DIRECTOR AND OFFICER RESPONSIBILITIES DURING CORPORATE TURMOIL

By

BYRON F. EGAN
Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202-3797
began@jw.com

GENERAL COUNSEL RIDE TO THE RESCUE DURING CORPORATE TURMOIL

TEXAS GENERAL COUNSEL FORUM
FOURTH ANNUAL CORPORATE COUNSEL CONFERENCE

Dallas, TX – November 22, 2002

Sponsored By: Texas General Counsel Forum

Copyright© 2002 by Byron F. Egan. All rights reserved.

TABLE OF CONTENTS

Page

I. Introduction. 1
II. Fiduciary Duties Generally. 2
A. General Principles. 2
B. Applicable Law. 3
C. Fiduciary Duties in Texas Cases. 3
1. Loyalty. 3
2. Care (including business judgment rule). 4
3. Other (obedience). 6
D. Fiduciary Duties in Delaware Cases. 7
1. Loyalty. 7
2. Care. 7
3. Other (candor). 11
III. Standards of Review in Change of Control Context. 12
A. Texas Standard of Review. 12
B. Delaware Standard of Review. 13
1. Business Judgment Rule. 15
2. Enhanced Scrutiny. 15
a. Defensive Measures. 16
b. Sale of Control. 16
3. Entire Fairness. 17
C. Action Without Bright Lines. 18
IV. Application of Delaware Standards in a Friendly Merger. 18
A. Management's Immediate Response. 19
B. The Board's Consideration. 19
1. Matters Considered. 20
2. Being Adequately Informed. 21
a. Investment Banking Advice. 21
b. Value of Independent Directors, Special Committees. 22
C. Value of Thorough Deliberation. 25
D. The Decision to Remain Independent. 26
1. Judicial Respect for Independence. 27
2. Defensive Measures. 29
E. The Pursuit of a Sale. 30
1. Value to Stockholders. 30
2. Ascertaining Value. 31
3. Protecting the Merger. 33
a. No-Shops. 34
b. Lock-ups. 35
c. Break-Up Fees. 36
4. Specific Cases Where No-Shops, Lock-ups, and Break-Up Fees Have Been Invalidated. 37

3219088v2

5. Specific Cases Where No-Shops, Lock-ups and Break-Up Fees Have Been Upheld. 39
F. Dealing with a Competing Acquiror........ 42
1. Flexibility in the Merger Agreement........ 42
2. Level Playing Field. 43
3. Best Value........ 44
V. Dealing With Existing Defenses. 45
A. Certain Defenses........ 45
B. Rights Plans........ 45
C. Business Combination Statutes. 48
VI. Director Responsibilities and Liabilities. 50
A. Limitation of Director Liability — Article 1302-7.06 of the TMCL and Section 102(b)(7) of the DGCL. 50
B. Indemnification — Article 2.02-1 of the TBCA and Section 145 of the DGCL.51
C. Interested Director Transactions — Article 2.35-1 of the TBCA and § 144 of the DGCL. 53
D. Director Consideration of Long-Term Interests. 54
E. Liability for Unlawful Distributions. 55
F. Reliance on Reports and Opinions. 56
G. Inspection of Records. 56
H. Right to Resign. 56
VII. Committees of the Board. 57
A. General. 57
B. Audit Committees. 58
1. Role of Audit Committee 58
2. Effects of SOB on Audit Committees. 60
3. Audit Committee Charters. 64
a. Proxy Statement Disclosure. 69
b. Audit Firm Non-Audit Services. 69
c. Liability Concerns. 71
C. Compensation Committee. 72
VIII. Shifting Duties When Company on Penumbra of Insolvency. 73
A. Insolvency Changes Relationships. 73
B. When is a Corporation Insolvent or in the Vicinity of Insolvency? 74
C. Director Liabilities to Creditors........ 75
D. Conflicts of Interest. 76
E. Fraudulent Transfers. 76
IX. Post Enron Issues of Special Concern. 77
A. Outside Director Independence. 77
B. Codes of Conduct. 84
C. Record Retention. 87
D. Recent Proposals for Change. 89
1. Accounting for and Approval of Stock Options. 89
2. Accelerated Filing of SEC Reports. 90
3. Increased Liability for Directors. 94

4. Overhaul Regulation of Auditors. 94
5. There is Nothing New Under the Sun. 94

Appendix A – Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., William C. Powers Chair, dated February 1, 2002

Appendix B – Form of Audit Committee Charter

Appendix C – Selected Provisions from a form of Code of Conduct

Appendix D – Summary of Sarbanes-Oxley Act of 2002 and Related SEC Rulemaking

Appendix E – NYSE Proposed Rules Comparison Chart

Appendix F – Arthur Andersen Document Retention Policy

DIRECTOR AND OFFICER RESPONSIBILITIES DURING CORPORATE TURMOIL

By

Byron F. Egan, Dallas, TX*

I. Introduction.

These are troubled times in parts of corporate America. The collapse of many dot.com companies was followed by the tragedy of September 11, 2001 and its after-shocks which hurt many businesses. Then came some high profile bankruptcies and related startling developments.

The conduct of directors and officers has long been scrutinized when the corporation was confronted with the prospect of a business combination, whether friendly or hostile, or when the corporation was charged with illegal conduct. These recent events have further focused attention on how directors and officers discharge their duties, particularly during times of corporate turmoil, and have caused much reexamination of how corporations are governed and how they relate to their shareholders.

