is notified of the trading suspension at any time prior to, or within 30 calendar days after, the employee's formal enrollment in the plan, or, in the case of a subsequent amendment to the plan, within 30 calendar days after adoption of the amendment. *Id.*

199 17 C.F.R. § 245.102 (2010). In the case of a temporary trading suspension in issuer equity securities imposed in connection with a merger, acquisition, divestiture, or similar transaction, Regulation BTR provides that the temporary suspension will not constitute a "blackout period" for purposes of SOX § 306(a) if: (i) its principal purpose is to enable individuals to become participants or beneficiaries in an individual account plan by reason of the transaction, or to terminate participation in the plan, even though the suspension is also used to effect other administrative actions that are incidental to the admission or withdrawal of plan participants or beneficiaries and (ii) the persons becoming participants or beneficiaries are not permitted to participate in the same class of equity securities after the merger, acquisition, divestiture, or similar transaction as before the transaction. *See* 1934 Act Release No. 47,225, *supra* note 157, at 4348.

200 SOX § 306(a)(1)-(2), *supra* note 152.

201 SOX § 306(a)(2)(A), *supra* note 152.

202 17 C.F.R. § 240.16a-1(a)(2) (2010).

ending date of the blackout period.[203] Otherwise, profit is to be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided as a result of the transaction taking place during the blackout period rather than taking place outside of the blackout period.[204] To mitigate the effect of large fluctuations in the market price of an issuer's equity securities after a blackout period and deter attempts to manipulate this market price, Regulation BTR uses a three-day average trading price to determine the amount that a director or executive officer would have paid or received if the transaction had occurred after the end of the blackout period.[205]

Notice of Blackout Period. SOX § 306(a)(6) requires that an issuer provide timely notice to its directors and executive officers[206] and to the SEC on Form 8-K of the imposition of a blackout period that triggers the trading prohibition of SOX § 306(a).[207]

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203 1934 Act Release No. 47,225, *supra* note 157, at 4357.

204 *Id*.

205 *Id*. at 4349.

206 SOX § 306(a)(6), *supra* note 152. Regulation BTR requires that the notice specify the length of the blackout period, using either the actual or expected beginning date and ending date of the blackout period, or the calendar week or weeks during which the blackout period is expected to begin and end, provided that during such week or weeks information as to whether the blackout period has begun or ended is readily available without charge (such as via a toll-free telephone number or access to a specified web site), to affected directors and executive officers and that the notice describes how to access the information. Regulation BTR further permits the length of the blackout period to be described in the notice to the SEC using the calendar week or weeks during which the blackout period is expected to begin and end, provided that the notice also describes how a security holder or other interested person may obtain, without charge, the actual beginning and ending dates of the blackout period. Under the rule, it is permissible to use a "week of _____" beginning date and a "week of _____" ending date. It also is permissible to use a specific beginning date and a "week of _____" ending date, or the converse. For purposes of the rule, a calendar week is defined to mean a seven-day period beginning on Sunday and ending on Saturday. If an issuer elects to provide the actual or expected beginning and ending dates of a blackout period in the required notice, and either or both of those dates change, the issuer is required to provide directors and executive officers and the SEC with an updated notice identifying the change in date or dates, explaining the reasons for the changes and identifying all material changes in the information contained in the prior notice. The updated notice is required to be provided as soon as reasonably practicable.

See Filing Guidance Related to: Conditions for Use of Non-GAAP Financial Measures; and Insider Trades During Pension Fund Blackout Periods, 1933 Act Release No. 8216, 1934 Act Release No. 47,583, 68 FED. REG. 15,939 (April 2, 2003), *available at* http://www.sec.gov/rules/final/33-8216.htm.

Regulation BTR provides that the notice to directors and executive officers will be considered timely if an issuer provides it no later than five business days after the issuer receives the notice from the pension plan administrator required by the Department of Labor Rules. If the issuer does not receive such notice, the issuer must provide its notice to directors and executive officers at least 15 calendar days before the actual or expected beginning date of the blackout period. This provision is designed to ensure that an issuer will typically not be required to provide the notice under SOX § 306(a)(6) to its directors and executive officers until it has received notice of an impending blackout period from the pension plan administrator. Notwithstanding this general requirement, Regulation BTR provides that advance notice is not required in

IV.
ENHANCED FINANCIAL DISCLOSURES;
PROHIBITION ON INSIDER LOANS (SOX TITLE IV)

Off-Balance Sheet Transactions; Use of Non-GAAP Financial Measures. SOX § 401 instructs the SEC to require by rule: (1) Form 10-K and 10-Q disclosure of all material off-balance sheet transactions and relationships with unconsolidated entities that may have a material effect upon the financial status of an issuer[208] and (2) presentation of pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles.[209] Also under SOX § 401, each financial report must "reflect" all material adjustments proposed by the auditors, which we interpret to mean all material suggested auditor adjustments must be disclosed in the 10-K or 10-Q, either through incorporation into the issuer's financial presentation or in a separate discussion explaining why the adjustment was not made.[210]

MD&A Disclosures. SEC Release No. 33-8182 titled "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations"[211] states that the principle behind the rules adopted therein is that the issuer should disclose information to the extent that it is necessary to reach an understanding of an issuer's material off-balance sheet arrangements and their material effects on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.[212] Consistent with the traditional principles applicable to the "Management's Discussion and Analysis of Financial Condition and Results of Operations" (*"MD&A"*) section in a company's disclosure documents, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the company.[213] In the SEC's view, as codified by the adopted rules, these items require disclosure of the following information to the extent necessary for an understanding of an issuer's off-balance sheet arrangements and their effects:

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any case where unforeseeable events or circumstances beyond the issuer's reasonable control prevent the issuer from providing advance notice to its directors and executive officers.

207 SOX § 306(a)(6), *supra* note 152.

208 SOX § 401(a), *amending* 15 U.S.C.A. § 78m (West Supp. 2010) [hereinafter *"SOX § 401"*].

209 *Id*.

210 *Id*.

211 Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 1933 Act Release No. 8182, 1934 Act Release No. 47,264, 68 Fed. Reg. 5982, 5992 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

212 *Id*. at 5985.

213 *Id*.

- The nature and business purpose of the issuer's off-balance sheet arrangements;

- The importance of the off-balance sheet arrangements to the issuer for liquidity, capital resources, market risk or credit risk support, or other benefits;

- The financial impact of the arrangements on the issuer (*e.g.*, revenues, expenses, cash flows or securities issued) and the issuer's exposure to risk as a result of the arrangements (*e.g.*, retained interests or contingent liabilities); and

- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits to the issuer of material off-balance sheet arrangements.[214]

In addition, there is another principles-based requirement, similar to that used elsewhere in MD&A, that the issuer provide other information that it believes to be necessary for an understanding of its off-balance sheet arrangements and their material effects on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.[215] The rule further requires an issuer to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements.[216]

The rule also requires an issuer to provide an overview of its aggregate contractual obligations in a tabular format in the MD&A.[217] The following categories of contractual obligations must be included within the table:

- Long-term debt obligations;

- Capital lease obligations;

- Operating lease obligations;

- Purchase obligations; and

- Other long-term liabilities reflected on the issuer's balance sheet under GAAP.[218]

The rules require disclosure of the amounts of an issuer's purchase obligations without regard to whether notes, drafts, acceptances, bills of exchange, or other commercial instruments will be used to satisfy such obligations because those instruments could have a significant effect

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214 *Id*.

215 *Id*.

216 *Id*. at 5991.

217 1933 Act Release No. 8182, *supra* note 211, at 5983.

218 *Id*. at 5986.

on the issuer's liquidity.[219] The SEC's purpose in requiring this disclosure item is to obtain enhanced disclosure concerning an issuer's contractual payment obligations.[220]

Conditions for Use of Non-GAAP Financial Measures: Regulation G. SEC Release No. 33-8176 titled "Conditions for Use of Non-GAAP Financial Measures," made rule changes designed to address reporting companies' use of "non-GAAP financial measures" in various situations, including (i) Regulation G which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure; (ii) amendments to Item 10 of Regulation S-K to include a statement concerning the use of non-GAAP financial measures in filings with the SEC; and (iii) amendments to Form 8-K to require issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods.[221]

Regulation G applies whenever an issuer[222] publicly discloses or releases material information that includes a non-GAAP financial measure.[223] Regulation G contains an exception for non-GAAP financial measures included in a disclosure relating to a proposed business combination transaction if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.[224]

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[219] *Id*.

[220] *Id*.

[221] Conditions for Use of Non-GAAP Financial Measures, 1933 Act Release No. 8176, 1934 Act Release No. 47,226, 68 Fed. Reg. 4820 (Jan. 30, 2003), available at http://www.sec.gov/rules/final/33-8176.htm.

[222] See *infra* notes 552-555 and related text with respect to the application of Regulation G to issuers that are foreign private issuers.

[223] 1933 Act Release No. 8176, *supra* note 221, at 4821.

[224] *Id*. In a response to a "Frequently Asked Questions" dated June 13, 2003, the SEC discussed whether the exemption from Regulation G and Item 10(e) of Regulation S-K for disclosure of non-GAAP financial measures made in connection with a business combination transaction extended to non-GAAP financial measures contained in registration statements, proxy statements, and tender offer materials. The staff noted that disclosures of non-GAAP financial measures made in communications subject to 1933 Act Rule 425 or 1934 Act Rules 14a-12 or 14d-2(b)(2) are exempt from Regulation G and Item 10(e) of Regulation S-K. According to the staff, this exemption also was intended to apply to communications subject to Rule 14d-9(a)(2). This exemption does not extend beyond communications that are subject to those rules. Thus, if the same non-GAAP financial measure that was included in a communication filed under one of those rules was also disclosed in a 1933 Act registration statement or a 1934 Act proxy statement or tender offer statement, the exemption would be inapplicable to that disclosure. *See* U.S. Securities Exchange Commission Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures, Transition Issues, Question 2 (June 13, 2003), *at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

Disclosures subject to Item 1015 of Regulation M-A are also exempt from Regulation G and Item 10(e) of Regulation S-K. This exemption is not limited to pre-commencement communications and, accordingly, the exemption would also be available for Item 1015 disclosure found in registration statements, proxy statements, and tender offer statements. In addition, where reconciliation of a non-GAAP financial measure is required and the most directly comparable measure is a pro forma measure prepared and

For purposes of Regulation G, a non-GAAP financial measure is a numerical measure of an issuer's historical or future financial performance, financial position, or cash flows that:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or

- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.[225]

The definition of "non-GAAP financial measures" does not capture measures of operating performance or statistical measures that fall outside the scope of the definition set forth above, such as:

- Operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers); and

- Ratios or statistical measures that are calculated using exclusively one or both of:

  - Financial measures calculated in accordance with GAAP; and
  - Operating measures or other measures that are not non-GAAP financial measures.[226]

Non-GAAP financial measures also do not include financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure, such as:

- Disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;

- Disclosure of amounts of repayments that have been planned or decided upon but not yet made;

- Disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as would be computed under GAAP; and

- Measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP.[227]

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presented in accordance with Article 11 of Regulation S-X, companies may use that measure for reconciliation purposes instead of a GAAP financial measure.

225 1933 Act Release No. 8176, *supra* note 221, at 4822.

226 *Id*.

The definition of non-GAAP financial measure is intended to capture all measures that have the effect of depicting either:

- A measure of performance that is different from that presented in the financial statements, such as income or loss before taxes or net income or loss, as calculated in accordance with GAAP; or

- A measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.[228]

An example of a non-GAAP financial measure would be a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring."[229] Another example would be EBITDA, which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP.[230] There is an exclusion from the definition of "non-GAAP financial measure" for financial measures required to be disclosed by GAAP, SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the issuer.[231]

Whenever an issuer publicly discloses any material information that includes a non-GAAP financial measure, Regulation G requires the issuer to provide the following information as part of the disclosure or release of the non-GAAP financial measure:

- A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and

- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historic measures and quantitative, to the extent available without unreasonable efforts, for prospective measures, of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.[232]

If a non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast, or by similar means, the issuer may provide the accompanying information required

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[227] *Id.*

[228] *Id.*

[229] *Id.*

[230] *Id.*

[231] 1933 Act Release No. 8176, *supra* note 221, at 4822.

[232] *Id.* at 4823.

by Regulation G by: (1) posting that information on the issuer's web site and (2) disclosing the location and availability of the required accompanying information during its presentation.[233]

With regard to the quantitative reconciliation of non-GAAP financial measures that are forward-looking, Regulation G requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure.[234] If the GAAP financial measure is not accessible on a forward-looking basis, the issuer must disclose that fact and provide reconciling information that is available without an unreasonable effort.[235] Furthermore, the issuer must identify information that is unavailable and disclose its probable significance.[236]

Regulation FD and Regulation G are intended to operate in tandem.[237] A "private" communication of material, non-public information to, for example, an analyst or a shareholder triggers a requirement for broad public disclosure under Regulation FD.[238] If that public disclosure is of material information containing a non-GAAP financial measure, Regulation G will apply to that disclosure.[239]

The amendments to Item 10 of Regulation S-K require issuers using non-GAAP financial measures in filings with the SEC to provide:

- A presentation, with equal or greater prominence, of the most directly comparable financial measure . . . calculated and presented in accordance with . . . GAAP;

- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;

- A statement disclosing the reasons why the [issuer's] management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the [issuer's] financial condition and results of operations; and

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233 *Id.*

234 *Id.*

235 *Id.*

236 *Id.*

237 1933 Act Release No. 8176, *supra* note 221, at 4823.

238 *Id*.

239 *Id*.

- To the extent material, a statement disclosing the additional purposes, if any, for which the [issuer's] management uses the non-GAAP financial measure that are not otherwise disclosed.[240]

In addition to these mandated disclosure requirements, amended Item 10 of Regulation S-K prohibits the following:

- Exclud[ing] charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than the measures EBIT and EBITDA;

- Adjust[ing] a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;

- Present[ing] non-GAAP financial measures on the face of the issuer's financial statements prepared in accordance with GAAP or in the accompanying notes;

- Present[ing] non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and

- Us[ing] titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.[241]

EBIT and EBITDA are exempted from this provision because of their wide and recognized existing use.[242] However, issuers must reconcile these measures to their most directly comparable GAAP financial measure.[243]

With regard to the quantitative reconciliation of non-GAAP financial measures that are forward-looking, Item 10 of Regulation S-K requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure.[244] If the GAAP financial measure is not accessible on a forward-looking basis, the issuer must disclose that fact and provide reconciling information that is available without an unreasonable effort.[245]

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240 *Id*. at 4824.

241 *Id*.

242 *Id*.

243 1933 Act Release No. 8176, *supra* note 221, at 4824.

244 *Id*. at 4825.

245 *Id*.

Form 8-K Filings of Earnings Releases. As discussed previously, the SEC has reworked the regulatory framework for current reports on Form 8-K.[246] In addition to adding disclosure items, the SEC also accelerated the filing deadlines for Form 8-K.

The addition of Item 2.02 to Form 8-K requires issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly fiscal periods.[247] Item 2.02 does not require that companies issue earnings releases or similar announcements. However, such releases and announcements will trigger the requirements of Item 2.02.[248]

Item 2.02 requires issuers to furnish to the SEC a Form 8-K, within four business days of any public announcement or release disclosing material non-public information regarding an issuer's results of operations or financial condition for an annual or quarterly fiscal period that has ended, that identifies the announcement or release and includes the text thereof as an exhibit.[249]

Repetition of information that was publicly disclosed previously or the release of the same information in a different form (for example in an interim or annual report to shareholders) would not trigger the Item 2.02 requirement.[250] This result would not change if the repeated information were accompanied by information that was not material, whether or not already public.[251] However, release of additional or updated material non-public information regarding the issuer's results of operations or financial condition for a completed fiscal year or quarter would trigger an additional Item 2.02 obligation.[252]

The requirement to furnish a Form 8-K under Item 2.02 would not apply to issuers that make these announcements and disclosures only in, or approximately contemporaneously with, their quarterly reports filed with the SEC on Form 10-Q or their annual reports filed with the SEC on Form 10-K.[253] An issuer could make the required Form 8-K Item 2.02 disclosure in the

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246 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 1933 Act Release No. 33-8400, (March 16, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm, as amended by Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, 1933 Act Release No. 33-8400A, (Aug. 4, 2004) (the "*Form 8-K Release*"), *available at* http://www.sec.gov/rules/final/33-8400a.htm.

247 1933 Act Release No. 8176, *supra* note 221.

248 *Id*.

249 *Id*.

250 1933 Act Release No. 8176, *supra* note 221, at 4825.

251 *Id*. at 4825-26.

252 *Id*. at 4826.

253 *Id*.

text of, and file the release as an exhibit to, a Form 10-K or 10-Q Report.[254] Thus, an issuer could release earnings within four business days prior to the filing of its Form 10-K or 10-Q Report without filing a Form 8-K with the Item 2.02 information, although in the Form 10-K or 10-Q it would have to disclose the substance of the release and file the release as an exhibit thereto.[255]

Item 2.02 includes an exception from its requirements where non-public information is disclosed orally, telephonically, by webcast, by broadcast, or by similar means in a presentation that is complementary to, and occurs within 48 hours after, a related, written release or announcement that triggers the requirements of Item 2.02.[256] In this situation, Item 2.02 would not require the issuer to furnish an additional Form 8-K with regard to the information that is disclosed orally, telephonically, by webcast, by broadcast, or by similar means if:

- The related, written release or announcement has been furnished to the [SEC] on Form 8-K pursuant to Item 2.02 prior to the presentation;

- The presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;

- The financial and statistical information contained in the presentation is provided on the issuer's web site, together with any information that would be required under Regulation G; and

- The presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the issuer's web site where the information would be available.[257]

Item 2.02 of Form 8-K will apply only to publicly disclosed or released material non-public information concerning an annual or quarterly fiscal period that has ended.[258] While such disclosure may also include forward-looking information, it is the material information about the completed fiscal period that triggers Item 2.02.[259] Item 2.02 does not apply to disclosure of earnings for future or ongoing fiscal periods which are not included in a disclosure of previously undisclosed information about completed periods.[260]

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[254] *Id*. at 4826-27. See Instruction 4 to Form 8-K Item 2.02, http://www.sec.gov/about/forms/form8-k.pdf.

[255] *Id*. at 4825-26.

[256] 1933 Act Release No. 8176, *supra* note 221, at 4826.

[257] *Id*.

[258] *Id*.

[259] *Id*.

[260] *Id*.

The most significant implications of "furnishing" a Form 8-K to the SEC, rather than "filing" a Form 8-K with the SEC, are:

- Information that is "furnished to the [SEC]" in such a Form 8-K is not subject to [1934 Act §18] unless the issuer specifically states that the information is to be considered "filed";

- Information that is "furnished to the [SEC]" in such a Form 8-K is not incorporated by reference into a registration statement, proxy statement or other report unless the issuer specifically incorporates that information into those documents by reference; and

- Information that is "furnished to the [SEC]" in such a Form 8-K is not subject to the requirements of amended Item 10 of Regulation S-K . . . while "filed" information would be subject to those requirements.[261]

Item 2.02 of Form 8-K requires that earnings releases or similar disclosures be furnished to the SEC rather than filed.[262] Regulation G would, of course, apply to these releases and disclosures.[263] In addition to the requirements already imposed by Regulation G, issuers would be required to disclose:

- The reasons why the [issuer]'s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the issuer's financial condition and results of operations; and

- To the extent material, the additional purposes, if any, for which the [issuer]'s management uses the non-GAAP financial measure that are not otherwise disclosed.[264]

Issuers may satisfy this requirement by including the disclosure in Form 8-K or in the release or announcement that is included as an exhibit to Form 8-K.[265] As indicated above, issuers also may satisfy the requirement to provide these additional two statements by including the disclosure in their most recent annual report filed with the SEC (or a more recent filing) and by updating those statements, as necessary, no later than the time Form 8-K is furnished to the SEC.[266]

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[261] *Id*.

[262] 1933 Act Release No. 8176, *supra* note 221, at 4826.

[263] *Id*.

[264] *Id*.

[265] *Id*. at 4826-27.

[266] *Id*. at 4827.

Earnings releases and similar disclosures that trigger the requirements of Item 2.02 are also subject to Regulation FD.[267] The application of Item 2.02 would differ from Regulation FD, however, in that the requirements of Item 2.02 would always implicate Form 8-K for those disclosures, while Regulation FD provides that Form 8-K is an alternative means of satisfying its requirements.[268]

Prohibition on Loans to Directors or Officers. SOX § 402 generally prohibits a corporation from directly or indirectly making or arranging for personal loans to its directors and executive officers.[269] Four categories of personal loans by an issuer to its directors and officers are expressly exempt from SOX § 402's prohibition:[270]

(1) any extension of credit existing before SOX's enactment as long as no material modification or renewal of the extension of credit occurs on or after the date of SOX's enactment (July 30, 2002);

(2) specified home improvement and consumer credit loans if:

- made in the ordinary course of the issuer's consumer credit business,
- of a type generally made available to the public by the issuer, and
- on terms no more favorable than those offered to the public;

(3) loans by a broker-dealer to its employees that:

- fulfill the three conditions of paragraph (2) above,
- are made to buy, trade or carry securities other than the broker-dealer's securities, and
- are permitted by applicable Federal Reserve System regulations; and

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267 *Id*.

268 1933 Act Release No. 8176, *supra* note 221, at 4827.

269 SOX § 402(a) provides:

> It shall be unlawful for any issuer (as defined in [SOX Section 2]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

SOX § 402, *amending* 15 U.S.C.A. § 78m (West Supp. 2010) [hereinafter *"SOX § 402"*].

270 *Id.*; *See also* Foreign Bank Exemption From the Insider Lending Prohibition of Exchange Act Section 13(k), 1934 Act Release No. 34-48481, 68 Fed. Reg. 54,590, 54,590, *available at* http://www.sec.gov/rules/proposed/34-48481.htm.

(4) "any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."[271]

The SEC to date has not provided guidance as to the interpretation of SOX § 402, although a number of interpretative issues have surfaced. The prohibitions of SOX § 402 apply only to an extension of credit "in the form of a personal loan" which suggests that all extensions of credit to a director or officer are not proscribed.[272] While there is no legislative history or statutory definition to guide, it is reasonable to take the position that the following, in the ordinary course of business, are not proscribed: travel and similar advances, ancillary personal use of company credit card or company car where reimbursement is required, advances of relocation expenses ultimately to be borne by the issuer: stay and retention bonuses subject to reimbursement if the employee leaves prematurely, indemnification advances of expenses pursuant to typical charter, bylaw, or contractual indemnification arrangements, and tax indemnification payments to overseas-based officers.[273]

SOX § 402 raises issues with regard to cashless stock option exercises and has led a number of issuers to suspend cashless exercise programs.[274] In a typical cashless exercise program, the optionee delivers the notice of exercise to both the issuer and the broker, and the broker executes the sale of some or all of the underlying stock on that day (T). Then, on or prior to the settlement date (T+3), the broker pays to the issuer the option exercise price and applicable withholding taxes, and the issuer delivers (*i.e.*, issues) the option stock to the broker. The broker transmits the remaining sale proceeds to the optionee. When and how these events occur may determine the level of risk under SOX § 402.[275] The real question is whether a broker-administered same-day sale involves "an extension of credit in the form of a personal loan" made or arranged by the issuer. The nature of the arrangement can affect the analysis.[276]

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[271] SOX § 402, *supra* note 269. This last exemption applies only to an "insured depository institution," which is defined by the Federal Deposit Insurance Act (*"FDIA"*) as a bank or savings association that has insured its deposits with the Federal Deposit Insurance Corporation (*"FDIC"*). 1934 Act Release No. 48,481, *supra* note 270, at 54,590; Foreign Bank Exemption from the Insider Lending Prohibition of Exchange Act Section 13(k), 1934 Act Release No. 34-49616 (April 26, 2004), available at http://www.sec.gov/rules/final/34-49616.htm.

[272] SOX § 402, *supra* note 269.

[273] *See Sarbanes-Oxley Act: Interpretative Issues Under § 402 – Prohibition of Certain Insider Loans* (October 15, 2002) (an outline authored jointly by a group of 25 law firms), THE CORPORATE COUNSEL, October 15, 2002, *at* http://www.TheCorporateCounsel.net.

[274] *Id.*; Edmond T. FitzGerald, et al., *Public Company CEO Compensation: A Review of the Recent Reforms*, in Advanced Doing Deals 2004: Dealmaking in the New Transactional Marketplace 441 (Practicing Law Institute ed., 2004).

[275] See *Cashless Exercise and Other SOXmania*, THE CORPORATE COUNSEL September-October (2002).

[276] If the issuer delivers the option stock to the broker before receiving payment, the issuer may be deemed to have loaned the exercise price to the optionee, perhaps making this form of program riskier than others. If

Some practitioners questioned whether SOX § 402 prohibits directors and executive officers of an issuer from taking loans from employee pension benefit plans, which raised the further question of whether employers could restrict director and officer plan loans without violating the U.S. Labor Department's antidiscrimination rules.[277] In response, the Labor Department issued Field Assistance Bulletin 2003-1 providing that plan fiduciaries of public companies could deny participant loans to directors and officers without violating the Labor Department rules.[278]

Accelerated § 16(a) Reporting. SOX § 403 amended 1934 Act § 16(a) to require officers, directors, and 10% shareholders (collectively, *"insiders"*) of companies with securities registered under 1934 Act § 12 of the to file with the SEC Form 4 reporting (i) a change in ownership of equity securities or (ii) the purchase or sale of a security based swap agreement involving an equity security "*before the end of the second business day following the business day on which the subject transaction has been executed. . ..*"[279] The SEC issued a release (the *"16(a) Release"*) amending its rules and forms implementing the accelerated filing deadlines

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the broker advances payment to the issuer prior to T+3, planning to reimburse itself from the sale of proceeds on T+3, that advance may be viewed as an extension of credit by the broker, and the question then becomes whether the issuer "arranged" the credit. The risk of this outcome may be reduced where the issuer does not select the selling broker or set up the cashless exercise program, but instead merely confirms to a broker selected by the optionee that the option is valid and exercisable and that the issuer will deliver the stock upon receipt of the option exercise price and applicable withholding taxes. Even where the insider selects the broker, the broker cannot, under Regulation T, advance the exercise price without first confirming that the issuer will deliver the stock promptly. In that instance, the issuer's involvement is limited to confirming facts, and therefore is less likely to be viewed as "arranging" the credit.

Where both payment and delivery of the option stock occur on the same day (T+3), there arguably is no extension of credit at all, in which case the exercise should not be deemed to violate SOX § 402 whether effected through a designated broker or a broker selected by the insider.

If the insider has sufficient collateral in his or her account (apart from the stock underlying the option being exercised) to permit the broker to make a margin loan equal to the exercise price and applicable withholding taxes, arguably the extension of credit is between the broker and the insider and does not violate SOX § 402 assuming the issuer is not involved in arranging the credit.

Interpretative Issues Under § 402, *supra* note 273.

277 *See* Gaudreau, Jr., Russell A. & Solveig R. McShea, *Plan Loans to Participants and Beneficiaries*, in Advanced Law of Pensions, Welfare Plans, and Deferred Compensation 1547, 1570 (American Law Institute ed., 2004).

278 U.S. Department of Labor, *Field Assistance Bulletin 2003-1* (April 14, 2003), *at* http://www.dol.gov/ebsa/regs/fab_2003_1.html.

279 SOX § 403, *amending* 15 U.S.C.A. § 78p (West Supp. 2010) (emphasis added) [hereinafter *"SOX § 403"*]. Previously, Form 4 was required to be filed by the 10th day of the month following the month in which the transaction was executed.

described above for transactions subject to 1934 Act § 16(a).[280] There are two narrow exceptions to the this two business day reporting requirement, which apply only if the insider does not select the date of execution of the transaction.[281] These exceptions include (1) transactions pursuant to a contract, instruction, or written plan for the purchase or sale of issuer securities that satisfies the affirmative defense conditions of Rule 10b5-1(c) (including, according to the 16(a) Release, transactions pursuant to employee benefit plans and dividend and interest reinvestment plans that are not already exempt from 1934 Act § 16(a) reporting) and (2) "discretionary transactions" (as defined in Rule 16b-3(b)(1)) involving an employee benefit plan, whether or not exempted by Rule 16b-3.[282] In these cases, the date of execution (triggering the two-day deadline) is deemed to be the earlier of the date the executing broker, dealer, or plan administrator notifies the insider of the execution of the transaction or the third business day following the actual trade date of the transaction.[283] Other transactions exempt from 1934 Act § 16(b) previously reportable on Form 5 will remain reportable on Form 5.[284] These transactions include small acquisitions not from the issuer and gifts.[285] The SEC expects insiders to make arrangements with executing entities to provide such notification to the insider as quickly as feasible and urges executing entities to provide such information either electronically or by telephone and not rely on mailed confirmations.[286]

Website Posting. The SEC adopted rules mandating electronic filing and website posting for Forms 3, 4 and 5 amending Regulation S-T to require insiders to file Forms 3, 4 and 5 (§ 16(a) reports) with the SEC on EDGAR.[287] The rules also require an issuer that maintains a corporate website[288] to post on its website all Forms 3, 4 and 5 filed with respect to its equity

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280 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 1934 Act Release No. 46,421, 67 Fed. Reg. 56,462 (Sept. 3, 2002), *available at* http://www.sec.gov/rules/final/34-46421.htm [hereinafter the *"16(a) Release"*].

281 For example, the SEC pointed out in the 16(a) Release that transactions pursuant to a Rule 10b5-1(c) arrangement which specify a date for purchases for sales (e.g., the first business day of each month) would not qualify for this exception. *Id*. at 56,464.

282 *Id*. at 56,463-64.

283 *Id*. at 56,464-65.

284 *Id*. at 56,463.

285 16(a) Release, *supra* note 280, at 56,467.

286 *See e.g., id.* at 56,465.

287 Mandated Electronic Filing And Website Posting For Forms 3, 4 And 5, 1933 Act Release No. 8230, 1934 Act Release No. 47,809, 68 Fed. Reg. 25,788 (May 13, 2003), *available at* http://www.sec.gov/rules/final/33-8230.htm. As amended, Regulation S-T also requires the electronic filing of any related correspondence and supplemental information pertaining to a document that is the subject of mandated EDGAR filing. These materials will not be disseminated publicly but will be available to the SEC staff.

288 The term "corporate website" refers to public (internet) sites, as opposed to private (intranet) sites.

securities by the end of the business day after filing.[289] An issuer can satisfy this requirement whether it provides access directly or by hyperlinking to reports via a third-party service instead of maintaining the forms itself if the following conditions are met:

- The forms are made available in the required time frame;
- Access to the reports is free of charge to the user;
- The display format allows retrieval of all information in the forms;
- The medium to access the forms is not so burdensome that the intended users cannot effectively access the information provided;
- The access includes any exhibits or attachments;
- Access to the forms is through the issuer website address the issuer normally uses for disseminating information to investors; and
- Any hyperlink is directly to the Section 16 forms (or to a list of the Section 16 forms) relating to the posting issuer instead of just to the home page or general search page of the third-party service.[290]

The forms must remain accessible on the issuer's website (or through the hyperlink) for at least a 12-month period.[291]

Insiders are required to send or deliver a duplicate of each Section 16 form to the issuer not later than the time the form is transmitted for filing with the Commission to the person designated by the issuer to receive such statements, or, in the absence of such designation, to the issuer's corporate secretary or person performing equivalent functions.[292] An issuer which wishes to post the Section 16 reports on its website directly should implement procedures to ensure that its insiders provide notice and electronic copies of filed Section 16 reports in time to meet the posting date. An issuer that uses a hyperlink to an appropriate third-party site can avoid this concern.

Internal Control Over Financial Reporting. SOX § 404 directs the SEC to prescribe rules mandating inclusion in Annual Reports on Form 10-K of (i) a report by management on the issuer's internal control over financial reporting ("*ICFR*") and (ii) a PCAOB registered accounting firm's attestation report on the effectiveness of the issuer's ICFR.[293] The rules

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289 1933 Act Release No. 8230, *supra* note 287, at 25,790.

290 *Id*.

291 *Id*.

292 *Id*.

293 SOX § 404, 15 U.S.C.A. § 7262 (West Supp. 2010) [hereinafter *"SOX § 404"*].

implementing SOX § 404 define ICFR as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.[294]

The SEC rules implementing SOX § 404[295] require each reporting company to include in its Annual Report on Form 10-K an ICFR report of management that includes:

- A statement that it is management's responsibility to establish and maintain adequate ICFR for the issuer;[296]
- A statement identifying the framework[297] used by management to evaluate the effectiveness of the issuer's ICFR; and

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294 17 C.F.R. § 240.13a-15 (2010) (with regard to Regulation 13A); 17 C.F.R. § 240.15d-15 (2010) (with regard to Regulation 15D).

295 1933 Act Release No. 33-8238, 1934 Act Release No. 34-47986 (June 5, 2003) titled "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," which can be found at http://www.sec.gov/rules/final/33-8238.htm (the "*Internal Control Release*").

296 Controls over financial reporting may be preventive controls or detective controls. Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring (*e.g.*, segregation of duties; two check signers). Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements (*e.g.*, regular reconciliation of accounts payable and accounts receivable). Effective ICFR often includes a combination of preventive and detective controls. PCAOB Accounting Standards PCAOB Release 2007-005A (June 12, 2007) at A-8.

297 The framework on which management's evaluation is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The SEC staff has indicated that the evaluative framework set forth in the 1992 Treadway Commission report on internal controls (also known as the "*COSO Report*"), which is available at http://www.coso.org, will be a suitable framework, and that foreign private issuers will be permitted to use the framework in effect in their home countries. In the COSO

- Management's assessment of the effectiveness of the issuer's ICFR as of the end of the issuer's most recent fiscal year, including a statement as to whether or not the issuer's ICFR is effective. The assessment must include disclosure of any "material weaknesses" in the issuer's ICFR identified by management. Management is not permitted to conclude that the issuer's ICFR is effective if there are one or more material weaknesses in the issuer's ICFR.

In addition to management's assessment on ICFR and subject to the phase-in described below,[298] the Annual Report on Form 10-K must include an attestation report of the issuer's auditor as to the effectiveness of the issuer's ICFR.[299] SOX § 404(b) requires the auditor to "attest to, and report on, the assessment made by the management of the issuer," and SOX § 103(a)(2)(A)(iii) requires that each audit report describe the scope of the auditor's testing of the issuer's ICFR structure and procedures and present, among other information: (1) the findings of the auditor from such testing; (2) an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP; and (3) a description of any material weaknesses in such ICFR. The SEC believes that a single audit opinion directly on the effectiveness of the issuer's ICFR is consistent with both SOX § 404 and SOX § 103, and its rules now so require.[300]

Report, the term "*control environment*" encompasses the attitudes and values of executives and directors and the degree to which they recognize the importance of method, transparency, and care in the creation and execution of their company's policies and procedures. A proper control environment is one factor an external auditor considers when called upon to evaluate ICFR pursuant to SOX § 404. Stephen Wagner and Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, Best Practice, HARVARD BUS. REV. 133, 134 (April 2006).

[298] *See infra* notes 309 and 310 and related text.

[299] 17 C.F.R. § 210.2-02 (2010); Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, 1934 Act Release No. 34-55928 (June 20, 2007), available at http://www.sec.gov/rules/final/2007/33-8809.pdf.

[300] Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, 1934 Act Release No. 34-55928 (June 20, 2007), available at http://www.sec.gov/rules/final/2007/33-8809.pdf; SOX § 103(a)(2)(A)(iii), as amended by Dodd-Frank, states that "each registered public accounting firm shall --

> in each audit report describe the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) --
>
> (I.) the findings of the auditor from such testing;
>
> (II.) an evaluation of whether such internal control structure and procedures –
>
>> (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

Under these SOX § 404 rules, management must disclose any material weakness and will be unable to conclude that the issuer's ICFR is effective if there are one or more material weaknesses in such control.[301] The term "material weakness" is now defined in 1934 Act Rule 12b-2 as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis."[302] The SOX § 404 rules require reporting companies to perform quarterly evaluations of changes that have materially affected, or are reasonably likely to materially affect, the issuer's ICFR.[303]

Compliance with the SOX § 404 rules proved difficult and expensive for issuers. In response, on May 23, 2007 the SEC issued interpretive guidance intended to help public companies strengthen their ICFR while reducing unnecessary costs, particularly at smaller companies, by focusing company management on the internal controls that best protect against the risk of a material financial misstatement and enabling issuers to scale and tailor their evaluation procedures according to the facts and circumstances.[304] This guidance was principles based to afford flexibility to issuers and, notwithstanding requests from some commentators for more specific guidance, does not contain detailed rules, which the SEC feared some issuers might learn how to game. An issuer that performs an evaluation of ICFR in accordance with the interpretive guidance satisfies the annual evaluation required by 1934 Act Rules 13a-15 and 15d-15.

Then on May 24, 2007, the PCAOB adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements ("*AS 5*"),[305] that was approved by the SEC on July 25, 2007[306] and that superseded

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> > (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
>
> (III.) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing."

301 *Id.*

302 Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, 1934 Act Release No. 34-55928 (June 20, 2007), available at http://www.sec.gov/rules/final/2007/33-8809.pdf.

303 *Id.* §§ 13a-15(a), 15d-15(f).

304 Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 1934 Act Release No. 34-55929 (June 20, 2007), available at http://www.sec.gov/rules/interp/2007/33-8810.pdf.

305 PCAOB Auditing Standard No. 5 may be found at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx.

PCAOB Auditing Standard No. 2 (“*AS 2*”), which was adopted by the PCAOB in March 2004 and approved by the SEC in June 2004. This AS 5 standard applies to audits of all companies required by SEC rules to obtain an audit of ICFR. In adopting AS 5, the PCAOB commented that AS 5 results from the PCAOB’s monitoring of auditors’ implementation of AS 2 and that while the PCAOB observed significant benefits produced by the ICFR audit under AS 2, it also noted that the related effort has appeared greater than necessary to conduct an effective audit.[307] Based on these observations, and in light of the approaching date for smaller companies to comply with the SOX § 404 reporting requirements, the PCAOB adopted AS 5 to achieve four objectives:

1. Focus the Internal Control Audit on the Most Important Matters – AS 5 focuses auditors on those areas that present the greatest risk that an issuer’s ICFR will fail to prevent or detect a material misstatement in the financial statements. It does so by incorporating certain best practices designed to focus the scope of the audit on identifying material weaknesses in internal control, before they result in material misstatements of financial statements, such as using a top-down approach to planning the audit. It also emphasizes the importance of auditing higher risk areas, such as the financial statement close process and controls designed to prevent fraud by management. At the same time, it provides auditors a range of alternatives for addressing lower risk areas, such as by more clearly demonstrating how to calibrate the nature, timing and extent of testing based on risk, as well as how to incorporate knowledge accumulated in previous years’ audits into the auditors’ assessment of risk and use the work performed by companies’ own personnel, when appropriate.

2. Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits – After examining the ICFR audit processes to determine whether the previous standard encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit, the PCAOB decided not to include detailed requirements to evaluate management’s own evaluation process and to clarify that an internal control audit does not require an opinion on the adequacy of management’s process. As another example, AS 5 refocuses the multi-location direction on risk rather than coverage by removing the requirement that auditors test a "large portion” of the company’s operations or financial position.

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[306] Public Company Accounting Oversight Board: Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, 1934 Act Release No. 34-56152 (July 27, 2007), available at http://www.sec.gov/rules/pcaob/2007/34-56152.pdf.

[307] Press Release, Public Company Accounting Oversight Board, Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule (May 24, 2007), *available at* http://pcaobus.org/News/Releases/Pages/05242007_BoardApprovesNewAuditStandard.aspx.

3. Make the Audit Clearly Scalable to Fit the Size and the Complexity of Any Company – In coordination with PCAOB's ongoing project to develop guidance for auditors of smaller, less complex companies, AS 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited. AS 5 does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies.

4. Simplify the Text of the Standard – AS 5 eliminates the previous standard's discussion of materiality, thus clarifying that the auditor's evaluation of materiality for purposes of an ICFR audit is based on the same long-standing principles applicable to financial statement audits. AS 5 conforms certain terms to the SEC's rules and guidance, such as the definition of "material weakness" and use of the term "entity-level controls"[308] instead of "company-level controls."

Compliance with the rules regarding management's report on ICFR is required as follows: accelerated filers have been required to comply with the management report on ICFR requirements for fiscal years ending on or after November 15, 2004, and all other domestic issuers (including small business issuers) have been required to comply with the SOX § 404(a) requirement of including management's report on ICFR for fiscal years ending on or after December 15, 2007.

The SOX § 404(b) requirement of including the auditor's attestation report was originally scheduled to apply to all domestic issuers, including non-accelerated filers, for fiscal years ending on or after June 15, 2010. Dodd-Frank altered this landscape by adding § 404(c) to SOX, which provides that SOX § 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither a 'large accelerated filer' nor an 'accelerated filer' as those terms are defined in Rule 12b-2 of the Commission (17 C.F.R. 240.12b-2)."[309] Therefore, issuers with an aggregate worldwide market value below $75 million no longer have to comply with the requirements of SOX § 404(b) by having an auditor attest to their internal controls. Dodd-Frank also commissioned a study, with results due in 9 months, to determine how the SEC could reduce the burden of compliance for small Accelerated Filers with market cap between $75 million and $250 million.[310] Part of the mandate of the study is to consider whether reduction of the burden

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308 Entity level controls include tone at the top and corporate governance, including the effectiveness of the audit committee.

309 Dodd-Frank § 989G. Rule 12b-2 defines an accelerated filer as an issuer who: (i) had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) has been subject to the requirements of 1934 Act §§ 13(a) or 15(d) for a period of at least twelve calendar months; (iii) has filed at least one annual report pursuant to 1934 Act §§ 13(a) or 15(d); and (iv) is not eligible to use the requirements for smaller reporting companies for its annual and quarterly reports. A large accelerated filer, as the name implies, differs only in the aggregate worldwide market value, which in such a filers' case is $700 million or more.

310 *Id.*

or even a complete exemption would help encourage companies to list on U.S. exchanges. Perhaps in the future Congress will restrict the applicability SOX § 404(b) even further.

In response to Dodd-Frank the SEC has recently revised its rules to provide that SOX § 404(b) applies only to accelerated and large accelerated filers.[311] For example, the SEC amended Item 308 of Regulation S-K so that the disclosure of an attestation report is necessary only if an attestation report is included in the annual report.[312] Further, the SEC changed Rule 2-02(f) of Regulation S-X to clarify that only auditors filing reports for accelerated and large accelerated filers are required to include an assessment of ICFR.[313]

Codes of Ethics. SOX § 406 directs the SEC to issue rules requiring a code of ethics[314] for senior financial officers of an issuer applicable to the CFO, comptroller or principal accounting officer and to require disclosure on its Form 8-K within four days of any change in or waiver of the code of ethics for senior financial officers.[315]

Code of Ethics Disclosures. Pursuant to the direction of Sox § 406, the SEC has adopted rules that require reporting companies to disclose on Form 10-K:

- whether the issuer has adopted a code of ethics that applies to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and

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311 Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 1934 Act Release No. 34-62914 (September 15, 2010), available at http://www.sec.gov/rules/final/2010/33-9142.pdf.

312 *Id.*

313 *Id.* The SEC also revised some of the instructions for Form 20-F and Form 40-F to clarify that the attestation report is only required for accelerated and large accelerated filers. The SEC amended Rule 2-02(f) of Regulation S-X, Item 308 of Regulation S-K, Item 15 of Form 20-F, and General Instruction B.(6) of Form 40-F.

314 SOX § 406(c), 15 U.S.C.A. §7264(c) (West Supp. 2010) [hereinafter *"SOX § 406"*]. SOX § 406 defines a "code of ethics" to mean such standards as are reasonably necessary to promote:

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with governmental regulations.

315 SOX § 406(b), *supra* note 314.

- if the issuer has not adopted such a code of ethics, the reasons it has not done so.[316]

In the adopted SOX § 406 rules, "code of ethics" means a codification of written standards reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;

- compliance with applicable governmental laws, rules, and regulations;

- the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code;[317] and

- accountability for adherence to the code.[318]

The SOX § 406 rules indicate that in addition to providing the required disclosure, an issuer may:

- file with the SEC a copy of its code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its Form 10-K annual report;[319]

- post the text of such code of ethics on its Internet website and disclose, in its Form 10-K annual report, its Internet address and the fact that it has posted its code of ethics on its Internet website;[320] or

- undertake in its Form 10-K annual report filed with the SEC to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.[321]

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[316] Disclosure Required by Sections 406 and 407 of the Sarbanes Oxley Act of 2002, 1933 Act Release No. 8177, 1934 Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 23, 2003) (*codified at* 17 C.F.R. 229.406(a) (2010)), *available at* http://www.sec.gov/rules/final/33-8177.htm [hereinafter *"SOX §§ 406/407 Release"*].

[317] The company would retain discretion to choose the person to receive reports of code violations, but 1933 Act Release No. 8138, 1934 Act Release No. 46,701, *infra* note 329, suggests the person should have sufficient status within the company to engender respect for the code and authority to adequately deal with the persons subject to the code regardless of their stature within the company.

[318] 17 C.F.R. § 229.406(b) (2010).

[319] 17 C.F.R. §§ 228.406(c)(1), 229.406(c)(1) (2010).

[320] 17 C.F.R. §§ 228.406(c)(2), 229.406(c)(2) (2010).

Form 8-K or Internet Disclosure Regarding Changes to, or Waivers From, the Code of Ethics. The SOX § 406 code of ethics rules add an item to the list of Form 8-K triggering events to require disclosure of:

- the nature of any amendment to the company's code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions;[322] and

- the nature of any waiver, including an implicit waiver, from a provision of the code of ethics granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver.[323]

Only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed.[324] In the SOX §§ 406/407 Release, the SEC clarified that this limitation is intended to allow and encourage companies to retain broad-based business codes.[325] For example, if a company has a code of ethics that applies to its directors, as well as its principal executive officer and senior financial officers, an amendment to a provision affecting only directors would not require Form 8-K or Internet disclosure.

A company choosing to provide the required disclosure on Form 8-K must do so within four business days after it amends its code or grants a waiver.[326] As an alternative to reporting this information on Form 8-K, a company may use its Internet website as a method of disseminating this disclosure, but only if it previously has disclosed in its most recently filed annual report on Form 10-K:

- Its intention to disclose these events on its Internet website; and

- Its Internet website address.[327]

Audit Committee Financial Experts. SOX § 407 requires the SEC to promulgate rules mandating that each reporting company disclose whether (and, if not, why not) its audit committee includes at least one member who is a "financial expert."[328] The rules adopted by the

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321 SOX §§ 406/407 Release, *supra* note 316, at 5127 (*codified at* 17 C.F.R. §§ 228.406(c)(3), 229.406(c)(3) (2010)).

322 *Id*. at 5119; *see generally* SOX § 406(b), *supra* note 314.

323 *Id*.

324 *Id*.

325 *Id*.

326 *Id*.

327 SOX §§ 406/407 Release, *supra* note 316, at 5119 (*codified at* 17 C.F.R. § 229.406(d) (2010)).

328 SOX § 407, 15 U.S.C.A. § 7265 (West Supp. 2010) [hereinafter *"SOX § 407"*].

SEC to implement SOX § 407 use the term "audit committee financial expert," instead of the term "financial expert" used in SOX § 407 and an earlier proposed rule because the SEC believes the former term suggests more pointedly that the designated person must have characteristics that are particularly relevant to the functions of the audit committee.[329] The rules under SOX § 407 require reporting companies to disclose in their Form 10-K that:[330]

- Its board of directors has determined that the company *either* (i) has at least one "audit committee financial expert" serving on the company's audit committee[331] and the name of such person *or* (ii) does not have an audit committee financial expert serving on its audit committee and the reason it has no audit committee financial expert; and

- If the company discloses that it has at least one audit committee financial expert serving on its audit committee, the company must identify the audit committee financial expert by name and disclose whether that person is "independent,"[332] and if not, an explanation.[333]

The rules under SOX § 407 define the term "audit committee financial expert" to mean a person who has all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements;

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329 *See* Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes Oxley Act of 2002, 1933 Act Release No. 8138, 1934 Act Release No. 46,701, 67 Fed. Reg. 66,208 (Oct. 30, 2002), *available at* http://www.sec.gov/rules/proposed/33-8138.htm.

330 The rules discussed herein relating to annual reports of reporting companies on Form 10-K also contain similar provisions applicable to annual reports of small business reporting companies on Form 10-KSB. The SOX §§ 406/407 Release also adopted rules with similar requirements for investment companies. The disclosure regarding audit committee financial experts is required only in Form 10-K annual reports and may be incorporated therein by reference from the issuer's proxy statement. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 1933 Act Release No. 8177A, 1934 Act Release No. 47,235A, 68 Fed. Reg. 15,353 (Mar. 31, 2003), *available at* http://www.sec.gov/rules/final/33-8177A.htm.

331 SOX § 2(a), 15 U.S.C.A. § 7201 (West Supp. 2010) [hereinafter *"SOX § 2"*] defines the term "audit committee" as

> (A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
>
> (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

332 "Independence" for these purposes is defined in Item 7(d)(3)(iv) of Schedule 14A under the 1934 Act, which makes reference to the definition of independence in the various listing standards of the NYSE, AMEX, and NASDAQ. 17 C.F.R. § 229.407(a) (2010).

333 SOX §§ 406/407 Release, supra note 316, at 5111.

- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the [company]'s financial statements, or experience actively supervising one or more persons engaged in such activities;

- An understanding of internal controls and procedures for financial reporting; and

- An understanding of audit committee functions.[334]

Under the final SOX § 407 rules, a person must have acquired such attributes through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; or

- Other relevant experience.[335]

In allowing a person to qualify as an audit committee financial expert by having "other relevant experience," the SEC recognizes that an audit committee financial expert can acquire the requisite attributes of an expert in many different ways.[336] The SEC states in the SOX §§ 406/407 Release that it believes that this expertise should be the product of experience and not merely education.[337] If a person qualifies as an expert by virtue of possessing "other relevant experience," the company's disclosure must briefly list that person's experience.[338]

The SEC also found that it would be adverse to the interests of investors if the designation and identification of the audit committee financial expert affected the duties, obligations or liabilities to which any member of the company's audit committee or board is

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334 SOX §§ 406/407 Release, *supra* note 316, at 5113; SOX § 407, *supra* note 328.

335 *Id*. at 5113 (*codified at* 17 C.F.R. §§ 229.401, 229.407 (2010)).

336 *Id*. at 5116.

337 *Id*.

338 *Id*.

subject.[339] To codify that position, the SEC included in the adopting release a safe harbor which clarifies that:

- A person who is determined to be an audit committee financial expert will not be deemed an "expert" for any purpose, including without limitation for purposes of § 11 of the [1934 Act], as a result of being designated or identified as an audit committee financial expert [by a company];

- The designation or identification of a person as an audit committee financial expert [by a company] does not impose on such person any duties, obligations or liability[ies] that are greater than the duties, obligations and liability[ies] imposed on such person as a member of the audit committee and board of directors in the absence of such designation and identification; and

- The designation or identification of a person as an audit committee financial expert [by a company] does not affect the duties, obligations or liability[ies] of any other member of the audit committee or board of directors.[340]

The safe harbor clarifies that any information in a registration statement reviewed by the audit committee financial expert is not "expertised" unless such person is acting in the capacity of some other type of traditionally recognized expert.[341] Similarly, because the audit committee financial expert is not an expert for purposes of 1934 Act § 11, he or she is not subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification as an audit committee financial expert.[342]

SOX does not explicitly state who at the company should determine whether a person qualifies as an audit committee financial expert. The adopting release states that the SEC believes that the board of directors in its entirety, as the most broad-based body within the company, is best-equipped to make the determination.[343] The SEC also views it as appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.[344]

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339 *Id*.

340 SOX §§ 406/407 Release, *supra* note 316 at 5116-17.

341 *Id*. at 5117.

342 *Id*. at 5117 (*codified at* 17 C.F.R. §§ 229.407(d)(5)(iv) (2010)).

343 *Id*. at 5117.

344 *Id*.

The fact that a person previously has served on the company's audit committee would not, by itself, justify the board of directors in "grandfathering" that person as an audit committee financial expert under the adopted rules.[345]

Systematic SEC Review of 1934 Act Filings. SOX § 408 requires the SEC to review disclosures made by listed companies on a regular and systematic basis and to review disclosures made by a public company at least once every three years.[346] In scheduling the required reviews, the SEC is expected to focus upon:

(1) issuers that have issued material restatements of financial results;

(2) issuers that experience significant volatility in their stock price as compared to other issuers;

(3) issuers with the largest market capitalization;

(4) emerging companies with disparities in price to earning ratios; and

(5) issuers whose operations significantly affect any material sector of the economy.[347]

Accelerated Disclosure in Plain English. The 1934 Act is amended by SOX § 409 to require reporting companies to "disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, **in plain English**, which may include trend and qualitative information and graphic presentations," as the SEC may by rule prescribe.[348]

Accordingly, the SEC has amended[349] its rules and forms to accelerate the filing of quarterly and annual reports under the 1934 Act by larger domestic reporting companies so that the filing deadlines may be summarized as follows:[350]

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345 *Id*. at 5116.

346 SOX § 408, 15 U.S.C.A. § 7266 (West Supp. 2010) [hereinafter *"SOX § 408"*].

347 SOX § 408(b), *supra* note 346.

348 SOX § 409, *amending* 15 U.S.C.A. § 78m (West Supp. 2010) (emphasis added).

349 Acceleration of Periodic Reporting Filing Dates and Disclosure Concerning Website Access to Reports, 1933 Act Release No. 8128, 1934 Act Release No. 46,464, 67 Fed. Reg. 58,480 (September 16, 2002), *available at* http://www.sec.gov/rules/final/33-8128.htm. It should be noted that the SEC initially proposed these rules on April 12, 2002, which was prior to the enactment of SOX.

350 Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, 1933 Act Release No. 33-8644, 1934 Act Release No. 34-52989, (Dec. 21, 2005), *available at* http://www.sec.gov/rules/final/33-8644.pdf.

Category of Filer	Revised Deadlines For Filing Periodic Reports	
	Form 10-K Deadline	**Form 10-Q Deadline**
Large Accelerated Filer ($700MM or more)	60 days	40 days
Accelerated Filer ($75MM or more and less than $700MM)	75 days	40 days
Non-accelerated Filer (less than $75MM)	90 days	45 days

The SEC also adopted amendments to require accelerated filers to disclose in their Form 10-K annual reports where investors can obtain access to their filings and whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge. This is to be done as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission.[351]

V.
CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY (SOX TITLE VIII)

Records Retention. Title VIII of SOX is entitled the "Corporate and Criminal Fraud Accountability Act of 2002" and amends Federal criminal law to prohibit: (1) knowingly destroying, altering, concealing, or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy (this offense is punishable by up to 20 years in prison)[352] and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities.[353] The SEC is directed to promulgate regulations regarding the retention of audit records containing conclusions, opinions, analyses, or financial data.[354]

Pursuant to this SOX directive, the SEC adopted rules that added §210.2-06 to Regulation S-X (under "Qualifications and Reports of Accountants"),[355] which requires

351 1933 Act Release No. 8128, *supra* note 349, at 58,481.

352 SOX § 802(a), 18 U.S.C.A. § 1519 (West Supp. 2010).

353 SOX § 802(b), 18 U.S.C.A. § 1520 (West Supp. 2010).

354 *Id.*

355 Retention of Records Relevant to Audits and Reviews, 1933 Act Release No. 8180, 1934 Act Release No. 47,241, 68 Fed. Reg. 4862 (January 30, 2003) (*codified in* 17 C.F.R. § 210 (2010)), *available at* http://www.sec.gov/rules/final/33-8180.htm.

accountants who review or audit an issuer's financial statements to retain, for seven years after the end of the completion of the audit or review, certain materials relevant to the audit or review, including workpapers[356] and other documents that form the basis of the audit or review of an issuer's financial statements, memoranda, correspondence, communications, other documents, and records (including electronic records) that "(1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review[.]"[357]

Non-substantive materials that are not part of the workpapers, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions, or analyses would not meet the second of the criteria in Rule 2-06(a) and would not have to be retained.[358] The release adopting Rule 2-06 indicates that the following documents would not be considered substantive and would not have to be retained:

- Superseded drafts of memoranda, financial statements or regulatory filings;
- Notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking;
- Previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees;
- Duplicates of documents, or
- Voice-mail messages.[359]

However, these records would fall within the scope of Rule 2-06 to the extent they contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions, opinions, or analyses on that matter or the audit or review.[360] For example, Rule 2-06 would require the retention of an item in this list if that item documented a consultation or resolution of differences of professional judgment.[361]

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356 "Workpapers" are defined as "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the" SEC or the PCAOB. *Id*. at 4864.

357 *Id*. at 4863.

358 *Id*.

359 *Id*.

360 *Id*.

361 1933 Act Release No. 8180, *supra* note 355, at 4863.

All of the issuer's financial information, records, databases, and reports that the auditor examines on the issuer's premises, but are not made part of the auditor's workpapers or otherwise currently retained by the auditor, are not deemed to be "received" by the auditor under Rule 2-06(a)(1) and do not have to be retained by the auditor.[362]

Note that the PCAOB is directed in SOX § 103 to require auditors to retain, for a period of seven years, workpapers to support the auditor's conclusions.[363] Many documents may be subject to both retention requirements, though the SEC's retention requirement applies to a broader range of documents that do not necessarily just support conclusions.[364]

Non-dischargeable Fraud Judgments. SOX § 803 amends Federal bankruptcy law to make non-dischargeable bankruptcy judgments and settlement agreements that result from a violation of Federal or State securities law, or common law, fraud pertaining to securities sales or purchases.[365]

Extension of Statute of Limitation for Securities Fraud Claims. SOX § 804 amends the Federal judicial code to permit a private right of action for a securities fraud claim to be brought not later than the earlier of: (1) five years after the date of the alleged violation or (2) two years after its discovery.[366]

Sentencing Guidelines. SOX § 805 directed the U.S. Sentencing Commission to review and amend Federal sentencing guidelines to ensure that the offense levels, existing enhancements, or offense characteristics are sufficient to deter and punish violations involving: (1) obstruction of justice; (2) record destruction; (3) fraud when the number of victims adversely involved is significantly greater than 50 or when it endangers the solvency or financial security of a substantial number of victims; and (4) organizational criminal misconduct.[367]

Whistleblower Protection. Under SOX § 806, whistleblower protection is extended to individuals who report (to particular federal agencies, to Congress, or to a supervisor) conduct the individual reasonably believes constitutes a violation of: (a) the federal securities laws; (b) SEC rules; or (c) any provision of federal law relating to fraud against shareholders.[368] SOX § 806 forbids a public company and its officers, employees, contractors, subcontractors, and

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[362] *Id*.

[363] SOX § 103(a)(2)(A)(i), 15 U.S.C.A. § 7213(a)(2)(A)(i) (West Supp. 2010).

[364] 17 C.F.R. § 210.2-06 (2010).

[365] SOX § 803, *amending* 11 U.S.C.A. § 523 (West Supp. 2010).

[366] SOX § 804, *amending* 28 U.S.C.A. § 1658 (West Supp. 2010). *See* Jeffrey Q. Smith and James K. Goldfarb, *Circuit Courts Foreclose Retroactive Application of SOXA's New Statute of Limitations for Federal Securities Law Claims*, 37 BNA Securities Regulation & Law Rept. 236 (Feb. 7, 2005).

[367] SOX § 805 (*ordering review pursuant to* 28 U.S.C.A. § 994 (West Supp. 2010)).

[368] SOX § 806(a), 18 U.S.C.A. § 1514A (West Supp. 2010); *see* 29 C.F.R. § 1980 (2010).

agents from discharging, demoting, suspending, threatening, harassing, or in any way discriminating against an employee because the employee provided information or assisted in an investigation the employee reasonably believed constituted a violation of SOX, any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders.[369]

Furthermore, SOX § 806 protects a whistleblower even if his or her report of wrongdoing is incorrect, provided the whistleblower reasonably believed that what he or she reported constituted a violation.[370] This means a company can prove that a complainant's understanding of an SEC rule was mistaken, and the allegation thus unwarranted, and yet still *lose* a SOX whistleblower case.

Employees are also protected if they file, cause to be filed, testify in, participate in, or otherwise assist in a proceeding filed (or about to be filed) relating to any rule or regulation of the SEC or any provision of federal law relating to fraud against shareholders.[371] This means that employees are insulated from retaliation for testifying or participating in class action securities litigation, for example. Employers (and in some cases individuals) found to have retaliated against a whistleblower may be subject to administrative, civil, and criminal sanctions.[372]

Dodd-Frank §§ 922 and 929A significantly expand the provisions for whistle-blower protection in SOX § 806 by: (i) covering private subsidiaries or affiliates of publicly traded companies whose financial information is included in the consolidated financial statements of such companies and covering nationally recognized statistical rating organizations; (ii) increasing the current 90-day statute of limitations to 180 days; (iii) providing a right to a jury trial in SOX actions removed to federal district courts; and (iv) prohibiting pre-dispute arbitration agreements and any other "agreement, policy, form, or condition of employment" that requires a waiver of rights under SOX. Dodd-Frank's § 922 amends the 1934 Act by including a provision requiring the SEC to provide a monetary award to individuals who provide "original information" to the SEC that results in sanctions exceeding $1 million and giving the SEC discretion to award between 10% and 30% of the total amount of the sanctions.

Also, Dodd-Frank's § 922 affords whistle-blowers a private right of action that they may pursue directly in federal court, in contrast to SOX actions, which require an employee to exhaust administrative remedies by first filing a claim with the Occupational Safety and Health Administration.

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369 *Id.*

370 *Id.*

371 *Id.*

372 *See Id.*

Enhanced Fraud Penalties. SOX § 807 subjects any person who defrauds shareholders of publicly traded companies to a fine and imprisonment for up to 25 years.[373]

VI.
MISLEADING STATEMENTS TO AUDITORS

SOX § 303 Requirements. SOX § 303 makes it unlawful, in contravention of rules adopted by the SEC, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading. On May 20, 2003, the SEC amended and expanded Rule 13b2-2[374] under the 1934 Act (which already prohibited the falsification of books, records and accounts, and false or misleading statements, or omissions to make certain statements, to accountants) by adding (x) subsection (b)(1) that specifically prohibits officers and directors and "persons acting under [their] direction,"[375] from coercing, manipulating, misleading or fraudulently influencing

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[373] SOX § 807(a), 18 U.S.C.A. § 1348 (West Supp. 2010).

[374] Improper Influence on Conduct of Audits, 1934 Act Release No. 34-47890, 80 S.E.C. Docket 770 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm.

[375] In adopting 1934 Act Release No. 34-47890 (May 20, 2003), the SEC commented:

> "[N]ew rule 13b2-2(b)(1) covers the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also "any other person acting under the direction thereof." Activities by such "other persons" currently may constitute violations of the anti-fraud or other provisions of the securities laws or aiding or abetting or causing an issuer's violations of the securities laws. Section 303(a) and the new rule provide the Commission with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer's financial statements.
>
> As noted in the proposing release, we interpret Congress' use of the term "direction" to encompass a broader category of behavior than "supervision." In other words, someone may be "acting under the direction" of an officer or director even if they are not under the supervision or control of that officer or director. **Such persons might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor.** In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and **attorneys**, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer's financial statements. * * *

(collectively referred to herein as "*improperly influencing*") an auditor "engaged in the performance of an audit"[376] of the issuer's financial statements when the officer, director or other person "knew or should have known"[377] that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading and (y) subsection

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> "Some commenters were concerned that including customers, vendors and creditors in the discussion of those persons who, in appropriate circumstances, might be considered to be acting under the direction of an officer or director would have a chilling effect on communications between those persons and the auditors. Other commenters noted that this chilling effect would be enhanced by the Commission's position in the proposing release that **negligently misleading** the auditor was sufficient conduct to trigger application of the rule. * * * We believe that third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications. A primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports, which will require the cooperation of all parties involved in the audit process. We do not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues. We do believe, however, that those third parties who, under the direction of an issuer's officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to sanction by the Commission." [emphasis added]

[376] Amended Rule 13b2-2's applicability is not limited to the formal engagement period of the issuer's current outside auditor. In adopting 1934 Act Release No. 34-47890 (May 20, 2003), the SEC commented that "the phrase 'engaged in the performance of an audit' should be given a broad reading and . . . encompass the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports."

[377] Amended Rule 13b2-2 can be violated without any specific intent to render the issuer's financial statements materially misleading and without the prohibited action achieving its desired end or actually resulting in misleading financial statements. In adopting 1934 Act Release No. 34-47890 (May 20, 2003), the SEC commented that "the phrase 'knew or should have known,' . . . historically has indicated the existence of a negligence standard [which] is consistent with the Commission's enforcement actions in this area and . . . particularly in the absence of any private right of action under the rule, best achieves the purpose of restoring investor confidence in the audit process." Amended Rule 13b2-2 departs from the text of SOX § 303 by using "knew or should have known," a negligence standard, in place of the statutory "for the purpose of" language, which would require specific intent. Thus, the SEC will not be required to show that a person's actions were intended to render the issuer's financial statements materially misleading, but only that the person knew or was negligent in not knowing that his or her actions could achieve that result. The distinction is illustrated by an example in the adopting release:

> For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("GAAS") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule.

(b)(2) that provides examples of actions that improperly influence an auditor that could result in "rendering the issuer's financial statements materially misleading."

Types of conduct that the SEC suggests could constitute "improperly influencing" include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- **Providing an auditor with inaccurate or misleading legal analysis** [emphasis added],
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting,
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting,
- Blackmailing, and
- Making physical threats.

Rule 13b2-2 applies throughout the professional engagement and after the professional engagement has ended when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports. Conducting reviews of interim financial statements and issuing consents to use past audit reports are within the scope of Rule 13b2-2.

Enforcement. SOX § 303(b) provides the SEC with sole civil enforcement authority with respect to SOX § 303 and any rule or regulation issued under SOX § 303, thereby precluding a private right of action. While there is no private right of action for violations of SOX § 303 and related SEC rules, persons providing misleading information to auditors could have liability therefor under common law causes of action such as negligent misrepresentation.[378]

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[378] *Cf. Dean Foods Company v. Pappathanasi*, 18 Mass. L. Rep. 598, 2004 WL 3019442 (Mass. Super. Dec. 3, 2004), in which a $9 million judgment was rendered by a trial court after a non-jury trial against a law firm for negligent misrepresentation as a result of the failure to disclose in a closing opinion for an acquisition certain information which it had regarding a government subpoena of documents regarding a customer's alleged tax fraud. The defendant law firm had opined to the acquiring company, as counsel to the acquired company, to the acquiring company that "to the firm's knowledge, without investigation, except as disclosed in a schedule to the acquisition agreement: (a) there was no investigation of any kind pending or threatened against the Company and (b) the Company was not 'subject to any… continuing' governmental investigation." The law firm had assisted the acquired company in responding to the government's subpoena, had looked into whether the acquired company had aided the fraud, but guessed that the investigation had probably gone away with the customer making payments to the government. The law firm advised the acquired company that the matter did not require disclosure in a schedule to the acquisition agreement. Three months after the closing, the acquired company received a "target letter" from the government. Ultimately the acquired company pled guilty to aiding and abetting tax fraud, and paid a fine of $7.2 million. The purchaser sued the acquired company's law firm which had rendered the

Both before and after the May 20, 2003 amendment to 1934 Act Rule 13b2-2, the SEC was bringing enforcement actions against individuals (including inside counsel) for their roles in the falsification of accounting records and misleading statements to accountants, some of which predated the enactment of SOX. See, for example, the following actions:

Rite Aid. The Department of Justice and the SEC brought criminal and civil charges respectively against three senior executives of Rite Aid Corporation.[379] The executives (the chief executive officer, chief financial officer and the vice chairman/chief legal officer) were accused of utilizing various schemes to inflate Rite Aid's revenues and net income every quarter over a two year period, thereby increasing their performance based bonuses and other compensation, and, in furtherance of those schemes, directing Rite Aid's accounting staff to enter false or misleading accounting entries which were subsequently included in Rite Aid's public filings, registration statements and other documents related to offerings of securities. Among the violations alleged in the SEC's complaint were (i) deducting from amounts owed vendors inflated and unsupported allowances for damaged and outdated products that were not authorized by agreements, (ii) classifying vendor rebates that were contingent on future sales as reductions to accounts payable, (iii) prematurely recognizing income from a litigation settlement before the settlement agreement was signed, (iv) failing to disclose the CEO's personal interest in three properties which the company leased as store locations, (v) falsifying board committee minutes, (vi) making misrepresentations to lenders, and (vii) signing management representation letters to auditors that contained false statements.[380] Unraveling these schemes resulted in Rite Aid to restating cumulative pretax income by $2.3 billion and cumulative net income by $1.6 billion.[381]

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opinion that no proceedings were pending or threatened against the acquired company. The court concluded that the law firm had enough notice that it could not rely on the acquired company's representations and had a duty to investigate, which it did not do adequately. The law firm ended up settling the case. *See* Donald W. Glazer and Arthur Norman Field, *No-litigation Opinions Can Be Risky Business: Looking at the Facts – and Beyond*, 14 Business Law Today No. 6 (July/August 2005) at 37. An attorney could also have liability exposure under other provisions of federal or state securities laws. *Cf.* Memorandum and Order Re Secondary Actors' Motion to Dismiss filed December 20, 2002 in *In re Enron Corp. Securities, Derivative and ERISA Litigation,* 235 F.Supp. 2nd 549 (S.D. Tex. 2002), Civil Action No. H-03-3624, Consolidated Cases (also known as *Newby v. Enron* or the *Newby* case) (the opinion is 159 pages long in F.Supp. 2nd).

379 *See* Securities and Exchange Commission v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Litigation Release 17577 (June 21, 2002), which can be found at http://www.sec.gov/litigation/litreleases/lr17577.htm; press release "SEC Announces Fraud Charges Against Former Rite Aid Senior Management," dated June 21, 2002, which can be found at http://www.sec.gov/news/press/2002-92.htm.

380 *See* Complaint, Securities and Exchange Commission v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown (June 20, 2002), which can be found at http://www.sec.gov/litigation/complaints/complr17577.htm.

381 S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 1,581, 77 S.E.C. Docket 3003 (June 21, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17577.htm.

All three officers either pled guilty or were found guilty of criminal charges brought against them and received prison sentences ranging from 28 months to 10 years.[382] The SEC's civil actions against the officers were stayed during the pendency of the criminal actions and were settled subsequent to the criminal convictions with monetary penalties and injunctive relief. Rite Aid Corporation itself settled SEC charges by agreeing to a cease and desist order.

Computer Associates. Securities fraud charges were brought by the Department of Justice and the SEC against Computer Associates International, Inc. (*"CA"*) and three of the company's former top executives – Sanjay Kumar, former CEO and Chairman, Stephen Richards, former Head of Sales, and Steven Woghin, former General Counsel, alleging that from 1998 to 2000, CA routinely kept its books open to record revenue from contracts executed after the quarter ended in order to meet Wall Street quarterly earnings estimates and obstructed the SEC's investigation into the CA's accounting practices.[383] In settlements with the SEC and the Justice Department, CA agreed pay $225 million in restitution to shareholders and to make reforms to its corporate governance and financial accounting controls.[384] General Counsel Woghin pled guilty and agreed in a partial settlement to a permanent injunction and officer and director bar with monetary sanctions to be decided at a later point.[385]

The SEC's complaints in the CA cases filed in the U.S. District Court for the Eastern District of New York allege, among other things:

- The defendants manipulated CA's quarter end cutoff to align CA's reported financial results with market expectations.
- CA prematurely recognized revenue from software contracts that CA, its customer, or both parties, had not yet executed, in violation of GAAP.

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[382] *See* S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,023, 82 S.E.C. Docket 3327 (May 26, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18727.htm; S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,024, 82 S.E.C. Docket 3327 (May 27, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18728.htm; S.E.C. v. Frank M. Bergonzi, Martin L. Grass, and Franklin C. Brown, Accounting and Auditing Enforcement Act Release No. 2,328, (Sept. 30, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19409.htm.

[383] *U.S. vs. Sanjay Kumar, et al*, SEC Litigation Release No. 18891 (September 22, 2004), SEC Accounting and Auditing Enforcement Release No. 2106 (September 22, 2004); *SEC v. Computer Associates International, Inc.*, 04 Civ. 4088 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Sanjay Kumar and Stephen Richards*, 04 Civ. 4104 (E.D.N.Y.) (Glasser, I.L.); *SEC v. Steven Woghin*, 04 Civ. 0487 (E.D.N.Y.) (Glasser, I.L.). *See* Press Release, U.S. Department of Justice, Enforcement Proceedings: In the Matter of Steven Woghin (Nov. 12, 2004), *available at* http://www.sec.gov/news/digest/dig111204.txt.

[384] S.E.C. v. Computer Associates International, Inc., Accounting and Auditing Enforcement Act Release No. 2106, 83 S.E.C. Docket 2462 (Sept. 22, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm.

[385] *See* Press Release, U.S. Department of Justice, Enforcement Proccedings: In the Matter of Steven Woghin (Nov. 12, 2004), *available at* http://www.sec.gov/news/digest/dig111204.txt.

- CA executives, including defendants Kumar, Richards, and Woghin, held CA's books open for several days after the end of each quarter to improperly record in that quarter revenue from contracts that were not executed by customers or CA until several days or more after the expiration of the quarter. In a Superseding Indictment filed in the E.D.N.Y. in *U.S. vs. Sanjay Kumar and Stephen Richards* on June 30, 2005, the U.S. alleged that this practice was referred to within CA as the "35-day month" or the "three-day window." As a result of this improper practice, CA made material misrepresentations and omissions about its revenue and earnings in SEC filings and other public statements.

- Woghin (1) signed an SEC filing that contained materially false and misleading information regarding CA's revenues and earnings per share; (2) approved backdated contracts, including drafting a contract with misleading dates; and (3) allowed CA Legal Department to approve contracts obtained by the sales force while knowing, or recklessly disregarding the fact that, those contracts contained false and misleading signature dates and that CA would recognize revenue from those contracts in the incorrect fiscal quarter.

- Woghin encouraged several CA employees to make false and misleading statements to the SEC and/or CA's outside counsel.[386]

Isselmann. *In the Matter of John E. Isselmann*,[387] resulted in a consent cease and desist order being entered against John E. Isselmann, the General Counsel of Electro Scientific Industries, Inc. (*"ESI"*), whose "failure to fulfill his gatekeeper role was a cause of the Company reporting materially fake financial results for" a quarter. His failure was to timely advise ESI's Audit Committee and auditors that he had received an opinion of local foreign counsel that ESI could not eliminate benefits to its Asian employees where the benefits termination allowed ESI to report a profit rather than a loss and resulted improper financial reporting in its Form 10-Q Report.

The facts were that ESI's Chief Financial Officer (*"CFO"*) and Controller, without involving or consulting Isselmann, elected to terminate a retirement plan for ESI's employees in Asia and reverse an accrual for pension benefits. During an Audit Committee meeting two weeks before the close of the quarter, the CFO advised "that the Japanese benefits were not legally required and that the decision had been approved by legal counsel," and "Isselmann identified ESI's legal counsel in Japan, causing an Audit Committee member to believe that outside counsel had reviewed the decision." Isselmann's fault at this stage was not speaking up since he knew that he, as General Counsel, had not "sought any outside legal review of the issue." Three days after the end of the quarter Isselmann sought legal advice of counsel in Japan. When the Japanese opinion was received four days later, it indicated that the pension benefits could not be eliminated unilaterally. Isselmann tried to raise the point at meetings with ESI's

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386 S.E.C. v. Computer Assoc. Int'l, Inc., Accounting and Auditing Enforcement Act Release No. 2106, 83 S.E.C. Docket 2462 (Sept. 22, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm.

387 *In re* John E. Isselmann, Jr., Accounting and Auditing Enforcement Act Release No. 50,428, 83 S.E.C. Docket 2413 (Sept. 23, 2004), *available at* http://www.sec.gov/litigation/admin/34-50428.htm.

Audit Committee, Disclosure Committee and auditors prior to filing ESI's Form 10-Q, but he was cut off by the CFO, who signed the Form 10-Q Report. Five months after the foregoing events occurred, the CFO had been promoted to CEO, and the new CFO told Isselmann for the first time exactly what had occurred with regard to the earlier accrual reversal. Isselmann immediately advised ESI's Audit Committee and outside counsel, but the SEC concluded that his actions were too little-too late. While there is no allegation that Isselmann in any way participated in the scheme to falsify ESI's numbers, the SEC found that Isselmann's failure to timely disclose the Japanese legal opinion to the Audit Committee, the Board of Directors and outside auditors "allowed the CFO and Controller to hide an ongoing fraud." For their part the CFO and Controller were indicted on 17 counts of financial fraud and falsifying records.

Orlick/Gemstar-TV Guide. *In re Jonathan B. Orlick, Esq*,[388] the SEC announced settlement of an enforcement action against Jonathan B. Orlick, the former Executive Vice President, General Counsel, Secretary and a director of Gemstar-TV Guide International, Inc., a media and technology company that publishes TV Guide and "develops, licenses, and markets an interactive program guide (*"IPG"*) for televisions.....," which it touted as the "value driver" of the company's stock. According to the SEC, during the period from June 1999 through September 2002 Gemstar overstated its total revenues by at least $248 million to meet growth projections for IPG licensing and advertising, and the SEC alleged that Orlick knew that the company was improperly recognizing and reporting licensing revenue. It was also alleged that Orlick repeatedly signed false representation letters to the company's outside auditors regarding the status of negotiations with another company regarding a material licensing agreement. As part of the settlement, Orlick was enjoined from violating, or aiding and abetting violations, of securities laws, and was ordered to pay $305,511 in disgorgement of a prior bonus, interest and a civil penalty. In addition, Orlick may not serve as an officer or director of a public company for a period of ten years, and has been suspended from appearing or practicing before the SEC. Orlick consented to the penalties, but neither admitted or denied liability.

Fitzhenry. *In re James A. Fitzhenry*,[389] involved an SEC enforcement action against James A. Fitzhenry, Senior Vice President, General Counsel and Secretary for FLIR Systems, Inc. (*"FLIR"*). At year-end 1998, FLIR improperly recognized $4.1 million in revenue from two purported sales to one of FLIR's independent sales representatives in Columbia, based upon non-binding letters of intent. As part of the 1998 year-end audit of FLIR's financial statements, FLIR's outside auditors, PricewaterhouseCoopers LLP (*"PwC"*), selected these sales for testing and sent an accounts receivable confirmation, which the sales representative refused to return. In February 1999, Fitzhenry attempted to obtain a binding and unconditional agreement from FLIR's independent sales representative to purchase the units stated in the non-binding letters of intent. The sales representative refused to provide an agreement of the type requested by Fitzhenry. From Fitzhenry's negotiations with FLIR's independent sales representative, he understood that the $4.1 million in sales were conditional in nature because the sales

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388 *In re* Jonathan B. Orlick, Esq., Auditing and Auditing Enforcement Release No. 51,081, 84 S.E.C. Docket 2560 (Jan. 26, 2005), *available at* http://www.sec.gov/litigation/admin/34-51081.htm.

389 *In re* James A. Fitzhenry, Accounting And Auditing Enforcement Release No. 46870 (Nov. 21, 2002), *available at* http://www.sec.gov/litigation/admin/34-46870.htm.

representative had no obligation to purchase the units. On April 12, 1999 and April 20, 1999, Fitzhenry signed two management representation letters to PwC, in connection with FLIR's 1998 year-end audit. Among other things, both letters confirmed that: (1) risk of ownership for the units had passed to FLIR's independent sales representative; and (2) the independent sales representative had made a fixed commitment to purchase the goods. Fitzhenry never told PwC about his negotiations with the independent sales representative, nor did he tell PwC that he understood the transactions were "conditional" in nature. Consequently, Fitzhenry made material misrepresentations and omitted material information in the management representation letters. As a result of the conduct described above, the SEC found that Fitzhenry willfully violated pre-SOX Rule 13b2-2. In the settlement, Fitzhenry was denied the privilege of appearing or practicing before the SEC as an attorney for five years.

Steckler. In *SEC v. Vincent Steckler*, the SEC charged a vice president of sales of a subsidiary of a public company with aiding and abetting a supplier of his employer in improperly recognizing revenue in violation of Rules 10b-5 and 13b2-1 under the 1934 Act by arranging for an undisclosed side letter that made an otherwise unconditional order by his employer for the purchase of software provided to the supplier's legal and accounting departments subject to cancellation.[390] The SEC's Complaint stated that under GAAP the side letter made the sale a contingent sale, which should not be recognized as revenue, and that the defendant concealed the side letter from the supplier's legal and accounting departments, thereby causing the improper revenue recognition by the supplier.[391]

Google. *In the Matter of Google, Inc. and David C. Drummond*,[392] the general counsel of Google consented to a cease and desist order as a result of giving erroneous advice to Google regarding the availability of an exemption from 1933 Act registration for the grant of employee stock options. In 2003, Google was a privately held company whose financial statements were confidential. Google believed that disclosing these financial statements would be "strategically disadvantageous," and that making the financial statements widely available among Google employees could result in loss of information confidentiality that was essential at that stage in its business. At this time, Google was considering issuing stock options to its employees without registering the securities, but Rule 701 under the 1933 Act provided an exemption for the issuance of only $5 million in options over a 12-month period without providing detailed financial statements and other disclosures to the option recipients. When contemplating the first of these options grants in 2003, the general counsel consulted with outside counsel and his legal department colleagues at Google, and concluded that the $5 million threshold of the Rule 701

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[390] *See* S.E.C. v. Vincent Steckler, Accounting and Auditing Enforcement Act Release No. 1,850, 81 S.E.C. Docket 151 (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18327.htm; Complaint, S.E.C. v. Vincent Steckler, (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18327.htm.

[391] *See* Complaint, S.E.C. v. Vincent Steckler, (Sept. 8, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18327.htm.

[392] *In re* Google, Inc. and David C. Drummond, 1933 Act Release No. 8523, 84 S.E.C. Docket 2293 (Jan. 13, 2005), *available at* http://www.sec.gov/litigation/admin/33-8523.htm.

exemption would not likely be exceeded. Even if it were, he believed that exemptions under SEC Regulation D and 1933 Act § 4(2) might apply to allow Google to issue the options without registering the securities or transmitting detailed financial information to the option recipients, and "even if it were later determined that his analysis of the applicability of other registration exemptions was incorrect, Google could make an offer of rescission to the option holders." Ultimately, Google issued approximately $49 million worth of stock options during 2003 and an additional $33 million worth during the first four months of 2004, prior to the filing of its registration statement for an initial public offering (*"IPO"*), without the general counsel explaining to Google's board of directors that Rule 701 had not been complied with and the risks of reliance on another exemption from registration. The SEC ultimately concluded that there was no exemption from registration as all of the optionees did not have the requisite sophistication or receive the requisite information about Google. In August 2004 before its IPO, Google did offer rescission to the option holders, an offer that went unanswered due to the anticipated success of the IPO (the option exercise prices were less than $4 and the IPO price was expected to be over $100). By bringing this case, the Commission sent a reminder that a "technical violation" is a violation even if no economic harm occurs (i.e., there is no "good deal defense" to SEC enforcement actions).

FFP. In *In re FFP Marketing Company, Inc., Warner Williams, and Craig Scott, CPA*,[393] a general counsel was sanctioned for signing a misleading Form 12b-25 stating why the company could not file its Form 10-K Report within the prescribed time period. The Form 12b-25 failed to disclose that the auditors could not complete their audit because of an ongoing study into accounting irregularities that ultimately resulted in a significant write down of credit card receivables and a restatement of FFP's financial statements.

Biopure Corporation. In *SEC v. Biopure Corporation*,[394] Biopure Corporation and its general counsel consented to final judgments in a previously-filed action[395] that (i) permanently enjoins Biopure from violating antifraud provisions of the federal securities laws and requires the company to retain an independent consultant to review Biopure's disclosure, compliance and other policies and procedures and (ii) permanently enjoins the general counsel from aiding and abetting violations of the reporting provisions of the federal securities laws and orders her to pay a $40,000 civil penalty. The SEC's Complaint alleged that Biopure received negative information from the FDA regarding its efforts to obtain FDA approval of its synthetic blood product, but failed to disclose the information, or falsely described it as positive developments. Biopure's chief executive officer and its regulatory affairs head were separately charged.

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393 *In re* FFP Mktg. Co., Accounting and Auditing Enforcement Act Release No. 51,198, 84 S.E.C. Docket 2981 (Feb. 14, 2005), *available at* http://www.sec.gov/litigation/admin/34-51198.htm.

394 SEC Litigation Release No. 19825 (September 12, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19825.htm.

395 Securities and Exchange Commission v. Biopure Corporation, Thomas Moore, Howard Richman and Jane Kober, (United States District Court for the District of Massachusetts, Civil Action No. 05-11853-WGY), Litigation Release No. 19376 (September 14, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19376.htm.

False Confirmations. On November 2, 2005, the SEC charged seven individuals with providing false confirmations to the outside auditors of U.S. Foodservice, Inc., a subsidiary of Royal Ahold.[396] Each defendant was an employee of a supplier to a subsidiary of Royal Ahold and was also the subject of criminal conspiracy charges filed by the U.S. Attorney's Office for the Southern District of New York. Similar charges previously had been filed against nine others, and on June 7, 2006 civil charges were filed and settled against the owner/operator of several suppliers which had provided false confirmations to the subsidiary's auditors,[397] bringing the total number of third-party defendants in the matter to 17. Royal Ahold itself settled a related SEC proceeding in October 2004.

Industry practice was for such vendors to provide the Ahold subsidiary and other wholesale food distributors with sales rebates, referred to as "promotional allowances." The Government alleged that, between 2000 and 2003, the Ahold subsidiary's executives inflated the allowances paid by the vendors, and owed at year-end, by millions of dollars in the subsidiary's financial statements. The executives also allegedly "induced" the Ahold subsidiary's vendors to provide false confirmations of these amounts to Royal Ahold's auditors. The implication was that, had the vendors not gone along with the scheme, the subsidiary's officers would have steered business elsewhere.

This fact pattern is similar to prior cases in which the SEC has charged third parties who provided false confirmations to another company's auditors with aiding and abetting securities fraud.[398] What is significant in the Royal Ahold proceedings, however, is the number of third-party defendants who were charged. The majority of the defendants in the Royal Ahold proceedings were not employees of SEC registrants, but instead were owners or employees of private food distributors that did business with the Ahold subsidiary. The proceedings demonstrate that the SEC is prepared to bring charges against persons or entities not otherwise subject to SEC oversight, if their conduct interferes with the ability of a public company's auditors to conduct a fair examination of the company's financial statements.[399]

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[396] SEC Litigation Release No. 19454 (Nov. 2, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19454.htm.

[397] SEC Litigation Release No. 19721 (June 7, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19721.htm.

[398] *See In the Matter of Kemps LLC, f/k/a Marigold Foods, LLC, James Green and Christopher Thorpe*, Admin. Proc. File No. 3-11656, Accounting and Auditing Enforcement Release No. 2101 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8485.pdf; *In the Matter of John K. Adams*, Admin. Proc. File No. 3-11655, Accounting and Auditing Enforcement Release No. 2098 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8484.pdf; *In the Matter of Digital Exchange Systems, Inc., Rosario Coniglio and Steven Schmidt*, Admin. Proc. File No. 3-11654, Accounting and Auditing Enforcement Release No. 2099 (September 14, 2004), which can be found at http://www.sec.gov/litigation/admin/33-8483.pdf.