The individuals who play leadership roles in corporations are fiduciaries in relation to the corporation and its owners. These troubling times make it appropriate to focus upon the fiduciary and other duties of directors and officers, including the duties of care, loyalty and oversight. Those duties are generally owed to the corporation and its shareholders, but when the corporation is on the penumbra of bankruptcy and the shareholders have no equity remaining in the company, those duties may begin to shift to the new owners of the business – the creditors.

The failure of Enron Corp. ("*Enron*")[1] has resulted in renewed focus on how corporations should be governed, including the role of the audit committee of the board of directors[2] and the corporation's Code of Conduct.[3] Calls for a "tough new corporate fraud bill" led to the Sarbanes-Oxley Act of 2002 (H.R. 3763) (the "*SOB*"), which President Bush signed on July 30, 2002 and

---

* Copyright© 2002 by Byron F. Egan. All rights reserved.

Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is a former Chairman of the Texas Business Law Foundation and is also former Chairman of the Business Law Section of the State Bar of Texas and of that Section's Corporation Law Committee. Mr. Egan is Vice-Chair of the ABA Business Law Section's Negotiated Acquisitions Committee and former Co-Chair of its Asset Acquisition Agreement Task Force, which published the *ABA Model Asset Purchase Agreement with Commentary* (2001). He is also a director of the Texas General Counsel Forum and a member of the American Law Institute. The author wishes to acknowledge the contributions of the following in preparing this paper: Matthew A. McMurphy, Sabrina A. McTopy, Hal L. Sanders and John R. Williford.

1 *See Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, William C. Powers Chair, dated February 1, 2002 (the "*Powers Report*") is attached at Appendix A.

2 A form of Audit Committee Charter is attached as Appendix B.

3 Selected provisions from a form of Code of Conduct are attached as Appendix C.

which was intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.

The SOB is generally applicable to all companies required to file reports, or that have a registration statement on file, with the Securities and Exchange Commission ("*SEC*") regardless of size ("*public companies*"). Although the SOB does have some specific provisions, and generally establishes some important public policy changes, it will be implemented in large part through rules adopted and to be adopted by the SEC.

We will endeavor to focus on some of the issues raised by the fall of Enron, the enactment of SOB and related SEC rulemaking to date.[4] Our focus will be in the context of companies organized under the Texas Business Corporation Act ("*TBCA*") and the Delaware General Corporation Law ("*DGCL*").

II. Fiduciary Duties Generally.

A. General Principles.

The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago. The current concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.

Both the TBCA and the DGCL provide that the business and affairs of a corporation are to be managed under the direction of its board of directors.[5] While the TBCA and the DGCL 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, the fiduciary duty of a director has been characterized as including duties of loyalty, care and obedience.[6] In Delaware, the fiduciary duties include those of loyalty, care and candor.[7] 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.[8]

---

4 See Summary of the Sarbanes-Oxley Act of 2002 and Related SEC Rulemaking attached as Appendix D. Among other things, the SOB amends the Securities Exchange Act of 1934 (the "*1934 Act*") and the Securities Act of 1933 (the "*1933 Act*").

5 TBCA art. 2.31 and DGCL § 141(a).

6 *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).

7 *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

8 *See* Egan and 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).

B. Applicable Law.

Under the internal affairs doctrine, courts in Texas apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties.[9] Delaware also subscribes to the internal affairs doctrine. However, Delaware has a choice of law statute under which the parties can agree that internal matters ordinarily governed by the law of another state of incorporation will be resolved under the laws of Delaware in Delaware courts.[10]

C. Fiduciary Duties in Texas Cases.

The Fifth Circuit stated in *Gearhart* that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (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.[11] *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas, although there are subsequent cases which amplify *Gearhart* as they apply it in particular situations, such as lawsuits by the Federal Deposit Insurance Corporation ("*FDIC*") and the Resolution Trust Company ("*RTC*") arising out of failed financial institutions.[12]

1. Loyalty.

The duty of loyalty in Texas is a duty that dictates that the director act in good faith and not allow his personal interest to prevail over that of the corporation.[13] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[14] Whether there exists a personal interest by the director will be a question of fact.[15] In general, a director will not be permitted to derive a personal profit or advantage at the expense of the

---

9 TBCA art. 8.02 and Texas Miscellaneous Corporations Act ("*TMCLA*") art. 1302-1.03; *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000); *Gearhart*, 741 F.2d at 719; *A. Copeland Enterprises, Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989); *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Civ. App. - Houston [1st Dist.] 1987, writ ref'd n.r.e.), *cert. dismissed*, 485 U.S. 944 (1988).

10 Del. Code Ann. Tit. 6, §2708; *see* Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 Del. J. Corp. L. 999 (1994).

11 *Gearhart*, 741 F.2d at 712-720; *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

12 *See, e.g.*, *FDIC v. Harrington*, 844 F. Supp. 300 (N.D. Tex. 1994).

13 *Gearhart*, 741 F.2d at 719.

14 *International Bankers Life Insurance Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1967).