[399] *See SEC v. Scientific-Atlanta, Inc.*, 06 Civ. 4823 (PKC) (S.D.N.Y. June 22, 2006), which can be found at http://www.sec.gov/litigation/litreleases/2006/lr19735.htm (vendor that supplied set-top boxes for use in Adelphia Communications' cable business sued for aiding and abetting Adelphia's reporting, books and records, and internal controls violations by entering into marketing support arrangements pursuant to which

The SEC did not rely on amended Rule 13b2-2 in the Royal Ahold proceedings as most of the conduct predated the effective date of the revised rule. In the future, however, the SEC may bring cases under Rule 13b2-2 against third parties for providing "misleading" confirmations to another company's auditors, even if they did not conspire with issuer officials or know that their confirmations were inaccurate. Should this occur, questions likely will arise as to whether the party furnishing the confirmation was acting "under the direction" of an officer or director of the issuer, as required to establish a Rule 13b2-2 violation, simply because he or she provided a confirmation at the request of an issuer officer.

Internal Investigations. Internal investigations into allegations of wrongdoing by corporate representatives are being conducted with increasing frequency by counsel retained by boards of directors or audit committees.[400] The results of an internal investigation conducted by counsel are frequently furnished to the company's auditors. As a result, counsel conducting such an investigation in some circumstances could have a duty under Rule 13b2-2 to conduct the investigation with sufficient thoroughness that the results do not mislead the auditors. When he was Director of the SEC Division of Enforcement, Stephen Cutler commented:

> One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.[401]

The DOJ is taking the position that lying to issuer counsel conducting an internal investigation is equivalent to lying to a prosecutor, law enforcement officer or regulator about a crime, and exposes the liar to federal obstruction of justice charges.[402] The DOJ has indicted under 18 U.S.C. § 1512(c) added by SOX Title XI[403] two former officers of Computer

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Scientific-Atlanta made marketing-support payments to Adelphia that were offset by price increases on equipment it sold to Adelphia, which enabled Adelphia to reduce its ordinary marketing expense and book the offsetting additional equipment costs as capital expenditures); Brian A. Ochs, "*Has the Securities and Exchange Commission Expanded Corporate Liability?*", 38 BNA Sec. Reg. & L. Rept. 37 at 1549 (September 18, 2006).

400 *See* William R. Baker III and Joel H. Trotter, *Corporate Internal Investigations after Sarbanes-Oxley*, in 2 THE PRACTITIONER'S GUIDE TO THE SARBANES-OXLEY ACT VII-4-1 (John J. Huber et al. eds., ABA 2004).

401 Speech entitled "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" by Stephen M. Cutler, then Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at http://www.sec.gov/news/speech/spch092004smc.htm.

402 Timothy P. Harkness and Darren LaVerne, *Private lies may lead to prosecution – DOJ views false statements to private attorney investigators as a form of obstruction of justice*, NAT'L L.J., July 24, 2006, at S1.

403 SOX Title XI, entitled the "Corporate Fraud Accountability Act of 2002," provides in § 1102 for up to twenty years in prison for altering, destroying, or concealing anything with the intent to impair its use in any official proceeding, or any attempt to do so. SOX § 1102, *amending* 18 U.S.C.A. § 1512 (West Supp. 2010). SOX § 1103 also authorizes the SEC to seek a temporary injunction to freeze extraordinary payments earmarked for designated persons or corporate staff under investigation for possible violations of federal securities laws. SOX § 1103, *amending* 15 U.S.C.A. § 78u-3 (West Supp. 2010).

Associates International Inc. in respect of allegedly false statements made to issuer counsel during an internal investigation at that company.[404] Charges under 18 U.S.C. § 1512(c) added by SOX Title XI were also brought against an employee of El Paso Corp. based on statements made to outside counsel during an internal investigation.[405]

Relationship of SOX § 303 Requirements to 1934 Act §10A. A violation of Rule 13b2-2 is an "illegal act" within the meaning of Section 10A(b) of the 1934 Act and, therefore, must be reported by auditors under that section. Attorneys also should be aware that evidence of a violation of Rule 13b2-2 may be reportable by them under SOX § 307 if it amounts to "evidence of a material violation" as defined in the SOX § 307 Rules.

Foreign Private Issuers. There is no exemption or qualification in amended Rule 13b2-2 excluding foreign private issuers from its application.

VII.
ENHANCED ATTORNEY RESPONSIBILITIES UNDER SOX

SOX § 307. SOX § 307 mandates that the SEC shall adopt rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal officer or the equivalent (*"CLO"*), if the issuer has a CLO, or to both the CLO and the CEO, of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the board of directors or an appropriate committee thereof.[406] On January 23, 2003, the SEC complied with the SOX § 307 mandate by adopting the rules implementing provisions of SOX § 307 that prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers.[407] These rules adopted under SOX § 307 (the *"SOX § 307 Rules"*)

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404 *U.S v. Kumar*, No. 04-cr-846, slip op. (E.D.N.Y. Feb. 21, 2006).

405 *See U.S. v. Singleton*, No. 4:04-cr-514-1 (S.D. Texas filed Nov. 17, 2004).

406 SOX attempts to protect investors from a repeat of the scandals that led to its enactment by regulating "[t]he sentries of the marketplace: the auditors who sign off on companies' financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and the boards of directors responsible for oversight of company management." Speech entitled "The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program" by Stephen M. Cutler, Director of SEC Division of Enforcement, at UCLA School of Law on September 20, 2004, which can be found at http://www.sec.gov/news/speech/spch092004smc.htm. *See also In the Matter of John E. Isselmann*, 1934 Act Release No. 50428 (September 23, 2004), which can be found at http://www.sec.gov/litigation/admin/34-50428.htm and in which a consent cease and desist order was entered against a general counsel who failed to advise the audit committee and auditors that he had received an opinion of local foreign counsel that the company could not eliminate benefits to its Asian employees where the benefits termination allowed the company to report a profit rather than a loss and which resulted in improper financial reporting in the Form 10-Q Report.

407 1933 Act Release No. 33-8185 (January 29, 2003), titled "Implementation of Standards of Professional Conduct for Attorneys," and which can be found at http://www.sec.gov/rules/final/33-8185.htm (the *"SOX § 307 Release"*).

constitute Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission, and became effective on August 5, 2003.

Generally, the SOX § 307 Rules require that, in the event that an attorney has *credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation of any U.S. law or fiduciary duty has occurred, is on going, or is about to occur,* the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer. This standard, developed from the SEC's attempt to make objective rather than subjective the test of when a lawyer must report a violation, has a lower threshold than a "more likely than not" standard. An attorney's duty is not confined to matters as to which the attorney has formed a legal conclusion that there has been a material violation.

Relationship to State Disciplinary Rules. The SOX § 307 Rules purport to set forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer. SOX § 307 standards are intended to supplement applicable standards of any jurisdiction where an attorney is admitted or practices, and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of SOX § 307 Rules. Where the standards of a state or other U.S. jurisdiction where an attorney is admitted or practices conflict with SOX § 307 Rules, the SOX § 307 Rules provide that they shall govern.

Attorneys Covered. The SOX § 307 Rules apply to all attorneys, whether inside counsel or outside counsel and those in foreign jurisdictions, "*appearing and practicing*" before the SEC. The term "appearing and practicing" before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena; (3) providing advice in respect of the U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document;[408] or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (x) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship;[409] or (y) is a non-appearing foreign attorney.[410] The SEC intends that the issue

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[408] Mere preparation of a document that may be included as an exhibit to a filing with the SEC does not constitute "appearing and practicing" before the SEC, unless the attorney has notice that the document will be filed with or submitted to the SEC and he or she provides advice on U.S. securities law in preparing the document. Thus, preparing an employment contract for an executive officer would not be, but drafting a description of the contract for a proxy statement would be, "appearing and practicing" before the SEC.

[409] This portion of the definition of "appearing and practicing" before the SEC has the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may

whether an attorney-client relationship exists for purposes of the SOX § 307 Rules will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under the SOX § 307 Rules.

Who is the Client? The SOX § 307 Rules affirmatively state that an attorney representing an issuer represents the issuer as an entity, rather than the officers or others with whom the attorney interacts in the course of that representation. State ethics rules likewise provide that the attorney owes his or her professional and ethical duties to the issuer as an organization.[411] In the case of a large corporation with multiple subsidiaries, questions will arise as to whether the attorney represents the consolidated group or only a particular entity within, and the answers will vary depending on the unique facts of each situation.[412] While the state ethics rules apply to both public and private companies, the SOX § 307 Rules apply only to attorneys in the representation of public companies.[413]

What Evidence Triggers Reporting Duty? The SOX § 307 reporting duties are triggered when an attorney has "*evidence of a material violation*," which is defined to mean credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.[414] "*Material violation*" in turn is defined

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transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship.

410 The SOX § 307 Rules incorporate a concept of "non-appearing foreign attorney" to address the situation of attorneys who are admitted outside of the U.S., do not give advice as to U.S. securities laws and whose involvement with SEC matters is either peripheral or through U.S. counsel, and to relieve such attorneys of the responsibilities of the SOX § 307 Rules.

411 TEX. DISCIPLINARY R. PROF'L CONDUCT 1.12 (providing that "[a] lawyer employed or retained by an organization represents the entity" rather than the individuals to whom the lawyer reports in the ordinary course of working relationships. *See also* MODEL RULES OF PROF'L CONDUCT R. 1.13(a) ("[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents").

412 Attorneys' engagement letters sometimes are very specific as to the representation being solely of a specified entity and not any parent or subsidiary entities or related persons; sometimes the client will want the attorneys to agree that the client is all of the members of the consolidated group.

413 17 C.F.R. § 205.3 (2010).

414 The SOX § 307 Release comments that the definition of "evidence of a material violation" is an objective standard, instead of a subjective standard which would require "actual belief" that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer. In explaining how the definition's objective standard should be interpreted, the SOX § 307 Release states:

to mean a material violation of an applicable U.S. federal or state securities law, a material "breach of fiduciary duty" arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law. The SOX § 307 Release comments that the SOX § 307 Rules do not contain a separate definition of "material" because "that term has a well-established meaning under the federal securities laws and the [SEC] intends for that same meaning to apply" under the SOX § 307 Rules.[415] The SOX § 307 Release, however, does comment that material violations must arise under U.S. law (federal or state) and do not include violations of foreign laws. "*Breach of fiduciary duty*" under the SOX § 307 Rules refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common

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> Evidence of a material violation must first be credible evidence. An attorney is obligated to report when, based upon that credible evidence, "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.
>
> On the other hand, the rule's definition of 'evidence of a material violation" makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney "knows" that a material violation has occurred or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise." That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances in which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur. To be "reasonably likely" a material violation must be more than a mere possibility, but it need not be "more likely than not." If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

[415] The SOX § 307 Release cites *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-236 (1988); and *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) for the generally accepted definition of "material." Materiality is defined in those cases as follows: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus.,* 426 U.S. at 449 (expressly adopted in *Basic, Inc.* at 231-32). *See* 15 U.S.C. § 7245 (Supp. 2010).

law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.[416]

Duty to Report Evidence of a Material Violation. If an attorney, appearing and practicing before the SEC "in the representation of an issuer,"[417] becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer, the SOX § 307 Rules require the attorney to "*report*"[418] the evidence to the issuer's CLO (if the issuer has a CLO) or to both the issuer's CLO and its CEO forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.

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[416] Both TBCA art. 2.31 and DGCL § 141(a) provide that the business and affairs of a corporation are to be managed under the direction of its board of directors. While the Texas and Delaware corporation statutes provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the conduct of meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care." *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). *Gearhart* describes those duties as follows: (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances. In Delaware, the fiduciary duties include those of loyalty, care, candor and oversight. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); S*ee In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795 (7th Cir. 2003). Both Texas and Delaware have adopted a judicial rule of review of business decisions, known as the "business judgment rule," that is intended to protect disinterested directors from liability for decisions made by them when exercising their business judgment, but there are substantial differences in the Delaware and Texas judicial approaches to the business judgment rule. *See* Byron F. Egan, *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 Tex. J. Bus. L. 45 (Spring 2009), *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230; Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001). The extent to which traditional business judgment rule analyses will be applicable in respect of SOX requirements is unclear.

[417] The SOX § 307 Rules define "*in the representation of an issuer*" to mean providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.

[418] The SOX § 307 Rules define "*report*" to mean to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing.

The CLO is then obligated to cause such inquiry[419] into the evidence of a material violation as he or she "*reasonably believes*"[420] is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur. If the CLO determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an "*appropriate response*,"[421] and shall advise the reporting attorney thereof. In lieu of causing such an inquiry a CLO may refer a report of evidence of a material violation to a qualified legal compliance committee (*"QLCC"*) if the issuer has duly established a QLCC prior to the report of evidence of a material violation.

Unless an attorney who has made the report reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to: (i) the issuer's audit committee, (ii) another committee consisting solely of independent directors, or (iii) the board of directors.[422]

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[419] An attorney conducting an inquiry into reported evidence of a material violation would be deemed appearing and practicing before the SEC in the representation of the issuer. The attorney reporting the evidence to the CLO could be a person commissioned by the CLO to conduct the inquiry into the evidence. The inquiry is important not only for what it finds about the possible violation which initiated the inquiry, but also for any additional possible violations which it may uncover. *See* SOX § 307 Release, *supra* note 407.

[420] The SOX § 307 Rules provide that "*reasonably believes*" to mean that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable, and that "reasonable" or "reasonably" denote, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.

[421] "*Appropriate response*" is defined by the SOX § 307 Rules as a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes that: (1) no material violation has occurred, is ongoing, or is about to occur; (2) the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) the issuer, with the consent of the issuer's board of directors, an appropriate committee thereof or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either (x) has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence or (y) has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

[422] *See* Patrick McGeehan, *Lawyers Take Suspicions On TV Azteca To Its Board*," N.Y. TIMES, Dec. 24, 2003, Section C, page 1:

> "In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's CLO and CEO, the attorney may bypass them and report the evidence to the board or an appropriate committee.

An attorney retained or directed by an issuer to investigate evidence of a reported material violation shall be deemed to be appearing and practicing before the SEC. Directing or retaining an attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported from a duty to respond to the reporting attorney.

Under the SOX § 307 Rules, an attorney shall not have any obligation to report evidence of a material violation if (i) the attorney was retained or directed by the issuer's CLO to investigate such evidence of a material violation and reports the results of such investigation to the CLO and to the board or an appropriate committee or each of the attorney and the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, or (ii) the attorney was retained or directed by the CLO to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the CLO provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board or appropriate committee.

An attorney shall not have any obligation to report evidence of a material violation if the attorney was retained or directed by a QLCC to either investigate such evidence of a material violation or to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made need do nothing more under the SOX § 307 Rules with respect to his or her report.

> "The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than $100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.
>
> "… in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX § 307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it."

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made shall explain the reason behind his or her belief to the CLO, the CEO, and the directors to whom the attorney reported the evidence of a material violation. An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under the SOX § 307 Rules and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation. Discharging an attorney/employee for reporting under the SOX § 307 Rules would violate the whistleblower protections afforded by SOX § 806.

The SOX § 307 Rules are specific as to how reports thereunder must be made and how the recipient of the report must investigate and respond to the report. The SOX § 307 Rules do not restrict informal communication between the issuer representatives and the attorney to resolve the issue, but in the event that the SOX § 307 Rules are triggered, the SOX § 307 Rules should be promptly and literally complied with, even if it duplicates prior communications informally made to responsible issuer representatives.

Alternative Reporting Procedures For An Issuer That Has Established A QLCC. If an attorney, appearing and practicing before the SEC in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the preceding reporting requirements, report such evidence directly to a QLCC, if the issuer has formed such a committee. An attorney who reports evidence of a material violation to a QLCC has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.

A CLO may refer a report of evidence of a material violation to a QLCC in lieu of causing an inquiry to be conducted, and shall inform the reporting attorney that the report has been referred to a QLCC. Thereafter, the QLCC shall be responsible for responding to the evidence of a material violation reported to it.

Issuer Confidences. The SOX § 307 Rules provide that any report under or any response thereto (or any contemporaneous record of the report or the response) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with the SOX § 307 Rules is in issue. In the SOX § 307 Release, the SEC states that it is making "clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct," and that the SOX § 307 Rules are effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding "self-defense" exceptions to client-confidentiality rules in every state.[423]

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[423] The Texas Disciplinary Rules of Professional Conduct provide as follows:

RULE 1.05. CONFIDENTIALITY OF INFORMATION

The SOX § 307 Rules further provide that an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary: (i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer from committing or suborning perjury or committing any act that is likely to perpetrate a fraud upon the SEC; or (iii) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used. The SOX § 307 Release comments that in permitting, but not requiring, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the SEC in the representation of an issuer, the SOX § 307 Rules correspond to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("*Ethics 2000 Commission*") in 2000, and as adopted in the vast majority of states.[424]

Responsibilities of Supervisory Attorneys. An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a "*supervisory attorney*" and is required to make reasonable efforts to ensure that a

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(b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e) and (f), a lawyer shall not knowingly:

(1) Reveal confidential information of a client or a former client . . .

(c) A lawyer may reveal confidential information:

(5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.

(6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyers associates based upon conduct involving the client or the representation of the client.

(7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.

(8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.

(e) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person, the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act.

[424] *Id*.

subordinate attorney that he or she supervises or directs conforms to the SOX § 307 Rules. Supervising an attorney in the representation of an issuer in non-SEC related matters, or overall management of a law firm, would not result in an attorney being considered a "supervisory attorney" for SOX § 307 purposes.

A supervisory attorney is responsible for complying with the reporting requirements when a subordinate attorney has reported to the supervisory attorney evidence of a material violation and may report evidence of a material violation from a subordinate attorney to the issuer's QLCC.

Responsibilities of a Subordinate Attorney. An attorney who appears and practices before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's CLO) is a "*subordinate attorney*" and is obligated to comply with the SOX § 307 Rules notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.

A subordinate attorney complies with the SOX § 307 Rules if the subordinate attorney reports to his or her supervising attorney evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the SEC, but may "report up the ladder" if the subordinate attorney reasonably believes that the supervisory attorney to whom he or she has reported evidence of a material violation has failed to comply with the SOX § 307 Rules.

Sanctions and Discipline. A violation of the SOX § 307 Rules by any attorney appearing and practicing before the SEC in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the SEC, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices.

An attorney who complies in good faith with the provisions of the SOX § 307 Rules is not subject to discipline or otherwise liable under inconsistent standards imposed by any state or other U.S. jurisdiction where the attorney is admitted or practices.

Issues of compliance with the SOX § 307 Rules will likely arise when a corporate debacle emerges and the SEC staff investigates to find out who knew what and when, and asks where the lawyers were. In that context the staff will look at whether there was compliance with the SOX § 307 Rules. Under such circumstances, lawyers would be more comfortable if they could point to strict compliance with the SOX § 307 Rules rather than trusting to prosecutorial discretion to conclude that substantial compliance was good enough.

No SOX § 307 Private Right of Action. The SOX § 307 Rules provide that nothing therein is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions. Authority to enforce compliance with the SOX § 307 Rules is vested exclusively in the SEC.

Enron Civil Liability Fallout. Compliance with the requirements of the SOX § 307 Rules does not assure attorneys that they will not be subject to private claims based on other securities laws.[425] In her lengthy opinion dated December 19, 2002 on the motions to dismiss filed by Vinson & Elkins L.L.P. ("*V&E*"), Kirkland & Ellis ("*K&E*"), Arthur Andersen LLP and nine banks in the *Newby v. Enron* case, Judge Melinda Harmon granted the motions to dismiss of K&E and Deutsche Bank, but denied in whole or in part the motions of V&E, Arthur Andersen, J.P. Morgan Chase, Citigroup, Credit Suisse, CIBC, Merrill Lynch, Barclays, Lehman Brothers and Bank America. In exploring the circumstances under which law firms, accounting firms, and investment banks/integrated financial services institutions (lumped together by the Court as "*secondary actors in securities markets*") can be liable for the acts of companies they serve under SEC Rule 10b-5 and the Texas Securities Act, the Court noted that it was influenced by revelations of corporate corruption in other courts, Congress, investigations by the SEC and New York Attorney General Eliot Spitzer, and the media.

While paying homage to the 1994 holding of the Supreme Court in *Central Bank of Denver*[426] that a private plaintiff may not bring an aiding and abetting claim under Rule 10b-5, the Court found that the Supreme Court had left open for it to determine when the conduct of a secondary actor makes it a primary violator subject to liability under Rule 10b-5. Rejecting the "bright line" test that a defendant must actually make a false or misleading statement to be liable, the Court adopted the SEC's amicus position that a defendant can be liable if it "creates" a misleading document even though the defendant is not identified with it to the outside world, with "reliance" being established under the "fraud on the market" theory.[427] "Scienter" remains a crucial element, with the plaintiff having to show intent to deceive or extreme recklessness to sustain a Rule 10b-5 claim.

The Court gave a broad reading to the liability provisions of the Texas Securities Act,[428] commenting that "liability may be imposed against a defendant [who] constituted any link in the chain of the selling process" and that proof of reliance or scienter are not required. The Court

[425] *See* Memorandum and Order Re Secondary Actors' Motion to Dismiss filed December 20, 2002 in *In re Enron Corp. Securities, Derivative and ERISA Litigation,* 235 F.Supp. 2nd 549 (S.D. Tex. 2002), Civil Action No. H-03-3624, Consolidated Cases (also known as *Newby v. Enron* or the *Newby* case) (the opinion is 159 pages long in F.Supp. 2nd).

[426] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), in which the U.S. Supreme Court held that SEC Rule 10b-5 prohibits only the making of a material misstatement or omission (or the commission of a manipulative act) and does not prohibit the giving of aid to another who then commits a primary Rule 10b-5 violation.

[427] The Court in *Newby* wrote: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability . . . are met." 235 F. Supp. 2d 549, 582 (S.D. Tex. 2002).

[428] Tex. Sec. Act § 33, Art. 581-33 Tex. Rev. Civ. Stat. (Vernon Supp. 2010).

found that the Texas Securities Act "applies if any act in the selling process of securities…occurs in Texas."[429]

With respect to attorney liabilities, the Court acknowledged that Texas law requires privity for malpractice liability, but found that claims for fraudulent or negligent misrepresentation can be made by those who the attorney had reason to know would rely on the information and who justifiably relied on it. The Court concluded that "professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely."

In denying V&E's motion to dismiss, the Court recited V&E's involvement in structuring the partnerships and special purpose entities ("*SPEs*") that contributed to Enron's demise and in working on its SEC filings and other public disclosures, and found that V&E "was necessarily privy to its client's confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus, as a law firm highly sophisticated in commercial matters, had to know of the alleged ongoing illicit and fraudulent conduct." The Court wrote that V&E "was not merely a drafter, but essentially a co-author of the documents it created for public consumption." The Court commented "[r]evelant to Vinson & Elkins undertaking of the investigation of Enron in the fall of 2001, [Texas Rule of Professional Conduct] 1.06(a)(2) bars a lawyer from representing a client where that representation 'reasonably appears to be or becomes limited by the lawyer's or law firm's own interests….' [and under such circumstances] a client's consent is not effective.…"

However, the Court dismissed the lawsuit as to K&E, calling the charges against K&E "conclusory and general." The Court said any documents K&E drafted were for private transactions, "and were not included in or drafted for any public disclosure or shareholder solicitation" and noted that K&E was not Enron's counsel for its securities or SEC filings.

Attorney-Client/Work Product Privilege. The SOX § 307 Rules do not contain any provision to the effect that information reported by an attorney to the SEC does not constitute a waiver of any attorney-client or other privilege. The SOX § 307 Release states that the SEC finds that allowing issuers to produce internal reports to the SEC, including those prepared in response to reports as a result of the SOX § 307 Rules, without waiving an otherwise applicable attorney-client and other privilege, enhances the SEC's investigatory and enforcement capabilities and, thus, is in the public interest. The SOX § 307 Release further states that the SEC will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and will vigorously argue in defense of those confidentiality agreements where

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429 *Brown v. Cole*, 155 Tex. 624, 291 S.W.2d 704, 708 (Tex. 1956); *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 922 (Tex. Civ. App.-Houston [1st Dist.] 1976, writ ref'd n.r.e.); *Texas Capital Securities, Inc. v. Sandefer*, 58 S.W.3d 760, 775 (Tex. App. – Houston [1st Dist.] 2001).

litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.[430]

Differences From Proposed Rules. On November 21, 2002, the SEC issued proposed rules under SOX § 307.[431] After comment and significant revision, the final SOX § 307 Rules were issued on January 29, 2003 under the SOX § 307 Release.[432]

The final SOX § 307 Rules continue to emphasize, as did the proposed rules, that a lawyer for the corporation owes allegiance to the corporation and not to the individual who was responsible for retaining the lawyer or the lawyer's firm, but differ from the proposed rules in at least three important respects: First, in a reluctant retreat from the proposed "noisy withdrawal" rule, which many felt would have involved a breach of the attorney-client privilege, securities lawyers will **not** be required, if company executives and the board do not respond appropriately to a lawyer's warning or expressed concern that a material securities violation has occurred or will occur, to resign representation, report to the SEC that their resignation is for "professional reasons," and disaffirm any "tainted" documents filed with or submitted to the SEC.

Instead, the SEC extended for 60 days the comment period on the "noisy withdrawal" proposal, while proposing an alternative that still would require a lawyer to withdraw, but that would place instead upon the company the burden to report the lawyer's withdrawal.[433] Under the proposed alternative, the company would publicly disclose on a Form 8-K within two business days after the lawyer's withdrawal for professional considerations, or of having received a notice from its lawyer that the issuer did not appropriately respond to the lawyer's report of a material violation, either or both of such events. If the company does not make the required disclosure, the lawyer would then be permitted (but not required) to inform the SEC that he or she had withdrawn. Inside counsel would be required only to cease participating in the matter involving the violation and notify the company in writing that he or she believed the company had not appropriately responded to the lawyer's report of a material violation.

Second, the SEC changed the text of the rule specifying when lawyers must report "up the ladder." Under proposed rules, a lawyer had to report up the ladder if he had *"evidence of a material violation of securities law or breach of fiduciary duty or similar violation"* by a client. Under the final rules adopted, a lawyer must report *"credible evidence based upon which it*

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430 In *Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622 (Del. Ch. Nov. 13, 2002), the Delaware Chancery Court, while acknowledging inconsistent holdings from other jurisdictions, held that the attorney work product privilege had not been waived as to private litigants in respect of documents furnished to the SEC pursuant to a confidentiality agreement during an SEC investigation, but had been waived as to documents furnished to the SEC before a confidentiality agreement had been executed as there was no common interest with the SEC which was more foe than friend.

431 1933 Act Release No. 33-8150, which can be found at http://www.sec.gov/rules/proposed/33-8150.htm.

432 *See supra* note 407.

433 *See* 1933 Act Release No. 33-8186 (January 29, 2003), which can be found at http://www.sec.gov/rules/proposed/33-8186.htm.

would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." While this standard developed from the SEC's attempt to make objective rather than subjective the test of when a lawyer must report a violation, its tortured manner of expression, in terms of a double negative ("unreasonable … not to conclude that it is reasonably likely…"), may simply increase the SEC's burden of proving a lawyer has failed to comply. In response to questions at the open meeting, the SEC staff suggested that this standard has a lower threshold than a "more likely than not" standard.

Third, the final SOX § 307 Rules clarify that they cover lawyers providing legal services who have an attorney-client relationship, and then only if the lawyer has notice that documents they are preparing or assisting in preparing will be filed with or submitted to the SEC.

Other highlights of the final SOX § 307 Rules include (a) removal of the requirement that issuers and their lawyers document reports of violations and the related responses; (b) clarification of coordination with state-mandated reporting obligations: namely, that the final SOX § 307 Rules control if they conflict with less rigorous reporting requirements under state law, but that more rigorous state-imposed up-the-ladder reporting obligations will control, as long as they are not inconsistent with these rules; and (c) affirmation that the final SOX § 307 Rules are enforceable exclusively by the SEC and do not create any private right of action.

Finally, the proposed SOX § 307 rules provided that an issuer does not waive any applicable privileges by sharing confidential information regarding misconduct by the issuer's employees or officers with the SEC pursuant to a confidentiality agreement. This was replaced in the SOX § 307 Release with commentary that such is the SEC's view of good public policy.

VIII.
ATTORNEY LETTERS TO AUDITORS

SFAS 5. In March 1975 the Financial Accounting Standards Board (*"FASB"*) issued its Statement of Financial Accounting Standards No. 5 (*"SFAS 5"*)[434] entitled "Accounting for Contingencies" which sets forth the standards for issuers to accrue for or disclose loss contingencies. Under SFAS 5 if both a loss is "*probable*" and the amount can be reasonably estimated, the contingency has to be accrued in the financial statements of the company. On the other hand, if it is reasonably possible (but not probable) that a loss has occurred or will occur, then there has to be disclosure in the footnotes to the financial statements and an estimate of that loss or range of losses has to be provided, if one can be provided. Under SFAS 5 "*probable*" means "the future event or events are likely to occur," "*reasonably possible*" means that "the

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434 ACCOUNTING FOR CONTINGENCIES, Fin. Accounting Standards No. 5 (Fin. Accounting Standard Bd. 1975 [hereinafter "SFAS 5"], *available at* http://www.sec.gov/interps/account/sabcodet5.htm. As a result of the FASB Codification that became effective July 1, 2009 (the *"FASB Codification"*) for financial statements for periods ending after September 15, 2009 and replaced prior accounting pronouncements as generally accepted accounting standards, SFAS 5 is now Subtopic 450-20 of the FASB Codification. *See supra* note 78.

chance of the future event or events occurring is more than remote and less than likely," and "*remote*" means that "the chance of the future event or events occurring is slight."[435]

SAS 12. In January 1976, the American Institute of Certified Public Accountants (the *"AICPA"*) issued its Statement on Auditing Standards No. 12 (*"SAS 12"*), entitled Inquiry of a Client's Lawyer concerning Litigation, Claims, and Assessments,[436] which purports to provide "guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters when he is performing an examination in accordance with generally accepted auditing standards."[437] SAS 12 sets forth the auditing process to be followed by auditors in gathering information to confirm that the client has made the appropriate determinations required by SFAS 5, and remains operative today even after the enactment of SOX and the establishment of the PCAOB.[438] SAS 12 is really the auditing standard implementing the process under SFAS 5 and it provides guidelines for the types of inquiries that the client will make of the lawyer.

Pursuant to SAS 12, the auditor must obtain evidence regarding the following factors:

(1) The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments;

(2) The period in which the underlying cause for legal action occurred;

(3) The degree of probability of an unfavorable outcome; and

(4) The amount or range of potential loss.[439]

The auditor is instructed to seek such evidence from management.[440] However, because auditors are not equipped to make legal judgments regarding such matters, SAS 12 instructs the auditor to "request the client's management to send a letter of inquiry to those lawyers with whom they

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435 In the ABA Statement of Policy the respective definitions are slightly different.

436 *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, Statement on Auditing Standards No. 12 (American Inst. of Certified Pub. Accounts 1976), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00337.PDF, *reprinted in* ABA AUDITOR'S LETTER HANDBOOK (2003). SAS 12 has been adopted as an interim audit standard by the PCAOB.

437 SAS 12 ¶ 1 at 57.

438 The PCAOB has adopted the generally accepted auditing standards that existed on April 16, 2003 as the interim PCAOB standards. PCAOB Rulemaking: Public Company Accounting Oversight Board, 1934 Act Release No. 34-49707, 82 S.E.C. Docket 3079 (May 14, 2004), *available* at http://www.sec.gov/rules/pcaob/34-49707.htm.

439 SAS 12 ¶ 4 at 58.

440 SAS 12 ¶ 5 at 58-59.

consulted concerning litigation, claims, and assessments"[441] (an *"Inquiry Letter"*). The Inquiry Letter that lawyers receive is from the client, not from the auditors, although it probably was drafted by the auditors.[442] The Inquiry Letter might also cover the additional category of contractually assumed obligations, but such inquiries are rarely made.

The matters to be addressed in an Inquiry Letter to counsel include the following:

(a) Identification of the company, including subsidiaries, and the date of the examination;

(b) A list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation; and

(c) A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome, with respect to which the lawyer has been engaged and to which he has devoted substantive attention on behalf of the company in the form of legal consultation or representation.[443]

With respect to the information requested in paragraph (b) above, the lawyer is requested to furnish, among other things, a description of the matter, the action the company plans to take, "an evaluation of the likelihood of an unfavorable outcome, and an estimate, if one can be made, of the potential loss."[444] With respect to paragraph (c), the lawyer is requested to disclose if his views "differ from those stated by management."[445]

ABA Statement. Issued contemporaneously and in tandem with SAS 12, the ABA Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information (the *"ABA Statement"*),[446] attempts to balance the attorneys' need to avoid inadvertent waivers of the

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441 SAS 12 ¶ 6 at 59.

442 In some cases a foreign auditor may send the Inquiry Letter directly to the lawyer.

443 SAS 12 ¶ 9(a)-(c) at 60-61.

444 SAS 12 ¶ 9(d)(1), (2) at 61.

445 SAS 12 ¶ 9(e) at 61. With respect to unasserted claims, the client must arrive at a judgment that the claim is probable of assertion, that it would be material, and then identify it in the Inquiry Letter or the lawyer cannot respond because if the does respond, without it being identified in the letter, the lawyer is violating a confidence or secret of the client, which could be an ethical problem for the lawyer.

446 *Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities*

attorney-client privilege in responding to the auditors' letter with the auditors' need for complete and accurate information in audited financial statements, and addresses the privilege waiver concern as follows:

> To the extent that the lawyer's knowledge of unasserted possible claims is obtained by means of confidential communications from the client, any disclosure thereof might constitute a waiver as fully as if the communication related to pending claims.
>
> A further difficulty arises with respect to requests for evaluation of either pending or unasserted possible claims. It might be argued that any evaluation of a claim, to the extent based upon a confidential communication with the client, waives any privilege with respect to that claim.
>
> Another danger inherent in a lawyer's placing a value on a claim, or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.
>
> The Statement of Policy has been prepared in the expectation that judicial development of the law in the foregoing areas will be such that useful communication between the lawyers and the auditors in the manner envisaged in the Statement will not prove prejudicial to clients engaged in or threatened with adversary proceedings. If developments occur contrary to this expectation, appropriate review and revision of the Statement of Policy may be necessary.[447]

The ABA First Report of the Committee on Audit Inquiry Responses Regarding Initial Implementation of the Statement of Policy[448] sets forth an illustrative Inquiry Letter prepared in the name of the client pursuant to SAS 12.[449]

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and Exchange Commission, 31 BUS. LAW. 543 (Apr. 1976), *reprinted* in the ABA AUDITOR'S LETTER HANDBOOK (2003) at pp 5-32.

447 *Id.* at 12-13.

448 "*The ABA Statement of Policy Regarding Lawyers' Response to Auditor's Request for Information*," 31 BUS. LAW. 1709 (April 1976), *reprinted* in the ABA AUDITOR'S LETTER HANDBOOK (2003) at pp 33-44.

449 **Illustrative Form of Letter of Audit Inquiry:**

[Name and Address of Law Firm]

Dear Sirs:

In connection with an examination of the consolidated financial statements of [*insert name of client*] (the "Company") and its subsidiaries at [*insert balance sheet date*] and for the [*insert fiscal period under audit*] then ended, our auditors, [*insert name and address of accounting firm*], have asked that we request you to furnish them with information concerning certain contingencies involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company and/or any

of its subsidiaries. (For your convenience, a list of such subsidiaries is attached.) This request is limited to contingencies which [*insert standard of materiality to be used*] and they therefore should be considered in connection with our audit.

Pending or Threatened Litigation (excluding Unasserted Claims)

Please furnish to our auditors details relating to all matters of pending or threatened litigation your firm is handling on our behalf, which meet the standard of materiality stated above, including (1) a description of the nature of each matter, (2) the progress of each matter to date, (3) how the Company has responded or intends to respond (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss. Your response should include matters your firm was handling at [*insert balance sheet date*] as well as new engagements undertaken during the period from that date to the date of your response.

> [If one or more unasserted possible claims or assessments are to be listed in the inquiry letter, include the following paragraph. If not, the following paragraph (and caption heading) should be omitted for the reason that the lawyer should be apprised *only* that management has advised the auditor that management has disclosed to the auditor all unasserted possible claims that the lawyer has advised are probable of assertion and must be disclosed (as specified in FAS 5).]

Unasserted Claims or Assessments

We have informed our auditors that the following unasserted possible claims or assessments, for which you have been engaged and to which you have devoted substantive attention on our behalf in the form of legal consultation or representation, are considered by management to be probable of assertion and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome: [*insert information as appropriate; ordinarily, management's information would include: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss*]. Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, if you have formed a professional conclusion that we must disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional specific matters; for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the Company, such as guarantees of indebtedness of others, for which the addressee of the letter of audit inquiry has been engaged and to which such addressee has devoted substantive attention on the client's behalf in the form of legal consultation or representation.]

[The letter may also state: "We have represented to our auditors that there have been disclosed by management to them all unasserted possible claims that you have advised are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination." [or] "We have represented to our auditors that there are no unasserted possible claims that you have advised are probable of assertion and must be disclosed in

This Inquiry Letter is the client's authorization for the lawyer to prepare the lawyer's Response Letter, which is necessary for the attorney to reveal confidential client information to the auditors under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct and Rule 1.6 of the ABA Model Rules of Professional Conduct. If the Inquiry Letter is not in proper form, the attorney may discuss the situation with the client and request that the client submit another Inquiry Letter.

Attorney Response Letters under the ABA Statement may come from either an outside practitioner or law firm[450] or from inside counsel.[451] In each case, the Response letters

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accordance with Statement of Financial Accounting Standards No. 5 in the financial statements currently under examination."]

Very truly yours,

[450] Annex A to the ABA Statement sets forth the following illustrative form of letter to auditors for use by outside practitioner or law firm:

[Name and Address of Accounting Firm]

Re: [Name of Client] [and Subsidiaries]

Dear Sirs:

By letter dated [*insert date of request*] Mr. [*insert name and title of officer signing request*] of [*insert name of client*] [(the "Company") or (together with its subsidiaries, the "Company")] has requested us to furnish you with certain information in connection with your examination of the accounts of the Company as at [*insert fiscal year-end*].

[Insert description of the scope of the lawyer's engagement; the following are sample descriptions:]

While this firm represents the Company on a regular basis, our engagement has been limited to specific matters as to which we were consulted by the Company.

[or]

We call your attention to the fact that this firm has during the past year represented the Company only in connection with certain [Federal income tax matters] [litigation] [real estate transactions] [describe other specific matters, as appropriate] and has not been engaged for any other purpose.

Subject to the foregoing and to the last paragraph of this letter, we advise you that since [*insert date of beginning of fiscal period under audit*] we have not been engaged to give substantive attention to, or represent the Company in connection with, [*material*]* loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]†

[If the inquiry letter requests information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations:]

With respect to the matters specifically identified in the Company's letter and upon which comment has been specifically requested, as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, we advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and we disclaim any undertaking to advise you of changes which thereafter may be brought to our attention.

[Insert information with respect to outstanding bills for services and disbursements.]

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December l975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in its audit inquiry letter to us that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement.]

Very truly yours,

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* *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

In recognition of the FASB Codification, the reference to "Statement of Financial Accounting Standards No. 5" may be revised to read as follows: "FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies)". *See* note 434 and **Appendix C**.

[451] Annex A to the ABA Statement also sets forth the following illustrative form of letter for use by inside general counsel:

[Name and Address of Accounting Firm]

Re: [Name of Company] [and Subsidiaries]

Dear Sirs:

As General Counsel* of [*insert name of client*] [(the "Company"] [together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year end*].

I call your attention to the fact that as General Counsel* for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance upon be placed on other sources*.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.

Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:

[Describe litigation and claims which fit the foregoing criteria.]

[If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]

With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:

[Insert information as appropriate]

The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced our internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement].

Very truly yours,

differentiate between unasserted claims and pending litigation.[452] As to unasserted claims, the attorneys usually only confirm that they are aware of their professional responsibility not to knowingly participate in any violation by the client of the disclosure requirements of the securities laws and have consulted with the client regarding the client's disclosure obligations in language like the following:

> Consistent with the last sentence of the paragraph 6 of the ABA Statement of Policy, and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in the audit inquiry letter to us, that whenever in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for a financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we as a matter of professional responsibility to the Company will so advise the Company and will consult with the Company concerning questions of such disclosure and the applicable requirements of FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies).

The use of "whenever" in a Response Letter is very carefully worded and very carefully chosen by the ABA Committee that developed the Response Letter so that it is not saying we have done

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* It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

** *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

In recognition of the FASB Codification, the reference to "Statement of Financial Accounting Standards No. 5" may be revised to read as follows: "FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies)". *See* note 434 and **Appendix C**.

[452] The Preamble to the ABA Statement provides in part:

> Consistent with the foregoing public policy considerations, it is believed appropriate to distinguish between, on the one hand, litigation which is pending or which a third party has manifested to the client a present intention to commence and, on the other hand, other contingencies of a legal nature or having legal aspects. As regards the former category, unquestionably the lawyer representing the client in a litigation matter may be the best source for a description of the claim or claims asserted, the client's position (e.g. denial, contest, etc.), and the client's possible exposure in the litigation (to the extent the lawyer is in a position to do so). As to the latter category, it is submitted that, for the reasons set forth above, it is not in the public interest for the lawyer to be required to respond to general inquiries from auditors concerning possible claims.

this in the past, or that we did this during the last year – it only says whenever necessary will we do it.

If the client does not identify an unasserted claim that the attorney recognizes should be disclosed to the auditors, the attorney would under the preceding paragraph be expected to discuss the issue with the client. If the client declined to authorize the attorney to disclosure in the Response Letter, the attorney would have to consider his duties under Rule 12b2-2 and the SOX § 307 Rules and might have to decline to issue a Response Letter or resign. Ultimately the financial statements, and the information provided to the auditors in connection with the audit thereof, are the responsibility of the client and the attorney's duty is to advise the client, although the lawyer has a duty not to mislead the auditors.[453]

As to pending litigation, the attorneys typically include an identification of the case or other proceeding, a brief description of the nature of the litigation or matter, the position asserted or to be asserted by the client, and the current procedural status of the matter. In the evaluation of overtly threatened or pending litigation, paragraph 5 of the ABA Statement states that lawyers should provide an opinion predicting the outcome of overtly threatened or pending litigation only in those relatively few clear cases that the likelihood of an unfavorable outcome is either "*probable*" or "*remote*."[454] The definitions of those terms in paragraph 5 of the ABA statement

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453 Paragraph 6 of the ABA Statement provides:

> (6) *Lawyer's Professional Responsibility*. Independent of the scope of his response to the auditor's request for information, the lawyer, depending upon the nature of the matters as to which he is engaged, may have as part of his professional responsibility to his client an obligation to advise the client concerning the need for or advisability of public disclosure of a wide range of events and circumstances. The lawyer has an obligation not knowingly to participate in any violation by the client of the disclosure requirements of the securities laws. The lawyer also may be required under the Code of Professional Responsibility to resign his engagement if his advice concerning disclosures is disregarded by the client. The auditor may properly assume that whenever, in the course of performing legal services for the client with respect to a matter recognized to involve an unasserted possible claim or assessment which may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client must disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise the client and will consult with the client concerning the question of such disclosure and the applicable requirements of FAS 5.

Id. at 10 (internal citations omitted).

454 Paragraph 5 of the ABA Statement provides in part:

> In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote;" for purposes of any such judgment it is appropriate to use the following meanings:
>
> > (i) *probable* - an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

are narrow definitions, so that, unless the likelihood of an unfavorable outcome of the matters described is either probable or remote, the language that would typically be used in response would be to say with respect to each of the foregoing matters "because we have not concluded that the likelihood of an unfavorable outcome is either probable or remote, as those terms are defined in the ABA statement, we express no opinion as to the likely outcome of such matters." This is not casual language: "We express no opinion" is not the same as "we have not formed an opinion" or "we cannot form an opinion" or "we decline to express an opinion," each of which could later be viewed as having predicted that at some point in the future, an opinion would be forthcoming, or might indicate that an opinion has not been formed when in fact there may have been conversations between the lawyer and the client.

Discoverability of Audit Response Letters. The Response Letter approach in the ABA Statement is intended to reduce the likelihood of any waiver of privilege as to unasserted claims.[455] The ABA Statement is structured such that ordinarily a Response Letter states little

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> (ii) *remote* - an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

> If, in the opinion of the lawyer, considerations within the province of his professional judgment bear on a particular loss contingency to the degree necessary to make an informed judgment, he may in appropriate circumstances communicate to the auditor his view that an unfavorable outcome is "probable" or "remote," applying the above meanings. No inference should be drawn, from the absence of such a judgment, that the client will not prevail.

> The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount of range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

In the commentary on Paragraph 5, the ABA Statement on page 14 states:

> [S]tatements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense.

455 *See* Michael J. Sharp & Abraham M. Stanger, *Audit-Inquiry Responses in the Arena of Discovery: Protected by the Work-Product Doctrine*, 56 BUS. LAW. 183, 206 (Nov. 2000). This article notes:

> In December 1988, the Southern District of New York issued a sealed opinion ordering Drexel's lawyer to disclose audit-inquiry responses. Unfortunately, because the decision was unpublished there is no way of knowing the court's rationale.

> The ABA, however, reacted to the Drexel case. In December 1989, the Subcommittee on Audit Inquiry Responses issued a report on the matter. Writing the report "[b]ecause of a recent court case and other judicial decisions involving lawyer's responses to auditor's requests for information," the Subcommittee chose not to amend the *Statement of Policy*, but "[i]n order to preserve explicitly the evidentiary privileges" suggested that in the audit-inquiry letter clients state the following: "[W]e do not intend that either our request to you to provide information to our auditor or your response to our

more about loss contingencies than what is in the public record, which may explain a paucity of reported cases in which a Response Letter has been held to have resulted in a privilege waiver.[456] As to pending litigation, any waiver as to the letter itself would likely not be harmful because the lawyer ordinarily would not be making an assessment of the case which could be construed as an admission against interest. Since a letter regarding pending litigation would be at a time when the work product privilege would be applicable to the litigation work product and work product waiver ordinarily is limited to the specific documents disclosed,[457] a Response Letter to auditors describing the case should not result in the attorney having to turn over the firm's litigation file to the other side.

There is, however, no consensus among the courts that have addressed the discoverability of Response Letters. Litigants who have been confronted with a discovery request seeking a Response Letter, and who have resisted discovery, have argued attorney-client privilege, work product exclusion, or relevance as bases for refusing to produce the audit response letter.[458] A

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auditor should be construed in any way to constitute a waiver of the attorney-client privilege or the attorney work-product privilege."

To the extent that language is not in the audit-inquiry letter, the Subcommittee suggested insertion of similar language in the audit-inquiry response, "The Company … has advised us that … [it] does not intend to waive the attorney-client privilege [and] our response to you should not be construed in any way to constitute a waiver of the protection of the attorney work-product privilege. . . ." Two months later, the AICPA, working in conjunction with the ABA Subcommittee, issued its Auditing Interpretations of AU Section 337 (*Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*) to acknowledge such language would not result in a limitation on the scope of an audit.

456 *See* Douglas R. Richmond & William Freivogel, *The Attorney-Client Privilege and Work Product in the Post Enron Era*, 2004 ABA ANNUAL MEETING PROGRAM MATERIALS, at 11.

457 *But cf. U.S. v. Skeddle*, 989 F.Supp. 917, 921 (N.D. Ohio 1997).

458 In *Tronitech, Inc. v. NCR Corporation*, the Court held (i) the audit response letter was not relevant because it was clearly inadmissible at trial and contained only opinions which could not conceivably lead to admissible evidence, and (ii) while acknowledging that work product protection applies only to materials prepared in anticipation of litigation or for trial, held that an audit letter "is not prepared in the ordinary course of business but rather arises only in the event of litigation," and therefore constituted work product that was not discoverable. 108 F.R.D. 655 (S.D. Ind. 1985). *See also United States v. Arthur Young & Co.*, No. 84-C-606-B, 1984 U.S. Dist. LEXIS 22991, at *11 (N.D. Okla. Oct. 5, 1984) (noting that "[i]f some theory of relevance can be advanced concerning the documents under review, the Court would conclude its probative value is substantially outweighed by the danger of unfair prejudice and public interest concerns."); *In re Genentech, Inc. v. Securities Litig.*, No. C-99-4038 (N.D. Cal. 1999) (unpublished) (noting that attorney's opinions are not relevant or at issue in the lawsuit); *Comerica Bank of Calif. v. Lloyd Raymond Free*, Case No. 88-20880 (N.D. Cal. 1999) (unpublished) (noting "tangential relevance" of information and finding public policy in favor of protecting attorney's work-product to be more important); *Teberg v. Am. Pacific Int'l, Inc.*, No. C 196448 (L.A. Sup. Ct., Apr. 29, 1982) (unpublished) (noting that relevance of documents was outweighed by the public policy of promoting candid and full disclosure by counsel to auditor and by the right of privacy).

Other courts, when confronted with disputes regarding discovery of lawyer's responses to auditor's requests, found the letters to be discoverable. *See United States v. Gulf Oil Corp*, 760 F.2d 292 (Temp. Emer. Ct. App. 1985) (dismissing a claim that the audit letters constituted work product by holding "that these documents do not constitute attorney work product because they were created primarily for the business purpose of

recent California opinion reviewed the conflicting decisions from other jurisdictions and held that a Response Letter was protected by the work product doctrine,[459] reasoning as follows:

> Neither party cited nor did we find any California law dealing with the specific question of whether work product loses its protection if it is disclosed to an auditor in an audit response letter. The few cases from federal courts have come down on both sides of this issue. For example, in *Tronitech, Inc. v. NCR Corp.* (S.D.Ind. 1985) 108 F.R.D. 655, the court held an audit response letter was protected by the work product rule (Fed. Rules Civ.Proc., rule 26(b)(3)) because it was "comprised solely of an attorney's opinion." (*Id.* at p. 656.) Further, "[a]n audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation, and it is comprised of the sum total of the attorney's conclusions and legal theories concerning that litigation." (*Ibid.*)
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> The cases finding against the protection are distinguishable. First, as interpreted in some circuits, the federal work product doctrine is more limited than California's, with its protection extending only to documents "prepared in anticipation of litigation or for trial ...." (Fed. Rules Civ.Proc., rule 26(b)(3); see, e.g., *JumpSport, Inc. v. Jumpking, Inc.* (N.D.Cal. 2003) 213 F.R.D. 329, 330-331; *Dawson v. New York Life Ins. Co.* (N.D.Ill. 1995) 901 F.Supp. 1362, 1368.) In California, however, "[t]he protection afforded by the [attorney work product doctrine] is not limited to writings created by a lawyer in anticipation of a lawsuit. It applies as well to writings prepared by an attorney while acting in a nonlitigation capacity. [Citation.]" (*County of Los Angeles v. Superior Court* (2000) 82 Cal.App.4th 819, 833.) Thus, *United States v. Gulf Oil Corp.* (Temp. Emer. Ct.App. 1985) 760 F.2d 292 is inapt because the decision not to afford work product protection to audit inquiry responses was based on the finding that the "documents were not created to assist ... in the litigation ...." (*Id.* at pp. 296-297.)
>
> Moreover, in *In re Hillsborough Holdings Corp.* (Banks. M.D.Fla. 1991) 132 B.R. 478, the court did not rely on the work product doctrine. The decision to require production of audit inquiry responses was based on the finding that the documents were not protected by the accountant-client privilege. (*Id.* at pp. 480-481.)
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> Thus, based on the contents of the letters, which contain the attorney's thoughts, impressions, and opinions, plus the purpose of the work product doctrine, and the rule

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compiling financial statements which would satisfy the requirements of the federal securities laws"). *See also Indep. PetroChemical Corp. v. Aetna Cas. & Sur. Co.*, 117 F.R.D. 292 (D. D.C. 1987) (holding that any attorney-client privilege associated with the audit response letter was waived when the letter was furnished to the auditor and that the work product exclusion was not applicable); *United States v. El Paso Corp.*, 682 F.2d 530, 543-44 (5th Cir. 1982) (noting that lawyer's analysis and memoranda "written ultimately to comply with SEC regulations" were prepared "with an eye on [the company's] business needs, not on its legal ones" and did not "contemplate litigation in the sense required to bring it within the work product doctrine").

[459] *Laguna Beach County Water Dist. v. Superior Court of Orange County*, 22 Cal. Rptr. 3d 387 (Cal. App. 4th Dist. 2004).

that waiver occurs only when work product is disclosed to a third party "'who has no interest in maintaining the confidentiality ... of a significant part of the work product'" (*OXY Resources California v. Superior Court*, *supra*, 115 Cal.App.4th at p. 891), we conclude Gokoo's audit response letters to Diehl remained protected work product. Based on our determination on this ground, we have no need to and do not decide the effect of the attorney-client privilege on these two documents.[460]

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[460] Similar reasoning was followed in *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004), in which internal investigation reports did not result in a loss of work product protection because they were turned over to independent auditors:

> Generally speaking, "the work product privilege should not be deemed waived unless disclosure is inconsistent with maintaining secrecy from possible adversaries." *Stix Prods. v. United Merchants & Mfrs.*, 47 F.R.D. 334, 338 (S.D.N.Y. 1969). "The work product privilege is not automatically waived by any disclosure to third persons. Rather, the courts generally find a waiver of the work product privilege only if the disclosure 'substantially increases the opportunity for potential adversaries to obtain the information.'" *In re Pfizer Inc. Sec. Litig.*, 1993 U.S. Dist. LEXIS 18215, No. 90 Civ. 1260, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) (quoting *In re Grand Jury*, 561 F. Supp. 1247, 1257 (E.D.N.Y. 1982)) (internal citation omitted). Implicit in this analysis is the question of whether the third party itself can or should be considered an adversary. Accordingly, courts have generally held that where the disclosing party and the third party share a common interest, there is no waiver of the work product privilege. E.g., id. ("Disclosure of work product to a party sharing common interests is not inconsistent with the policy of privacy protection underlying the doctrine."); *see also In re Copper Mkt. Antitrust Litig.*, 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001) (same).
>
> This much is settled. However, courts are split in their treatment of disclosures to a corporation's accountants or auditors. More precisely, courts differ in their conceptualization of two critical points that are often implicitly intertwined in their analysis: whether the "adversary" contemplated by the work product privilege is necessarily a litigation adversary and whether a corporation's auditor is such an adversary, to whom disclosure will waive the privilege. While admittedly there are good arguments on both sides, in this case, I answer both questions in the negative and conclude that Merrill Lynch's disclosure of the reports to Deloitte & Touche did not constitute a waiver of the applicable work product protection.
>
> In a frequently cited case, *In re Pfizer, Inc. Sec. Litig.*, Judge Buchwald held that Pfizer's disclosure of documents to its independent auditor, KPMG Peat Marwick ("Peat Marwick"), did not waive its work product privilege. 1993 U.S. Dist. LEXIS 18215, 1993 WL 561125, at *6. Judge Buchwald's decision was based on her observation that "Pfizer and Peat Marwick obviously shared common interests in the information, and Peat Marwick is not reasonably viewed as a conduit to a potential adversary." Id. Other courts have adopted precisely this analysis. E.g., *Gutter v. E.I. Dupont de Nemours & Co.*, 1998 U.S. Dist. LEXIS 23207, No. 95 Civ. 2152, 1998 WL 2017926,at *5 (S.D. Fla. May 18, 1998) (holding that disclosure to outside accountants did not waive the work product privilege "since the accountants are not considered a conduit to a potential adversary"); *Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, No. 87 Civ. 5122, 1990 WL 142404, at *5 (S.D.N.Y. Jan. 25, 1990) (same). Still others have applied this approach, but scrutinized the precise role of the accountants. E.g., *Samuels v. Mitchell*, 155 F.R.D. 195, 201 (N.D. Cal. 1994) (deciding that disclosure did not

constitute a waiver of the work product privilege because the accounting firm was acting as a consultant, not a "public accountant," at the relevant time).

Judge Hellerstein articulated another view in *Medinol, Ltd. v. Boston Scientific Corp.*, where, in finding a waiver of the work product privilege, he emphasized the "public watchdog" role of independent auditors. 214 F.R.D. 113, 116 (S.D.N.Y. 2002) (quoting *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18, 79 L. Ed. 2d 826, 104 S. Ct. 1495 (1984)). Judge Hellerstein observed that it "has become crystal clear in the face of the many accounting scandals that have arisen as of late, in order for auditors to properly do their job, they *must* not share common interests with the company they audit." *Id.* 214 F.R.D. at 116 (emphasis in original). While this is a valid policy consideration, the fact is that the determination in Medinol was based on a finding that the auditor's interests were not aligned with that of the corporation and that the disclosure of the documents at issue -- the Special Litigation Committee's minutes -- did not serve a pertinent litigation interest.

* * *

As these cases make clear, the Court's inquiry must not end with the mere fact of a disclosure to the independent auditors. * * *

Instead, the critical inquiry -- to me -- must be whether Deloitte & Touche should be conceived of as an adversary or a conduit to a potential adversary. As Judge Hellerstein and other courts have observed, an independent auditor could be conceived of as an adversary because of its important public function to independently ensure the accuracy of a company's financial reports. Clearly, outside auditors must maintain an independent role in this regard. Indeed, a good portion of the reforms embodied in the *Sarbanes-Oxley Act of 2002* ("Sarbanes Oxley"), 15 U.S.C. § 7201 *et seq.*, are aimed at strengthening the independence of auditors and eliminating conflicts of interest (S.E.C. Release No. Jan 28, 2003). * * *

Thus, any tension between an auditor and a corporation that arises from an auditor's need to scrutinize and investigate a corporation's records and book-keeping practices simply is not the equivalent of an adversarial relationship contemplated by the work product doctrine. Nor should it be. A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage. * * *

There was no further disclosure of the protected material in this case, nor could there have been, as Deloitte & Touche was under an ethical and professional obligation to maintain materials received from its client confidential, unless disclosure was required by law or accounting standards. Gueli Letter, Ex. B P7. The relevant standards at the time in question did not contemplate disclosure of documents or their specific contents to a third party. Instead, if an auditor learned of a "reportable condition," i.e., an internal control deficiency that "could adversely affect the organization's ability to record, process, summarize, and report financial data," AICPA SAS 60.02, the auditor was obligated to report this information to corporate management, the audit committee, and/or the board of directors, AICPA SAS 60.02, .09, .10, AICPA SAS 61. The applicable standard specifically provides that an auditor's report on a reportable condition should state that it is to be used only by personnel within the corporation, unless the auditor is required to furnish the report to government authorities. AICPA SAS 60.10. The only public revelation could have been, in the worst case scenario, a general statement by Deloitte & Touche regarding its inability to accurately evaluate Merrill Lynch's financial

Even though the lawyer's letter to the auditor may not be protected by the attorney-client privilege, any waiver should be limited to the contents of the letter and should not require the contents of the attorney's entire file on the matter covered by the letter.[461]

Auditors often ask for information about loss contingencies beyond Response Letters, and courts often hold that disclosure of attorney-client communications to auditors waives the attorney-client privilege, just as almost any disclosure to an outsider breaches the confidence and waives the attorney-client privilege.[462] Thus, unless the controversy arises in one of the fifteen states that, by statute, recognize an accountant-client privilege[463] or the accountant is helping the attorney to advise the client (a role that an auditor typically does not undertake given independence constraints), disclosure to the outside accountant likely waives the attorney-client privilege.[464] With respect to whether work product protection survives disclosure to auditors, the opinions are divided, but the majority view seems to be that work product includes any material prepared "because of" actual or potential litigation (thus encompassing analysis of litigation

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> statements due to internal control deficiencies. In sum, the nature of the disclosure in this case and the obligations of Deloitte & Touche under the applicable accounting standards simply do not make out a waiver.

461 *See United States v. Upjohn Company*, 600 F.2d 1223, 1227 n.12 (6th Cir. 1979), *rev'd on other grounds*, 449 U.S. 383 (1981) ("The corporation's voluntary disclosure to the SEC amounts to a waiver of the privilege only with respect to the facts actually disclosed.").

462 *See, e.g., Gutter v. E.I. Dupont De Nemours and Co.*, 1998 WL 2017926, at *3 (S.D. Fla. May 18, 1998) ("[d]isclosure to outside accountants waives the attorney-client privilege"); *In re Pfizer Inc. Securities Litig.*, 1993 WL 561125, at *6 (S.D.N.Y. Dec. 23, 1993) ("Disclosure of documents to an outside accountant destroys the confidentiality seal required of communications protected by the attorney-client privilege, notwithstanding that the federal securities laws require an independent audit").

463 The fifteen states that recognize the accountant-client privilege are listed below:

> Arizona, ARIZ. REV. STAT. § 32-749; Colorado, COLO. REV. STAT. § 13-90-107; Florida, FLA. STAT. ANN. § 90.5055; Georgia, GA. CODE ANN. § 43-3-32; Idaho, IDAHO CODE § 9-203A AND IDAHO ST. REV., Rule 515; Illinois, 225 ILL. COMP. Stat. 450/27; Indiana, IND. CODE. § 34-46-2-18; Kansas, KS. STAT. ANN. § 1-401; Louisiana, LA. CODE EVID. ANN. art. 515; Maryland, MD. CODE ANN., CTS. & JUD. PROC. § 9-110; Michigan, MICH. COMP. LAWS § 339.732; Missouri, MO. REV. STAT. § 326.322; New Mexico, N.M. STAT. ANN. § 38-6-6; Pennsylvania, PA. STAT. ANN. tit. 63 § 9.11; and Tennessee, TENN. CODE ANN. § 62-1-116.

Other states have statutes requiring accountants and auditors to maintain the confidentiality of client materials, but not purporting to establish any evidentiary privilege from discovery. *See* Alabama, ALA. CODE § 34-1-21; California, 16 CAL. CODE REGS. tit. 16, § 54 ; Connecticut, CONN. GEN. STAT. ANN. § 20-281j; Iowa, IOWA CODE ANN. § 542.17; Kentucky, KY. REV. STAT. ANN. § 325.440; Massachusetts, MASS. GEN. LAWS ANN. ch. 112 § 87E; Minnesota, MINN. STAT. ANN. § 326A.12; Mississippi, MISS. CODE. ANN. § 73-33-16; Montana, MONT. CODE. ANN. § 37-50-402; New Jersey, N.J. STAT. ANN. § 45:2B-65; North Dakota, N.D. CENT. CODE § 43-02.2-16; Oregon, OR. REV. STAT. § 673.385; Rhode Island, R.I. GEN. LAWS § 5-3.1-23; Vermont, VT. CODE R. § 81; Washington, WASH. REV. CODE ANN. § 18.04.405.

464 *See Ferko Nat'l Assoc. for Stock Car Auto Racing*, 218 F.R.D. 125, 135 (E.D. Tex. 2003), citing *United States v. Kovel*, 296 F.2d 918, 921-22 (2d Cir. 1961), which extended the attorney client privilege to attorney-accountant communications for the purpose of assisting the lawyer to advise the client.

exposure prepared in response to an Inquiry Letter) and survives disclosure to the auditors.[465] The forum in which the discoverability issues are litigated, as well as particular circumstances of the case, will determine whether the protection otherwise applicable will survive disclosure to auditors.[466] Companies, therefore, have no guarantee that courts will protect the work product generated from internal investigations from waiver as to adversaries if these materials are disclosed to auditors, and could complain: "[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[467]

IX.
SELECTED RESPONSE LETTER ISSUES

Is the ABA Statement Superseded by SOX § 303? Concern has been expressed as to whether compliance with the ABA Statement will protect the lawyer in view of the SOX § 303 Requirements. The ABA Statement has not been superseded by the SOX § 303 Requirements.

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465 *See United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998) (observing, in *dicta*, that the work-product doctrine would protect an audit-inquiry response and approving the rule adopted by the Third, Fourth, Seventh, Eighth, and D.C. Circuits that a document is work product if "in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation") (emphasis in original); *In re Honeywell Int'l, Inc. Securities Litig.*, 2003 WL 22722961, at *6 (S.D.N.Y. Nov. 18, 2003) (rejecting plaintiff's argument that the "preeminent business purpose" of an audit rendered the work product doctrine inapplicable and finding that defendant's "assertion of work product protection for …audit letters and litigation reports prepared by its internal and external counsel, as well as PWC documents memorializing … opinion work product, is proper."); *Southern Scrap Material Co. v. Fleming*, 2003 WL 21474516, at *9 (E.D. La. June 18, 2003) ("The audit letters … were prepared by outside counsel at the request of [party's] general counsel with an eye toward litigation then ongoing. [Thus] … they are attorney work product of the opinion/mental impression/litigation strategy genre."); *In re Raytheon Securities Litig.*, 218 F.R.D. at 358 (citing cases in the Third, Fourth, Seventh, Eighth and D.C. Circuits that have adopted the "because of" definition of work product); *Vanguard Sav. and Loan Assoc. v. Barton Banks*, 1995 U.S. Dist. LEXIS 13712, at *11-12 (E.D. Pa. 1995) (holding that lawyer letters regarding litigation, prepared to assist client in reporting loss contingencies for a regulatory examination, were work product and protected even though created "primarily" for a business purpose); *Tronitech, Inc. v. NCR Corp.*, 108 F.R.D. 655, 657 (S.D. Ind. 1985) ("an audit letter is not prepared in the ordinary course of business but rather arises only in the event of litigation. It is prepared because of the litigation … [and] should be protected by the work product privilege").

466 Compare *Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) (minutes of the Special Litigation Committee meeting reflecting counsel's investigation were provided to the auditors in connection with their audit of loss contingency reserves and the court held that the disclosure waived the work product protection), *with Gramm v. Horsehead Indus., Inc.*, 1990 U.S. Dist. LEXIS 773, at *19 (S.D.N.Y. Jan. 25, 1990) (finding no waiver upon disclosure to auditors because "disclosure to another person who has an interest in the information but who is not reasonably viewed as a conduit to a potential adversary will not be deemed a waiver of protection of the rule"); *Tronitech*, 108 F.R.D. at 657 (no waiver upon disclosure of work product to auditors since "audit letters are produced under assurances of strictest confidentiality"). *See Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 441 (S.D.N.Y. 2004) and cases discussed therein.

467 *Upjohn Co. v. U.S.*, 449 U.S. 383, 391 (1981).

In a situation where no estimate of outcome is given in the audit response because the likelihood of a unfavorable outcome is considered neither "remote" or "probable," but the lawyer has in fact developed the view that the likelihood of an unfavorable outcome is significant (but short of "probable"), could the response be said to be misleading on the basis that it fails to state a material fact? The lawyer's communication would be within the framework of the ABA Statement that established clear standards for what will and will not be included in the Response Letters.

A Response Letter conforming to the ABA Statement delivered to accountants who were parties to the professional treaty memorialized in the ABA Statement should not be misleading to the accountants to whom it is addressed since (i) they know the basis on which it was prepared and (ii) the Response Letter states the framework under which it was prepared. If, however, the Response Letter does not conform to the ABA Statement or the attorney has oral communication with the auditors, the attorney would not be responding within the framework of the ABA Statement and would have the risk of negligent advice which would be sanctionable under Rule 13b2-2 under the 1934 Act.

Further, the attorney has a duty to consult with the client regarding unasserted material loss contingencies not disclosed in the Response Letter which the attorney believes the client should disclose or consider disclosing. If the client does not respond appropriately, the lawyer would have to comply with the lawyer's reporting up the ladder obligation under the rules under SOX § 307 described below or consider whether to resign or decline to deliver a Response Letter. An attorney could also have exposure under common law or applicable securities laws for an improper Response Letter.[468]

The Company Dilemma. The ABA Statement cautions that the lawyer "should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'." However, what if the auditor asserts that the attorney must provide an evaluation by reason of SOX § 303? The attorney representing the company faces the following unattractive choices. If the attorney provides an evaluation, it may be asserted that it is a waiver of the attorney-client privilege or work product protection that might under normal circumstances insulate the information from third party discovery.[469] Moreover, if the privilege or protection is waived, it is potentially waived for all purposes and as to all third parties.[470] Although it is far from clear that a waiver would be found, this potential could be a very high price to pay with respect to the pending case or claim.

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468 *Cf. In re Enron Corp. Sec., Derivative and ERISA Litig.*, 235 F. Supp. 2d 549, 563 (S.D. Tex. 2002) (containing Memorandum and Order Re Secondary Actors' Motion to Dismiss filed December 20, 2002). The opinion (also known as *Newby v. Enron* or the *Newby* case) is 159 pages long in F. Supp. 2d. *Cf. Dean Foods Co. v. Pappathanasi*, 18 Mass. L. Rep. 598, 2004 WL 3019442 (Mass. Super. Dec. 3, 2004); Donald W. Glazer and Arthur Norman Field, *No-litigation Opinions Can Be Risky Business: Looking at the Facts – and Beyond*, 14 BUS. L. TODAY No. 6, July/August 2005, at 37.

469 *See* **Appendix B** Attorney-Client Privilege and the Work Product Doctrine in the Corporate Context.

470 *Id.*

Further, if the attorney decides or is instructed by the company to provide information beyond that specified in the ABA Statement, the nonconforming communication could expose the attorney to enforcement action under the SOX § 303 Requirements if the case or claim ultimately results in a material exposure relative to the assets of the company which was not foreseen at the time of the attorney communication. In this regard, the SEC has already indicated that one type of conduct that could result in rendering an issuer's financial statements materially misleading would be providing an auditor with an inaccurate or misleading response or legal analysis, and the SEC has also indicated that responsibility for a misleading response or analysis falls on the attorney providing information to the auditor.[471] Thus, if the case or claim results in a material adverse judgment or settlement, the attorney (particularly in the case of an inside attorney acting under the direction of, or based on information supplied by, the company general counsel or its chief financial officer or their designee(s)) could be asserted to have been responsible, as may be those supplying the information or direction, for "misleading" the auditor. This is not a very attractive situation and one which could also result in significant personal exposure to the responsible parties.

As a practical matter the dilemma described above is most likely to arise relative to large, complex cases or claims of potential material significance, particularly in circumstances in which it may be too early in the proceedings to form a solid conclusion as to whether the matter is in the "probable" or "remote" category for purposes of the ABA Statement. What is clear in such situations is the need for close and continuous consultation between outside lawyers representing the company and the general counsel, chief financial officer or their designee(s). There is unquestionably a need to develop a "good faith" consensus among the issuer and its attorneys on responses to any auditor request for information and to maintain consistency throughout the process of interaction with the auditor, while not undermining the independence of the attorney's professional judgment. This process may also include requests for estimates of loss, requests beyond the ABA Statement, updates, informal discussions and information as to specific cases. These issues are discussed in greater detail in the material which follows.

Thus, while the ABA Statement remains in full force and effect, the risks associated with responses in connection with potentially material cases or claims which have not matured to the point of being able to be categorized as either "probable" or "remote" must be considered in view of SOX § 303 Requirements. It may be hoped that the policy importance of protecting the attorney-client and work product privileges will be recognized in appropriate situations, but the likelihood is that barring further legislative or regulatory clarification, the contours of such risks of waiver as well as of enforcement attitudes will be defined over some time and on a case-by-case basis.

Law Firm Policies. Many law firms have adopted policies and procedures for processing Inquiry Letters and issuing Response Letters which typically are based on the ABA Statement.[472] Law firms typically have adopted policies for circulating information to its

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[471] *See supra* notes 374-378 and related text.

[472] Attached as **Appendix C** is a common form of law firm Response Letter.

attorneys that the client's Inquiry Letter has been received and soliciting information needed to complete the Response Letter. Some firms designate a particular individual or committee to respond to questions or to review all or particular kinds of Response Letters. Before undertaking to respond to an Inquiry Letter or work on a Response Letter, attorneys should become familiar with the ABA Statement and the firm's policies and procedures.

Estimates of Loss. With respect to opinions as to outcome and estimates of potential loss, each lawyer should carefully read and consider Paragraph 5 of the ABA Statement. There the lawyer is cautioned that the lawyer "should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'," using such terms in accordance with their meanings set forth in Paragraph 5 and the related Commentary. It should be noted that a lawyer is not in a position to express an opinion that the likelihood of an unfavorable outcome is "remote" unless in the lawyer's "unqualified judgment, taking into account all relevant facts which may affect the outcome,...the client may confidently expect to prevail on a motion for summary judgment on all issues due to the clarity of the facts and the law." Likewise, the lawyer should not attempt to estimate, in dollar terms, the potential amount of loss or range of loss in the event of an unfavorable outcome unless the lawyer believes that the probability of inaccuracy of the estimate is slight. In practical terms, in a situation involving an unliquidated claim or demand, attorneys should rarely if ever make a loss estimate. Unless the likelihood of an unfavorable outcome is probable or remote, within the meaning of the ABA Statement, a typical response to an inquiry concerning outcome and the amount or range of potential loss is the following:

> Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as those terms are defined in the ABA Statement), we express no opinion with respect to the likelihood of an unfavorable outcome or the amount or range of potential loss if the outcome should be unfavorable.

The language used when declining to state an opinion as to outcome can be important and should track the wording and structure of the ABA Statement. To state "we are unable to express an opinion" may be inadvisable because it does not track the structure of the ABA Statement, and could be misleading if the attorney in fact has formed an opinion. Similarly, keying the non-expressing of an opinion as to outcome to the case being in the early stages of litigation should be avoided, as arguably it could be construed to create a duty to update which is contrary to other wording in the Response Letter. Language that is keyed to the language of the ABA Statement, such as "because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as those terms are defined in the ABA Statement), we express no opinion as to the likelihood of an unfavorable outcome" should be good practice.

Requests Beyond Scope of ABA Statement. Ordinarily, the Response Letter should include only information as to loss contingencies as permitted by the ABA Statement and, if requested, information as to fees and disbursements owed by the client. As a result of the

pressures on auditors to be more thorough in their audit procedures and documentation,[473] some Request Letters ask for information about other matters, such as security agreements, the filing of financing statements, outstanding stock, legislative developments, compliance with environmental laws, securities laws or ERISA, violations of laws or codes of conduct, or fiduciary duties or changes in business practices. One form of non-standard Inquiry Letter asks the law firm to confirm in the Response Letter that any possible illegal acts of the company that the law firm knows of have been reported to the company's audit committee and auditors. Since attorneys cannot be assured that auditors will conform to the Inquiry Letter format contemplated by the ABA Statement or to the form of Inquiry Letter issued for the same client in prior years,

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[473] SEC Deputy Chief Accountant Scott A. Taub summarized the SEC's concerns that the audit process adequately address accruals for and disclosures of loss contingencies, including obtaining appropriate information from counsel, in the following remarks delivered at the University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference (May 27, 2004), which can be found at http://www.sec.gov/news/speech/spch052704sat.htm.

> … I am well aware that loss contingencies are one of the most difficult areas there is to audit. Representations from management and from attorneys sometimes seem to be all that there is to support an accrual or the lack of one. The difficulty in auditing these types of accruals, however, should cause the auditor to spend more time on them, not less. Auditors should seek to review the company's own analyses of the issues, including the support for the conclusions as to whether an accrual is necessary, and what the possible range of loss is. If the only procedures that can be performed are face-to-face discussions with company personnel and with outside counsel, those discussions should be held, and experienced auditors should be part of them. If a company's outside counsel is unwilling or unable to provide its expert views, the auditor should consider whether sufficient alternate procedures can actually be performed to allow the audit to be completed. Audit documentation should follow the same high standards that apply to other areas of the audit, as well. This, of course, includes the documentation of the audit of the tax contingency accounts. A note or short memo that indicates that qualified personnel from the audit firm held discussion of all relevant risks with company personnel is not sufficient. I would expect that the PCAOB inspection teams will be looking at the audit work done in these sensitive areas as they begin their first year of a full inspection schedule.

On August 26, 2004 in a limited inspection report on one of the largest accounting firms (which can be found at http://www.pcaobus.org/Inspections/Public_Reports/2003/Deloitte_and_Touche.pdf) the PCAOB criticized the firm for instances of inadequate support regarding the treatment of contingent liabilities under FAS 5, including:

> … With respect to a potential contingent liability, the engagement team obtained a memo from the issuer that documented the company's conclusions regarding the loss contingency, and the engagement team documented in a memo to the work papers its conclusion that no accrual for this liability was required as of a particular date. The memo documented that the contingent liability could arise from two default provisions in an existing agreement – currently known defaults by the company or future potential defaults based on operating decisions the company was contemplating. The memo and the disclosures in the financial statements indicated that management's conclusion that an accrual was not required was based on the advice of legal counsel. The work papers maintained by the U.S. engagement team, however, did not include a copy of a letter to the issuer from its counsel containing legal advice on which the issuer had based its conclusions. Nor did the work papers make any specific reference to such a letter being maintained elsewhere. The work papers also did not provide a clear assessment as to the basis, as between the competing alternative bases, for the conclusion that accrual of the potential contingent liability was not required.

attorneys will need to consider each Inquiry Letter individually for particular issues of non-conformity with the ABA Statement. These non-standard Inquiry Letters typically do not reflect sensitivity to the importance of avoiding waiver of the attorney-client privilege.[474]

Attorneys often decline to supply information in a Response Letter beyond what is contemplated by the ABA Statement, and generically comment that such other information is not being provided.[475] Some commentators suggest that, in addition, it is appropriate to specifically reference the requested information not being furnished and state that it is not being provided because the request is beyond the scope of the ABA Statement in order that there be no ambiguity that the non-conforming request is being denied.[476] Attorneys should understand, however, that the auditors' requests for the additional information may be based upon a real need for corroborative information to complete their audit procedures and that there are circumstances in which the auditors' inability to obtain the requested additional information could lead the auditors to qualify opinions on clients' financial statements, which could be worse for the clients than the consequences of giving the auditors the information they require. For example, in circumstances in which the auditor believes that it needs the attorney's response about illegal acts in order to satisfy the auditor's Section 10A obligations, there may need to be communications from a reliable source sufficient to satisfy the auditor's requirements.

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474 In a Report to the ABA House of Delegates by an ABA Task Force on Attorney-Client Privilege, it was noted:

> The AICPA interpretations of SAS No. 12 (AU Section 337.09) also recognize the importance of the attorney-client privilege by limiting the need to examine documents in the company's possession that are subject to the privilege. Recently, however, with increasing frequency, auditors have requested from companies privileged communications or attorneys' litigation work product. The Task Force has been made aware of several types of material that auditors are requesting that companies provide for audits. Examples of the requested material include (1) tax opinions prepared for companies by outside counsel that underlie tax positions and tax accruals; (2) assessments prepared by both in-house and outside counsel that relate to litigation accruals and set forth counsel's reasoning underlying such accruals; (3) reports and papers produced as a result of internal investigations regardless of whether such investigations are ongoing or are likely to have an impact upon an audit; and (4) materials related to compliance with legal and regulatory requirements, e.g., requests to see board and committee members' annual self-assessments.

Report of the American Bar Association's Task Force on the Attorney-Client Privilege, 60 BUS. LAW. 1029, 1053 (May 2005), *available at* http://www.abanet.org/buslaw/attorneyclient/. *See supra* notes 455-467 and related text.

475 The second paragraph of a typical Response Letter provides:

> This response is limited by, and is in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December, 1975) and the accompanying Commentary (collectively, the *"ABA Statement of Policy"*). We are not responding to any request, nor are we commenting on any statement, contained in the Request Letter which we believe to be inconsistent with the intent of the ABA Statement of Policy. No inference should be drawn from our failure to respond to or comment on any such request or statement.

476 *See* Ad Hoc Committee on Audit Responses: Report on Listserv Activity (Inception to August 3, 2004), ABA Section of Business Law Ad Hoc Committee on Audit Responses.

Some Inquiry Letters include a request beyond the scope of the ABA Statement in the form of a general inquiry regarding unasserted claims. Since under the ABA Statement a request for comment about unasserted claims is appropriate only if the client has determined that it is probable that a claim will be asserted, that there is a reasonable possibility that the outcome (assuming the claim is asserted) will be unfavorable, and that the resulting liability would be material, some lawyers specifically note in their Response Letter the general inquiry and the inappropriateness under the ABA Statement of responding to it. Others rely on the general incorporation by reference of the ABA Statement into the Response Letter as sufficient explanation as to why there is no response to a non-standard general inquiry regarding unasserted claims.

Requests for Updates or Informal Discussions. The constraints on what may be said in Response Letters under the ABA Statement sometimes lead to requests for informal discussions in which supplemental information is elicited from the lawyer. The ABA Statement does not envision informal sessions with auditors or otherwise provide any parameters for what may be communicated to auditors in such a context different from those applicable to a formal response. While many law firms discourage or even forbid such discussions because of the risks of miscommunication or misunderstanding[477] or inadvertent waiver of privilege, auditors may insist that they require such discussions or written representations as a prerequisite to expressing an unqualified opinion on the client's financial statements. When and if an attorney enters into such a discussion, he can expect that his oral statements will be summarized in auditors' notes and workpapers, which the attorney will not have an opportunity to review or correct.

Auditors often ask for updated Response Letters. Providing an updated Response Letter requires that the firm's internal search process be repeated, and is often discouraged for cost and timing reasons.

Auditors sometimes request updates via telephone. Attorneys often respond that responses to auditor requests for information should be in accordance with the ABA Statement, which does not contemplate oral updates. Further, an update requires reinitiation of the firm search process, which takes time and costs the client money. Nonetheless, if the auditors conclude that they need an update as a prerequisite for an unqualified opinion on the financial statements, the client may ask the attorneys to perform the appropriate procedures to provide an updated Response Letter.

Information as to Specific Cases. On occasion an auditor will advise the client that the typical "we express no opinion" as to outcome or amount or range of loss is unsatisfactory and will advise the client that the significance of the case requires further guidance from the lawyer or the auditor will have to qualify the auditor's opinion as to the financial statements. In such a

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477 *See* the discussion of SEC Rule 13b2-2, *supra*, notes 374-378 and related text, and *In the Matter of Google, Inc. and David C. Drummond*, 1933 Act Release No. 8523 (January 13, 2005), supra at note 392 and related text, which can be found at http://www.sec.gov/litigation/admin/33-8523.htm and in which the general counsel of Google consented to a cease and desist order as a result of giving erroneous advice to Google regarding disclosures required to be given to employees to whom employee stock options were granted.

case the attorney is permitted by the ABA Statement to provide additional information. Since predictions as to the outcome of litigation are fraught with peril for both the client and the lawyer, the client's disclosure position does not justify a deviation from the principles of the Statement as to predictions as to outcome or loss exposure.

Inside Counsel Special Issues. The ABA Statement applies to both inside and outside counsel, and includes a form of response letter for an inside general counsel[478] that is similar to

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[478] Annex A to the ABA Statement also sets forth the following illustrative form of letter for use by inside general counsel:

> [Name and Address of Accounting Firm]
>
> Re: [Name of Company] [and Subsidiaries]
>
> Dear Sirs:
>
> As General Counsel* of [*insert name of client*] [(the "Company"] [together with its subsidiaries, the "Company")], I advise you as follows in connection with your examination of the accounts of the Company as at [*insert fiscal year end*].
>
> I call your attention to the fact that as General Counsel* for the Company I have general supervision of the Company's legal affairs. [*If the general legal supervisory responsibilities of the person signing the letter are limited, set forth here a clear description of those legal matters over which such person exercises general supervision, indicating exceptions to such supervision and situations where primary reliance upon be placed on other sources*.] In such capacity, I have reviewed litigation and claims threatened or asserted involving the Company and have consulted with outside legal counsel with respect thereto where I have deemed appropriate.
>
> Subject to the foregoing and to the last paragraph of this letter, I advise you that since [*insert date of beginning of fiscal period under audit*] neither I, nor any of the lawyers over whom I exercise general legal supervision, have given substantive attention to, or represented the Company in connection with, [material]** loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as follows:
>
> [Describe litigation and claims which fit the foregoing criteria.]
>
> [If information concerning specified unasserted possible claims or assessments and/or contractually assumed obligations is to be supplied:]
>
> With respect to matters which have been specifically identified as contemplated by clauses (b) or (c) of Paragraph 5 of the ABA Statement of Policy, I advise you, subject to the last paragraph of this letter, as follows:
>
> [Insert information as appropriate]
>
> The information set forth herein is [as of the date of this letter] [as of [*insert date*], the date on which we commenced out internal review procedures for purposes of preparing this response], except as otherwise noted, and I disclaim any undertaking to advise you of changes which thereafter may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision.

the form for outside counsel,[479] although the inside counsel form differs in its description of the attorney's capacity and does not refer to an Inquiry Letter since the attorney is employed by the company. Some inside counsel use adaptions of this Treaty form of Response Letter, while others who were formerly with law firms use essentially the same form of Response Letter as when they were in private practice. Others will coordinate the receipt of Response Letters from outside counsel and deliver them to the auditors with a letter to the effect that they are not aware of any pending or threatened or pending litigation not referenced in the outside counsel Response Letters. In some cases, inside counsel will deal with pending and threatened litigation in a representation letter structured much like a typical Response Letter, while in other instances the representation letter looks more like a typical management representation letter to auditors.

Whatever the form of the inside attorney written communication to the auditors, the auditors are increasingly pressing for inside counsel to provide much more detail as to the expected outcome of the cases and seeking to tie those evaluations to the loss reserves, if any, established by management for the cases. Often inside counsel, irrespective of how they respond

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This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975); without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (Paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of the Statement and the accompanying Commentary (which is an integral part of the Statement). Consistent with the last sentence of Paragraph 6 of the ABA Statement of Policy, this will confirm as correct the Company's understanding that whenever, in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, I have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, I, as a matter of professional responsibility to the Company, will so advise the Company and will consult with the Company concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5 [Describe any other or additional limitation as indicated by Paragraph 4 of the Statement].

Very truly yours,

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* It may be appropriate in some cases for the response to be given by inside counsel other than inside general counsel in which event this letter should be appropriately modified.

** *NOTE*: See Paragraph 3 of the ABA Statement of Policy and the accompanying Commentary for guidance where the response is limited to material items.

In recognition of the FASB Codification, the reference to "Statement of Financial Accounting Standards No. 5" may be revised to read as follows: "FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies)". *See* note 434 and **Appendix C**.

[479] See the form of outside counsel Response Letter attached as **Appendix C**.

to the auditors in writing, will meet with the auditors to discuss pending and threatened litigation and there will be candid discussions regarding the loss reserves established by management, the risks seen in particular cases and inside counsel's views as to the likely outcome of the case. Those communications are not protected by the ABA Statement, and expose the inside attorney to charges under SOX § 303 if the information given ultimately proves incorrect and misleads the auditors.[480]

Triangle. The preparation of client financial statements involves at least three directions of communication: (1) client with auditor, (2) attorney with client, and (3) attorney with auditor. The most significant side of this triangle is the communication between the client and its auditors, for the financial statements are those of the client and report on its financial position and results of operations, and the auditor, which is performing specified processes in order to issue an opinion or report thereon. The Response Letter is the most typical attorney communication with the auditors and the formalized way that the ABA Statement contemplates attorneys are to provide information to the auditors as they pursue their processes in respect of the client financial statements. The Response Letter with respect to the sensitive subject of unasserted claims typically contains an attorney undertaking to communicate with the client that includes the following:

> Consistent with the last sentence of the paragraph 6 of the ABA Statement of Policy, and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in the audit inquiry letter to us, that whenever in the course of performing legal services for the Company with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for a financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment, we as a matter of professional responsibility to the Company will so advise the Company and will consult with the Company concerning questions of such disclosure and the applicable requirements of Statement of Auditing Standards No. 5.