15 *Id.* at 578.

corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.[16]

The court in *Gearhart* summarized Texas law with respect to the question of whether a director is "interested":

> A director is considered 'interested' if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . .; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated . . .; or (4) transacts business in his director's capacity with a family member.[17]

2. ***Care (including business judgment rule).***

The duty of care in Texas requires the director to handle his duties with such care as an ordinary prudent man would use under similar circumstances. In performing this obligation, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests.[18]

In general, the duty of care will be satisfied if the directors' actions are covered by the business judgment rule. The Fifth Circuit stated in *Gearhart* that, in spite of the requirement that a corporate director handle his duties with such care as an ordinarily prudent man would use under similar circumstances, Texas courts will not impose liability upon a *noninterested* corporate director unless the challenged action is *ultra vires* or is tainted by fraud. In a footnote in the *Gearhart* decision, the Fifth Circuit stated:

> The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an ultra vires act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.[19]

In applying the business judgment rule in Texas, the courts in *Gearhart* and other recent cases have quoted from the early Texas decision of *Cates v. Sparkman*,[20] as setting the standard for judicial intervention in cases involving duty of care issues:

> [I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are

---

16 *Copeland Enterprises*, 706 F. Supp. at 1291; *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App. — Waco 1953, writ ref'd n.r.e.). *See* Kendrick, *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

17 *Gearhart*, 741 F.2d at 719-20 (citations omitted).

18 *Gearhart*, 741 F.2d at 719; *McCollum v. Dollar*, 213 S.W. 259 (Tex. Comm'n App. 1919, holding approved).

19 *Gearhart*, 741 F.2d at 723 n.9.

20 11 S.W. 846 (1889),

> within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.[21]

In *Gearhart* the Court commented that "[e]ven though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar, supra,* Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is ultra vires or is tainted by fraud."[22]

Neither *Gearhart* nor the earlier Texas cases on which it relied referenced "gross negligence" as a standard for director liability. If read literally, the business judgment rule articulated in the case would protect even grossly negligent conduct. Recent Federal district court decisions in FDIC and RTC initiated cases, however, have declined to interpret Texas law this broadly and have held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment."[23]

In response to RTC and FDIC claims that ordinary negligence was the standard for duty of care cases against failed Texas financial institutions, the Texas legislature in 1993 passed House Bill 1076 which, purporting not to change existing law, provided that a disinterested director of a failed institution may not be held personally liable unless the director was grossly negligent or committed willful or negligent misconduct. While House Bill 1076 is inapplicable beyond FDIC and RTC cases, its legislative imprimatur "gave added weight to the *Gearhart* standard of liability" since the "statute explicitly provides that officers and directors may be held liable only for acts of gross negligence" and "was not intended to change, but merely clarify, existing law regarding the proper standard of care for directors and officers of insured financial institutions."[24] The RTC challenged the constitutionality of House Bill 1076 in *Harrington*, but the court resolved the issues before it without reaching the constitutional question.

Gross negligence in Texas is defined as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or

---

21 *Id.* at 849.

22 *Gearhart*, 741 F.2d at 721.

23 *FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *see also RTC v. Acton*, 844 F. Supp, 307, 314 (N.D. Tex. 1994); *RTC v. Norris*, 830 F. Supp. 351, 357-58 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992); *cf. RTC v. Miramon*, 22 F.3d 1357 (5th Cir. 1994) (followed *Harrington* analysis of Section 1821(K) of the Financial Institutions Reform, Recovery and Enforcement Act ("*FIRREA*") which held that federal common law of director liability did not survive FIRREA and applied Texas' gross negligence standard for financial institution director liability cases under FIRREA).

24 *Harrington*, 844 F. Supp. at 307, n.8.

welfare of the person or persons to be affected by it."[25] In *Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[26]

The business judgment rule does not necessarily protect a director with respect to transactions in which he is "interested." It simply means that the action will have to be challenged on duty of loyalty rather than duty of care grounds.[27]

Directors may "in good faith and with ordinary care, rely on information, opinions, reports or statements, including financial statements and other financial data," prepared by officers or employees of the corporation, counsel, accountants, investment bankers or "other persons as to matters the director reasonably believes are within the person's professional or expert competence."[28]

3. ***Other (obedience).***

The duty of obedience in Texas requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the powers of the corporation as defined by its articles of incorporation and Texas law.[29] An *ultra vires* act may be voidable under Texas law, but the director will not be held personally liable for such act unless the act is in violation of a specific statute or against public policy.

The RTC's complaint in *RTC v. Norris*[30] asserted that the directors of a failed financial institution breached their fiduciary duty of obedience by failing to cause the institution to adequately respond to regulatory warnings: "The defendants committed *ultra vires* acts by ignoring warnings from [regulators], by failing to put into place proper review and lending procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth's Bylaws."[31] In rejecting this RTC argument, the court wrote:

> The RTC does not cite, and the court has not found, any case in which a disinterested director has been found liable under Texas law for alleged *ultra vires* acts of employees, absent pleadings and proof that the director knew of or took part in the act, even where the act is illegal.
>
> . . . .

---

25 *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981) (citing *Missouri Pacific Ry. v. Shuford*, 72 Tex. 165, 10 S.W. 408, 411 (1888)).

26 844 F. Supp. at 306 n.7.

27 *Gearhart*, 741 F.2d at 723, n.9.

28 TBCA art. 2.41D.

29 *Gearhart*, 741 F.2d at 719.

30 830 F. Supp. 351 (S.D. Tex. 1993).

31 *Norris*, 830 F. Supp. at 355.