Communications by attorneys with their clients need to be made with sensitivity to client disclosure obligations under applicable securities laws and to attorney professional responsibilities under applicable state ethics rules and SOX § 307 Rules.

Gain Contingencies. Both the foregoing discussion and the ABA Statement focus on loss contingencies, but companies may also seek to recover damages or other relief from third parties as a plaintiff. Some Inquiry Letters may request information regarding "contingencies", rather than "loss contingencies", or may frame the inquiry relating to overtly threatened or pending litigation in the form of a request such as: "Please furnish our auditors with a description of all pending or threatened litigation that you are handling on our behalf" and ask for "an evaluation of the likelihood of an unfavorable outcome", suggesting that the disclosable items are not limited to "loss" contingencies arising from pending or threatened litigation against the

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[480] See *supra* notes 374-378 and related text.

company.[481] Attorneys generally read "contingencies" in such letters in the context of the ABA Statement, which clearly deals with "loss" contingencies, and deliver a standard Response Letter based on the Treaty.[482] In such a case, it may be desirable for the attorney to consider whether the company's assertion of claims is likely to lead to the assertion of counter- or cross-claims that either need to be disclosed as overtly threatened claims or considered as unasserted claims likely of assertion, although the attorney should not have a duty to address the possibility of counter- or cross-claims in a Response Letter in the absence of facts which would support the reference under a traditional unasserted claims analysis.

Other attorneys interpret "contingencies" to include not only claims against the client, but also claims by the client, and then proceed to respond in accordance with Treaty guidelines.[483] The August 1976 Second Report of the Committee on Audit Inquiry Responses Regarding Internal Implementation of the Statement of Policy[484] recognized that it would be appropriate for counsel to respond to inquiries regarding gain contingencies as follows:

> Historically, the auditor's concern, in his inquiry directed to the lawyer, has been limited to contingent liabilities. With the advent of FAS 5, this focus has been upon litigation. claims and assessments with present loss contingencies. In this connection, the Financial Accounting Standards Board continued in effect the provisions of Accounting Research Bulletin No. 50 regarding contingent assets: paragraph 17 of FAS 5 provides that:
>
> > a) Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

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481 FAS 5 provides at Paragraph 17b. "Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization." Footnote disclosure thus may be required of material gain contingencies. Accruals are not made for gain contingencies.

482 Where counsel is not addressing a request that would encompass gains contingencies, some Response Letters express such limitations in language such as the following: "our response deals only with the subject of loss contingencies (i.e., litigation, claims, and assessments where the Company's involvement is as a defendant or prospective defendant) and not with matters in which we represent the Company as claimant or as plaintiff in which no litigation has been asserted against the Company or other matters (except billing information where requested in the Company's Inquiry letter)". Such a response also does not address uncollectible receivables or other forms of asset impairment beyond the type of loss contingencies identified in the Treaty.

483 James J. Fuld, *Lawyers' Responses to Auditors-Some Practical Aspects*, 44 BUS. LAW, 159, 162 (Nov. 1988).

484 *Second Report of the Committee on Audit Inquiry Responses Regarding Internal Implementation of the Statement of Policy*, 32 BUS. LAW, 43, 51 (Nov. 1976).

> b) Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

> Given the orientation of the auditing and accounting professions to disclosure considerations as they relate to loss contingencies, the ABA Statement of Policy deals only with the subject of loss contingencies (i.e., litigation, claims and assessments where the client's involvement is as a defendant or prospective defendant). However, footnote 2 to SAS No. 12 does refer to the auditor's procedures with respect to gain contingencies; and, consistent therewith, some auditors have concluded that logic compels a better balanced presentation of contingencies, whether they are loss contingencies or gain contingencies, and have therefore solicited information, in the audit inquiry letter, with respect to matters in which the lawyer is acting in behalf of the client where the client is either plaintiff or defendant.

> When the audit letter solicits such additional information, it is not improper for the lawyer to respond, but his response should be within the limits established by the ABA Statement of Policy. In this connection, it should be noted that there may be gain contingencies of such a material nature that they should be the subject of disclosure in financial statements and, in some instances, the auditor may conclude it appropriate or necessary to make the audit opinion "subject to" the uncertainty presented by such gain contingency.

Tax Loss Contingencies: FIN 48. Loss contingencies for Response Letters can include potential liabilities for federal, state, local or foreign taxes. FASB Interpretation No. 48 (*"FIN 48"*) on Accounting for Uncertainty in Income Taxes,[485] which is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, issued in 1992[486] and generally is applicable to both public and non-public companies, provides that its guidance governs with respect to accounting for such tax contingencies in place of SFAS 5. FIN 48 requires a company to account in its financial statements for income tax loss contingencies, which FIN 48 refers to as "income tax uncertainties," based on its assessment under a two-step process: (1) determine whether it is more likely than not that its position will be sustained upon examination, and (2), if so, measure and recognize the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.[487] The unrecognized tax benefit is a liability and, if the company cannot reach the

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485 Fin. Accounting Standards Bd., FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (June 2006), *available at* http://www.fasb.org/pdf/fin%2048.pdf.

486 Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (Feb. 1992), *available at* http://www.fasb.org/pdf/fas109.pdf.

487 *See* FIN 48 at ¶¶ 5–8, which provide:

> **Recognition**

"more likely than not" conclusion, the entire tax liability must be recognized. In making the determinations under FIN 48, the company may choose to seek legal assistance regarding its tax position, but the required assessment and corresponding measurement is that of the company

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5. The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used in applying the provisions of this Interpretation shall consider the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination.

6. An enterprise shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. As used in this Interpretation, the term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. The more-likelythan-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.

7. In assessing the more-likely-than-not criterion as required by paragraph 6 of this Interpretation:

a. It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

b. Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account.

c. Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.

Measurement

8. A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement using the facts, circumstances, and information available at the reporting date. As used in this Interpretation, the term *reporting date* refers to date of the enterprise's most recent statement of financial position.

under the ABA Statement which provides that a lawyer is not required to make determinations of what should be disclosed in financial statements.[488]

For purposes of preparing a Response Letter after FIN 48, the Committee on Audit Responses of the ABA Business Law Section (the *"ABA Audit Response Committee"*) has issued a Statement on Effect of FIN 48 on Audit Response Letters (the *"ABA FIN 48 Supplement"*) to the effect that FIN 48 does not change the standards under which a lawyer should respond to Inquiry Letters and that, "although FIN 48 can affect the way a lawyer advises his or her client when income tax matters are involved, it does not alter the lawyer's professional responsibility to provide that advice when that is required within the scope of the lawyer's engagement."[489]

The ABA FIN 48 Supplement comments that a lawyer should continue to follow the usual practice under the ABA Statement regarding whether or not to comment on the expected outcome of asserted and unasserted claims disclosed in the Response Letter under the "probable" or "remote" standard, leaving it to the company to determine for financial reporting purposes whether its position will be sustained and the amount of the tax benefit, including whether the "more likely than not" determination can be made.[490] The ABA FIN 48 Supplement comments that a lawyer may appropriately decline to comment in the Response Letter on the determinations required to be made under FIN 48 because to do so would be a departure from the ABA Statement.

FIN 48 proceeds on the assumptions that, in assessing whether the client satisfies the "more likely than not" criterion for success, it is to be presumed that the client's tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.[491] Since the client's judgment that a claim is not likely to be asserted by a taxing authority ceases to be applicable in determining what the client may need to disclose in the financial statements with respect to unasserted contingencies relating to income taxes, the ABA FIN 48 Supplement comments:

> In cases where the lawyer has rendered substantive advice to the client with respect to a material unasserted contingent liability relating to income taxes, the lawyer, in responding to the auditor's request for information, should be aware of FIN 48, and if the lawyer has concluded that financial statement disclosure of the income tax contingency is required but is not satisfied that the auditor has been or will be made aware of the contingency, the lawyer should consider what action is appropriate as a matter of professional responsibility. Such action might include,

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488 64 Bus. Law. At 391.

489 ABA Audit Response Committee, *Statement on Effect of FIN 48 on Audit Response Letters*, 64 Bus. Law. 389 (Feb. 2009).

490 *Id.*

491 *See* FIN 48 at ¶ 7a.

depending on the circumstances, refraining from providing the audit response letter and possibly withdrawing from the engagement.[492]

X.
LIMITATION OF LIABILITY PROVISIONS IN AUDITOR ENGAGEMENT LETTERS

Faced with the experience of liabilities to third parties resulting from the fraudulent or willful misconduct of their audit clients, or their failure to detect client frauds, auditors are increasingly in their engagement letters seeking to shift responsibility for client misconduct to the client.[493] Auditor engagement letters typically describe the objectives of the audit, provide that the information provided to the auditors is the responsibility of management, and set forth the fee arrangements.[494] Increasingly auditors are seeking to allocate risks to clients through engagement letter provisions that the client agrees (i) not to hold the auditor liable for damages except those resulting from the auditor's fraud or willful misconduct (i.e., release the auditor from liability for its own negligence in the conduct of the audit); (ii) the auditor will not be responsible for incidental or consequential damages; (iii) no claim will be asserted against the auditor after a fixed period of time (e.g., two years); (iv) the auditor will be liable only for losses that occur during the period covered by the audit; (v) the client will not assign or transfer any claim against the auditor, including assignments in business combinations or reorganizations; (vi) the client will protect the auditor from third party claims arising from the auditor's failure to discover negligent conduct by management; and (vii) the auditor's liability is limited to the amount of fees paid.[495]

In an Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters (the *"Advisory"*),[496] the five federal agencies supervising financial institutions[497] expressed the view that limiting an auditor's liability for an

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492 64 Bus. Law. At 392.

493 *See* David Reilly, "Generally Accepted Accounting Principle? Auditor Pacts With Companies That Prevent Suits, Limit Awards Draw Scrutiny as Disclosure Grows," WALL St. J., March 6, 2006 at C-1, which notes that public companies are beginning to disclose such engagement letter provisions in their proxy materials; *see also* "Survey Results: Auditor Inspection Reports and Engagement Letters," The Corporate Counsel.net (January-February 2006), which reports that a survey of 30 companies showed (i) 63.33% of the companies reported that their most recent auditor engagement letter included a cap on the auditor's liability (i.e., no liability except for willful misconduct and gross negligence); and (ii) 70% reported that their most recent auditor engagement letter included a provision that waives a jury trial.

494 Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, 71 Federal Register No. 27 at 6847, 6849 (February 9, 2006), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-1189.pdf.

495 *Id*. at 6854-55.

496 *Id*. at 6847.

497 The Office of Thrift Supervision, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency. *Id*.

audit may make the auditor less diligent in the audit process and thus make the audit less reliable, which raises safety and soundness concerns. The Advisory excludes (x) limitations on liability for punitive damages and (y) arbitration and other alternative dispute resolution provisions that apply equally to all parties, provide neutral decision makers and appropriate hearing procedures.[498] The Advisory warns directors, audit committees and management that "certain insurance policies (such as error and omission policies and director and officer liability policies) might not cover losses arising from claims that are precluded by limitation of liability provisions."[499]

While the Advisory by its terms applies only to financial institutions (whether public or private), its principles apply to other entities. The SEC has stated that when an auditor and its client enter into an agreement which purports to provide the auditor limitation of liability for its negligent acts, the auditor is not independent:

> "When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation."[500]

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498 *Id*. at 6853-6854.

499 *Id*. at 6853.

500 SEC Financial Reporting Policies Section 602.02.f.i—Indemnification by Client, 3 Fed. Sec. L. (CCH) ¶ 38,335, at 38,603–17 (2003); *see also* SEC Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions—Question 4 (issued December 13, 2004):

> Q: Has there been any change in the Commission's long standing view (Financial Reporting Policies—Section 600—602.02.f.i. "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?
>
> A: No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the accountant is not independent. Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs

The PCAOB and the American Institute of Certified Public Accountants ("*AICPA*") are reviewing the impact of auditor engagement letter provisions that would reduce auditor liability exposure.[501] Currently, Ethics Ruling Number 94 under Rule 101 of AICPA's Code of Professional Conduct, which is included in the PCAOB's interim independence standards,[502] states that the auditor's independence is not impaired if the engagement letter includes "a clause that provides that the client would release, indemnify, defend, and hold the member . . . harmless from any liability and costs resulting from knowing misrepresentations by management.[503] Since auditors must comply with the SEC's auditor independence requirements set forth above (as well as those of the PCAOB) in a public company audit, AICPA Ethics Ruling Number 94 has no practical effect with respect to audits of public companies. Additionally, Ethics Ruling Number 95 under Rule 101 of the AICPA Code of Professional Conduct, which is also included in the PCAOB's interim independence standards, currently states that independence would not be impaired if the auditor and the audit client agreed to alternative dispute resolution ("ADR") to resolve disputes relating to past services.[504] The AICPA is proposing to amend its independence standards to parallel the position of the Advisory so that generally limitation of auditor liability provisions in engagement letters would prejudice independence, but punitive damage limitation, ADR and the unsuccessful party to a lawsuit or ADR pays the costs of the successful party provisions would not impair auditor independence.[505]

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resulting from knowing misrepresentations by management would also impair the firm's independence.

[501] *See* Agenda for PCAOB Standing Advisory Group Meeting on February 9, 2006 under "Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters," *available at* http://www.pcaobus.org/News_and_Events/Events/2006/02-09.aspx, and related Standing Advisory Group white paper dated February 9, 2006 and entitled "Emerging Issue--The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters", available at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Indemnification.pdf; AICPA Proposed Interpretation 101-16 (September 15, 2005), *available at* http://www.aicpa.org/download/ethics/2--5_0915_ed_Indemn.pdf, which sets forth the AICPA's position on the types of clauses discussed above.

[502] The PCAOB adopted as its interim independence standards (see PCAOB Rule 3600T) the AICPA Code of Professional Conduct Rules 101 and 191, and related interpretations and rulings, as they existed on April 16, 2003, to the extent not superseded or amended by the PCAOB. *See* PCAOB R. 3600T.

[503] AICPA Code of Professional Conduct, ET § 191-94, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 94, Indemnification Clause in Engagement Letters" (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/about/code/et_191.html#N94._indemnification_clause_in_engagement_letters.

[504] AICPA Code of Professional Conduct, ET § 191-95, *Ethics Rulings on Independence, Integrity, and Objectivity*, "Ethics Ruling No. 95, Agreement With Attest Client to Use ADR Techniques" (Am. Inst. of Certified Pub. Accountants), *available at* http://www.aicpa.org/about/code/et_191.html#N95._agreement_with_attest_client_to_use_adr_techniques.

[505] *See* AICPA Proposed Interpretation 101-16, *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters* (Sept. 15, 2005) *available at* http://www.aicpa.org/download/ethics/2--

XI.
EFFECT OF SOX ON FOREIGN COMPANIES

Which Foreign Companies are Subject to SOX. The provisions of SOX apply to public companies even if domiciled outside of the U.S.[506] Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which the SEC defines as a private corporation or other organization incorporated outside of the U.S., as long as:

(1) More than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents; and

(2) Any one of the following:

- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer's assets are not located in the U.S.; or
- The issuer's business is not administered principally in the U.S.[507]

A foreign private issuer may use Form 20-F both to register a class of its securities under the 1933 Act and as its SEC annual report under the 1934 Act, due within six months after the end of each fiscal year.[508] A number of the SOX provisions have exceptions applicable to foreign private issuers as discussed below.

What Differences Are There in the Application of SOX Provisions to Foreign Private Issuers?

Public Company Accounting Oversight Board – The Title I rules apply to foreign accounting firms that audit foreign corporations which are reporting companies under the 1934 Act or that are offering securities in a registered public offering under the 1933 Act.[509] The PCAOB may also determine by rule that a foreign public accounting firm that does not prepare or issue the audit report of such a foreign company, but that nonetheless plays such a substantial

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5_0915_ed_Indemn.pdf (setting forth the AICPA's proposed position on the types of clauses discussed above).

506 *See* note 3, *supra*.

507 17 C.F.R. § 240.3b-4 (2010).

508 17 C.F.R. § 249.220f (2010).

509 *See supra* notes 24-28 and related text.

role in preparing or issuing its audit report, should be treated as a public accounting firm under SOX.[510]

Auditor Independence; Non-Audit Services – All of the Title II rules apply equally to foreign private issuers.[511] A foreign private issuer is required to disclose in its Form 20-F or 40-F the fees paid to its auditors for (1) audit services; (2) audit-related services; (3) tax services; and (4) other services.[512]

Corporate Responsibility

Audit Committee Independence Rules. The SOX § 301 rule applies to foreign private issuers.[513] Because the requirements for a U.S.-style audit committee may conflict with legal requirements, corporate governance standards, and the methods for providing auditor oversight in the home jurisdictions of some foreign private issuers, the SEC has provided some exceptions to the audit committee independence rules.[514] These exceptions provided by the SOX § 301 Release are summarized below:

- *Allowing Non-Management Employee to Serve*. Non-management employees will be allowed to serve on the audit committee of a foreign private issuer if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to home country legal or listing requirements.[515]

- *Allowing Controlling Shareholder to Serve*. In foreign jurisdictions providing for audit committees, representation of controlling shareholders is common. The SEC suggests that in the case of foreign private issuers, one member of the audit committee could be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of the foreign private issuer, if the "no compensation" prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, and the member in question is not an executive officer of the issuer.[516]

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[510] SOX § 106(a)(1), 15 U.S.C.A. § 7216(a)(1) (West Supp. 2010) [hereinafter *"SOX § 106"*].

[511] Title II Release, *supra* note 29, at 6006.

[512] *Id*. at 6024.

[513] SOX § 301 Release, *supra* note 92, at 18,790.

[514] For example, in some countries: (i) the auditors report to shareholders at the annual meeting and are responsible to them; (ii) there are no requirements to have an audit committee; (iii) if there is a requirement for an audit committee, there is no requirement its members are independent; and (iv) there are two tiers of board membership: a lower tier of employee members, either management or non-management, and an upper-tier of supervisory members.

[515] SOX § 301 Release, *supra* note 92, at 18,802.

[516] *Id*. at 18,802-03.

- *Allowing Government Representative to Serve*. To accommodate foreign practices, one member of the audit committee of a foreign private issuer could be a representative of a foreign government or foreign governmental entity, as long as the "no compensation" prong of the independence requirement is satisfied and the member in question is not an executive officer of the issuer.[517]

- *No Independent Audit Committee Required if Board of Auditors*. Foreign private issuers' boards of auditors or similar bodies or statutory auditors, which operate under legal or listing provisions and are intended to provide oversight of outside auditors that are independent of management are exempted from the more demanding independence requirements in the SOX § 301 Release, as long as membership on such a board excludes executive officers of the foreign private issuer and such board or body is (to the extent permitted by the law of its home jurisdiction) responsible for the appointment and retention of any registered public accounting firm engaged by the listed issuer.[518]

- *Audit Committee Financial Experts*. A foreign private issuer must disclose whether it has an audit committee financial expert who is independent, as that term is defined by the applicable listing standards for the issuer's exchange.[519] If a foreign company is not a listed issuer, it must choose one of the definitions of audit committee member independence used by a major stock exchange for purposes of determining whether its financial expert is independent.[520]

A foreign private issuer availing itself of any of the exemptions described above must disclose in, or incorporate by reference into, its annual report on Form 20-F or 40-F its (a) reliance on the exemption; and (b) assessment of whether (and if so, how) such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the proposed rules.[521]

In the case of a foreign private issuer with a two-tier board of directors, the term "board of directors" means the supervisory or non-management board.[522] That board may either form an audit committee that complies with the independence requirements, or if the entire board is independent, it may be designated as the audit committee. To the extent an audit committee is required to conduct oversight duties, establish procedures to receive complaints, have authority to hire independent counsel, identify and disclose the "financial expert" if there is one (and if not, why not), and if the foreign private issuer is not required to have an audit committee under

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[517] *Id*. at 18,803.

[518] *Id*.

[519] *Id*. at 18,808.

[520] *Id*. at 18,808-09.

[521] SOX § 301 Release, *supra* note 92, at 18,820.

[522] *Id*. at 18,817.

one of the exemptions to the Title III Rules provided above (e.g., either because it has a two-tier board structure and the upper tier is independent, or because it has a board of auditors), then the board members represented by the alternatively allowed structure shall perform the duties of an audit committee.[523]

CEO/CFO Certifications under SOX §§ 302 and 906. Calendar year foreign private issuers must include certifications in their annual Forms 20-F and 40-F.[524] Since foreign private issuers make no quarterly filings but report updated information from time to time during the year on Form 6-K, no quarterly certification would be required (Form 6-K, like Form 8-K, is not considered "filed" with the SEC).[525]

Misleading Statements to Auditors. Foreign companies are equally subject to SOX § 303 and expanded Rule 13b2-2. In applying the rule to foreign private issuers, the terms "officer" and "director" would indicate those performing equivalent functions under the local laws and corporate governance practices where the issuer is domiciled.[526] "In addition, the term 'independent public or certified public accountant' includes accountants in foreign countries who engage in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the [SEC], regardless of the title or designation used in those countries."[527]

CEO/CFO Reimbursement. SOX § 304 applies equally to foreign companies, with the same July 30, 2002, effective date, although, as in the case of U.S. issuers, it is unclear how SOX § 304 will be enforced in practice.[528]

Insider Trading Freeze During Plan Blackout. Regulation BTR limits SOX § 306(a)'s application to the directors and executive officers of a foreign private issuer[529] to situations where (i) 50% or more of the participants or beneficiaries located in the U.S. in individual account plans maintained by the issuer are subject to a temporary trading suspension in issuer equity securities, (ii) the affected participants and beneficiaries represent an appreciable portion of the issuer's worldwide employees, and (iii) the issuer is considered to have a sufficient presence for purposes of applying the SOX § 306(a) trading prohibition to its directors and

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523 *Id*. at 18,809.

524 Certification of Disclosure in Companies' Quarterly and Annual Reports, 1934 Act Release No. 46,079, 67 Fed. Reg. 41,877, 41,882 (June 20, 2002), *available at* http://www.sec.gov/rules/proposed/34-46079.htm.

525 *See id*.

526 1934 Act Release No. 47,890, *supra* note 374, at 31,821 n.12.

527 *Id.* at 31,825 n.67.

528 SOX § 304, s*upra* note 143.

529 For a foreign private issuer, a "director" is a director who is a management employee of the issuer, and an "executive officer" is the principal executive officer or officers, a principal financial officer or officers, and the principal accounting officer or officers. 17 C.F.R. § 245.100 (2010).

executive officers.[530] A foreign private issuer will have sufficient presence for the trading prohibition if:

- The number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities exceeds 15% of the number of employees of the issuer worldwide; or

- The number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities does not exceed 15% of the number of employees of the issuer worldwide but exceeds 50,000 participants and beneficiaries.[531]

Likewise, if the number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities does not exceed 15% of the issuer's employees worldwide and involves 50,000 or fewer participants and beneficiaries, the issuer's presence in the U.S. will be considered sufficiently small so that its directors and executive officers will not be subject to the SOX § 306(a) trading prohibition.[532]

Enhanced Attorney Responsibilities. The SOX § 307 Rules apply to all attorneys, whether in-house counsel or outside counsel or those in foreign jurisdictions, "*appearing and practicing*" before the SEC.[533] The term "appearing and practicing" before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena; (3) providing advice in respect of the U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (i) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or (ii) is a non-appearing foreign attorney.[534] In recognition of the difficulties encountered by foreign lawyers and international law firms because applicable

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[530] 1934 Act Release No. 47,225, *supra* note 157, at 4339.

[531] *Id*. at 4346.

[532] *Id*.

[533] 17 C.F.R. § 205.1 (2010).

[534] 17 C.F.R. § 205.2 (2010).

foreign standards might be incompatible with the attorney conduct rules,[535] the SOX § 307 Rules exempt "non-appearing foreign attorneys" who:

- Are admitted to practice law in a jurisdiction outside the United States;
- Do not hold themselves out as practicing, and do not give legal advice regarding, U.S. federal or state securities or other laws; and either

  (i) Conduct activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the U.S.; or

  (ii) Appear and practice before the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other U.S. jurisdiction.[536]

Thus, foreign attorneys who provide legal advice regarding U.S. securities law, other than in consultation with U.S. counsel, are subject to the SOX § 307 Rules if they conduct activities that constitute appearing and practicing before the SEC.[537] The SOX § 307 Rules cite as an example an attorney licensed in Canada who independently advises an issuer regarding the application of SEC regulations to a periodic filing with the SEC, who would in those circumstances be subject to the SOX § 307 Rules.[538]

In addition, the SEC adopted Paragraph 205.6(d) of the SOX § 307 Rules to protect a lawyer practicing outside the U.S. in circumstances where foreign law prohibits compliance with the SOX § 307 Rules:

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[535] In the SOX § 307 Release, *supra* note 407, the SEC commented:

> The Commission respects the views of the many commenters who expressed concerns about the extraterritorial effects of a rule regulating the conduct of attorneys licensed in foreign jurisdictions. The Commission considers it appropriate, however, to prescribe standards of conduct for an attorney who, although licensed to practice law in a foreign jurisdiction, appears and practices on behalf of his clients before the Commission in a manner that goes beyond the activities permitted to a non-appearing foreign attorney. Non-United States attorneys who believe that the requirements of the rule conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with United States counsel whenever they engage in any activity that constitutes appearing and practicing before the Commission.

SOX § 307 Release, *supra* note 407, at 6303.

[536] *Id.*

[537] *Id. See also* 17 C.F.R. § 205.1 (2010).

[538] The SOX § 307 Release, *supra* note 407, at 6303.

(d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.[539]

Where the foreign attorney rules are not prescribed by statute but by bar association or court rules, the Paragraph 205.6(d) exception may not be available.[540] In any event, the SEC would require that the foreign lawyer comply with the SOX § 307 Rules to the maximum extent not prohibited by applicable foreign law.[541]

Further, U.S. attorneys who work for foreign private issuers would be subject to the SOX § 307 Rules[542] and applicable state bar disciplinary rules in respect of their service for foreign private issuers and could be held responsible under SEC Rule 13b2-2 under the 1934 Act for

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539 17 C.F.R. § 205.6(d) (2010).

540 The SOX § 307 Release, *supra* note 407, at 6314 ("paragraph 205.6(d) addresses the conduct of non-U.S. attorneys who are *subject to this part*. . .") (emphasis added).

541 17 C.F.R.§ 205.6(d) (2010).

542 In advising foreign private issuers with respect to U.S. securities law matters, U.S. counsel may encounter situations where, in their judgment, the U.S. securities laws and SOX § 307 Rules require them to take actions which would not be required under the laws of the jurisdiction in which the issuer is organized or principally conducts its business. *See* Patrick McGeehan, *Lawyers Take Suspicions On TV Azteca To Its Board*, N.Y. TIMES, Dec. 24, 2003, at C1:

> In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.
>
> The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than $100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.
>
> . . . in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX § 307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it.

The SEC filed civil fraud charges against TV Azteca, its parent company, and three of its officers and directors on January 4, 2005 alleging significant related party transactions which were undisclosed in TV Azteca's periodic reports. *See* TV Azteca, 84 SEC Docket 52,283 (Jan. 4, 2005). In the SEC Litigation Release, the SEC noted that the company's outside counsel withdrew from its representation pursuant to its duties under SOX § 307.

improperly influencing the auditor of a foreign private issuer's financial statements filed with the SEC.[543]

Enhanced Financial Disclosures; Prohibition on Insider Loans

Off-Balance Sheet Transactions; Use of Non-GAAP Financial Measures. Forms 20-F and 40-F have been amended to require foreign private issuers to make the same disclosures required of domestic companies in respect of off-balance sheet items in filings made for fiscal years ending on or after June 15, 2003.[544] The table of contractual obligations is required in filings made for fiscal years ending on or after December 15, 2003.[545]

The SEC did not impose U.S. GAAP on foreign private issuers with respect to the preparation of their primary financial statements.[546] Thus, for a foreign private issuer that discloses a non-GAAP financial measure derived from a measure calculated in accordance with its home country or local GAAP, "GAAP" refers to its home country GAAP.[547] For those that disclose a non-GAAP financial measure derived from a measure calculated in accordance with U.S. GAAP, "GAAP" refers to U.S. GAAP, for purposes of applying Regulation G to the disclosure of that measure.[548] However, foreign private issuers whose primary financial statements are prepared in accordance with a non-U.S. GAAP were required pre-SOX to include in their management discussion and analysis (MD&A) a discussion of the reconciliation to U.S. GAAP and any differences between foreign and U.S. GAAP, if it would be necessary for an understanding of the financial statements as a whole.[549] Consistent with that pre-SOX MD&A requirement for foreign private issuers, the disclosure about off-balance sheet arrangements and the table of contractual obligations should focus on the primary financial statements presented in the document, while taking the reconciliation into account.[550]

The SEC has published for public comment a proposal that would allow foreign private issuers to file their financial statements without reconciliation to U.S. GAAP, as currently required by Form 20-F. The relief would only be available to foreign private issuers that file their financial statements in full compliance with the English language version of International Financial Reporting Standards ("*IFRS*"), as published by the International Accounting Standards

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543 *See* notes 374-378 and related text, *supra*.

544 1933 Act Release No. 8182, *supra* note 211, at 5991.

545 *Id*. at 5992.

546 1933 Act Release No. 8176, *supra* note 221.

547 *Id*.

548 *Id*.

549 1933 Act Release No. 8182, *supra* note 211, at 5992.

550 *Id*.

Board ("*IASB*").[551] Foreign private issuers would be required to state in a prominent footnote to their financial statements that such financial statements are in compliance with IFRS as published by IASB. Furthermore, the independent auditor of the issuer must render an opinion stating that the issuer's financial statements comply with IFRS (as published by the IASB).

Conditions for Use of Non-GAAP Financial Measures: Regulation G. Regulation G applies to any disclosures made in a Form 20-F unless:

- The securities of the foreign company are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with generally accepted accounting principles in the U.S.; and
- The disclosure is made by or on behalf of the foreign private issuer outside the U.S. or is included in a written communication that is released by or on behalf of the foreign private issuer outside the U.S.[552]

These exceptions apply even if one or more of the following circumstances exists:

- A written communication is released in the United States as well as outside the United States, so long as the communication is released in the U.S. contemporaneously with or after the release outside the U.S. and is not otherwise targeted at persons in the U.S.;
- Foreign journalists, U.S. journalists or other third parties have access to the information;
- The information appears on one or more websites maintained by the [foreign private issuer], so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or
- Following the disclosure or release of information outside of the United States, the information is included in a submission to the SEC in a Form 6-K.[553]

There is no such exemption from Regulation G for disclosure of non-GAAP financial measures in Form 20-F. However, an otherwise impermissible non-GAAP financial measure will be allowed if it is affirmatively permitted (and not just not disallowed) by the standard-setter for GAAP used in the foreign private issuer's primary financial statements and it is included in

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[551] Press release, "SEC Soliciting Public Comment on Eliminating Reconciliation Requirement for IFRS Financial Statements," dated July 3, 2007, *available at* http://www.sec.gov/news/press/2007/2007-128.htm; *see* press release, "SEC Soliciting Public Comment on Role of IFRS in the U.S.," dated July 25, 2007, *available at* http://www.sec.gov/news/press/2007/2007-145.htm.

[552] 1933 Act Release No. 8176, *supra* note 221, at 4821.

[553] *Id*.

the foreign private issuer's annual report of financial statements used in its home country jurisdiction.[554] Certain Canadian issuers who file annual reports with the SEC on Form 40-F under the Multi-Jurisdictional Disclosure System (the *"MJDS"*) are not subject to reconciliation of non-GAAP measures used in Form 40-F because the Canadian disclosure form dictates what must be disclosed in filings made with the SEC under the MJDS. However, those Canadian issuers are subject to Regulation G with respect to any public disclosures made in the U.S. that contain non-GAAP financial measures.[555]

Internal Controls. While SOX § 404(a) rules require management to base its assessment of the effectiveness of the issuer's ICFR on a suitable, recognized control framework established by a group or body that has followed due process procedures (including the evaluative framework set forth in the COSO Report), foreign private issuers are permitted to use the framework in effect in their home country jurisdictions for this purpose.[556] The dates by which foreign private issuers must comply with SOX § 404 are as follows:[557]

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[554] In *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures* (June 13, 2003), *available at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm, the staff discussed the note to Item 10(e) of Regulation S-K that permits a foreign private issuer to include in its filings a non-GAAP financial measure that otherwise would be prohibited if, among other things, the non-GAAP financial measure is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the SEC. In response to the question of what "expressly permitted" means, the staff advised that a measure would be considered "expressly permitted" if the particular measure "is clearly and specifically identified as an acceptable measure by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the Commission." For example, some non-U.S. GAAP standard setters specify a minimum level of caption detail for financial statement presentation but require or permit additional caption detail, and sometimes the standard setter does not specify the particular additional captions to be presented. The staff stated that the "additional detail of the components of the financial statements determined in conformity with the GAAP used in the primary financial statements will generally be useful to U.S. investors and the 'expressly permitted' condition is not intended to prohibit the inclusion of those captions." Likewise, some non-U.S. GAAP standard setters permit or require subtotals in financial statements that are not calculated consistently with those permitted or required by U.S. GAAP, and provided that the subtotal is clearly derived from the appropriately classified financial statement captions that precede it, the staff advised that the "expressly permitted" condition was not intended to prohibit inclusion of those subtotals.

[555] N. Adele Hogan, *Non-GAAP Financial Measures & "Real-Time" Reporting: Final Rules Pursuant to Sections 401(b) & 409 of the Sarbanes-Oxley Act*, in Understanding the Securities Laws, 93 (Practicing Law Institute 2003).

[556] 1933 Act Release No. 8238, *supra* note 130, at 36,642.

[557] Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers, 1933 Act Release No. 33-8730A, 1934 Act Release No. 34-54294A (Aug. 9, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8760.pdf.

Issuer Status	Management Assessment of ICFR – Fiscal Year Ending	Auditor's Attestation Report – Fiscal Year Ending
Large Accelerated Filer[558]	July 15, 2006	July 15, 2006
Accelerated Filer[559]	July 15, 2006	July 15, 2007
Non-accelerated Filer[560]	December 15, 2007	December 15, 2009

Prohibition on Loans to Directors and Officers. SOX § 402 applies equally to foreign companies, with the same July 30, 2002, effective date, but the exception for loans by banks whose deposits are insured by the Federal Deposit Insurance Corporation ("*FDIC*") disadvantages foreign banks whose deposits generally cannot be FDIC-insured even though they might be subject to insider lending restrictions similar to those applicable to FDIC-insured institutions. Under some foreign banking regulations, bank directors and executive officers are further prohibited from borrowing money from other banks and financial institutions.[561] In addition, although not required by local regulations, some foreign banks, like some of their U.S. counterparts, have implemented policies that prohibit senior insiders from borrowing money from other banks for the purpose of enhancing oversight and surveillance of financial transactions by insiders. The combination of these prohibitions and the provisions of SOX § 402 would effectively foreclose a director or executive officer of a foreign bank whose securities are registered with the SEC from borrowing money.[562] To level the playing field, the SEC has

558 1934 Act Rule 12b-2(2) [17 C.F.R. 240.12b-2(2)] defines a large accelerated filer as an issuer that, among other criteria, has an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer of $700 million or more as of the last day of the issuer's most recently completed second fiscal quarter.

559 1934 Act Rule 12b-2(1) [17 C.F.R. 240.12b-2(1) (2010)] defines an accelerated filer as an issuer that, among other criteria, has an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer of $75 million or more as of the last day of the issuer's most recently completed second fiscal quarter and is not a "large accelerated filer."

560 The term "non-accelerated filer" is not defined in the SEC rules, but is used by the SEC to refer to a 1934 Act reporting company that does not meet the 1934 Act Rule 12b-2 definition of either an "accelerated filer" or a "large accelerated filer." Internal Control Over Financial Reporting In Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers, 1933 Act Release No. 33-8730A, 1934 Act Release No. 34-54294A (Aug. 9, 2006) at note 5, available at http://www.sec.gov/rules/final/finalarchive/finalarchive2006.shtml.

561 Foreign Bank Exemption From the Insider Lending Prohibition of Exchange Act Section 13(k), 1934 Act Release No. 48,481, 68 Fed. Reg. 54,590, 54,591 (Sept. 17, 2003), *available at* http://www.sec.gov/rules/proposed/34-48481.htm.

562 *Id.*

adopted 1934 Act Rule 13k-1 that exempts from the SOX § 402 insider lending prohibition an issuer that is a foreign bank[563] or the parent company of a foreign bank with respect to loans by the foreign bank to its insiders or the insiders of its parent company as long as:

(1) Either:

(i) The laws or regulations of the foreign bank's home jurisdiction require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme; or

(ii) The Board of Governors of the U.S. Federal Reserve System has determined that the foreign bank or another bank organized in the foreign bank's home jurisdiction is subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor in its home jurisdiction under 12 CFR 211.24(c); and

(2) The loan by the foreign bank to any of its directors or executive officers or those of its parent or other affiliate:

(i) Is on substantially the same terms as those prevailing at the time for comparable transactions by the foreign bank with other persons who are not executive officers, directors or employees of the foreign bank, its parent or other affiliate; or

(ii) Is pursuant to a benefit or compensation program that is widely available to the employees of the foreign bank, its parent or other affiliate and does not give preference to any of the executive officers or directors of the foreign bank or its parent company over any other employees of the foreign bank, its parent or other affiliate over any other employees of the foreign bank, its parent or other affiliate; or

(iii) Has received express approval by the bank's supervisor in the foreign bank's home jurisdiction.[564]

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563 *See* SOX § 401, *supra* note 208. Rule 13k-1 employs a definition of "foreign bank" that is similar to the definition under Regulation K of the Federal Reserve Board. Under the Rule 13k-1 definition, a foreign bank is an institution that is:

(1) incorporated or organized under the laws of a country other than the United States or a political subdivision of a country other than the United States;

(2) regulated as a bank by that country's or subdivision's government; and

(3) engaged directly in the business of banking.

This definition also includes a provision explaining that, in order to be an institution engaged directly in the business of banking, a foreign entity must engage directly in banking activities that are usual for the business of banking in its home jurisdiction.

564 Foreign Bank Exemption from the Insider Lending Prohibition of Exchange Act Section 13(k), 1934 Act Release 34-49616 (Apr. 26, 2004), *available at* http://www.sec.gov/rules/final/34-49616.htm.

Accelerated § 16(a) Reporting. Rule 3(a)12-3 under the 1934 Act provides that securities registered by a foreign private issuer are exempt from Section 16.[565]

Code of Ethics. A foreign private issuer is required to make disclosure regarding its Code of Ethics on Forms 20-F and 40-F filed for fiscal years ending on or after July 15, 2003.[566] Disclosure of waivers that have occurred during the past fiscal year must be made in the annual report, although the SEC encourages disclosure to be made more promptly on Form 6-K or on the company's website.[567]

Systematic Review of 1934 Act Filings. Like U.S. issuers, foreign private issuers can expect to have their annual reports reviewed by the SEC at least once every three years.[568]

Accelerated Disclosure in Plain English. Foreign private issuers filing annual reports on Form 20-F or 40-F are not required to make "real time" disclosure in plain English.[569] To the extent that a foreign private issuer has as class of its securities listed on a national securities exchange or NASDAQ, it may be required to make disclosures of material nonpublic information under such SRO's standards for continued listing.[570]

Accelerated Filing Deadlines. Foreign filers are not subject to the accelerated filing deadlines of 10-Ks and 10-Qs, but the SEC has indicated it is continuing to consider changes to the Form 20-F filing deadlines.[571]

Enhanced MD&A Disclosure. Foreign private issuers are subject to the same required enhanced MD&A disclosure requirements as U.S. issuers.[572] However, foreign private issuers are not required to file "quarterly" reports with the SEC. Thus, unless a foreign private issuer files a 1933 registration statement that must include interim period financial statements and

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565 17 C.F.R. § 240.3a12-3 (2010).

566 SOX §§ 406/407 Release, *supra* note 316.

567 *Id.* at 5120-21.

568 SOX § 408, *supra* note 346.

569 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 1933 Act Release No. 8400, 1934 Act Release No. 49,424, 69 Fed. Reg. 15,594 (Mar. 25, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

570 Selective Disclosure and Insider Trading, 1933 Act Release No. 7881, 1934 Act Release No. 43,154, 65 Fed. Reg. 51,716, 51,724-25 (August 24, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm; *see also* Michael Gruson, *Global Shares of German Corporations and Their Dual Listings on the Frankfurt and New York Stock Exchanges*, 22 U. PA. J. INT'L ECON. L. 185, 189 n.7 (2001).

571 1933 Act Release No. 8128, *supra* note 349, at 58,488.

572 1933 Act Release No. 8182, *supra* note 211, at 5991.

related MD&A disclosure, it will not be required to update its MD&A disclosure more frequently than annually.

Termination of SEC Filing Obligations. On March 27, 2007, the SEC amended its rules to make it easier for foreign private issuers to deregister and terminate their SEC reporting obligations in the U.S.[573] A foreign private issuer of equity securities will be permitted to terminate its reporting obligations under 1934 Act §§ 13(a) or 15(d) by meeting a quantitative benchmark designed to measure relative U.S. market interest for its equity securities that does not depend on a head count of the issuer's U.S. security holders, as under the previous rules, and will permit a foreign private issuer, regardless of size, to compare the average daily trading volume of its securities in the U.S. with its worldwide average daily trading volume, using a 5 percent benchmark. The determination of the denominator when measuring against this 5 percent threshold is based on worldwide trading volume, rather than trading volume in the issuer's one or two primary markets. Off-market trading will be counted worldwide, and not only in the U.S., so long as the information source is reliable and not duplicative of exchange-reported trading. Convertible and other equity-linked securities are also not counted in the threshold calculation. Issuers terminating their listings or ADR programs must have satisfied the trading volume standard as of the date of delisting, as measured over the 12 months immediately preceding the date of delisting.

XII.
EFFECT OF SOX ON PRIVATE COMPANIES AND BUSINESS COMBINATIONS

The impact of SOX is beginning to extend beyond the companies to which it is literally applicable to encompass private companies in which the owner's exit strategy may be sale to a public company or a public offering.[574] Those entities providing or arranging financing for public companies, or private companies whose exit strategy includes a public offering or being acquired by a public company, also will need to consider how the SOX requirements may affect the companies with which they deal.

SOX will be applicable to the buyer if it will be a public company after the transaction, even through a class of high yield debt which may have been privately placed in an SEC Rule 144A transaction with a covenant to exchange the privately placed debt for SEC registered debt or to become and remain subject to the SEC reporting requirements.[575] Further, if the seller is a public company going private, SOX problems present while the company was public will follow the company's reputation into its private company life.

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[573] Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 1934 Act Release No. 34-55540 (Mar. 27, 2007), *available at* http://www.sec.gov/rules/final/2007/34-55540.pdf.

[574] American Institute of Certified Public Accountants (AICPA), *The State Cascade – An Overview of the State Issues Related to the Sarbanes-Oxley Act*, *at* http://www.aicpa.org/statelegis/index.asp (last visited Nov. 13, 2004).

[575] Gerald T. Nowak, Andrew J. Terry & William Chou, *In the Twilight Zone: The Unique Status of High Yield-Only Issuers*, 18 No. 8 INSIGHTS 10, 10 (August, 2004).

In the case of a private company being acquired, the acquiring public company will have to certify in its SEC reports as to its consolidated financial statements in its first periodic report after the combination, which will put the CEO and CFO of the buyer in the position of having to certify as to the financial statements and internal controls of the consolidated entity, including the acquired company.[576] Those certifications in turn will require the buyer to be sure of the seller's SOX conformity before the transaction is contemplated so that there will not be a post closing financial reporting surprise.