> Under the business judgment rule, Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act . . . .[32]

D. Fiduciary Duties in Delaware Cases.

1. Loyalty.

The duty of loyalty in Delaware imposes on the director an obligation to refrain from doing anything that would effect an injury to the corporation, or deprive it of profits or advantages which the director's skill and ability might properly bring to the corporation, or enable the corporation to make in the reasonable and lawful exercise of its powers. The duty of loyalty requires an undivided and unselfish loyalty by the director to the corporation and demands that there not be any conflict between the director's duty to the corporation and the self-interest of the director.[33] The standard which must be followed by a director in complying with the duty of loyalty will not be subject to any fixed schedule and will be dependent upon the facts and circumstances.[34]

2. Care.

(a) *Duty of Care*. The duty of care under Delaware law is a duty that requires the director exercise his business judgment in the management of the corporation with due care and good faith. In 1962, the Delaware Supreme Court stated:

> [D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends upon the circumstances of and facts of the particular case.[35]

This duty requires the director to inform himself of all material information reasonably available to him prior to making a decision.[36] The "term 'material' is used in this context to mean relevant and of a magnitude to directors in carrying out their fiduciary care in decisionmaking," which is "distinct from the use of the term 'material' in disclosure to stockholders in which [a]n

---

32 *Id.*

33 *See Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) ("[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

34 *Id.* at 514-515.

35 *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1962).

36 *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). *See Brehm v. Eisner*, 746 A.2d 244, 259 (Del. Supr. 2000) ("[T]he standard for judging the informational component of the directors' decision does not mean that the Board must be informed of every fact. The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the board's reasonable reach."

omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.")

(b) *Business Judgment Rule.* The business judgment rule is premised on the fact that courts are ill equipped to engage in substantive reviews of business decisions taken by directors in the management of their corporations and a public policy that encourages entrepreneurial risk taking by corporate managers without the specter of personal liability for decisions that in hindsight prove to be wrong or imprudent. In Delaware the business judgment rule provides that an independent corporate director who makes a business decision on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation will not be held personally liable for mistakes of business judgment that damage corporate interests.[37]

The business judgment rule in Delaware is both a presumption (i.e., a burden-allocating mechanism used in litigation) and a substantive rule of law. As a presumption, the rule provides that acts by independent directors will be presumed to have been taken with due care and good faith and in a belief that the act was in the best interest of the corporation.[38] The standard for liability under the Delaware business judgment rule is gross negligence.[39] Thus, a challenge to an action by an independent director requires the complaining party to prove that the action by the director was grossly negligent or was not taken in an honest attempt to foster the corporation's interests. As a substantive rule of law, the business judgment rule provides that there is no liability to a director for authorizing a corporate action if the director acted in good faith and with appropriate care in informing himself of all material information reasonably available to him under the circumstances.[40]

"A conscious decision to refrain from acting may none the less be a valid exercise of business judgment and enjoy the protections of the [business judgment] rule."[41] Because deliberate inaction is protected by the business judgment rule and other inaction is not so protected, the focus in a director inaction case must be on the process by which the decision not to act was made.[42]

---

37 *In re J.P. Stevens & Co. Shareholders Litig.,* Del. Ch., 542 A.2d 770, 780 (1988) ("a decision made by an independent board will not give rise to liability . . . if it is made in good faith and in the exercise of due care"); *see Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (directors approved lucrative consulting contract with founder/controlling shareholder in his seventies that gave him a percentage of the corporation's profits above a threshold without any requirement that he be able to work plus interest-free loans; court found directors "independent" because they had no financial interest in the transactions, although they were dependent upon the founder for their positions, and applied business judgment rule).

38 *Aronson*, 473 A.2d at 812; *AC Acquisitions Corp. v. Anderson, Clayton & Co.,* Del. Supr., 519 A.2d 103, 111 (1986) (business judgment rule is "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

39 *Van Gorkom*, 488 A.2d at 873.

40 *Aronson*, 473 A.2d at 812.

41 *Aronson*, 473 A.2d at 813.

42 *See In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); Funk, *Note: In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 Del. J. Corp. L. 311 (1997).

(c) *Duty of Oversight*. The Delaware Court of Chancery has suggested that business judgment protection is unavailable where directors failed to act because they were ignorant of the operative facts.[43] In such a case, ordinary negligence would be the standard by which the directors' conduct is measured.[44]

Other decisions, however, indicate that director inaction will be entitled to some level of protection. The Delaware Supreme Court has made clear that director inaction standing alone is not determinative, and "a conscious decision to refrain from acting may none the less be a valid exercise of business judgment and enjoy the protections of the [business judgment] rule."[45] Thus, a conscious decision not to act should be measured by the business judgment rule, with the likely result that an informed decision not to act would be protected.

Because deliberate inaction is protected by the business judgment rule, the focus in a director inaction case must be on the process by which the decision not to act was made. In *In re Caremark International, Inc. Derivative Litigation*,[46] The Delaware Court of Chancery approved the settlement of a derivative action that involved claims that members of Caremark's board of directors breached their fiduciary duty of care to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes. In so doing, the court discussed the scope of a board of directors' duty to supervise or monitor corporate performance and stay informed about the business of the corporation as follows:

> [I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligations to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[47]

Stated affirmatively, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may . . . render a director liable."[48] While *Caremark* recognizes a cause of action for uninformed inaction the holding is subject to the following:

First, the Court held that "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting

---

43 *Rabkin v. Philip A. Hunt Chem. Corp.,* 1987 Del. Ch. LEXIS 522, 1987 WL 28436, at *1 (Del. Ch.).

44 *Id.*

45 *Aronson,* 473 A.2d at 813.

46 698 A.2d 959 (Del. Ch. 1996).

47 *Id.* at 970.

48 *Id.*

system exists — will establish the lack of good faith that is a necessary condition to liability."[49] It is thus not at all clear that a plaintiff could recover based on a single example of director inaction, or even a series of examples relating to a single subject.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"[50] which indicates that the presence of an existing information and reporting system will do much to cut off any derivative claim, because the adequacy of the system itself will be protected.