The foregoing results in increased emphasis on due diligence. This emphasis manifests itself through expanded representations and warranties in acquisition agreements and financing agreements, as well as through hiring auditors to review the work papers of the seller's auditors.[577] The target's auditors typically resist opening up their work papers, but ultimately may accede in exchange for a letter to the effect that the buyer acknowledges that the work papers are useless and will not be relying on them.[578] Sometimes the auditors ask for (but do not receive) an indemnification in exchange for access to the work papers.

Set forth below are sample representations as to financial statements, internal controls, SEC reports, CEO/CFO certifications, loans to directors and officers, and compliance with laws that have been modified to address SOX concerns and sample covenants dealing with certain SOX issues (provisions that are particularly relevant post-SOX are bold faced):[579]

> Financial Statements. The financial statements of the Company and its subsidiaries included in the Company SEC Documents (including the related notes) complied as to form, as of their respective dates of filing with the SEC, in all material respects with applicable accounting requirements and the published rules and regulations of the SEC with respect thereto (including, without limitation, Regulation S-X, **have been prepared in accordance with generally accepted accounting principles in the United States (*"GAAP"*)** (except, in the case of unaudited statements, to the extent permitted by Regulation S-X for Quarterly Reports on Form 10-Q) applied on a consistent basis during the periods and at the dates involved (except as may be indicated in the notes thereto) **and fairly present the consolidated financial condition of the Company and its**

576 *See supra* "CEO/CFO Certifications," in notes 129-142.

577 Robert J. Lowe, et al., *Employee Benefit Plans in Corporate Acquisitions, Dispositions and Mergers*, in Tax Strategies for Corporate Acquisition, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 271, 289-90 (Practicing Law Institute ed., 2004).

578 *See* Sharon D. Stuart, *How Lawyers Use Financial Information*, in Basics of Accounting & Finance What Every Practicing Lawyers Needs to Know 711, 717 (Practicing Law Institute ed., 2004).

579 The sample provisions set forth herein to address SOX issues are derived in large part from Lee Walton and Joel Greenberg, "*The Impact of Sarbanes-Oxley on Merger and Acquisition Practices*" (February 19, 2003), which was presented at the Committee Forum of the ABA Negotiated Acquisitions Committee in Los Angeles on April 5, 2003, http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/03spring/59/soxma.pdf.

subsidiaries at the dates thereof and the consolidated results of operations and cash flows for the periods then ended (subject, in the case of unaudited statements, to notes and normal year-end audit adjustments that were not, or with respect to any such financial statements contained in any Company SEC Documents to be filed subsequent to the date hereof are not reasonably expected to be, material in amount or effect). **Except (A) as reflected in the Company's unaudited balance sheet** at _______________ or liabilities described in any notes thereto (or liabilities for which neither accrual nor footnote disclosure is required pursuant to GAAP) **or (B) for liabilities incurred in the ordinary course of business** since _______________ consistent with past practice or in connection with this Agreement or the transactions contemplated hereby, **neither the Company nor any of its subsidiaries has any material liabilities or obligations of any nature. Part ____ of the Company Disclosure Statement lists, and the Company has delivered to Parent copies of the documentation creating or governing, all securitization transactions and *"off-balance sheet arrangements"* (as defined in Item 303(c) of Regulation S-K of the SEC) effected by the Company or its subsidiaries since ____________. ____________, which has expressed its opinion with respect to the financial statements of the Company and its subsidiaries included in Company SEC Documents (including the related notes), is and has been throughout the periods covered by such financial statements (x) a registered public accounting firm (as defined in Section 2(a)(12) of the Sarbanes-Oxley Act of 2002) [*"SOX"*], (y) "independent" with respect to the Company within the meaning of Regulation S-X and, with respect to the Company, and (z) in compliance with subsections (g) through (l) of Section 10A of the 1934 Act and the related Rules of the SEC and the Public Company Accounting Oversight Board. Part ____ of the Company Disclosure Schedule lists all non-audit services performed by __________ for the Company and its subsidiaries since __________, all of which have been duly approved as required by Section 202 of SOX.**

Internal Controls. The Company has implemented and maintains a system of internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the 1934 Act) sufficient to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP, including, without limitation, that (i) transactions are executed in accordance with management's general or specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

SEC Reports. The Company has on a timely basis filed all forms, reports and documents required to be filed by it with the SEC since __________. Part ____ of the Company Disclosure Schedule lists, and, except to the extent available in

full without redaction on the SEC's web site through the Electronic Data Gathering, Analysis and Retrieval System (*"EDGAR"*) two days prior to the date of this Agreement. The Company has delivered to Parent copies in the form filed with the SEC of (i) the Company's Annual Reports on Form 10-K for each fiscal year of the Company beginning since **__________**, (ii) its Quarterly Reports on Form 10-Q for each of the first three fiscal quarters in each of the fiscal years of the Company referred to in clause **____** above, (iii) all proxy statements relating to the Company's meetings of stockholders (whether annual or special) held, and all information statements relating to stockholder consents since the beginning of the first fiscal year referred to in clause (i) above, **(iv) all certifications and statements required by (x) the SEC's Order dated June 27, 2002 pursuant to Section 21(a)(1) of the 1934 Act (File No. 4-460), (y) Rule 13a-14 or 15d-14 under the 1934 Act or (z) 18 U.S.C. §1350 (Section 906 of SOX) with respect to any report referred to in clause (i) or (iii) above,** (v) all other forms, reports, registration statements and other documents (other than preliminary materials if the corresponding definitive materials have been provided to Parent pursuant to this Section **____** filed by the Company with the SEC since the beginning of the first fiscal year referred to in clause (i) above (the forms, reports, registration statements and other documents referred to in clauses (i), (ii), (iii), (iv) and (v) above are, collectively, the *"Company SEC Reports"* and, to the extent available in full without redaction on the SEC's web site through EDGAR two days prior to the date of this Agreement, are, collectively, the *"Filed Company SEC Reports"*), **and (vi) all comment letters received by the Company from the Staff of the SEC since __________ and all responses to such comment letters by or on behalf of the Company**. The Company SEC Reports (x) were or will be prepared in accordance with the requirements of the 1933 Act and the 1934 Act, as the case may be, and the rules and regulations thereunder and (y) did not at the time they were filed with the SEC, or will not at the time they are filed with the SEC, contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. No Subsidiary of the Company is or has been required to file any form, report, registration statement or other document with the SEC. **The Company maintains disclosure controls and procedures required by Rule 13a-15 or 15d-15 under the 1934 Act; such controls and procedures are effective to ensure that all material information concerning the Company and its subsidiaries is made known on a timely basis to the individuals responsible for the preparation of the Company's filings with the SEC and other public disclosure documents. Part ____ of the Company Disclosure Schedule lists, and the Company has delivered to Parent copies of, all written descriptions of, and all policies, manuals and other documents promulgating, such disclosure controls and procedures. To the Company's knowledge, each director and executive officer of the Company has filed with the SEC on a timely basis all statements required by Section 16(a) of the 1934 Act and the rules and regulations thereunder since __________. As used in this Section ____, the term "file" shall be broadly construed to include any manner in**

which a document or information is furnished, supplied otherwise made available to the SEC.

Reports and Financial Statements – Certifications. **The Chief Executive Officer and the Chief Financial Officer of the Company have signed, and the Company has furnished to the SEC, all certifications required by SOX Section 906**; such certifications contain no qualifications or exceptions to the matters certified therein and have not been modified or withdrawn; and neither the Company nor any of its officers has received notice from any Governmental Entity questioning or challenging the accuracy, completeness, form or manner of filing or submission of such certifications.

Loans to Executives and Directors. The Company has not, since July 30, 2002, extended or maintained credit, arranged for the extension of credit, or renewed an extension of credit, in the form of a **personal loan to or for any director or executive officer** (or equivalent thereof) of the Company. Part ____ of the Company **Disclosure Schedule identifies any loan or extension of credit maintained by the Company to which the second sentence of Section 13(k)(1) of the 1934 Act applies**.

Legal Proceedings and Compliance with Laws. The Company is, or will timely be in all material respects, in compliance with all current and proposed listing and corporate governance requirements of the [New York] Stock Exchange, and is in compliance in all material respects, and will continue to remain in compliance following the Effective Time, with all rules, regulations and **requirements of SOX or the SEC**.

Each of the Company, its directors and its senior financial officers has consulted with the Company's independent auditors and with the Company's outside counsel with respect to, and (to the extent applicable to the Company) is familiar in all material respects with all of the requirements of, SOX. The Company is in compliance with the provisions of SOX applicable to it as of the date hereof and has implemented such programs and has taken reasonable steps, upon the advice of the Company's independent auditors and outside counsel, respectively, to ensure the Company's future compliance (not later than the relevant statutory and regulatory deadlines therefore) with all provisions of SOX which shall become applicable to the Company after the date hereof.

Covenant Regarding Scope of Due Diligence. Between the date of this Agreement and the Closing Date, the Company shall permit Buyer's senior officers to meet with the officers of the Company responsible for the Financial Statements, the internal controls of the Company and the disclosure controls and procedures of the Company to discuss such matters as Buyer may deem reasonably necessary or appropriate for Buyer to **satisfy its obligations under Sections 302 and 906 of SOX** and any rules and regulations relating thereto.

XIII.
CONCLUSION

SOX and the SEC's rules thereunder are having a significant impact on how issuers, both public and private, are governed and manage their disclosure processes. They are also having profound effects on the accountants, attorneys and other M&A professionals who deal with issuers, and their communications with each other.

JACKSON WALKER L.L.P.
ATTORNEYS & COUNSELORS

DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT
CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION MATTERS
CHART SUMMARY

Corporate Governance	Governmental Action Required	Description	Comments
Proxy access (Section 971)	SEC adopted Release No. 34-62764	Companies must include eligible director nominees by eligible shareholders in the company's proxy materials. • Eligible shareholders must own at least 3% of total voting power entitled to elect directors and must have held the shares for at least 3 years. • The nominee's candidacy and board membership must not violate applicable law or stock exchange rules, and the nominee must meet the stock exchange's independence requirements. The nominee need not be independent from the nominating shareholder. • The maximum number of nominees that can be included is 25% of the company's board (rounded down), but no less than one (regardless of whether there is a classified board). Priority of nominations is given to shareholders with the highest percentage of voting securities. • A nominating shareholder must file a Schedule 14N with the SEC no earlier than 150 days and no later than 120 days before the anniversary of the mailing date for the prior year's proxy statement. The Schedule 14N contains information about the nominating shareholder and the nominee(s). Shareholders may also require companies to include in proxy materials shareholder proposals to amend the company's governing documents regarding director nomination procedures and disclosures. Thus, if approved, a shareholder proposal could expand proxy access (but could not limit the new proxy access rules).	• Proxy access is effective for the 2011 proxy season.* Proxy access will be effective for smaller reporting companies in the 2014 proxy season. • Eligible shareholders must hold both investment power and voting power of the applicable shares. Eligible shareholders cannot hold the shares for the purpose of changing control of the company or gaining more board seats than permitted under the proxy access rules. • Shareholders may aggregate their holdings with other shareholders to meet the eligibility requirements. • If the company decides to include a nominee in its proxy materials, it must notify the nominating shareholder at least 30 days before filing the definitive proxy statement with the SEC. • If the company seeks to exclude a nominee, it must provide notice to the nominating shareholder no later than 14 days after the deadline for submitting nominations to the company. The nominating shareholder then has 14 days after receiving such notice to respond and/or correct any deficiencies. If the company continues to believe it can exclude the nominee, the company must provide notice to the SEC no later than 80 days before filing the definitive proxy statement. • Action Items: (1) Assess shareholder base (2) Evaluate shareholder engagement (3) Review bylaws and board committee charters to determine if changes need to be made (4) Assess board size and makeup

* The SEC has stayed the effectiveness of the proxy access rule pending resolution of a lawsuit filed in federal court challenging the legality of the proxy access rule. It is unclear whether the legal issues will be resolved before the 2011 proxy season. As a result, the proxy access rule might not be effective for the 2011 proxy season.

Corporate Governance	Governmental Action Required	Description	Comments
Chairman/CEO disclosures (Section 972)	SEC to establish rules by January 17, 2011	• Requires the SEC to adopt rules requiring proxy statement disclosure of whether the Chairman and CEO are the same person and why or why not.	• Similar disclosure is already required by SEC rules
Broker discretionary voting authority (Section 957)	• SEC to establish rules • No deadline	• Brokers prohibited from exercising discretionary authority with respect to director elections, executive compensation or any other significant matter as determined by the SEC.	• Prohibition with respect to director elections and executive compensation take effect immediately. Other significant matters will be determined by the SEC. • The NYSE already prohibits its member firms from exercising discretionary authority with respect to director elections and approval of equity compensation plans (or material amendments thereto).

Executive Compensation	Governmental Action Required	Description	Comments
Say-on-pay votes – annual meetings (Section 951)	None specified	• Two votes are required for the first annual or other shareholder meeting occurring on or after 6 months after the date of enactment (i.e., required for the 2011 proxy season): (1) vote to approve compensation of executive officers as disclosed in the proxy statement (2) vote on whether future shareholder votes on executive compensation should take place every one, two, or three years • Companies must hold a shareholder vote on the frequency of say-on-pay votes (i.e., whether such votes should occur every one, two, or three years) at least once every six years.	• Votes are non-binding. • SEC may clarify that these votes do not require the filing of a preliminary proxy statement. • Action items: (1) Consider providing an overview in the CD&A to summarize key compensation actions taken during the year. (2) Consider making CD&A clearer (including use of graphics) and focusing more on analysis
Say-on-pay votes - golden parachutes (Section 951)	None specified	• Vote required for the first shareholder meeting occurring on or after 6 months after the date of enactment (i.e., required for the 2011 proxy season) at which shareholders are being asked to approve an acquisition, merger, consolidation or sale of all or substantially all the company's assets. • The company must disclose, and have the shareholders vote to approve, agreements that	• Vote is non-binding. • Vote must be a separate vote from the transaction itself. • Vote not required if the agreements were already subject to an annual meeting vote (regardless of the outcome of such vote).

Executive Compensation	Governmental Action Required	Description	Comments
		the company or other party to the transaction has with any of the company's named executive officers concerning any compensation that relates to the transaction and the aggregate total of such compensation.	
Executive officer pay-versus-performance disclosure (Section 953(a))	• SEC to establish rules • No deadline	• SEC must establish rules that require proxy statement disclosure that shows the relationship between executive compensation actually paid and the financial performance of the company.	• The company's financial performance may take into account any change in the value of company shares and any dividends paid. • The disclosure may be in graphical or narrative form
CEO pay equity disclosure (Section 953(b))	• SEC to amend executive compensation disclosure rules • No deadline	• SEC must establish rules that require proxy statement disclosure of: (1) median of annual total compensation of all company employees other than the CEO; (2) annual total compensation of the CEO; and (3) the ratio of the two amounts.	• Total compensation of employees to be calculated in same manner as that for named executive officers under Item 402(c)(2)(x) of Regulation S-K. • Action items: (1) Ensure procedures are in place to calculate total compensation of employees in accordance with Item 402(c)(2)(x) of Regulation S-K.
Executive compensation clawbacks (Section 954)	• SEC to establish rules to direct national securities exchanges to develop listing standards • No deadline	• SEC must establish rules directing national securities exchanges to require listed companies to implement an executive compensation clawback policy. • Clawback policy must provide that if a company is required to restate its financial statements due to material noncompliance with any financial reporting requirement under securities laws, the company will recover from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period before the restatement an amount equal to the incentive-based compensation actually paid less what would have been paid under the restated financial statements.	• No misconduct required. • Clawback policies would be disclosed in the proxy statement. • Section 304 of Sarbanes-Oxley Act (SOX) provided for a more limited clawback against CEOs and CFOs only in cases of misconduct and for compensation received for the year following reinstatement. • Action items: (1) Design and implement a clawback policy that complies with the Act and exchange rules.
Disclosures regarding hedging by employees or directors (Section 955)	• SEC to establish rules • No deadline	• SEC must establish rules that require proxy statement disclosure as to whether company employees or directors are permitted to hedge any decrease in the market value of company equity securities.	• Item 403 of Regulation S-K requires disclosure of pledges of company securities by executive officers and directors. • Action items: (1) Review insider trading policies to determine whether such hedging transactions are prohibited for directors and all employees.

Executive Compensation	Governmental Action Required	Description	Comments
			If not, consider revising insider trading policy to: (i) prohibit all such hedging transactions; (ii) require pre-approval for hedging transactions; or (iii) otherwise restrict hedging transactions.
Disclosure of say-on-pay votes by institutional investment managers (Section 951)	• SEC to establish rules • No deadline	• Institutional investment managers that file Form 13F (i.e., exercise investment discretion over $100MM or more of U.S. public company equity or certain other securities) must disclose at least annually how they voted on say-on-pay votes.	• Applies to both annual meeting and golden parachute say-on-pay votes.

Compensation Committees	Governmental Action Required	Description	Comments
Independence (Section 952(a))	• SEC to establish rules within 360 days after enactment	• SEC must establish rules directing national securities exchanges to require that listed company compensation committee members be "independent." • In determining "independence," the national securities exchanges must consider: (1) source of compensation of a member, including any consulting, advisory, or other compensatory fee paid by the company (2) whether the member is affiliated with the company.	• Language is similar to language used in Rule 10A-3(b) regarding independence of Audit Committee members. • Should apply only to listed companies, not OTCBB or pink sheet companies. • Action items: (1) Evaluate the independence of current compensation committee members to determine whether any changes should be made to the composition of the committee membership.
Independence of advisors (Section 952(a))	• SEC to determine independence factors. • No deadline.	• Compensation committees of listed companies must take into consideration independence factors determined by the SEC when selecting a compensation consultant, legal counsel or other advisors. • SEC to determine the independence factors, which must include: (1) the provision of other services to the company by the advisor; (2) the amount of fees paid by the company as a percentage of total revenue of the	• Factors are to be "considered;" factors are not prohibitions. • Action items: (1) Consider the independence of current advisors to the compensation committee. (2) Review company policies to address conflicts of interests with compensation consultants, legal counsel, and other advisors.

Compensation Committees	Governmental Action Required	Description	Comments
		advisor; (3) the policies and procedures of the advisor that are designed to prevent conflicts of interest; (4) any business or personal relationship of the advisor with a member of the compensation committee; (5) any stock of the company owned by the advisor.	
Authority (Section 952(a))	None specified	• Listed company compensation committees must have authority to retain compensation consultants, independent legal counsel and other advisors. The committees are directly responsible for the appointment, compensation and oversight of the work of such advisors. • Companies must provide appropriate funding for the compensation committees to pay the reasonable fees of such advisors.	• This provision does not: (1) require the compensation committee to implement the recommendations of the advisors; (2) affect the ability of the compensation committee to exercise its own judgment.
Disclosure (Section 952(a))	• SEC to establish rules • No deadline	• For annual shareholder meetings occurring on or after July 21, 2011, proxy statements must disclose: (1) whether the compensation committee retained or received advice from a compensation consultant; (2) whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it was addressed.	• Item 407(e)(3)(iii) of Regulation S-K requires disclosure of fees paid to compensation consultants in certain circumstances.

Other Securities Act and Exchange Act Reforms	Governmental Action Required	Description	Comments
Regulation FD – Credit rating agencies (Section 939B)	SEC adopted Release No. 34-63003	• SEC amended Regulation FD to eliminate the exception for disclosures to credit rating agencies.	• Credit rating agencies are now required to publicly disclose their rating methodology and the company data relied upon in determining the ratings. As a result, it is unclear whether entering into a confidentiality agreement with the rating agency would allow the company to qualify for the confidentiality agreement exception.
Beneficial ownership	SEC may issue rules	• The SEC may establish rules to shorten the 10-	

Other Securities Act and Exchange Act Reforms	Governmental Action Required	Description	Comments
reporting (Section 929R)		day period for filing an initial Schedule 13D and Form 3.	
Beneficial ownership definition (Section 766(b))	SEC may issue rules	• Owners of security-based swaps (to be defined by the SEC) may be deemed owners of underlying equity securities to the extent that the swaps provide incidents of ownership comparable to direct ownership of the equity security.	
Regulation D amendments-Rule 506 (Section 926)	SEC to establish rules within one year	• SEC must establish rules that prohibit "bad actors" from relying on Rule 506 to exempt offerings. • "Bad actors" include any person: (1) barred by a state securities, banking or insurance authority or federal banking authority from engaging in the business of securities, insurance or banking or associating with an entity regulated by such authority; or (2) convicted of a felony or misdemeanor in connection with purchase or sale of securities or making a false filing with the SEC.	

Other Securities Act and Exchange Act Reforms	Governmental Action Required	Description	Comments
Regulation D amendments-Accredited investors (Section 413(a))	• SEC to establish rules • No deadline	• In determining whether an individual is an "accredited investor," the calculation of the net worth of the individual must exclude the value of his or her primary residence.	• This change is effective immediately. • The mortgage indebtedness secured by the primary residence should also be excluded from the net worth calculation, except to the extent the indebtedness exceeds the value of the primary residence. • SEC must review the definition of "accredited investor" as it applies to individuals at least once every four years. • Action items: (1) Update accredited investor questionnaires and other private placement documents where appropriate to reflect this change in determining accredited investor status. (2) If the company is in the process of conducting a private placement, it should obtain supplements to already-completed accredited investor questionnaires and other private placement documents to ensure subscribers continue to be accredited investors under the revised standards.
Smaller public company exemption from Sarbanes-Oxley internal control audit requirements (Section 989G(a))	• SEC to study the effects of Section 404(b) of SOX on mid-size companies ($75MM - $250MM market cap) • SEC adopted Release No. 34-62914	• Companies that are not large-accelerated filers or accelerated filers are exempt from Section 404(b) requirements for an external audit of internal controls. • The SEC must report the results of its study to Congress no later than 9 months after the date of enactment.	
Whistleblower protection (Section 922)	SEC to establish rules within 270 days	• In any enforcement action relating to a violation of securities laws that results in monetary sanctions in excess of $1MM, the SEC must pay the whistleblower(s) between 10% and 30% of the collected amount. • The Act provides whistleblowers a private right of action for retaliation or discrimination because of a lawful act by the whistleblower. The private right of action includes reinstatement, 2x back pay, and reimbursement for litigation costs.	

APPENDIX B

ATTORNEY-CLIENT PRIVILEGE AND THE WORK PRODUCT DOCTRINE IN THE CORPORATE CONTEXT

Introduction. Our system of jurisprudence is designed to facilitate resolving lawsuits based on what the facts reveal, not by what lawyers conceal. So that the real facts may be made known to all parties, the parties are permitted discovery from their opponents before trial begins. Each party may be called upon by his adversary or the court to, in effect, lay his cards on the table so that the dispute may be resolved on the basis of what all the cards show, rather than on the relative skill of the players. This philosophy is intended to level the tables between institutional litigants, perceived to have greater resources, and the individuals against whom they are often aligned. Countervailing considerations in the interests of fairness have produced a few limited exceptions to this policy of openness.

Attorney-Client Privilege.

Overview. The attorney-client privilege is the oldest recognized privilege against discovery known to the common law. It traces its roots back to the reign of Elizabeth I in the 16th century[1] during the days when a lawyer's honor as a gentleman was paramount.[2] The policy behind recognition of the privilege was most simply expressed by the United States Supreme Court in *Upjohn Co. v. United States*,[3] where the Court characterized the purpose of the privilege as being "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[4] A more eloquent justification is found in the comment to Rule 210 of the American Law Institute's *Model Code of Evidence*:

> In a society as complicated in structure as ours and governed by laws as complex and detailed as those imposed upon us, expert legal advice is essential. To the furnishing of such advice the fullest freedom and honesty of communication of pertinent facts is a prerequisite. To induce clients to make such communications, the privilege to prevent their later disclosure is said by courts and commentators to be a necessity. The social good derived from the proper performance of the functions of lawyers acting for their clients is believed to outweigh the harm that may come from the suppression of the evidence in specific cases.[5]

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1 *See Kelway v. Kelway*, 21 Eng. Rep. 47 (Ch. 1580).

2 Because divulging confidences entrusted to him would do him dishonor, it was the attorney, not the client who could exercise the privilege. The privilege now is considered to belong to the client, and not the lawyer. *See Apex Mun. Fund v. N-Group Securities*, 841 F. Supp. 1423 (S.D. Tex. 1993).

3 449 U.S. 383 (1981).

4 *Id*. at 389.

5 A.L.I. MODEL CODE OF EVID. R. 210, cmt (*quoted in* United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358 (D. Mass. 1950)).

Unfortunately, one of the complex and detailed laws referred to in the aforementioned comment turns out to be the attorney-client privilege itself. There are numerous requirements for the privilege to be applicable, and judicial interpretations differ from jurisdiction to jurisdiction and even from judge to judge.[6]

The attorney-client privilege protects communications of legal advice made (and kept) between attorneys and clients, including communications between corporate employees and a corporation's attorneys to promote the flow of information between clients and their attorneys.[7] Although the attorney-client privilege does not require ongoing or threatened litigation, it covers only "communications" between the lawyer and his client for the purposes of legal assistance.[8]

The core requirement of the attorney-client privilege is that the confidentiality of the privileged information be maintained. Therefore, the privilege is typically waived when the privilege holder discloses the protected information to a third party. A waiver of attorney-client privilege destroys the attorney-client privilege with respect to all future opposing parties and for the entire subject matter of the item disclosed.

Further, the attorney-client privilege does not protect all things that pass back and forth between attorneys and their clients under all circumstances. A number of the requirements and limitations of the attorney-client privilege are discussed in the subsections which follow.

Derivative Actions. There is an issue as to whether a shareholder or a partner may compel disclosure of matters protected by the attorney-client privilege on the theory that he is the "client" or at least a "representative of the client." The leading shareholder case on this issue is *Garner v. Wolfinbarger*.[9] In that case, the Fifth Circuit concluded that a shareholder maintaining a derivative action may have access to matters protected by the attorney-client privileged if he can show "good cause." The court set forth the circumstances by which good cause is to be judged, which include such factors as, the number of shareholders involved, the percentage of ownership they represent, the nature of the claim being made and the allegations made against the corporate officers, and similar concerns.[10] The *Garner* doctrine has been followed by some

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6 "So that lawyers and clients will know in advance what communications will and will not be protected, and can conform their conduct accordingly, courts have endeavored to draw the lines with some clarity. Of course, it is impossible to achieve absolute certainty. At the margins, the application of the privilege is not always clear, and indeed, treatises can and have been written on the privilege, its exceptions, its intricacies, and its areas of ambiguity. Further uncertainty results from the fact that the relevant case decisions (and, in some states, statutes) differ from jurisdiction to jurisdiction. With respect to federal proceedings, Congress has not codified the attorney-client privilege but has authorized ongoing common law development of this and other privileges. Pursuant to its authority under the Federal Rules of Evidence, the Supreme Court of the United States has consistently recognized and upheld the privilege. But the Supreme Court has resolved only a limited number of questions concerning the boundaries of the privilege, and on the remaining questions, different districts and circuits – and even different judges within a given federal district – may take different approaches." *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1033 (May 2005).

7 *Upjohn*, 449 U.S. at 389–391.

8 *Id.*

9 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971).

10 *Id.* at 1103-04.

courts,[11] but has been rejected as unnecessary by other courts, especially in light of the other exceptions to the attorney-client privilege, most notably the crime/fraud exception.[12] Further, the Garner exception is only applicable to the attorney-client privilege and will not result in discovery if the item is also protected by the work product doctrine.[13] In the partnership context, the courts have consistently held that the attorney-client privilege may not be used to deny a partner the right to inspect partnership records.[14]

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11 *In re Fuqua Industries, Inc. Shareholders Litigation*, Civ. Act. No. 11974, 2002 Del. Ch. LEXIS 52 at *12 (Del. Ch. May 2, 2002) (outlining that in the context of a derivative claim arising out of the Fuqua directors' decision to except its principal shareholder from DGCL § 203 (which restricts certain transactions with a 15% shareholder) and to authorize the repurchase of Fuqua shares allegedly for the purpose of enhancing the principal shareholder's control without paying a change in control premium and entrenching the directors, Chancellor Chandler wrote *Garner* requires "mutuality of interest between the parties" at the time of the disputed communication; "because the director is obligated to act in the best interests of the corporation and its shareholders, there is a mutuality of interest among the director, the corporation and the shareholders when such legal advice is sought . . . upon a showing of good cause, the attorney-client privilege does not attach to prevent a plaintiff-shareholder – for whose ultimate benefit that advice was sought – from discovering the contents of the communication . . . when the interests of the fiduciary diverge, however, there is no longer a mutuality of interest and a *Garner* analysis is not appropriate . . . that divergence must necessarily occur when the parties can reasonably anticipate litigation over a particular action"; "there is no *Garner* exception to the work product privilege"); *Deutsch v. Cogan*, 580 A.2d 100, 108 (Del. Ch. 1990) ("A fiduciary owes an obligation to his beneficiaries to go about his duties without obscuring reasons from the legitimate inquiries of the beneficiaries"); *cf. Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985).

12 *See, e.g., Shirvani v. Capital Investing Corp.*, 112 F.R.D. 389, 390 (D. Conn. 1986).

13 *Saito v. McKesson HBOC, Inc*., 2002 Del. Ch. LEXIS 125 at 11 (Del. Ch. October 25, 2002); *In re Fuqua Indus. Shareholders Litig.,* 2002 Del. Ch. LEXIS 52 at 20 (Del. Ch. May 2, 2002).

14 The courts that have considered the question whether a general partner may shield documents from its limited partner have consistently held that it cannot. *See Roberts v. Heim*, 123 F.R.D. 614, 625 (N.D. Cal. 1988) (limited partners of a partnership sued the partnership's general partners and its law firm to compel production of certain documents the defendants claimed were privileged; rejecting the defendant's argument that, for purposes of the attorney-client privilege, the law firm's clients were the general partners, the court held that the limited partners were clients of the law firm and were entitled to inspect all of the partnership's records, <u>including</u> the documents generated by and sent to the partnership's attorneys); *McCain v. Phoenix Resources, Inc.*, 230 Cal. Rptr. 25, 26-28 (Cal. Ct. App. 1986) (court concluded that "a limited partner has the right to inspect all documents and papers affecting the partnership, including those held by the partnership's attorney;" while recognizing that the attorney-client privilege could be asserted as to records relating to the "purely private or personal interest" of one of the partners, the court held the privilege would not bar disclosure of matters related to a partnership business "simply because such business was conducted through a law firm"); *Wortham & Van Liew v. Superior Court*, 233 Cal. Rptr. 725, 728 (Cal. Ct. App. 1987) (the court framed the issue as whether "the attorney for the partnership [could] withhold from a partner important information received from another partner concerning partnership transactions claiming the information is confidential under the attorney-client privilege," held that "[a]ll partners are entitled to access to a wide range of partnership information, whether or not that information is generated under the aegis of the partnership's attorney," and ordered the attorney to "divulge <u>all</u> partnership information to <u>all</u> partners"); *Abbott v. The Equity Group*, 1988 WL 86826 (E.D. La. 1988) ("We begin by stating that a member of a partnership is entitled to disclosure of communications to and from an attorney representing the partnership in connection with partnership matters. Because of the relationship existing between partners in the creation of a partnership, which we view as stronger than that existing between stockholder and corporation, we conclude that the bar preventing disclosure of attorney communications, as between partners, is not simply relaxed, but non-existent. Partners therefore need not establish "cause" to discover privileged communications of an attorney in matters in which the partnership, of which they are

Legal Advice Purpose. At the heart of the attorney-client privilege is the notion that communications are privileged in order to facilitate the delivery of legal advice. The privilege necessarily has encompassed communications that actually constitute legal advice as well as communications made for the purpose of seeking, obtaining or facilitating the rendition of legal advice. But the privilege does not protect all communications to or from an attorney,[15] and does not prevent disclosure of the underlying facts.[16] Accordingly, sending copies of documents to an attorney or including an attorney in a meeting will not automatically trigger the privilege.[17] It is only where the attorney is acting in his capacity as an attorney, that is, as a legal adviser, that the privilege is applicable.[18]

In many circumstances, especially for inside counsel, the determination of whether an attorney is acting in his capacity as a legal adviser, or in some other role, will be difficult.[19] The

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members, is the client"); *Adell v. Somers, Schwartz, Silver & Schwartz, P.C.*, 428 N.W.2d 26, 29 (Mich. App. 1988) (limited partner is "client" of partnership's law firm and has standing to assert malpractice claim against attorney); *Ronson v. Superior Court*, 29 Cal. Rptr. 2d 268, 280 (Cal. Ct. App. 1994) (because of mere "potential presence of implied attorney-client duties," limited partner is entitled to production of documents concerning partnership business over privilege objection); *but see Continental Ins. Co. v. Rutledge & Co., Inc.*, 1999 WL 66528 (not reported in A.2nd) (Del. Ch. Jan. 26, 1999) (in dispute between general and limited partners over whether limited partners had right to withdraw from partnership pursuant to partnership agreement, limited partners sought to compel production by general partner of documents containing legal advice regarding the formation and internal affairs of the partnership; the Delaware Chancery Court found an absence of Delaware precedent and followed the Fifth Circuit's corporate derivative action holding in *Garner v. Wolfinbarger* that allowed production upon a showing of "good cause" and the existence of a mutuality of interest between the parties; the required mutuality of interest was found lacking as to advice in connection with the formation of the partnership and after a dispute had arisen between the parties over the withdrawal issue that was the subject of the litigation).

15 *See Thacker v. State*, 852 S.W.2d 77 (Tex. App. — Austin 1993, writ denied).

16 *Upjohn Co. v. United States*, 449 U.S. 383, 396 (1981) (client cannot "refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication to his attorney"); *In re Six Grand Jury Witnesses*, 979 F.2d 939, 944 (2nd Cir. 1992) (communications between attorney and client regarding internal investigation into alleged fraud against government held privileged, but factual information contained in written communications between them, including results of investigation, were not privileged from discovery).

17 *See, e.g., U.S. Postal Serv. v. Phelps Dodge Ref. Corp.*, 852 F. Supp. 156, 163-64 (E.D.N.Y. 1994) (stating that "[a] corporation cannot be permitted to insulate its files from discovery simply by sending a 'cc' to in-house counsel"); *International Tel. & Tel. Corp. v. United Tel. Co. of Fla.*, 60 F.R.D. 177, 185 (M.D. Fla. 1973) (finding that "the mere attendance of an attorney at a meeting, even where the meeting is held at the attorney's instance, does not render everything done or said at that meeting privileged").

18 *See U.S. v. Ackert*, 169 F.3d 136 (2nd Cir. 1999) (attorney functioning as investment banker for Goldman Sachs & Co. provided information as to tax implications of a proposed transaction to tax counsel for Paramount; recognizing that attorney-client privilege applies only to communications between an attorney and his client, court held that the attorney at Goldman Sachs was not functioning as an attorney and that the attorney-client privilege was not applicable even though the communication did assist Paramount's attorney in representing his client); *Teltron, Inc. v. Alexander*, 132 F.R.D. 394 (E.D. Pa. 1990).

19 *See* Todd Presnell, *A Higher Standard: Claiming Attorney-Client Privilege is Tougher for In-House Counsel,* 14 Bus. L. Today No. 5 (May/June 2005) at 19; Derek Lisk, *When Does the Texas Attorney-Client Privilege Protect Communications With In-House Counsel?*, 68 TEX. BUS. J. 368 (May 2005).

difficulty may be increased when the attorney (whether inside or outside counsel) also serves as an officer[20] or director[21] of the corporation, because business advice is not privileged.

No bright-line tests have been developed for determining whether the attorney is acting as a legal advisor.[22] Most courts have stated that, for a communication to be privileged, the

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[20] *See Desert Orchid Partners LLC v. Transaction System Architects, Inc.*, 2006 WL 1401683 (D. Neb. May 17, 2006) (redacted portion of audit committee minutes held privileged based on attorney's affidavit that the redacted portion related to matters on which the audit committee "sought legal advice, which he gave regarding the proper course of action to take about . . . audit committee activities" even though he was secretary and unredacted portions of the minutes related to unprivileged discussions of business transactions).

[21] ABA Formal Opinion 98 410 (February 1998) holds that a lawyer may serve as a director of client-business entities provided the following precautions are taken:

> The Committee acknowledges that lawyers will continue to be asked and many will accept engagements as directors of client business entities and that it is not unethical for them to do so. It nevertheless is essential that lawyer-directors and their clients continue to be sensitive to the issues discussed in this opinion.
>
> Though a lawyer serving in the dual role of corporate counsel and director is not subject to discipline absent a violation of a specific Rule, the following suggestions . . . should help to avoid a disciplinary infraction. The lawyer-director should:
>
> 1. Reasonably assure that management and the board of directors understand (i) the different responsibilities of legal counsel and director; (ii) that when acting as legal counsel, the lawyer represents only the corporate entity and not its individual officers and directors; and (iii) that at times conflicts of interest may arise under the rules governing lawyers' conduct that may cause the lawyer to recuse herself as a director or to recommend engaging other independent counsel to represent the corporation in the matter, or to serve as co-counsel with the lawyer or her firm.
>
> 2. Reasonably assure that management and the board of directors understand that, depending upon the applicable law, the attorney-client evidentiary privilege may not extend to matters discussed at board meetings when the lawyer-director is not acting in her corporate counsel role and when other lawyers representing the corporation are not present in order to provide legal advice on the matters.
>
> 3. Recuse herself as a director from board and committee deliberations when the relationship of the corporation with the lawyer or her firm is under consideration, such as issues of engagement, performance, payment or discharge.
>
> 4. Maintain in practice the independent professional judgment required of a competent lawyer, recommending against a course of action that is illegal or likely to harm the corporation even when favored by management or other directors.
>
> 5. Perform diligently the duties of counsel once a decision is made by the board or management, even if, as a director, the lawyer disagrees with the decision, unless the representation would assist in fraudulent or criminal conduct, self-dealing or otherwise would violate the Model Rules.
>
> 6. Decline any representation as counsel when the lawyer's interest as a director conflicts with her responsibilities of competent and diligent representation, for example, when the lawyer is so concerned over her personal liability as a director resulting from the course approved by management or the board that her representation of the corporation in the matter would be materially and adversely affected.

ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 98-410 (1998). *See* Micalyn S. Harris and Karen L. Valihura, *Outside Counsel as Director: The Pros and Potential Pitfalls of Dual Service*, 53 BUS. LAW. 479, 483–89 (Feb. 1998).

[22] In *In re Texas Farmers Insurance Exchange*, 990 S.W.2d 337 (Tex. Civ. App. - Texarkana Feb. 18, 1999, no pet.), the Texarkana Court of Appeals held that communications between an insurance company and an attorney conducting for it a routine investigation of a fire of suspicious origin to determine whether a claim

lawyer must be acting "primarily" or "predominantly" as a lawyer,[23] although business advice may be intermingled with the legal advice and still be privileged.[24] One court defined "primarily legal" as requiring a showing that the communication "would not have been made but for the corporation's need for legal advice or services."[25] Another court has stated that the "critical inquiry is whether, viewing the lawyer's communication in its full content and context, it was made in order to render legal advice or services to the client."[26] By contrast, another court has held that legal advice may not be privileged if it is only incidental to business advice.[27]

Attorneys and clients recognize that statements made by an attorney to his client's adversary in a negotiation are not privileged, but would expect that private communications between attorney and client in respect of the negotiation would be privileged. Many courts, however, have held that a lawyer conducting negotiations is not acting in a legal capacity and his communications and advice to his client, therefore, are not privileged.[28] Undoubtedly, the notion that a negotiating lawyer is not acting in a legal capacity is surprising and alarming to all lawyers, not just to corporate counsel. The courts that have so held generally base their decision on the idea that the negotiation involves business judgment, not legal judgment. Fortunately, some courts have been more painstaking in their analysis and have concluded that the negotiation did, in fact, involve a preponderance of legally significant issues, and therefore, was a privileged act.[29] This idea is often referred to as "predominant purpose" test.[30] Unfortunately, there are no bright line rules to identify the precise degree of legal advice necessary to satisfy the predominant purpose test.

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should be paid were not privileged because the attorney was not functioning as such at the time of the communications and the communications concerned bare facts, but that the privilege would apply to communications with the attorney concerning legal strategy, assessments and conclusions.

23 *See, e.g., Sedco Int'l. S.A. v. Cory*, 683 F.2d 1201, 1205 (8th Cir.), *cert. denied*, 459 U.S. 1017 (1982) ("primarily"); *Arcuri v. Trump Taj Mahal Assoc.*, 154 F.R.D. 97, 102 (D.N.J. 1994) ("primarily"); *Zenith Radio Corp. v. Radio Corp. of Am.*, 121 F. Supp. 792, 794 (D. Del. 1954) ("predominantly").

24 *See Pittsburgh Corning Corp. v. Caldwell*, 861 S.W.2d 423 (Tex. App. — Houston [14th Dist.] 1993, no writ) (holding that the court was without authority to order privileged legal advice, opinions, or mental analysis in documents redacted and remainder produced).

25 *Leonen v. Johns-Manville*, 135 F.R.D. 94, 99 (D.N.J. 1990).

26 *Spectrum Sys. Int'l Corp. v. Chemical Bank*, 581 N.E.2d 1055, 1061 (N.Y. 1991).

27 *United States v. IBM*, 66 F.R.D. 206, 210 (S.D.N.Y. 1974).

28 *See, e.g., United States v. Wilson*, 798 F.2d 509 (1st Cir. 1986); *Georgia-Pacific Corp. v. GAF Roofing Mfg. Corp.* 1996 WL 29392 (S.D.N.Y. 1996); *J.P. Foley & Co. v. Vanderbilt*, 65 F.R.D. 523 (S.D.N.Y. 1974).

29 In *Note Funding Corp. v. Bobian Investment Co.*, No. 93 CIV. 7427 (DAB), 1995 WL 662402 (S.D.N.Y. Nov. 9, 1995), the court reasoned that "[i]f the attorney's advice is sought, at least in part, because of his legal expertise and the advice rests "predominantly" on his assessment of the requirements imposed, or the opportunities offered, by applicable rules of law, he is performing the function of a lawyer."

30 *See*, *e.g. McCormick, Barstow, Shepheer, Wayte & Carruth v. Superior Court*, Cal. Court. App. 5th Dist. No. F029503 (1998) (internal memos prepared by law firm in anticipation of becoming a defendant in a malpractice case held not privileged).

Internal Investigations. Most courts agree in principle that an investigation conducted by counsel for the purpose of rendering legal advice is privileged.[31] Generally speaking, though, the fact that a lawyer is involved in an investigation does not, standing alone, render the privilege applicable.[32] However, determining whether an investigation is conducted for that purpose, or some other, can be difficult.

There are a number of cases involving the application of the attorney-client privilege[33] to investigations conducted by counsel. In *Upjohn*, the privilege was held applicable when the investigation was conducted by "counsel for Upjohn acting as such, at the direction of corporate superiors in order to secure legal advice from counsel."[34] The Supreme Court quoted from the findings of the magistrate, who found:

> "[Counsel] consulted with the Chairman of the Board and outside counsel and thereafter conducted a factual investigation to determine the nature and extent of the questionable payments *and to be in a position to give legal advice to the company with respect to the payments*."[35]

By contrast, the court in *Mission National Insurance Co. v. Lilly*[36] found the results of an investigation conducted by outside counsel not privileged. There, the outside lawyers were hired by an insurance company "as a matter of course to conduct its claims adjustment investigations in a geographic area including Minnesota for all claims exceeding $25,000."[37] Thus, the court

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31 *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1036 (May 2005).

32 *See Seibu Corp. v. KPMG LLP*, 2002 U.S. Dist. LEXIS 906 at *9-10 (N.D. Tex. 2002) (the "critical inquiry is whether … any particular communication in connection with [the] investigation facilitated the rendition of legal advice to the client"); *Wells Fargo Bank v. Superior Court*, 22 Cal. 4th 201, 210 (2000) ("[A] client may be examined at deposition or at trial as to facts of the case, whether or not he has communicated them to his attorney").

33 Other privileges, more appropriate to rely upon, are often implicated, but are not discussed here. These might include the work product doctrine and the party communication privilege. There is no general "privilege of self-critical analysis" applicable to compliance manuals, internal audit findings, outside accountants' reports, management letters, and an outside accounting firm's review of internal controls and compliance. *See Dowling v. American Hawaii Cruises, Inc.*, 971 F.2d 423, 425-26 (9th Cir. 1992) (no protection for routine internal safety reviews prior to the accident); Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L.R. 1083 (1983). *But see In re Crazy Eddie Securities Litigation*, 792 F. Supp. 197, 205-06 (E.D.N.Y. 1992) (accounting firm's internal review of its audit, peer review report and letter of comments on internal quality controls protected). The Texas Legislature has recognized the value of critical self evaluation in certain areas when it adopted the Environmental, Health, and Safety Audit Privilege Act which appears at Tex. Rev. Civ. Stat. Ann. art. 4447cc (Vernon 2010); other states have similar statutes but the Environmental Protection Agency does not recognize the privilege. *See* Egan, *Miscellaneous Updates--"Ten Other Laws You Should Know About",* State Bar of Texas Professional Development Legislative Update Institute (Sept. 1995).

34 *Upjohn Co. v. United States*, 449 U.S. 383, 394 (1981).

35 *Id.* (emphasis in original).

36 112 F.R.D. 160 (D. Minn. 1986).

37 *Id.* at 162.

concluded that the lawyers were simply performing the business function of claims investigation, as opposed to any legal function.[38]

The touchstone of an investigation that constitutes an attorney-client privileged exercise seems to be the attorney's role as legal adviser. Where the investigation truly can be shown to have been conducted for the purpose of collecting the data necessary to render legal advice, then communications made during the investigation will be deemed privileged.[39] On the other hand, when a lawyer is used merely in the hope that the investigation will be privileged, most courts will not so find.[40] The safest practice is to document the reason for conducting the investigation, and include in all written communications some prefatory notation regarding the purpose for the communication along with the requirement that it be kept confidential.[41]

While an internal investigation conducted by counsel may be privileged, there are pressures by auditors to give them access to privileged materials developed during the investigation.[42] The materials sought by the auditors may include privileged materials such as the investigating counsel's notes of interviews, legal assessments and advice to the client, as well as factual information such as documents received and transcripts of interviews which may not be protected.[43] The auditors pressure may be attributed in part due to their obligations under 1934 Act § 10A[44] and the potential relevance to the issuer's internal controls.[45]

The U.S. Department of Justice (*"DOJ"*), the SEC and other federal and state governmental agencies are increasingly asking issuers under investigation to produce privileged materials, including materials developed in connection with internal investigations conducted by counsel, in order to show cooperation with the government in an effort to discourage prosecutorial or enforcement actions. This practice is supported by then Deputy Attorney General Larry Thompson's January 20, 2003 memorandum (the *"Thompson Memorandum"*) to

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38 *See also In re Texas Farmers Insurance Exchange*, 990 S.W.2d 337 (Tex. App. - Texarkana 1999, no pet.) (communications between insurance company and an attorney functioning as an investigator were not privileged because the attorney was not functioning as such at the time of the communications).

39 *See, e.g.*, *In re LTV Securities Lit.*, 89 F.R.D. 595 (N.D. Tex. 1981); *Spectrum Systems Int'l Corp. v. Chemical Bank*, 581 N.E.2d 1055 (N.Y. 1991).

40 *But see Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977), *rev'd on reh'g en banc*, 572 F.2d 596, 609 (8th Cir. 1978) (finding that use of an attorney is prima facie evidence of privilege).

41 For example: "This interview is conducted by counsel for XYZ, Inc. for the purpose of ascertaining facts needed in order to render legal advice to XYZ, Inc. This document is a confidential, attorney-client privileged communication; the contents of this document should not be disclosed other than to [insert names or titles]." In addition, inclusion of statements relevant to showing work product also might be helpful. *E.g.* "This document is prepared by counsel in anticipation of litigation for the purpose of facilitating the defense or prosecution of litigation."

42 Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006).

43 *Id*. at V.

44 *See supra* notes 17-22 and related text.

45 Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006) at 10.

the DOJ addressing the "Principles of Federal Prosecution of Business Organizations."[46] The Thompson Memorandum identified nine factors that federal prosecutors should utilize in making their charging decisions regarding corporations or other business entities, including the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, *including, if necessary the waiver of corporate attorney-client and work product protection.*

As a practical matter, corporations rarely can resist prosecutorial requests for disclosure, because of the harsh consequences of having to defend against criminal charges, and because, in cases where criminal charges are brought and sustained, corporations depend on the leniency in sentencing that results from providing assistance satisfactory to the prosecution, which was reinforced by the November 1, 2004 amendments to the Commentary for Chapter 8, Section 8C2.5 of the Guidelines, to qualify for a reduction in its sentence for providing assistance to the government investigation, a corporation would be required to waive confidentiality protections if "such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.[47]

The SEC and other regulators have adopted policies and practices mirroring those of the Thompson Memorandum, which while discussing "cooperation credit," mention disclosures of protected confidential information.[48]

Turning over privileged materials from an internal investigation may result in a waiver of the privilege,[49] at least for the materials furnished.[50]

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[46] Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003) (available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm). The Thompson Memorandum expanded and revised previous policies of the DOJ that were established in a memorandum drafted by former Deputy Attorney General Eric Holder. Memorandum from Deputy Attorney General Eric Holder to Head of Department Components and U.S. Attorneys, Bringing Criminal Charges Against Corporations (June 16, 1999), reprinted in *Justice Department Guidance on Prosecution of Corporations*, in 66 CRIM. L. REP. (BNA) 189 (1999) (available at http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html).

[47] U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2004) (emphasis added) (available at http://www.ussc.gov/2004guid/8c2_5.htm); Report to the ABA House of Delegates, ABA Task Force on the Attorney-Client Privilege (June 14, 2006) at 15.

[48] *Id.* at 16-17; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, 1934 Act Release No. 44969 (Oct. 23, 2001).

[49] *In re Qwest Communications International Inc. Securities Litigation*, 450 F.3d 1179 (10th Cir. 2006) (Qwest Communications International Inc.'s voluntary disclosure of sensitive documents to the DOJ and SEC waived the attorney-client privilege and work product protection as to third parties who seek the documents in civil litigation against the company; surveying case law from other circuits and weighing policy arguments, the court found no basis for embracing the concept of "selective waiver" in this case and that the company's confidentiality agreements with the agencies did little to prevent further dissemination of the privileged materials). *See infra* Waiver.

[50] *See supra* notes 449-461 and related text and *infra* notes 69-83 and related text.

Generally Unprivileged Items. Consistent with the idea that the communication must be for the purpose of rendering or facilitating legal advice, various types of information relating to the attorney-client relationship or otherwise in the possession or knowledge of the attorney are not considered privileged. These include the identity of the client,[51] fee arrangements,[52] factual circumstances surrounding the communication,[53] and billing statements.[54]

Waiver. The privileged nature of an attorney-client communication must be preserved by not voluntarily disclosing the privileged communication to third parties[55] or injecting it as an issue in litigation.[56] The privilege belongs to the client, and only may be waived by the client or by the attorney as agent for the client.[57]

Compelled disclosure does not constitute a waiver.[58] Governmental authorities are increasingly putting pressure on corporations to "voluntarily" provide privileged information to them in order to show the cooperation with their investigations and thereby receive less harsh treatment.[59]

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[51] *See In re Grand Jury Subpoena Served upon Doe*, 781 F.2d 238, 248 (2nd Cir.) (en banc), *cert. denied sub nom.*, *Roe v. United States*, 475 U.S. 1108 (1986); *Humphreys, Hutcheson and Mosely v. Donovan*, 755 F.2d 1211 (6th Cir. 1985). *But see In re Grand Jury Proceedings (Jones)*, 517 F.2d 666, 672 (5th Cir. 1975) (identity protected to the extent it constitutes last link to inculpate client).

[52] *See In re Two Grand Jury Subpoenae Duces Tecum*, 793 F.2d 69, 71-72 (2nd Cir. 1986).

[53] *See Condon v. Petacque*, 90 F.R.D. 53 (N.D. Ill. 1981).

[54] *See Clarke v. American Commerce Nat'l Bank*, 974 F.2d 127, 130 (9th Cir. 1992).

[55] *See, e.g., United States v. Stewart*, 287 F.Supp. 2d 461, 464 (S.D.N.Y. 2003) (Martha Stewart lost the attorney-client privilege covering her e-mail to her lawyer by sharing it with her own daughter*); Stenovich v. Wachtell, Lipton, Rosen & Katz*, 756 N.Y.S.2d 367, 378-79 (N.Y. App. Div. 2003) (attorney-client privilege lost as to communications shared with corporation's investment bankers); *United States v. El Paso Co.*, 682 F.2d 530, 540-41 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984) (disclosure to outside auditors of internal tax analysis in which attorneys participated constituted waiver of attorney-client privilege); *In re John Doe Corp.*, 675 F.2d 482, 488-89 (2nd Cir. 1982) (disclosure of internal report to outside auditors and underwriters constituted waiver of the attorney-client privilege).

[56] *See McIntyre v. Main St. & Main Inc.*, 2000 U.S. Dist. LEXIS 19617 at 9 (N.D. Cal. 2000) ("Plaintiffs are correct that defendant cannot rely on the investigation by outside counsel as part of its defense, while at the same time shielding the investigation from discovery. Any use of the investigation in its defense would waive the privilege."); *Wellpoint Health Networks v. Superior Court*, 59 Cal. App. 4th 110 (1997) (employer was not entitled to engage an attorney to conduct an investigation, cite the investigation as a defense, and then selectively produce only those portions of the investigation file that it deemed not to be privileged).

[57] *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1041 (May 2005).

[58] *See* Tex. R. Evid. 512 (2009). *See also In re Grand Jury Proceedings (Vargas)*, 723 F.2d 1461 (10th Cir. 1983) (production of documents in response to a court order is not necessarily a voluntary disclosure constituting waiver).

[59] Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003) (*available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (identified nine factors that federal prosecutors should utilize in making their charging decisions regarding corporations or other business entities, including the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, *including, if necessary, the waiver of corporate attorney-client and work*

No Waiver Where Common Interest. Voluntary disclosure of a privileged communication to a person with a common interest does not constitute waiver.[60] Thus, communications between a lawyer for a parent corporation and an employee of a wholly-owned subsidiary usually are considered privileged.[61] Similarly, multiple clients represented by the same attorney may talk freely with their attorney without fear that the presence of more than one client will constitute a waiver as to third parties.[62]

Disclosure to lawyers or clients in a joint defense situation also does not create waiver.[63] In the event the clients in the joint defense arrangement later become adverse to each other, their

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product protection); U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2004) (emphasis added) (*available at* http://www.ussc.gov/2004guid/8c2_5.htm) (to qualify for a reduction in its sentence for providing assistance to the government investigation, a corporation may be required to waive confidentiality protections if "such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization"); Report of Investigation Pursuant to Section 21(a) of the 1934 Act and SEC Statement on the Relationship of Cooperation to Agency Enforcement Decisions, 1934 Act Rel. No. 44969 (Oct. 23, 2001) (available at http://www.sec.gov/litigation/investreport/34-44969.htm) (the "*Seabord Report*") (in determining whether to initiate SEC enforcement proceedings, the SEC considers the seriousness of the conduct; whether the company had "cooperate[d] completely with appropriate regulatory and law enforcement bodies"; whether the company had conducted "a thorough review of the nature, extent, origins and consequences of the conduct and related behavior"; whether the company "promptly [made] available to [SEC] staff the result of its review and provide[d] sufficient documentation reflecting its response to the situation"; whether "the company identif[ied] possible violative conduct with sufficient precision to facilitate prompt enforcement actions against those who violated the law"; whether "the company produce[d] a thorough and probing written report detailing the findings of its review"; and whether "the company voluntarily disclose[d] information [SEC] staff did not directly request and otherwise might not have uncovered." *Report of ABA's Task Force on the Attorney-Client Privilege*, 60 Bus. Lawyer 1029, 1043-52 (May 2005) (discussing these recent governmental policies, practices and procedures, and the implications thereof to the attorney-client privilege and the public policies underlying it). *See* William W. Horton, "*A Transactional Lawyer's Perspective on the Attorney-Client Privilege: A Jeremiad for Upjohn*," 61 Bus. Law. 95 (Nov. 2005) (officers and employees of corporations need confidence that attorney-client privilege will protect the confidence of their communications with their counsel (both inside and outside) so that they will provide counsel with the candid information needed to keep the corporation out of trouble) and Molly McDonough, *Justice Memo Stirs Up Another Storm – NY Judge Asks Whether Prosecutors Pressed Firm to Cut Off Legal Fees*, ABA Journal eReport (April 28, 2006), available at http://www.abanet.org/journal/ereport/a28thomson.html.

[60] *See United States v. Zolin*, 809 F.2d 1411, 1417 (9th Cir. 1987), opinion withdrawn in part and reinstated in part by *U.S. v. Zolin*, 842 F.2d 1135 (9th Cir. 1988) (in tax fraud case involving L. Ron Hubbard, court found attorney-client privilege had not been waived by presence of members of Church of Scientology at meetings with attorney because the persons present had a common interest in sorting out the respective affairs of the Church and Mr. Hubbard, commenting that "[e]ven where the non-party who is privy to the attorney-client communications has never been sued on the matter of common interest and faces no immediate liability, it can still be found to have a common interest with the party seeking to protect the communications.").

[61] *See In re Grand Jury Subpoenas, 89-3 and 89-4*, *John Doe* 89-129, 902 F.2d 244 (4th Cir. 1990); *Admiral Ins. Co. v. U.S. Dist. Court*, 881 F.2d 1486 (9th Cir. 1989); *Bowne of New York City, Inc. v. AmBase Corp.*, 150 F.R.D. 465 (S.D.N.Y. 1993).

[62] *See In re Grand Jury Proceedings (Auclair)*, 961 F.2d 65 (5th Cir. 1992).

[63] The courts have developed two doctrines of exceptions to the waiver of the privilege through voluntary disclosure. *Wilson P. Abraham Constr. Corp. v. Armco Steel Corp.*, 559 F.2d 250, 253 (5th Cir. 1977); *Ryals v. Canales*, 767 S.W.2d 226, 228 (Tex. App. — Dallas 1989, no writ). The joint defendant rule, embodied in UNIF. R. EVID. 502(b)(5), protects communications relevant to a matter of common interest

communications which were privileged as to third parties are not privileged in the controversy between them.[64] As a consequence, attorneys whose clients are entering into a joint defense arrangement and sharing otherwise privileged information have an ethical duty to advise their clients of this risk of privilege loss.

Issue Injection. Another means of waiver is through offensive use, sometimes also called issue injection. The rule is simple, although sometimes difficult to implement. A client may not make an affirmative claim for relief, assert privilege as to an outcome determinative

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between two or more clients of the same lawyer from disclosure. UNIF. R. EVID. 502 (d)(5) (2009). This widely accepted doctrine applies strictly to clients of the same lawyer who are joint defendants in litigation. Several courts have expanded the joint defense doctrine in order to create another exception to the waiver of attorney-client privilege: the doctrine of common-interest. Under the common interest doctrine, privileged information can be disclosed to a separate entity that has a common legal interest with the privilege holder, whether or not the third party is a co-defendant.

Federal circuit courts and state courts diverge in their interpretation and application of the common interest and joint defendant doctrine. *United States v. Weissman*, No. S1 94 CR. 760 CSH, 1996 WL 737042, at *7 (S.D.N.Y. Dec. 26, 1996). In the most expansive application of the common interest doctrine, courts exclude a waiver of the attorney-client privilege when there is a common interest between the disclosing party and the receiving party, and parties have a reasonable expectation of litigation concerning their common interest. *See Hewlett-Packard Co. v. Bausch & Lomb*, 115 F.R.D. 308, 309 (N.D.Cal. 1987). More restrictive courts require that the parties share an identical legal, as opposed to purely commercial, interest. *See Duplan Corp. v. Deering Milliken*, 397 F. Supp. 1146, 1172 (D.S.C. 1974). Finally, some courts persist in rejecting the common interest theory absent actual or pending litigation in which both parties are or will be joint defendants. See *Int'l Ins. v. Newmont Mining Corp.*, 800 F.Supp. 1195, 1196 (S.D.N.Y. 1992).

Although there is no uniform test for application of the common interest doctrine, courts have consistently examined three elements when applying the doctrine: (1) whether the confidentiality of the privileged information is preserved despite disclosure; (2) whether, at the time that the disclosures were made, the parties were joint defendants in litigation or reasonably anticipated litigation; and (3) whether the legal interests of the parties are identical or at least closely aligned at the time of disclosure. *See, e.g. U.S. v. Gulf Oil Corp.*, 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

The core requirement of the common interest doctrine is the existence of a shared legal interest. Courts will have less difficulty in finding an exception to a waiver when the parties actively pursue common legal goals. *See U.S. v. Schwimmer*, 892 F.2d 237, 244 (2nd Cir. 1989). An asset purchase agreement in which the buyer does not assume the litigation liability of the seller does not demonstrate an alignment of the parties' interests. A common business enterprise, such as the sale of assets, or a potential merger, will not suffice unless the parties' legal interests are at least parallel and non-adverse. *Jedwab v. MGM Grand Hotels, Inc.*, No. 8077, 1986 WL 3426, at * 2 (Del. Ch. Mar. 20, 1986). Disclosures by a corporation and its counsel to the corporation's investment banking firm during merger discussions have resulted in a waiver of the attorney-client privilege because the common interest rule did not apply. *See Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D. 233, 237 (N.D. Ill. 2000). The court said the common-interest rule protects from disclosure those communications between one party and an attorney for another party "where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," noting that the common interest must be a legal one, not commercial or financial. *Id*. at 237. The court concluded, however, that the common interest rule did not apply because the defendants did not demonstrate that the investment banking firm's legal interest in the threatened litigation was anything more than peripheral. *Id*. at 237.

[64] *See Garner v. Wolfinbarger*, 430 F.2d 1093, 1103 (5th Cir. 1970) ("In many situations in which the same attorney acts for two or more parties having a common interest, neither party may exercise the privilege in a subsequent controversy with the other. This is true even where the attorney acts jointly for two or more persons having no formalized business arrangement between them.").

matter, and deny the adverse party its only means of discovering the information.[65] The key to this test is whether the privileged matter is outcome determinative. If so, the client is given the choice of disclosing the privileged information or abandoning his claim.[66]

Clients may assert a defense based on their good faith belief that their actions were in conformity with applicable laws. Often the good faith can be shown only by showing that the action was in reliance on advice of counsel. Once the client opens the issue of the advice received by selectively revealing any of the advice it received, the client risks placing at issue, and waives the privilege as to, all steps it took to comply with the law at issue.[67] Such a waiver can result in both the client and the attorney being compelled to submit to deposition and testimony at trial.[68]

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65 *Republic Ins. Co. v. Davis*, 856 S.W.2d 158 (Tex. 1993).

66 *Cf. Texas Dept. of Pub. Safety Officers Ass'n v. Denton*, 897 S.W.2d 757, 760 (Tex. 1995) (involving offensive use of Fifth Amendment privilege).

67 *See Nguyen v. Excel Corp.*, 197 F.3d 200, 206-7 (5th Cir. 1999), which explained:

> A corporate client has a privilege to refuse to disclose, and prevent its attorneys from disclosing, confidential communications between its representatives and its attorneys when the communications were made to obtain legal services. A client waives the attorney-client privilege, however, by failing to assert it when confidential information is sought in legal proceedings. Inquiry into the general nature of the legal services provided by counsel does not necessitate an assertion of the privilege because the general nature of services is not protected by the privilege. Further inquiry into the substance of the client's and attorney's discussions does implicate the privilege and an assertion is required to preserve the privilege. A client's specific request to an attorney and pertinent information related thereto fall within the reaches of the privilege. Additionally, the research undertaken by an attorney to respond to a client's request also falls within the reaches of the privilege.
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> Though Excel raised some privilege-based objections, it did not object to all questions designed to elicit information about privileged communications. The district court observed that Excel did not object to all questions designed to elicit information about confidential communications, and that Excel did not halt its executives' responses to all such questions. * * * Excel waived the attorney-client privilege by its failure to assert the privilege.
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> As related, but alternative, grounds for affirming the district court's order, Excel waived the attorney-client privilege by selectively disclosing confidential communications. When relayed to a third party that is not rendering legal services on the client's behalf, a communication is no longer confidential, and thus it falls outside of the reaches of the privilege. Therefore, a client implicitly waives the attorney-client privilege by testifying about portions of the attorney-client communication.

But see In re Carbo Ceramics, Inc., 81 S.W.3d. 369, 378-379 (Tex. App.—Houston [14th Dist.] 2002, no pet.) ("Texas courts apply the offensive use doctrine when the advice of counsel defense is raised. [Citations omitted]. The offensive use doctrine applies when a party seeking affirmative relief attempts to claim a privilege to shield evidence that would materially weaken or defeat that party's claims. [Citation omitted]. 'A plaintiff cannot use one hand to seek affirmative relief in court and with the other lower an iron curtain of silence against otherwise pertinent and proper questions which may have a bearing upon his right to maintain his action.'….Texas courts define affirmative relief narrowly for the purpose of determining whether offensive use commands the waiver of privilege.").

68 *See Excel*, *supra*, 197 F.3rd at 208-210, which explained:

Scope of Waiver. Concerns about waiving privilege surround communications with accountants, underwriters and prospective merger partners regarding litigation loss contingencies. In each of those communications, there is a voluntary disclosure that is necessary for the corporation to accomplish its business. Yet, when documents or other communications are disclosed to persons outside the scope of the attorney-client privilege, waiver of the privilege occurs. The issue involves how far the waiver goes.

The scope of waiver is broad. It is generally considered to be permanent, that is, the privilege cannot be reclaimed in another circumstance or proceeding.[69] Furthermore, the waiver may extend not only to the document or communication specifically disclosed, or to which the privilege was waived, but to all communications on the "**subject matter**."[70]

In *In re Grand Jury Proceedings*,[71] the Court addressed the issue of whether a corporate officer inadvertently waived attorney-client privilege *to the entire **subject matter** of communications with their lawyer about a particular matter* when they disclosed *certain portions* of the attorney's advice to a government agent. In making their determination, the court allowed discovery of certain information, disallowed discovery of other information, and specifically instructed the lower court to conduct further proceedings in order to determine what other information came within the "subject matter" of the information disclosed:

> Excel next maintains that, even if it waived the privilege, its executives rather than its counsel should be deposed regarding matters no longer privileged. Excel encourages this court to adopt the inquiry of the Eighth Circuit [in *Shelton v. Am. Motors Corp.*, 805 F.2d 1323 (8th Cir. 1986)] and forbid a party from deposing opposing counsel unless (1) no other means exist to obtain the information, (2) the information sought is relevant and non-privileged, and (3) the information is crucial to the preparation of the case. Excel contends that appellees cannot establish any of the three criteria.
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> * * *
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> Because depositions of opposing counsel are disfavored generally and should be permitted in only limited circumstances, one would suspect that a request to depose opposing counsel generally would provide a district court with good cause to issue a protective order. The district court, however, did not abuse its discretion in authorizing the depositions of defense counsel, even assuming the applicability of the *Shelton* inquiry.
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> * * *
>
> The second sentence of the magistrate judge's order permits inquiry into counsels' understanding of defendant's perceptions, and the third sentence of the order permits inquiry into counsels' opinions. These inquiries are impermissible. "An attorney's thoughts [are] inviolate . . . ." Even though an attorney's mental impressions and opinions fall outside of the attorney-client privilege, they also "fall[ ] outside the arena of discovery [as their disclosure would] contravene[ ] the public policy underlying the orderly prosecution and defense of legal claims."

[69] *See United States v. Suarez*, 820 F.2d 1158, 1160 (11th Cir. 1987), *cert. denied*, 484 U.S. 987 (1987).

[70] 8 J. WIGMORE, EVIDENCE § 2328, at 638 (McNaughton rev. ed. 1961). *See also United States v. Davis*, 636 F.2d 1028, 1043 n. 18 (5th Cir.), *cert. denied*, 454 U.S. 862 (1981); *Zielinski v. Clorox Co.*, 504 S.E.2d 683, 685-86 (Ga. 1998) (the court held that attorney-client privilege was waived as to the subject matter of certain documents turned over to the district attorney's office as part of an ongoing embezzlement investigation).

[71] 78 F.3d 251 (6th Cir. 1996).

[T]wo government investigators met with [a company's] owner and president. Shortly after the meeting began, the owner and president informed the agents that they had met with a Washington, D.C. attorney who specializes in Medicare law, and they told the investigators the attorney's name. They told the agents that they brought their twenty-four point marketing plan to the attorney and that they described the various elements of the plan to her in detail.

* * *

The owner and president told the investigators that their attorney was concerned that providing free Sharps needle disposal containers could constitute an illegal inducement or kickback. But, the president noted, the attorney had no problem with the laboratory billing Medicare for tests done by nursing home personnel or with providing nursing homes free glucose testers and lancets. When asked by the agents about the apparent inconsistency between the lawyer's advice regarding free Sharps disposal containers and free glucose testers, the president responded, "That's the advice I had of the attorney at the time."

The District Court held that the owner and president had waived the attorney-client privilege by voluntarily disclosing the substance of their attorney's advice to the government agents. The District Court also held that "the government's motion to compel is granted to the extent of the legal advice and documents relating to [the laboratory's] marketing plan."

* * *

Having concluded that the attorney-client privilege was waived as to specific elements of the marketing plan, we must now determine the scope of that waiver.

* * *

In support of the District Court's order, the Government argues that "[i]t is well established that voluntary disclosure of the content of a privileged communication constitutes a waiver of the privilege as to all other such communication on the same subject matter." The government relies on several cases to support its claim that in view of the waiver on specific items of the marketing plan, the laboratory waived its privilege with respect to the rest of the plan. *See*, *e.g.*, *United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir.1982) ("Any voluntary disclosure by the client to a third party waives the privilege not only as to the specific communication disclosed, but often as to all other communications relating to the same subject matter."); *In re Sealed Case*, 676 F.2d 793, 818 (D.C.Cir.1982) ("When a party reveals part of a privileged communication in order to gain an advantage in litigation, it waives the privilege as to all other communications relating to the same subject matter...."); *Edwards v. Whitaker*, 868 F.Supp. 226, 229 (M.D.Tenn.1994) ("[V]oluntary disclosure of the content of a privileged attorney communication constitutes waiver of the privilege as to all other such communications on the same subject.").

> * * *
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> [T]he government may ask questions that clearly pertain to the subject matter of the specific points on which a waiver did occur. *The District Court will have to decide whether the remaining points in the marketing plan are truly the same subject matter as those in the specific marketing plan points on which there was a waiver and approve or disallow questions on that basis.*[72]

While *In re Grand Jury Proceedings* adopts the subject matter test, only one court has given much guidance in determining what is and what is not in the same subject matter when disclosure of some privileged communications has taken place. In a series of opinions arising from the case styled *U.S. v. Skeddle*,[73] a U.S. District Court in Ohio addressed the scope of a corporation's waiver to its claim of attorney-client privilege. The case arose in the context of a criminal charge of wire and mail fraud against former employees of Libbey Owens Ford Co. ("LOF") arising out of their allegedly improper self-dealing transactions with LOF. LOF's general counsel became suspicious of defendants' activities and began an internal investigation which led to LOF commencing civil litigation against the criminal defendants and others. In connection with the general counsel's trial testimony in the criminal case, LOF agreed to waive its attorney-client privilege as to communications between the general counsel and LOF management prior to his discovery of the allegedly fraudulent activities, but refused to waive the privilege as to communications related to its internal investigation and litigation against defendants.[74] The general counsel then testified at the criminal trial of the former LOF employees regarding conversations he had with other LOF officials as to which LOF had expressly waived its attorney-client privilege. The defendants claimed that this testimony waived the corporation's attorney-client privilege as to the entire contents of the investigative file.[75]

Exhibiting a judicial tendency to narrowly construe the subject matter as to which the privilege has been waived, the court noted that the general counsel's file covered three stages in respect of the case: (i) an "implementation" phase during which the legal department was communicating with management as the transactions at issue were being developed in the apparent ordinary course of business, (ii) an "investigatory phase" that began when LOF had significant reason to believe wrongdoing had occurred, and (iii) a "litigation" phase after LOF had decided to file suit to recover the value defendants had wrongfully obtained. The court then held that LOF could waive its privilege as to the implementation phase without any waiver as to the investigatory and litigation phases. The court noted that in the implementation phase, the legal department lawyers were working with defendants in the transaction in the ordinary course, perhaps acting in the dual role of lawyer and businessman, and were involved as the facts at issue were developing. In the investigatory and litigation phases, the legal department was

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72 *Id.* at 253-56 (emphasis added).

73 *United States v. Skeddle*, 989 F. Supp. 905 (N.D. Ohio 1997) (*Skeddle I*); 989 F. Supp. 913 (N.D. Ohio 1997) (*Skeddle II*); 989 F. Supp. 917 (N.D. Ohio 1997) (*Skeddle III*).

74 *Skeddle I*, 989 F.Supp. at 908.

75 *Skeddle III*, 989 F.Supp. at 919.

endeavoring to assert the interests of LOF against defendants. In so holding, the court explained the subject matter test as follows:

> As a general rule, waiver of the privilege with regard to some communications waives the privilege as to all other communications relating to the "same subject matter." *In re Grand Jury Proceedings,* 78 F.3d at 255-256; *United States v. Mendelsohn*, 896 F.2d 1183, 1189 (9th Cir. 1990). This rule seeks to avoid the unfairness that might result from selective disclosure while, at the same time, upholding the privilege and preserving the interests it protects form excessive exposure.
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> Despite the centrality of the term, "same subject matter," to this inquiry, courts have not defined its meaning and content precisely. Aside from a general instruction to construe "same subject matter" narrowly, . . . no guidance has been given about how a trial court is to determine what is and what is not within the same subject matter when disclosure of some privileged communications has taken place.
>
> Among the factors which appear to be pertinent in determining whether disclosed and undisclosed communications relate to the same subject matter are: 1) the general nature of the lawyer's assignment; 2) the extent to which the lawyer's activities in fulfilling that assignment are undifferentiated and unitary or are distinct and severable; 3) the extent to which the disclosed and undisclosed communications share, or do not share, a common nexus with a distinct activity; 4) the circumstances in and purposes for which disclosure originally was made; 5) the circumstances in and purposes for which further disclosure is sought; 6) the risks to the interests protected by the privilege if further disclosure were to occur; and 7) the prejudice which might result if disclosure were not to occur. By applying these factors, and such other factors as may appear appropriate, a court may be able to comply with the mandate that it construe "same subject matter" narrowly while accommodating fundamental fairness.[76]

The *Skeddle* court then applied these factors to the specifics of the general counsel's testimony. While the general counsel did testify regarding telephone conversations and meetings with certain corporate officers and other facts acquired during the general counsel's investigation into the scheme, the court concluded that the subject of the general counsel's limited testimony could not be found to cover the entire investigative file of the corporation, finding that the testimony referred to only a small portion of the general counsel's activities for the corporation, activities consisting of distinct and severable activities, all self-contained and unitary in focus.[77] The court further stated that the testimony did not have a common nexus with every other attorney-client communication in the corporation's investigative file, and that to use the limited,

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[76] *Skeddle I*, 989 F. Supp. at 908-09.

[77] *Skeddle III*, 989 F. Supp. at 920.

factual disclosures as a bootstrap to discover the entire investigative file would run counter to the principles underlying the narrow waiver of the attorney-client privilege.[78]

The *Skeddle* court even found that the disclosure of documents which made references to discussions that were otherwise privileged did not waive privilege as to those discussions, finding that the referenced discussions related to a subject distinct from the subject of the documents disclosed.[79] The court noted the jeopardy in which privileged documents would be placed if partial disclosure waived privilege as to the entire matter, stating:

> "If . . . disclosure of the notes exposed every otherwise privileged communication as to the matters referenced . . . , the privilege would be withdrawn from dozens, if not hundreds of communications as to which all participants had expected confidentiality. Interests protected by the privilege would be placed in great jeopardy if the subject matter of the . . . notes were deemed to be every topic mentioned in those notes."[80]

One document addressed in this opinion is of particular relevance. A letter from the corporation's outside counsel to an attorney for liability insurers of corporate directors and officers, which set forth the corporation's basis for an insurance claim arising from the defendants' alleged misconduct, was disclosed at trial.[81] While the letter itself was found not privileged, the court found privileged the communications which underlay the conclusions of the letter because allowing such disclosure would undermine substantially, if not completely, the purpose of the attorney-client privilege.[82] The court stated that, "requiring such disclosure would permit discovery of underlying privileged communications whenever an attorney states an opinion based on such communications. Such broad waiver runs counter to the protection generally afforded to attorney-client relationship."[83]

In light of the potential danger of a broad scale waiver of attorney-client privilege under the subject matter test, counsel should be particularly attentive to opportunities to stress the confidential nature of attorney-client communications with the officers and representatives of their clients. When disclosing information that may be privileged, counsel may endeavor to limit the scope of any waiver by stating in writing that no waiver of the attorney-client privilege is intended thereby.

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78 *Id.*

79 *Skeddle* I, 989 F. Supp. at 911. A close examination of this series of opinions illustrates the court's effort to find the undisclosed statements privileged. For example, relating to one particular document, the court found that the subject matter of the document was the author's understanding of the significance of certain events rather than being the subject matter of the events themselves. *See In re Carbo Ceramics, Inc.*, in which the court focused on particular documents as to which the privilege was waived and rejected claims that all other documents on a privilege log lost their privilege as a result of a waiver as to other documents. 81 S.W 3d 369, 378-79 (Tex.App.—Houston [14th Dist.] 2002, pet. granted in prt and denied in part).

80 *Skeddle I*, 989 F. Supp. At 911.

81 *Id.*

82 *Id*. at 911-12.

83 *Id*. at 912.

In one unreported case, a corporation avoided waiving the attorney-client privilege in certain documents, and as to all other documents covering the same subject matter, by specifically not waiving the attorney-client privilege in the process of disclosing the documents:

> Ernst & Young next claims that ShareAmerica's "disclosure of communications with and among attorneys from K & L regarding the SEC's inquiry and the planned public offering constitutes a waiver of the attorney-client and work product privileges with respect to those documents *and all other documents covering the same subject matter*." (Defendant's brief dated 5/30/97 at p. 13.) ShareAmerica, however, has submitted an affidavit from Attorney Daniel Shepro that shows the document production and testimony occurred without a waiver of ShareAmerica's privileges . . .The motion to compel is denied.[84]

Federal Rule of Evidence 502 Limiting Waiver of Privileges. On September 19, 2008, Senate Bill 2450 was signed into law, amending the Federal Rules of Evidence to add Rule 502 which limits the circumstances under which a disclosure of information (particularly one that is inadvertent) results in a waiver of the attorney-client or work-product privilege. Rule 502 applies in all proceedings commenced after the date of enactment (September 19, 2008) and, insofar as is just and practicable, in all proceedings pending on that date.[85]

Rule 502 addresses the issue of subject matter waiver by providing that when a disclosure is made in a federal proceeding (or to a federal office or agency) and waives the attorney-client or work-product privilege, that waiver will extend to undisclosed materials in a state or federal proceeding only if the waiver is *intentional* and the disclosed and undisclosed materials concern the same subject matter and ought in fairness to be considered together.[86] Rule 502 also addresses *inadvertent* disclosures by providing that when a disclosure is made in a federal proceeding (or to a federal office or agency), the disclosure will not operate as a waiver in a federal or state proceeding if the disclosure is *inadvertent* and the holder of the privilege took reasonable steps to prevent the disclosure and promptly took reasonable steps to rectify the error.[87]

An addendum to the explanatory note in the Congressional Record accompanying Rule 502 cautions that Rule 502 "does *not* provide a basis for a court to enable parties to agree to a selective waiver of the privilege, such as to a federal agency conducting an investigation, while preserving the privilege as against other parties seeking the information."[88]

Exceptions to the Privilege. The Texas Rules of Evidence recognize the following five exceptions to the attorney-client privilege:

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84 *ShareAmerica, Inc. v. Ernst & Young*, No. 933071325, 1998 WL 90731, at *3 (Conn. Super. Feb 20, 1998) (not reported in A.2d) (emphasis added).

85 154 Cong. Rec. H7817 (daily ed. Sept. 8, 2008).

86 *Id.*

87 *Id.*

88 *Id.* at H7818-19.

(1) *Furtherance of Crime or Fraud.* If the services of the lawyer were sought or obtained to enable or aid anyone to commit or further continuing or future criminal or fraudulent activity, as contrasted with advice regarding prior wrong doing.[89]

(2) *Claimants Through Same Deceased Client.* As to a communication relevant to an issue between parties who claim through the same deceased client, regardless of whether the claims are by testate or intestate succession or by *inter vivos* transactions;

(3) *Breach of Duty by a Lawyer or Client.* As to a communication relevant to an issue of breach of duty by a lawyer to the client or by a client to the lawyer;

(4) *Document Attested by a Lawyer.* As to a communication relevant to an issue concerning an attested document to which the lawyer is an attesting witness; or

(5) *Joint Clients.* As to a communication relevant to a matter of common interest between or among two or more clients if the communication was made by any of them to a lawyer retained or consulted in common, when offered in an action between or among any of the clients.[90]

In contrast to other aspects of the attorney-client privilege, the exceptions are relatively straightforward and have yielded remarkably little litigation. Of the five, the crime/fraud exception has resulted in the most controversy in terms of its applicability. The U.S. Supreme Court has explained that the "privilege takes flight if the relation is abused. A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law. He must let the truth be told."[91]

Some plaintiffs have tried to pierce the attorney-client privilege by simply asserting a fraud cause of action and then arguing that the crime/fraud exception applies to all legal advice the adverse party received. This tactic has been rejected, with courts holding that the plaintiff must first prove a prima facie case of fraud and then show that the attorney-client communication was in furtherance of the fraud in order to commit the fraud.[92] Key to the application of the crime/fraud exception is the timing of the communication. In order for the exception to apply, it is usually necessary for the communication to have been made in contemplation of the fraud[93] and either before or during the commission of the fraud.[94] Recently,

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89 *In re Grand Jury Subpoena*, 419 F.3d 329 (5th Cir. 2005) (crime-fraud exception does not extend to all communications made in the course of the attorney-client relationship, but rather is limited to those communications and documents in furtherance of the contemplated or ongoing criminal or fraudulent conduct and does not apply to advice regarding prior wrongful acts).

90 TEX. R. EVID. 503(d).

91 *Clark v. United States*, 289 U.S. 1, 15 (1933).

92 *Cigna Corp. v. Spears*, 838 S.W.2d 561 (Tex. App. — San Antonio 1992, no writ).

93 *Arkla, Inc. v. Harris*, 846 S.W.2d 623, 630 (Tex. App. — Houston [14th Dist.] 1993, orig. proceeding).

94 *Freeman v. Bianchi*, 820 S.W.2d 853, 861-62 (Tex. App. — Houston [1st. Dist.] 1991), *leave granted, mand. denied., Granada Corp. v. First Ct. of Appeals*, 844 S.W.2d 223, 225 (Tex. 1992, writ denied).

several courts have applied the exception in situations where the attorney's advice was alleged to have assisted in covering up the fraud.[95]

<u>Work Product Doctrine</u>. The work product privilege[96] is a common law doctrine now codified in the federal and state rules of civil procedure that protects the privacy of an attorney's trial preparations, and may protect an attorney's work product from discovery by opposing counsel where the attorney-client privilege is not available. Generally, the work product privilege only protects from unwarranted disclosure materials prepared by an attorney, or under an attorney's direction, "in anticipation of litigation or for trial."[97] Therefore, in absence of any anticipated or pending litigation,[98] documents prepared for the purposes of a specific business transaction are not protected by the work product doctrine.[99]

The work product doctrine was first recognized by the U. S. Supreme Court in *Hickman v. Taylor*[100] wherein, finding no existing privilege that applied, the Court created a new common law privilege for what it termed the "work product of the lawyer," consisting of interviews,

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95 *See, e.g., American Tobacco Co. v. Florida*, 697 So.2d 1249 (Fla. App. 4th Dist. 1997); *In re A. H. Robins Co., Inc.*, 107 F.R.D. 2 (D. Kan. 1985).

96 Some courts prefer to use the term "doctrine" rather than "privilege" because of the more limited protection given to work product in certain situations. *See Westinghouse Elec. Corp. v. Republic of The Philippines*, 951 F.2d 1414, 1417 n. 1 (3rd Cir. 1991).

97 *See* Fed. R. Civ. P. 26(b)(3); Tex. R. Civ. P. 192.5(a)(1).

98 *See McCoo v. Denny's, Inc.*, 192 F.R.D. 675, 683 (D. Kan. 2000) (noting "[t]he inchoate possibility, or even likely chance, of litigation does not give rise to the privilege"); *Garrett v. Metropolitan Life Ins. Co.*, No. 95 Civ. 2406, 1996 WL 325725 at *3 (S.D.N.Y. June 12, 1996) (noting that investigations by regulatory agencies may present "more than a mere possibility of future litigation, and provide reasonable grounds for anticipating litigation"). In *United States v. Textron Inc. and Subsidiaries*, 577 F.3d 21 (1st Cir. 2009) (en banc), *cert. denied*, *Textron Inc. and Subsidiaries v. U.S.*, 2010 WL 2025148 (U.S. May 24, 2010), the First Circuit sitting *en banc* held that the work product doctrine did not apply to Textron's tax accrual work papers because the work papers were independently required by statutory and audit requirements in connection with the preparation of its audited financial statements to be filed with the SEC and were not prepared for litigation, and wrote:

> To sum up, the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron's work papers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters. 577 F.3d at 31-32.

See also U.S. v. El Paso Co., 682 F.2d 530 (5th Cir. 1982) (quoting *U.S. v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981)) (the Fifth Circuit in *U.S. v. El Paso* denied work product protection because "the work papers' 'sole function' was to back up financial statements").

99 Internal investigation to satisfy auditors or lenders did not have required relationship to litigation, although litigation was looming. *In re Royal Ahold N.V. Securities & ERISA Litigation*, 230 F.R.D. 433 (D. Md. 2006).

100 329 U.S. 495 (1947).

memoranda, briefs and other materials prepared "with an eye toward litigation."[101] The Court justified the privilege as follows:

> Proper preparation of a client's case demands that [the attorney] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests.[102]

The Court indicated that the privilege could be overcome as to factual information otherwise unavailable to the opposing party, but not as to the attorney's "mental impressions."[103]

The *Hickman* work product doctrine was codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure in 1970, which extends protection to the work of a party's representatives, "including an attorney, consultant, surety, indemnitor, insurer, or agent" in anticipation of litigation or for trial. The rule maintains the distinction between ordinary work product, which is discoverable upon a showing of "substantial need" and "undue hardship," and an attorney's "mental impressions, conclusions, opinions, or legal theories," which are discoverable, if at all, only upon a much higher showing.[104] This latter category has come to be known as "opinion" or "core" work product.[105] Rule 26(b)(3) has been adopted verbatim by 34 states, and in substantial part by 10 others.[106] The work product doctrine has been more specifically and comprehensively incorporated into Texas Rules of Civil Procedure,[107] which defined *"work product"*[108] consistently with the Federal Rules of Civil Procedure.

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[101] *Hickman*, 329 U.S. at 511.

[102] *Id.*

[103] *Id.* at 512.