Third, *Caremark* considered it obvious that "no rationally designed information system . . . will remove the possibility" that losses could occur.[51] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[52] This holding indicates that a loss to the corporation is not itself evidence of an inadequate information and reporting system. Instead, the court will focus on the adequacy of the system overall and whether a causal link exists.[53]

Caremark was followed by the Seventh Circuit applying Illinois law in *In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002), which involved a shareholders derivative suit against the health care corporation's directors, alleging breach of fiduciary duty and asserting that directors were liable under state law for harms resulting from a consent decree between corporation and the Food and Drug Administration ("*FDA*"). The consent decree had followed a six-year period during which the FDA had given numerous notices to the company of violations of FDA manufacturing regulations and imposed a $100 million fine, which resulted in a $168 million charge to earnings. In reversing a district court dismissal of plaintiff's complaint for failure to adequately plead that demand upon board of directors would be futile, the Seventh Circuit held that the complaints raised reasonable doubt as to whether directors' actions were product of valid exercise of business judgment, thus excusing demand requirement, and were sufficient to overcome directors' exemption from liability contained in articles of incorporation. In so holding, the Seventh Circuit noted that the complaint pled that the directors knew or should have known of the FDA noncompliance problems and demonstrated gross negligence by ignoring them for six years and not disclosing them in the company's SEC periodic reports during this period. The Court relied upon Delaware case law and wrote:

---

49 *Id.* at 971.

50 *Id.* at 970.

51 *Id.*

52 *Id.* at 970 n. 27.

53 *See generally* Eisenberg, *Corporate Governance The Board of Directors and Internal Control,* 19 CARDOZO L. REV. 237 (1997); Pitt, et al., *Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct,* 1005 PLI/CORP. 301, 304 (1997); Gruner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond,* 995 PLI/CORP. 57, 64-70 (1997); Funk, *Recent Developments in Delaware Corporate Law:* In re Caremark International Inc. Derivative Litigation: *Director Behavior, Shareholder Protection, and Corporate Legal Compliance,* 22 DEL. J. CORP. L. 311 (1997).

> We find that the facts alleged are sufficient to show that although corporate governance practices were in place, the directors were grossly negligent in failing to inform themselves of all reasonably available material information.
>
> Delaware law also states that director liability may arise for the breach of the duty to exercise appropriate attention to potentially illegal corporate activities from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996). The court held that "a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to [director] liability." *Id.* at 971. Although the present case does not deal with a claim of fraud like that in *In re Caremark*, with the extensive paper trail concerning the violations and the implied awareness of the problems in the SEC filings, it is clear that the directors either knew or should have known of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in the substantial losses incurred by the consent decree. 393 F.3d at 389-390.

The Seventh Circuit further held that the provision in the corporation's articles of incorporation limiting director liability[54] would not be applicable to facts alleged as the "plaintiffs' complaint sufficiently alleges 'omissions not in good faith' and 'intentional misconduct' concerning 'violations of law,' which conduct falls outside of the exemption."[55]

3. ***Other (candor).***

Delaware has also imposed a duty of candor.[56] This duty requires disclosure to shareholders of "all germane or material information" and information that "would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[57] This duty imposes, at a minimum, that a director not use superior information or knowledge to mislead others in the performance of their fiduciary obligations to the corporation, and the breach

---

54 Abbott's Articles of Incorporation included the following provision limiting director liability:

> "A director of the corporation shall not be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) under Section 8.65 of the Illinois Business Corporation Act, or (iv) for any transaction from which the director derived an improper personal benefit . . . ."

393 F.3d at 390-391.

55 393 F.3d at 391.

56 *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev'd*, 559 A.2d 1261 (Del. 1988).

57 *Stroud v. Milliken Enterprises, Inc.*, 552 A.2d 476, 480 (Del. 1989); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 846 (Del. 1989); *Day v. Quotron Systems, Inc.*, 16 Del. J. Corp. Law 297, 307 (Del. Ch. 1989); *see also Goodwin v. Live Entertainment, Inc.*, 1999 WL 64265, at *6 (Del. Ch. 1999).

thereof can be established without any showing that the directors acted with *scienter*. The judicial focus in the reported cases to date has been on information related to the process followed by the directors leading up to its decision to recommend that the shareholders approve a transaction and to the relative value to be received by the shareholders, rather than on compliance with Securities and Exchange Commission disclosure rules.[58]

III. Standards of Review in Change of Control Context.

A. Texas Standard of Review.

Possibly because the Texas business judgment rule, as articulated in *Gearhart*, protects so much director action, the parties and the courts in the two leading cases in the takeover context have concentrated on the duty of loyalty in analyzing the propriety of the director conduct. This focus should be contrasted with the approach of the Delaware courts which often concentrates on the duty of care.

To prove a breach of the duty of loyalty, it must be shown that the director was "interested" in a particular transaction.[59] In *Copeland*, the court interpreted *Gearhart* as indicating that "[a]nother means of showing interest, when a threat of takeover is pending, is to demonstrate that actions were taken with the goal of director entrenchment."[60]

Both the *Gearhart* and *Copeland* courts assumed that the defendant directors were interested, thus shifting the burden to the directors to prove the fairness of their actions to the corporation.[61] Once it is shown that a transaction involves an interested director, the transaction is "subject to strict judicial scrutiny but [is] not voidable unless [it is] shown to be unfair to the corporation."[62] "[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation."[63]

In analyzing the fairness of the transaction at issue, the Fifth Circuit in *Gearhart* relied on the following criteria set forth by Justice Douglas in *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939):

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness

---

58 *See generally*, Pease, *Delaware's Disclosure Rule: The "Complete Candor" Standard, its Application, and Why Sue in Delaware*, 14 Del. J. Corp. L. 446 (1989).