[104] The work product doctrine, however, is not an impenetrable barrier, it is a qualified immunity: "It allows a party to seek materials prepared in anticipation of litigation only when the party: 1) has a substantial need for the materials; and 2) the party cannot acquire a substantial equivalent of the materials by other means without undue hardship. Even when such a showing of need and unavailability is made, the rule specifically protects the mental impressions, conclusions, opinions and legal theories of the party's attorney. This is referred to as *opinion* work product (as opposed to trial preparations that are merely historical or fact based). Opinion work product is subject to disclosure according to a more stringent standard. A court will protect opinion work product unless the requesting party can show that it is *directed to the pivotal issue* in the current litigation and the need for the information is compelling." *Saito v. McKesson HBOC, Inc.*, No. 18553, 2002 Del. Ch. LEXIS 125 at *9 (Del. Ch. Oct. 25, 2002).

[105] *See In re Murphy*, 560 F.2d 326, 329 n. 1 (8th Cir. 1977); Jeff A. Anderson et al., Special Project, *The Work Product Doctrine*, 68 Cornell L.Rev. 760, 817-20 (1983).

[106] See Elizabeth Thornburg, *Rethinking Work Product*, 77 Va.L.Rev. 1515, 1520-21 (1991).

[107] See Tex. R. Civ. P. 192.5. The party communication privilege, previously codified separately in the Texas Rules of Civil Procedure 166b(3)(d), has been incorporated into the work product rule as Rule 192.5(a)(2). The Texas Supreme Court has previously held under old Texas Rules of Civil Procedure 166(3)(d) that the party communications privilege is case specific (i.e. to be privileged, the communication must "occur during or in anticipation of the particular suit in which the privilege is asserted") in *Republic Insurance Co. v. Davis*, 856 S.W.2d 158, 164-65 (Tex. 1993), but this result was based on specific wording of the old rule

Like the attorney-client privilege, the work product privilege is subject to waiver, but the scope of a work product waiver is more limited. Work product protection can be destroyed or waived only by an action that substantially increases the possibility that an adversary in litigation will gain access to the work product documents,[109] and waiver of work product protection by sharing the work product with one adversary can result in waiver as to other unrelated adversaries.[110] For example, waiver will not result from disclosing work product information to a non-adversarial party with a common interest.[111] Disclosure under a confidentiality agreement

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that is different in new Rule 192.5(a)(2) and should not be the result under the wording of the new rule, which is not case specific. In *Owens-Corning Fiberglas v. Caldwell*, 818 S.W.2d 749, 751-52 (Tex. 1991), the Texas Supreme Court rejected the argument that the work product privilege applies only in the particular case in which it was generated, writing "we hold that the work product privilege in Texas is of continuing duration."

108 Tex. R. Civ. P. 192.5(a) (1999) provides:

192.5 Work Product.

(a) *Work product defined.* Work product comprises:

(1) material prepared or mental impressions developed in anticipation of litigation or for trial by or for a party or a party's representatives, including the party's attorneys, consultants, sureties, indemnitors, insurers, or agents; or

(2) a communication made in anticipation of litigation or for trial between a party and the party's representatives or among a party's representatives.

(b) *Protection of work product.*

(1) *Protection of core work product -- attorney mental processes.* Core work product -- the work product of an attorney or an attorney's representative that contains the attorney's or the attorney's representative's mental impressions, opinions, conclusions, or legal theories -- is not discoverable.

(2) *Protection of other work product.* Any other work product is discoverable only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the material by other means.

109 In most jurisdictions, a waiver of the work-product protection can occur where the protected communications are disclosed in a manner which "substantially increases the opportunity for potential adversaries to obtain the information." *See Behnia v. Shapiro*, 176 F.R.D. 277, 279 (N.D.Ill. 1997); *see also* 8 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & RICHARD L. MARCUS, FEDERAL PRACTICE AND PROCEDURE: CIVIL, § 2024, at 369 (1994). The question is whether the particular disclosure was of such a nature as to enable an adversary to gain access to the information. *See Behnia*, 176 F.R.D. at 279-80; *United States v. Amer. Tel. & Tel.*, 642 F.2d 1285, 1299 (D.C.Cir. 1980); *United States v. Gulf Oil Corp.*, 760 F.2d 292, 295 (Temp. Emer. Ct. App. 1985); *In re Grand Jury Subpoenas*, 561 F. Supp. 1247, 1257 (E.D.N.Y. 1982). In a minority of jurisdictions, the waiver of work product protection depends on whether the parties share a common legal interest. In such jurisdictions, the courts will apply the same analysis as for the waiver of attorney-client privilege. *See In re Grand Jury Subpoenas 89-3 v. United States*, 902 F.2d 244, 248 (4th Cir. 1990).

110 *See In re Stone Energy Corporation*, No. 05-2088, 2008 WL 4868086 (W.D. La. Nov. 4, 2008) (Plaintiff in securities fraud class action was not entitled to review attorney internal investigation report prepared for audit committee in anticipation of litigation because the court deemed it to "constitute opinion work product which require[s] an almost absolute protection under *Hickman v.* Taylor" despite the fact that the defendant company provided it to SEC which was held to be adversary).

111 *Gulf Oil*, 760 F.2d at 296; *In re Grand Jury Subpoenas*, 561 F. Supp. at 1257.

militates against a finding of waiver, for it is evidence the party took steps to insure that its work product did not land in the hands of its adversaries.[112] Widespread disclosure, however, might prompt a court to find waiver from substantially increasing the probability that privileged information will fall into the hands of an adversary.[113] Disclosing work product documents to a government body, particularly where the government is an adversary, can result in privilege waiver.[114]

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112 *Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D., 233, 237 (N.D.Ill. 2000).

113 *Id.*

114 *See Westinghouse Elec. Corp. v. Republic of The Philippines*, 951 F.2d 1414, 1423-31 (3rd Cir. 1991); *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1369-75 (D.C. Cir. 1984); *United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir. 1982); *but see Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (voluntary disclosure to a government agency waives the privilege only for the purpose of litigation against that government agency) and *Teachers Ins. and Annuity Ass'n v. Shamrock Broadcasting Co.*, 521 F.Supp. 638, 644-45 (S.D.N.Y. 1981) (disclosure waives the privilege only for the purpose of litigation against the agency if the disclosing party expressly reserves the privilege; otherwise, complete waiver occurs). The forum in which the waiver issue is adjudicated can be outcome determinative. *Contrast McKesson Corp. v. Green*, 610 S.E.2d 54 (Ga. 2005) (in which the Supreme Court of Georgia held that the voluntary production of a 180-page internal investigation report by PricewaterhouseCoopers and Skadden, Arps to the SEC and the U.S. Attorney's Office resulted in a waiver of the work product privilege as they were actual or potential adversaries and the confidentiality agreement allowed the SEC to give the documents to others if it deemed such to be "in furtherance of the [SEC's] discharge of its duties and responsibilities"), *with Saito v. McKesson HBOC, Inc.*, No. 18553, 2002 WL 31657622 at 3-11 (Del. Ch. Nov. 13, 2002), in which the Delaware Chancery Court adopted a "selective waiver" doctrine that allowed disclosures to the SEC pursuant to a confidentiality agreement without waiver of the work product protection, *vis a vis* private litigants, reasoning as follows:

> As with any privilege, the protection of work product may be waived when it no longer serves its useful purpose. The purpose behind the protection of work product is "to promote the adversary system by safeguarding the fruits of an attorney's trial preparations from the discovery attempts of the opponent." * * * Thus, the focus of the doctrine is upon preventing discovery of the work product from an "*opposing party in litigation*, not necessarily from the rest of the world generally." * * * There is no waiver of privileged information to third parties if a disclosing party had a reasonable expectancy of privacy when it made an earlier disclosure. * * * .Disclosures to, a third party do not waive attorney work product when the disclosing party and its recipient share some common interest. * * * The common interest question here boils down to whether the SEC acts as a friend or foe when it begins investigating a company for potential violations of the Securities Act. I think the more reasonable conclusion is that the SEC was a foe in this instance.
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> * * *
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> The Delaware Supreme Court has already determined that it is sometimes unfair to allow for *partial* waivers of work product. No Delaware court, however, has decided whether to allow *selective* waivers of work product. Selective waiver is the type of waiver at issue in this case, as McKesson HBOC has selectively disclosed its work product to the SEC and now asserts its work product privilege as to these same documents when requested by plaintiff Saito.
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> * * *
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> When attorneys secure a confidentiality agreement before sharing their work product with the SEC, as McKesson HBOC's attorneys did, those attorneys can

Legal Fee Audits. Insurers routinely audit bills from outside defense counsel to measure compliance with billing guidelines and reduce costs. Disclosure of itemized billings to outside auditors may waive the attorney-client privilege for the documents disclosed.[115] Under the subject matter standard discussed above under "Scope of Waiver," the waiver might (but should not) be extended beyond the bills themselves to the items referred to therein.

Issues have been raised in ethics opinions in a number of states regarding the propriety of an attorney's submission of legal bills for outside audit review. The typical conclusion is that law firms may submit their bills directly to an audit company after an informed consent is obtained from the client.[116]

> reasonably assume that the SEC would not reveal those confidential disclosures to other adversaries.
>
> Although it can be argued that McKesson HBOC should not have had an expectation of privacy because some other courts have decided, that such disclosures waive work product privilege, the courts of Delaware have not considered the issue. In fact, plaintiff, defendant, and the SEC alike fight this battle in this Court using weaponry borrowed almost exclusively from foreign jurisdictional battlefields because Delaware's terrain is barren. The vigorousness of this clashing of swords suggests that the matter is far from settled even on foreign soil.
>
> The resulting decisions cover the entire spectrum--from protection of work product in the absence of a confidentiality agreement to no protection of work product even when a disclosure was secured by a confidentiality agreement. The Eighth Circuit first established the selective waiver doctrine and protected work product disclosures made to the SEC during a private, nonpublic investigation, even without a confidentiality agreement in place. The D.C. Circuit has since found that work product privilege could only be preserved if a confidentiality agreement is in place before the disclosure. The Second, Third, Fourth, and Sixth Circuits have found that waiver of the privilege as to one opponent waives the privilege as to all when there is no confidentiality agreement in place. Of these, some indicated that a confidentiality agreement may have changed the outcome of their decision. Only two cases cited to this Court found that the privilege was waived even when the disclosure was subject to a confidentiality agreement. Therefore, in light of conflicting but non-binding precedent, McKesson HBOC acted reasonably in expecting that its disclosures to the SEC under a confidentiality agreement would not reach the hands of its other adversaries.
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> * * *
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> Thus, because I find that it is in the best interests of the shareholders to encourage corporate compliance, and because the law enforcement agencies are designed by our legislature as the first line of defense for such shareholders, I adopt a selective waiver rule for disclosures made to law enforcement agencies pursuant to a confidentiality agreement. Confidential disclosure of work product during law enforcement agency investigations relinquishes the work product privilege only as to that agency, not as to the client's other adversaries. The selective waiver rule encourages cooperation with law enforcement agencies without any negative cost to society or to private plaintiffs.

[115] *See United States v. Mass. Inst. of Tech.*, 129 F.3d 681 (1st Cir. 1997).

[116] K. Hansen and L. Marema, *Confidentiality Issue Sparks Controversy*, Bests Review '77 (Feb. 1999). *See* Tex. Comm. on Prof'l Ethics, Formal Op. 552 (2004) (in which the Professional Ethics Committee opines that a lawyer's fee statement or invoice is confidential information which the lawyer must protect under Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct and that a lawyer who has been retained

Mergers and Acquisitions. One of the more troublesome problems related to the disclosure of confidential information in the context of negotiating a business combination is how to disclose information to facilitate a meaningful evaluation of litigation-related confidential information without waiving any work-product protections, attorney-client privileges, and similar protections and privileges. The issue can arise either prior to or after closing of a proposed transaction. In an attempt to allow the seller to furnish to the buyer confidential information without waiving the seller's work product, attorney-client privilege and similar protections by demonstrating that the buyer and seller have or should be presumed to have common legal and commercial interests, or are or may become joint defendants in litigation, Section 12.6 of the ABA Model Asset Purchase Agreement with Commentary (2001) provides:

> 12.6 ATTORNEY-CLIENT PRIVILEGE.
>
> The Disclosing Party is not waiving, and will not be deemed to have waived or diminished, any of its attorney work product protections, attorney-client privileges, or similar protections and privileges as a result of disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party, regardless of whether the Disclosing Party has asserted, or is or may be entitled to assert, such privileges and protections. The parties (a) share a common legal and commercial interest in all of the Disclosing Party's Confidential Information that is subject to such privileges and protections, (b) are or may become joint defendants in Proceedings to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, (c) intend that such privileges and protections remain intact should either party become subject to any actual or threatened Proceeding to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, and (d) intend that after the Closing the Receiving Party shall have the right to assert such protections and privileges. No Receiving Party shall admit, claim or contend, in Proceedings involving either party or otherwise, that any Disclosing Party waived any of its attorney work product protections, attorney-client privileges, or similar protections and privileges with respect to any information, documents or other material not disclosed to a Receiving Party due to the Disclosing Party disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party.

There may be instances when the receiving party is an actual or potentially adverse party in litigation with the disclosing party (*e.g.*, when litigation is the driving force behind an acquisition). In those cases, the language of Section 12.6 is intended to bolster a claim by the disclosing party that the recipient is later precluded from using disclosure as a basis for asserting that the privilege was waived.

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by an insurance company to defend its insured cannot disclose the lawyer's fee statement to the insurance company's third party auditor absent consent of the client after consultation (consent in advance through a policy provision is not sufficient consent since it is by definition not made after consultation with the client)).

Whether work product protections and attorney-client privileges will be deemed to be waived as a result of disclosures in connection with a consummated or unconsummated asset purchase depends on the law applied by the forum jurisdiction and the forum jurisdiction's approach to the joint defendant and common interest doctrines. In most jurisdictions, work product protection will be waived only if the party discloses the protected documents in a manner which substantially increases the opportunities for its potential adversaries to obtain the information. By contrast, the attorney-client privilege will be waived as a result of voluntary disclosure to any third party, unless the forum jurisdiction applies a form of the joint defense or common interest doctrines.

Although the consummation of a transaction is not determinative of the existence of a waiver, the interests of the parties may become closely aligned as a result of the closing. As a result, there is a higher probability that information will remain protected in a transaction that closes, and in which the buyer assumes liability for the seller's litigation, than in a transaction that does not close and in which the buyer does not assume liability for the seller's litigation.[117] Generally, (i) in a statutory merger the surviving corporation can assert the attorney-client privilege, (ii) in a stock-for-stock deal the privilege goes with the corporation, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale some cases hold no privilege passes because the corporate holder of the privilege has not been sold[118] while others hold that a transfer of all of sellers right, title and interest in the assets of a business effectively transfers the right to assert or waive the privilege.[119] In an asset sale, including a sale

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[117] *See* Hundley, "*White Knights, Pre-Nuptial Confidences, and the Morning After: The Effect of Transaction-Related Disclosures on the Attorney-Client and Related Privileges*," 5 DEPAUL BUS. L.J. 59 (Fall/Winter, 1992/1993); *cf. Cheeves v. Southern Clays, Inc.*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) ("Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney".)

[118] *Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989); *In re Cap Rock Elec. Coop., Inc.*, 35 S.W.3d 222 (Tex. App.—Texarkana 2000, no pet.).

[119] *Louisiana Municipal Police Employees' Retirement System v. Sealed Air Corp.*, Fed. Sec. L. Rep. (CCH) ¶94,807 (D.N.J. August 11, 2008) (In rejecting plaintiff's assertion of both attorney work product and attorney-client privilege waivers because buyer and seller were on opposite sides of a negotiated transaction, the Court wrote, "The weight of case law suggests that, as a general matter, privileged information exchanged during a merger between two unaffiliated business would fall within the common-interest doctrine," quoting from *Cavallaro v. United States*, 153 F. Supp. 2d 52, 61 (D. Mass. 2001), *aff'd on other grounds* 284 F.3d 236 (1st Cir. 2002), and citing *Rayman v. Am. Charter Fed. Sav. & Loan Ass'n*, 148 F.R.D. 647, 655 (D. Neb. 1993)); *Coffin v. Bowater Incorporated*, Civ. No. 03-227-P-C, 2005 U.S. Dist. LEXIS 9395 (D. Maine May 13, 2005); *Soverain Software LLC v. Gap, Inc.*, 340 F. Supp. 2d 760 (E.D. Tex. 2004); *Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989); *In re Cap Rock Elec. Coop., Inc.*, 35 S.W.3d 222 (Tex. App.—Texarkana 2000, no pet.); *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 1007-1009 (2006).

In *Tekni-Plex, Inc. v. Meyner and Landis*, 89 N.Y.2d 123, 674 N.E. 2d 663 (1996), the New York Court of Appeals held that in a triangular merger the purchaser could not preclude long-time counsel for the seller and its sole shareholder from representing the shareholder in an indemnification claim arising out of the merger, and that the purchaser controlled the attorney-client privilege as to pre-merger communications with the seller, other than those relating to the merger negotiations. Responding to an argument that the transaction was really an asset acquisition, the Court said in dictum: "When ownership of a corporation changes hands, whether the attorney-client relationship transfers . . . to the new owners turns on the practical consequences rather than the formalities of the particular transaction." 89 N.Y.2d at 133. *See*

of a division, the parties could provide contractually for the buyer to have the benefit of the privilege, as Section 12.6 does, and, by analogy to joint defense and common interest cases, the privilege agreement should be upheld.[120] Further, by analogy to those cases and the principle that the privilege attaches to communications between an attorney and prospective client prior to engagement, parties should be able to provide that due diligence information provided is protected by the attorney-client privilege.[121]

Courts may also maintain the attorney-client privilege when the interests of both parties are aligned through specific contractual relationships.[122] Therefore, the parties may find some comfort in provisions that align their legal interests and burdens, such as provisions pursuant to which buyer assumes the litigation liability of seller, indemnification provisions or assistance provisions which may facilitate a court's application of the common interest doctrine. If appropriate, the parties also should consider signing a "common interest agreement" or a "joint defense plan" that evidences their common legal interests and stipulates a common plan for litigation.

Henry Still Bryans, *Business Successors and the Traspositional Attorney-Client Relationship*, 64 BUS. LAW 1039, 1041-1052 (Aug. 2009).

Postorivo v. AG Paintball Holdings, Inc., 2008 WL 343856 (Del. Ch. 2008), arose in the context of a contract indemnity action brought by the buyer under an asset purchase agreement against the seller over seller's representations, warranties and covenants. The Delaware Chancery Court (applying New York law and relying on *Tekni-Plex, Inc. v. Meyner & Landis*, *supra*) held that, under the asset purchase agreement, the seller retained the attorney-client privilege with respect to communications regarding the excluded assets and liabilities. The Court confirmed the agreement of the parties that buyer holds the attorney-client privilege with respect to communications regarding the operation of the business before and after the asset purchase agreement, and seller holds the privilege as to communications regarding the negotiation of the asset purchase agreement. In so holding, the Court cited with approval the *Tekni-Plex* approach that practical consequences trump the form of the transaction, and rejected buyer's argument that the attorney-client privilege is "an incident of control and cannot be split among several different entities, even if a written contract among the parties provides to the contrary"). *See* Henry Still Bryans, *Business Successors and the Traspositional Attorney-Client Relationship*, 64 BUS. LAW 1039, 1067-1069 (Aug. 2009).

120 *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 861-63 (2005) (discussing *Venture Law Group v. Superior Court*, 12 Cal. Rptr. 3d 656 (Cal. Ct. App. 2004) which held that the surviving corporation in a merger is the holder of the attorney-client privileges of both constituent corporations post merger and an attorney for the non-surviving corporation has a duty to exercise the privilege unless instructed not to do so by the surviving corporation).

121 *Cap Rock*, 35 S.W.3d at 222; *cf. Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) ("Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney").

122 *See In Re Regents of Univ. of Cal.*, 101 F.3d 1386, 1390 (Fed. Cir. 1996) (holding that parties to an exclusive license agreement have a substantially identical legal interest).

<u>**APPENDIX C**</u>

FORM OF OUTSIDE LAW FIRM RESPONSE LETTER

Re: ______________ (the *"Company"*, such term to refer also to the subsidiaries or other related entities, if any, listed in Annex A hereto)

Gentlemen:

By letter dated ____________ (the *"Inquiry Letter"*), ____________, requested that we furnish you certain information in connection with your examination of the accounts of the Company as of ____________ (the *"Examination Date"*) and for the year then ended. Accordingly, subject to the qualifications and limitations set forth below, we advise you that as of ____________, which is the date our internal review procedure for purposes of preparing this letter was commenced (the *"Review Date"*), we were not engaged on behalf of the Company in giving substantive legal attention to, or representing the Company in connection with, any Loss Contingency, except as set forth in Annex B hereto. As used herein, "Loss Contingency" means (i) any overtly threatened or pending litigation (as defined in the ABA Statement of Policy referred to below) which we have recognized as involving a potential loss to the Company of ____________ or more, (ii) any contractually assumed obligation, if any, which the Company has, in the Inquiry Letter, specifically identified and requested that we comment on herein and (iii) any unasserted possible claim or assessment, if any, which the Company has, in the Inquiry Letter, specifically identified and requested that we comment on herein.

This response is limited by, and is in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December, 1975) and the accompanying Commentary (collectively, the *"ABA Statement of Policy"*). We are not responding to any request, nor are we commenting on any statement, contained in the Inquiry Letter which we believe to be inconsistent with the intent of the ABA Statement of Policy. No inference should be drawn from our failure to respond to or comment on any such request or statement.

The information set forth in this response is current as of the Review Date, except as otherwise noted, and we disclaim any undertaking or obligation to advise you of any changes which thereafter may have been or may be brought to our attention.

In connection with the preparation of this response, we have made no examination of the records or files of the Company, nor have we reviewed any of the transactions or contractual arrangements of the Company or interviewed any of the officers or employees of the Company, or made any other investigation of the Company whatsoever. On the contrary, our procedures in the preparation of this response have been limited to an endeavor to determine from lawyers presently in our Firm who, on behalf of the Firm, have performed services for the Company since ____________ whether such services involved substantive attention in the form of legal consultation or legal representation (as distinguished from general legal advice) concerning any Loss Contingency of the nature described in clause (i) of the definition of such term in the first paragraph of this letter existing as of the dates referred to in the second sentence of such first paragraph.

Consistent with the last sentence of paragraph 6 of the ABA Statement of Policy and pursuant to the Company's request, this will confirm as correct the Company's understanding as set forth in the Company's inquiry letter to us that whenever, in the course of performing legal services for the Company on specific matters which we have recognized as involving an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure concerning such possible claim or assessment we, as a matter of professional responsibility to the Company, will endeavor to so advise the Company and, if requested to do so, will consult with the Company concerning the question of such disclosure and the applicable requirements of FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies). You are further advised, however, that we have not been engaged by the Company for the specific purpose of providing advice and consultation concerning questions of financial disclosure. Accordingly, and in view of the limited extent to which we have represented the Company and our limited knowledge of the Company's affairs and the requirements for financial statement disclosures applicable to the Company, it is unlikely that we would form any professional conclusions concerning such disclosures. Furthermore, while we will so consult with the Company, we will not ordinarily make an independent investigation of facts furnished to us by the Company. Also, in the course of such consultation we will not ordinarily reach and express a professional conclusion that the Company must disclose a discrete matter or that the ultimate decision which the Company may make is either correct or incorrect. We are not commenting on the accuracy or completeness of any specification, or lack of specification, made by the Company in the Inquiry Letter in respect of unasserted possible claims or assessments or any advice, or lack of advice, we may have given the Company with respect to any such claims or assessments.

It is our understanding that the Company, by making the request set forth in the Inquiry Letter, does not intend to waive the attorney-client privilege with respect to any information which the Company has furnished to us. Moreover, please be advised that this response should not be construed in any way to constitute a waiver of the attorney-work product privilege with respect to any of our files involving the Company.

Please refer to Annexes A and B hereto for certain other information relating to this response letter.

This letter is solely for your information and assistance in connection with your audit of the financial condition of the Company as of the Examination Date and is not to be quoted or otherwise referred to in any financial statement of the Company or related documents nor is it to be filed with or furnished to any governmental agency or any other person without the prior written consent of this Firm.

Very truly yours,

[Law Firm Name]

By_________________________________

ANNEX A

MISCELLANEOUS MATTERS

1. List of Subsidiaries or Other Related Entities

List all subsidiaries or other related entities, if any, named in the Inquiry Letter. Make certain that each subsidiary or other related entity named in the Inquiry Letter was similarly named in the related Firm information request form. If no subsidiaries or other related entities are named in the Inquiry Letter, insert the word NONE.

[LIST SUBSIDIARIES HERE]

2. Scope of Engagement

Insert one of the following paragraphs or an appropriate variation thereof:

While we represent the Company on a regular basis, we are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility or on matters in respect of which we may have rendered general legal advice to the Company.

While we represent the Company (or certain of the subsidiaries or other entities included within the meaning of *"Company"* herein) on a regular basis, the Company, as you are aware, engages other counsel from time to time with respect to various legal matters. We are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility or on matters in respect of which we may have rendered general legal advice to the Company.

We do not represent the Company generally and our representation of the Company is limited to matters for which we are specifically engaged as its counsel. We are not undertaking to comment on whether the Company is involved in legal matters for which we have no responsibility.

3. Other Matters

(a) If requested by the Inquiry Letter, insert one of the following paragraphs or an appropriate variation thereof:

Our records reflect that as of _____________, there was _____________ and _____________, respectively, owing to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

Our records reflect that as of ____________, there was no amount owing to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

Our records reflect that as of ____________, there was ____________ owing to us by the Company for services and disbursements previously billed and that as of the date hereof no amount is owed to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

Our records reflect that as of ____________ no amount was owing to us by the Company for services and disbursements previously billed and that as of the date hereof ____________ is owed to us by the Company for services and disbursements previously billed. It is not our practice to quote unbilled expenses and estimated fees.

(b) Insert the following paragraph if appropriate:
____________, an attorney in this Firm, is a Director of the Company. This letter does not purport to encompass information which may have been communicated to such attorney by reason of his serving as a Director.

(c) Insert paragraphs containing other information, if any, which the attorney in charge deems necessary or appropriate. If no paragraphs are being inserted in response to this Item 3, insert the word NONE.

ANNEX B

DESCRIPTION OF LOSS CONTINGENCIES

1. Contractually Assumed Obligations

Describe each Loss Contingency of this type being commented on. Remember that no such Loss Contingency is to be commented on unless it is specifically identified in the Inquiry Letter. See "CAUTION" at the end of this Fill-in Information Sheet.

If no Loss Contingency of this type is specifically identified in the Inquiry Letter, insert the following:

NONE. No contractually assumed obligation was specifically identified in the Inquiry Letter for comment in this response. Accordingly, we are not commenting on any contractually assumed obligations or any representations of the Company in the Inquiry Letter with respect thereto.

2. Unasserted Possible Claims and Assessments

Describe each Loss Contingency of this type being commented on. Remember that no such Loss Contingency is to be commented on unless it is specifically identified in the Inquiry Letter. See "CAUTION" at the end of this Fill-in Information Sheet.

If no Loss Contingency of this type is specifically identified in the Inquiry Letter, insert the following:

NONE. No unasserted claim or assessment was specifically identified in the Inquiry Letter for comment in this response. Accordingly, we are not commenting on any unasserted possible claims or assessments or any representations of the Company in the Inquiry Letter with respect thereto.

3. Overtly Threatened or Pending Litigation

Describe each Loss Contingency of this type being commented on. See "CAUTION" at the end of this Fill-in Information Sheet. If there is no Loss Contingency of this type to be described, insert the word NONE.

(a) Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as defined in the ABA Statement of Policy), we express no opinion as to the likelihood of an unfavorable outcome or the amount or range of any possible loss to the Company.

CAUTION: BE SURE TO REMOVE THIS INFORMATION BEFORE FINALIZING THE LETTER!!!

The definition of "Loss Contingency" is contained in the first paragraph of the response letter. For this purpose, the attorney preparing the response letter should understand that the ABA Statement of Policy defines "overtly threatened litigation" to mean "that a potential claimant has manifested to the client an awareness of and present intention to assert a possible claim or assessment unless the likelihood of litigation (or of settlement when litigation would normally be avoided) is considered remote".

Each Inquiry Letter which we receive from a client attempts, in one way or another, to get us to evaluate, with respect to each Loss Contingency described in our response letter, the likelihood of an unfavorable outcome and to estimate the amount or range of potential loss. Because applicable accounting rules (FASB Accounting Standards Codification Subtopic 450-20 (originally issued as FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies)) use the terms "probable", "reasonably possible" and "remote" in describing the process of quantifying the likelihood of an unfavorable outcome, such terms, when used in a response letter, will generally be accorded specific meanings. Therefore, none of these terms should be utilized unless the attorney preparing the response letter intends to convey the specific meaning contemplated by the accounting rules.

The ABA Statement of Policy contains several statements to the effect that, given the uncertainties associated with defending or prosecuting a Loss Contingency, clients (and their auditors) generally should not expect attorneys to render, and attorneys generally will not be in a position to give, any meaningful estimate of the likelihood of an unfavorable outcome or the amount or range of damages. Consider, in this regard, the following excerpts from the ABA Statement of Policy:

> **"In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'; for purposes of any such judgment it is appropriate to use the following meanings:**
>
> **(i) probable--an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.**
> **(ii) remote--an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight....**
> **[T]he amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss (if the outcome should be unfavorable) only if he believes that the probability of**

> **inaccuracy of the estimate of the amount or range of potential loss is slight.... In most cases, the lawyer will not be able to provide any such estimate to the auditor."**

Essentially, a response letter can properly contain an unqualified evaluation of probable outcome only in instances where we believe the client would win or lose on summary judgment. If we cannot say that the client would prevail on a summary judgment motion filed by it, then we cannot say that a favorable outcome is probable or that an unfavorable outcome is remote. Moreover, if we cannot say that the client would lose a summary judgment motion filed against it, then we cannot say that a favorable outcome is remote or that an unfavorable outcome is probable.

For the foregoing reasons, Loss Contingency descriptions typically conclude with or otherwise contain a sentence reading substantially as follows:

> **"Because we have not formed a conclusion as to whether an unfavorable outcome is either probable or remote (as defined in the ABA Statement of Policy), we express no opinion as to the likelihood of an unfavorable outcome or the amount or range of any possible loss to the Company".**

Any response letter containing a Loss Contingency description which does not include a sentence similar to the foregoing must be signed or otherwise approved by [a member of the Firm Response Letter Committee].

The Commentary forming a part of the ABA Statement of Policy observes that:

> **"statements that litigation is being defended vigorously and that a client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense."**

The information which we provide to auditors regarding Loss Contingencies can have a significant effect on, and is therefore very important to, the client. Depending on the nature of the information, the auditors may, for example, either "qualify" their audit report or insist that the client establish a loss reserve. Should such a situation arise, all Firm attorneys are expected to demonstrate a sincere willingness to cooperate in any way possible so that the needs and wishes of our clients are satisfied. In most situations, it is possible to expand on the description of a Loss Contingency in a way which satisfies the concerns of the auditors but which nonetheless does not result in the rendering of an opinion as to probable outcome or amount of loss.

APPENDIX D

EGAN ON ENTITIES

Byron Egan is a partner in the Dallas office of Jackson Walker L.L.P. specializing in corporate, financing, mergers and acquisitions, and securities related matters. He is also a prolific speaker and writer, having penned more than 240 papers relating to business entities. Mr. Egan writes about the issues that he deals with every day as a seasoned corporate lawyer: corporation, partnership and limited liability company formation, entity governance, financing transactions, mergers and acquisitions, and securities laws.

This bulletin, called Egan on Entities, contains introductions to Mr. Egan's recent significant writings in four areas of the law relating to business entities, including how they are formed, governed and combined with other entities.[1] These writings contain practical insights regarding these subjects developed from his law firm practice and his interaction with others, as well as a thorough analysis of statutory and case law from which these practical insights have been developed.

Full versions of the writings referenced below can be found in the links identified below.

For further information or to provide your suggestions for additional bulletins, feel free to contact Mr. Egan directly at 214 953-5727, or by email at *began@jw.com*. Additionally, a listing of Mr. Egan's writings available online may be accessed at: *http://www.jw.com/site/jsp/attyinfo.jsp?id=77*.

More about Byron Egan: In addition to practicing corporate, financing, mergers and acquisitions, and securities law at Jackson Walker L.L.P. and making himself available as a resource to other lawyers, Mr. Egan currently serves as Senior Vice Chair and Chair of Executive Council of the ABA Business Law Section's Mergers & Acquisitions Committee and was Co-Chair of its Asset Acquisition Agreement Task Force, which published the ABA Model Asset Purchase Agreement with Commentary. A former Chair of both the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas, as well as that Section's Corporation Law Committee, Mr. Egan has been involved in the drafting and enactment of many Texas business entity statutes, and that experience continues to enrich his current law practice. Four of Mr. Egan's law journal articles have received the Burton Award for excellence in legal writing presented at the Library of Congress. In 2009, his paper entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years. A profile of Mr. Egan published in The M&A Journal is available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=540.

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1.

CHOICE OF ENTITY AND FORMATION

EXCERPTED FROM: "Choice of Entity Alternatives" – prepared for a May 28, 2010 program in Houston at the TexasBarCLE and Business Law Section of State Bar of Texas' program on Choice and Acquisitions of Entities in Texas. Published on the JW website and full text available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396

Key Issues Covered:

- Key factors in entity selection
- Summaries of key provisions of Texas and Delaware laws relating to
    - Corporations
    - General Partnerships
    - Limited Partnerships
    - Limited Liability Partnerships
    - Limited Liability Companies
- Summaries of U.S. and Texas tax treatment of entities

In selecting a form of business entity in which to engage in business in the United States, the organizer or initial owners should consider the following five business entity forms:

- Corporation
- General Partnership
- Limited Partnership
- Limited Liability Partnership ("LLP")
- Limited Liability Company ("LLC")

The form of business entity most advantageous in a particular situation depends on the objectives of the business for which the entity is being organized. In most situations, the focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners of the business from liabilities arising out of its activities.

The Texas Legislature has enacted the Texas Business Organizations Code (the "TBOC") to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities. The TBOC is applicable for entities formed or converting under Texas law after January 1, 2006. Entities in existence on January 1, 2006 must conform to TBOC by January 1, 2010, but may continue to be governed by the Texas source statutes until then.

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the Internal Revenue Code of 1986 and the "Check-the-Box" regulations promulgated by the Internal Revenue Service, an unincorporated business entity may be classified as an "association" taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable "flow-through" entity in which taxation is imposed only at the ownership level. Although generally a corporation may be classified only as a corporation for federal income tax purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the "Margin Tax," which is imposed on all business entities other than general partnerships wholly owned by individuals and certain "passive entities." Essentially, the calculation of the Margin Tax is based on a taxable entity's, or unitary group's, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the "tax base" for the Margin Tax may not exceed 70% of the entity's total revenues. This "tax base" is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate.

The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes and has the same Margin Tax treatment as most limited partnerships, but the uncertainties as to an LLC's treatment for self-employment purposes continue to restrict its desirability in some situations.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396.

2.
CORPORATE GOVERNANCE

EXCERPTED FROM: "Fiduciary Duties of Corporate Directors and Officers in Texas" – 43 Texas Journal of Business Law 45 (Spring 2009). Published on the JW website and full text available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230

Key Issues Covered:

- Fiduciary duties of directors and officers generally in both Texas and Delaware
- Fiduciary duties in insolvency situations
- Fiduciary duties regarding compensation
- Fiduciary duties regarding mergers and acquisitions
- Fiduciary duties regarding alternative entities

See also *"Recent Fiduciary Duty Cases Affecting Advice to Directors and Officers of Delaware and Texas Corporations"* – prepared for a February 12, 2010 program in Dallas at the UT School of Law 32nd Annual Conference on Securities Regulation and Business Law. Published on the JW website and full text available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=1344

The conduct of corporate directors and officers is subject to particular scrutiny in the context of executive compensation and other affiliated party transactions, business combinations (whether friendly or hostile), when the corporation is charged with illegal conduct, and when the corporation is insolvent or in the zone of insolvency. The high profile stories of how much corporations are paying their executive officers, corporate scandals, bankruptcies and related developments have further focused attention on how directors and officers discharge their duties, and have caused much reexamination of how corporations are governed and how they relate to their shareholders and creditors. Where the government intervenes (by investment or otherwise) or threatens to do so, the scrutiny intensifies, but the courts appear to resolve

the controversies by application of traditional principles while recognizing the 800-pound gorilla in the room.

The individuals who serve in leadership roles for corporations are fiduciaries in relation to the corporation and its owners. These troubled times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including their duties of care and loyalty. Increasingly the courts are applying principals articulated in cases involving mergers and acquisitions ("*M&A*") to cases involving executive compensation, perhaps because both areas often involve conflicts of interest and self-dealing or because in Delaware, where many of the cases are tried, the same judges are writing significant opinions in both areas. Director and officer fiduciary duties are generally owed to the corporation and its shareholders, but when the corporation is insolvent, the constituencies claiming to be beneficiaries of those duties may expand to include the entity's creditors.

While federal securities laws and stock exchange listing requirements have mandated changes in corporate governance practices, our focus will be on state corporate statutes and common law. Our focus is in the context of entities organized under the applicable Delaware and Texas statutes.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1230.

3.
MERGERS & ACQUISITIONS

EXCERPTED FROM: "Acquisition Agreement Issues" – prepared for an October 8, 2010 program in New York at the Penn State Law and City Bar Center for CLE, New York City Bar, 7th Annual Institute on Corporate, Securities, and Related Aspects of Mergers and Acquisitions. Published on the JW website and full text available at:
http://images.jw.com/com/publications/1475.pdf

Key Issues Covered:

- Alternative structures for sales of businesses
- Successor liability
- Form of asset purchase agreement with commentary

See also *"Contractual Limitations on Seller Liability in M&A Transactions"* – prepared for an April 22, 2010 program in Denver at the ABA Section of Business Law Spring Meeting. Published on the JW website and full text available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=1362

See also *"Challenges in Joint Venture Formation"* – prepared for the UT School of Law 32nd Annual Corporate Counsel Institute in Dallas on April 16 and in Houston on April 30, 2010. Published on the JW website and full text available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=1376

Buying or selling a business in uncertain times, including the purchase of a division or a subsidiary, revolves around a purchase agreement between the buyer and the selling entity and sometimes its owners. Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When

the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.

A number of things can happen during the period between the signing of an asset purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering? The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years.

The issues to be dealt with by the parties to an acquisition transaction will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller. The paper has the following topics:

This paper includes:

- An overview of the three basic forms of business acquisitions:
    - Statutory business combinations (e.g., mergers, consolidations and share exchanges);
    - Stock purchases; and
    - Asset purchases.
- Introductory matters concerning the reasons for structuring the transaction as an asset purchase.
- A discussion of the various successor liability doctrines and some suggested means of minimizing the risk.

- An initial draft of certain key provisions of an Asset Purchase Agreement which focuses on the definition and solution of the basic issues in any asset purchase: (1) what assets are being acquired and what liabilities are being assumed, (2) what assets and liabilities are being left behind, (3) what are the conditions of the obligations of the parties to consummate the transaction and (4) what are the indemnification obligations of the parties. While these matters are always deal specific, some generalizations can be made and common problems identified.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1244.

4.
SECURITIES LAWS

EXCERPTED FROM: "Major Themes of the Sarbanes-Oxley Act" – 42 Texas Journal of Business Law 339 (Winter 2008). Published on the JW website and full text available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186

Key Issues Covered:

- Effects of the Sarbanes-Oxley Act of 2002 ("SOX") on issuers, directors and professionals generally
- SOX audit committee provisions
- SOX auditor independence provisions
- SOX prohibitions on misleading statements to auditors
- SOX internal controls provisions
- Attorney responsibilities under SOX
- Letters to auditors regarding loss contingencies
- Attorney-client and work product privilege considerations

See also *"Perils of In-House Counsel"* – prepared for a July 22, 2010 program in San Antonio at the TexasBarCLE and Business Law and Corporate Counsel Sections of State Bar of Texas' Advanced In-House Counsel Course. Published on the JW website and full text available at:
http://www.jw.com/site/jsp/publicationinfo.jsp?id=1430

The Sarbanes-Oxley Act of 2002 ("SOX") was trumpeted by the politicians and in the media as a "tough new corporate fraud bill" in response to the corporate scandals that preceded it and as a means to protect investors by improving the accuracy and reliability of corporate disclosures. Among other things, SOX amended the Securities Exchange Act of 1934 (the "1934 Act") and the Securities Act of 1933. Although SOX does have some specific provisions, and generally establishes some important public policy changes, it has been implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB"), which have impacted auditing standards and have increased scrutiny on auditors' independence and procedures to verify company financial statement positions and representations. Further, while SOX is by its terms generally applicable only to public companies, its principles are being applied by the marketplace to privately held companies and nonprofit entities.

Following the enactment of SOX and the adoption of rules thereunder, the role of independent auditors in detecting financial statement fraud within public companies has received enhanced scrutiny. In turn, companies are expected both to implement controls for dealing with alleged fraud internally and to

provide their auditors with detailed information on a wide range of corporate issues. Companies involve legal counsel, both inside and outside, for a wide variety of tasks, from conducting investigations of alleged fraud to dealing with employee issues (including whistleblower complaints) and advising directors on their duties in connection with corporate transactions. Auditors are increasingly asking for information regarding these often privileged communications to supplement their reliance on management representations. Making such privileged information available to auditors, however, subjects companies to the risk of loss of attorney client and work product privileges, which can provide a road-map to success for adversaries in civil litigation.

Further, in providing such information to auditors, the provider must comply with the requirements of Section 303 of SOX and expanded Rule 13b2-2 under the 1934 Act adopted pursuant to SOX §303. The SOX §303 requirements specifically prohibit officers and directors, and "persons acting under [their] direction," from coercing, manipulating, misleading or fraudulently influencing an auditor "engaged in the performance of an audit" of the issuer's financial statements when the officer, director or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading. Since attorneys and other mergers and acquisitions professionals representing a corporation are usually engaged by, and are acting at the direction of, its directors or officers, they are subject to the SOX §303 Requirements. The SEC has demonstrated its willingness to bring sanction proceedings against lawyers when they have been perceived to have failed in their responsibilities.

The SOX §303 requirements should influence an attorney in communicating with accountants, and reinforce the importance of providing meaningful information to auditors and clients. The SOX §303 requirements, however, should not be viewed as repudiating or supplanting the ABA Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information regarding client loss contingencies. Resulting from a compromise reached in 1976 between the lawyers and the accountants, this ABA Statement of Policy provides a framework under which lawyers can provide information to auditors regarding client loss contingencies in connection with their examination of client financial statements, while minimizing the risk of loss of attorney-client privilege in the process.

In addition, the requirements of SOX §307 are specifically applicable to attorneys. The SEC rules under SOX §307 generally provide that, in the event that an attorney has "credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur," the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer to the issuer's chief legal officer, or to both the chief legal officer and the chief executive officer, or if those executives do not respond appropriately, to the issuer's board of directors or an appropriate committee thereof. SEC rulemaking and enforcement actions post-SOX attempt to place lawyers in the role of "gatekeepers" or "sentries of the marketplace" whose responsibilities include "ensuring that our markets are clean." These SEC actions will directly affect the role of the lawyer in dealing with clients, auditors, M&A professionals and others.

For the full version, please go to the Jackson Walker L.L.P. website, www.jw.com, where the full text is available at: http://www.jw.com/site/jsp/publicationinfo.jsp?id=1186.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas, where he practices corporate, financing, mergers and acquisitions, and securities law.

Additionally, a more complete listing of Mr. Egan's recent writings is available online and may be accessed at: http://www.jw.com/site/jsp/attyinfo.jsp?id=77.