59 *Gearhart*, 741 F.2d. at 719; *Copeland*, 706 F. Supp. at 1290.

60 *Copeland*, 706 F. Supp. at 1290-91.

61 *Gearhart*, 741 F.2d at 722; *Copeland*, 706 F. Supp. at 1291-92.

62 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

63 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.[64]

In *Gearhart*, the court also stated that a "challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of stockholders."[65]

In setting forth the test for fairness, the *Copeland* court also referred to the criteria discussed in *Pepper v. Litton* and cited *Gearhart* as controlling precedent.[66] In analyzing the shareholder rights plan (also known as a "poison pill") at issue, however, the court specifically cited Delaware cases in its after-the-fact analysis of the fairness of the director action.[67] Whether a Texas court following *Gearhart* would follow Delaware case law in its fairness analysis remains to be seen, especially in light of the Fifth Circuit's complaint in *Gearhart* that the lawyers focused on Delaware cases and failed to deal with Texas law:

> We are both surprised and inconvenienced by the circumstance that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law. We note that two cases cited to us as purported Texas authority were both decided under Delaware law. . . .[68]

Given the extent of Delaware law in the takeover context, it is certain, however, that Delaware cases will be cited and argued by the corporate lawyers negotiating the transaction and by any subsequent litigants. The following analysis, therefore, focuses on the pertinent Delaware cases.

B. Delaware Standard of Review.

Under Delaware law, there are generally three standards against which the courts will measure director conduct in a takeover context. As articulated by the Delaware courts, these standards provide important guidelines for directors and their counsel as to the process to be followed for director action to be sustained. These standards are:

(i) the business judgment rule -- for a decision to remain independent or to approve a transaction not involving a sale of control;

---

64 *Gearhart*, 741 F.2d at 723 (citations omitted).

65 *Id*. at 720 (citation omitted).

66 *Copeland*, 706 F. Supp. at 1290-91.

67 *Id*. at 1291-93.

68 *Gearhart*, 741 F.2d. at 719 n.4.

(ii) enhanced scrutiny -- for a decision to adopt or employ defensive measures[69] or to approve a transaction involving a sale of control; and

(iii) entire fairness -- for a decision to approve a transaction involving management or a principal shareholder.

The business judgment rule provides a presumption in favor of directors, and places the burden on those challenging director action, where the directors have acted with care, loyalty and independence. Before the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.*,[70] it was generally believed that in the takeover context director action would be accorded the protection of the business judgment rule in the absence of a traditional conflict of interest. As applied in the takeover context in *Smith v. Van Gorkom*,[71] this protection of the business judgment rule was premised upon directors adequately informing themselves of all material information reasonably available to provide bases for their decisions.

Beginning with *Unocal*, however, the conduct of directors was subjected to "enhanced scrutiny" in circumstances where a traditional conflict of interest was absent. The enhanced scrutiny standard places a burden on directors not only to be adequately informed but also to have "acted reasonably."[72] The range of reasonableness addressed by enhanced scrutiny may be a middle ground between the "any rational purpose" to which the business judgment rule defers and the "entire fairness" sought for transactions in which directors or other affiliates have an interest.[73]

Enhanced scrutiny was initially the product of court review of defensive techniques used to respond to an unwanted suitor.[74] The burden of enhanced scrutiny was extended to director responses to competing bids when a decision is made to sell a company.[75] In *QVC*, the Delaware Supreme Court confirmed that the application of enhanced scrutiny is to sales of control generally.[76]

Whether the burden of proof is ultimately found to be with the directors or their challengers, in all cases, directors and their counsel are well advised to establish a record supporting the reasonableness of their actions from the very beginning of the decision-making process.

---

69 In *Williams v. Geier*, 671 A.2d 1368 (Del. 1996), the Delaware Supreme Court held that an antitakeover defensive measure will not be reviewed under the enhanced scrutiny standard when the defensive measure is approved by stockholders. The court stated that this standard "should be used only when a board unilaterally (i.e. without stockholder approval) adopts defensive measures in reaction to a perceived threat." *Id.* at 1377.

70 493 A.2d 946 (Del. 1985).

71 488 A.2d 858 (Del. 1985).

72 *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994); *see also Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*, 721 A.2d 1281, 1290 (Del. 1998).

73 *See QVC*, 637 A.2d at 42, 45.

74 *See Unocal*, 493 A.2d 946; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

75 *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

76 *QVC*, 637 A.2d at 46.

1. ***Business Judgment Rule.***

The Delaware business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[77] "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose'."[78]

The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors must satisfy their duty of care even when they act in the good faith belief that they are acting only in the interests of the corporation and its stockholders. Their decision must be an informed one. "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[79] In *Van Gorkom*, notwithstanding a transaction price substantially above the current market, directors were held to have been grossly negligent in, among other things, acting in haste without adequately informing themselves as to the value of the corporation.[80]

2. ***Enhanced Scrutiny.***

When applicable, enhanced scrutiny places on the directors the burden of proving that they have acted reasonably. The key features of enhanced scrutiny are:

(i) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and

(ii) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing.

The directors have the burden of proving that they were adequately informed and acted reasonably.[81]

The reasonableness required under enhanced scrutiny falls within a range of acceptable alternatives, which echoes the deference found under the business judgment rule.

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even

---

77 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citation omitted); *see also Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1997).

78 *Unocal*, 493 A.2d at 954 (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

79 *Van Gorkom*, 488 A.2d at 872 (citation omitted).

80 *Id*. at 874.

81 *QVC*, 637 A.2d at 45; *see also Quickturn*, 721 A.2d at 1290.

> though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[82]

a. **Defensive Measures.**

When directors authorize defensive measures, there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[83] Courts review such actions with enhanced scrutiny even though a traditional conflict of interest is absent. In refusing to enjoin a selective exchange offer adopted by the board to respond to a hostile takeover attempt, the *Unocal* court held that the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation) and (ii) the responsive action taken was reasonable in relation to the threat posed.[84]

b. **Sale of Control.**

In *QVC*, the issues were whether a poison pill could be used selectively to favor one of two competing bidders, effectively precluding shareholders from accepting a tender offer, and whether provisions of the merger agreement (a "no-shop" clause, a "lock-up" stock option, and a break-up fee) were appropriate measures in the face of competing bids for the corporation. Although the decision can be viewed as a variation on *Unocal and Revlon*, the Delaware Supreme Court's language is sweeping as to the possible extent of enhanced scrutiny.

> The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.[85]

The rule announced in *QVC* places a burden on the directors to obtain the *best value* reasonably available once the board determines to sell the corporation in a change of control transaction. This burden entails more than obtaining a fair price for the shareholders, one within the range of fairness that is commonly opined upon by investment banking firms. In *Cede & Co. v. Technicolor, Inc.*,[86] the Delaware Supreme Court found a breach of duty even though the transaction price exceeded the value of the corporation determined under the Delaware appraisal statute: "[I]n the review of a transaction involving a sale of a company, the directors have the burden of

---

82 *QVC*, 637 A.2d at 45.

83 *Unocal*, 493 A.2d at 954.

84 *Id.* at 954-55.

85 *QVC*, 637 A.2d at 43 (footnote omitted).

86 634 A.2d 345 (Del. 1993).

establishing that the price offered was the highest value reasonably available under the circumstances."[87]

Although *QVC* mandates that enhanced scrutiny for board action involving a sale of control, certain stock transactions are considered not to involve a change in control for such purpose. In *Arnold v. Soc'y for Sav. Bancorp*,[88] the Delaware Supreme Court considered a merger between Bancorp and Bank of Boston in which Bancorp stock was exchanged for Bank of Boston stock.[89] The shareholder plaintiff argued, among other things, that the board's actions should be reviewed with enhanced scrutiny because (i) Bancorp was seeking to sell itself and (ii) the merger constituted a change in control because the Bancorp shareholders were converted to minority status in Bank of Boston, losing the opportunity to enjoy a control premium.[90] The Court held that the corporation was not for sale because no active bidding process was initiated and the merger was not a change in control and, therefore, that enhanced scrutiny of the board's approval of the merger was not appropriate.[91] Citing *QVC*, the Court stated that "there is no 'sale or change in control' when '[c]ontrol of both [corporations] remain[s] in a large, fluid, changeable and changing market.'"[92] As continuing shareholders in Bank of Boston, the former Bancorp shareholders retained the opportunity to receive a control premium.[93] The Court noted that in *QVC* a single person would have control of the resulting corporation, effectively eliminating the opportunity for shareholders to realize a control premium.[94]

3. ***Entire Fairness.***

Both the business judgment rule and the enhanced scrutiny standard should be contrasted with the standard applied in transactions with affiliates. In reviewing board action in transactions involving management, board members or a principal shareholder, the Delaware Supreme Court has imposed an "entire fairness" standard.[95] Under this standard the burden is on directors to show both (i) fair dealing and (ii) a fair price:

> The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates

---

87 *Id.* at 361.

88 650 A.2d 1270 (Del. 1994).

89 *Id.* at 1273.

90 *Id.* at 1289.

91 *Id.* at 1289-90.

92 *Id.* at 1290.

93 *Id.*

94 *Id.*; *see also Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

95 *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988).

> to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[96]

The burden shifts to the challenger to show the transaction was unfair where (i) the transaction is approved by the majority of the minority shareholders, though the burden remains on the directors to show that they completely disclosed all material facts relevant to the transaction,[97] or (ii) the transaction is negotiated by a special committee of independent directors that is truly independent, not coerced and has real bargaining power.[98]

C. Action Without Bright Lines.

Whether the burden will be on the party challenging board action, under the business judgment rule, or on the directors, under enhanced scrutiny, clearly the care with which the directors acted in a change of control transaction will be subjected to close review. For this review there will be no "bright line" tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances. Thus directors, and counsel advising them, should heed the Delaware Supreme Court in *Barkan v. Amsted Indus., Inc.*:[99] "[T]here is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today's corporate environment." In the absence of bright lines and blueprints that fit all cases, the process to be followed by the directors will be paramount. The elements of the process should be clearly understood at the beginning, and the process should be guided and well documented by counsel throughout.

IV. Application of Delaware Standards in a Friendly Merger.

How do the Delaware fiduciary duties outlined above play out in the context of a friendly merger involving a sale of control? The typical friendly merger begins when an unaffiliated suitor contacts a corporation's CEO to propose a merger, generally for a cash price or a combination of cash and stock. If the consideration is for cash, the proposed transaction would likely include an "any and all" tender offer for the corporation's shares. Management would not have any special interest in the transaction, nor would management wish to pursue its own buyout or implement another competing transaction intended to enhance shareholder value. In these circumstances, how should the directors respond? Are they required to evaluate the proposed transaction and, if so, to what extent? If after an evaluation, they do not wish to pursue the combination, what is required to protect them and their decision from challenge? Or if they wish to pursue the combination, how should they proceed? If a merger agreement is signed, can the suitor protect its deal? If a competing suitor emerges, how should the directors respond?

---

96 *Weinberger*, 457 A.2d at 711.

97 *Id* at 703.

98 *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

99 567 A.2d 1279, 1286 (Del. 1989).

A. Management's Immediate Response.

Serious offers require serious consideration. The CEO and management will usually be called upon to make an initial judgment as to seriousness. A written, well developed proposal from a credible prospective acquiror should be studied. In contrast, an oral proposal, or a written one that is incomplete in material respects, should not require management efforts to develop the proposal further. In no event need management's response indicate any willingness to be acquired. In *Citron v. Fairchild Camera and Instrument Corp.*,[100] for example, the Delaware Supreme Court sanctioned behavior that included the CEO's informing an interested party that the corporation was not for sale, but that a written proposal, if made, would be submitted to the board for review. Additionally, in *Matador Capital Management Corp. v. BRC Holdings, Inc.*,[101] the Delaware Chancery Court found unpersuasive the plaintiff's claims that the board failed to consider a potential bidder because the board's decision to terminate discussion was "justified by the embryonic state of [the potential bidder's] proposal."[102] In particular, the court stated that the potential bidder did not provide evidence of any real financing capability and conditioned its offer of its ability to arrange the participation of certain members of the target company's management in the transaction.[103]

B. The Board's Consideration.

"When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."[104] Just as all proposals are not alike, board responses to proposals may differ. A proposal that is incomplete in material respects should not require serious board consideration. On the other hand, because more developed proposals may present more of an opportunity for shareholders, they ought to require more consideration by the board.[105]

---

100 569 A.2d 53 (Del. 1989).

101 729 A.2d 280 (Del. Ch. 1998).

102 *Id*. at 292.

103 *Id*.

104 *Unocal*, 493 A.2d at 954.

105 *See Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289, 1300 (N.D. Ill. 1988) (applying Delaware law) ("The Board did not breach its fiduciary duty by refusing to negotiate with Desert Partners to remove the coercive and inadequate aspects of the offer. USG decided not to bargain over the terms of the offer because doing so would convey the image to the market place 'that (1) USG was for sale – when, in fact, it was not; and (2) $42/share was an 'in the ballpark' price - when, in fact, it was not.'"); and *Citron*, 569 A.2d at 63, 66-67 (validating a board's action in approving one bid over another that, although higher on its face, lacked in specifics of its proposed back-end which made the bid impossible to value). *Compare Golden Cycle, LLC v. Allan*, 1998 WL 892631 (board not required to contact competing bidder for a higher bid before executing a merger agreement where bidder had taken itself out of the board process, refused to sign a confidentiality agreement and appealed directly to the stockholders with a consent solicitation).

1. Matters Considered.

Where an offer is perceived as serious and substantial, an appropriate place for the board to begin its consideration may be an informed understanding of the corporation's value. This may be advisable whether the board's ultimate response is to "say no," to refuse to remove pre-existing defensive measures, to adopt new or different defensive measures or to pursue another strategic course to maximize shareholder value. Such a point of departure is consistent with *Van Gorkom* and *Unocal*. In *Van Gorkom*, the board was found grossly negligent, among other things, for not having an understanding of the intrinsic value of the corporation. In Unocal, the inadequacy of price was recognized as a threat for which a proportionate response is permitted.[106]

That is not to say, however, that a board must "price" the corporation whenever a suitor appears. Moreover, it may be ill advised even to document a range of values for the corporation before the conclusion of negotiations. However, should the decision be made to sell or should a defensive reaction be challenged, the board will be well served to have been adequately informed of intrinsic value during its deliberations from the beginning.[107] In doing so, the board may also establish, should it need to do so under enhanced scrutiny, that it acted at all times to maintain or seek "the best value reasonably available to the stockholders."[108] This may also be advisable even if that value derives from remaining independent.

There are, of course, factors other than value to be considered by the board in evaluating an offer. The Delaware judicial guidance here comes from the sale context and the evaluation of competing bids, but may be instructive:

> In assessing the bid and the bidder's responsibility, a board may consider, among various proper factors, the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.[109]

---

[106] *Unocal*, 493 A.2d at 955; *see also Unitrin Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1384 (Del. 1995), noting as a threat "substantive coercion . . . the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value."

[107] *See Technicolor*, 634 A.2d at 368.

[108] *QVC*, 637 A.2d at 45.

[109] *Macmillan*, 559 A.2d at 1282 n.29 (citations omitted).

2. *Being Adequately Informed.*

Although there is no one blueprint for being adequately informed,[110] the Delaware courts do value expert advice, the judgment of directors who are independent and sophisticated, and an active and orderly deliberation.

a. Investment Banking Advice.

The fact that the board of directors relies on expert advice to reach a decision provides strong support that the board acted reasonably.[111]

Addressing the value of a corporation generally entails obtaining investment banking advice.[112] The analysis of value requires the "techniques or methods which are generally considered acceptable in the financial community. . . ."[113] Clearly, in *Van Gorkom*, the absence of expert advice prior to the first board consideration of a merger proposal contributed to the determination that the board "lacked valuation information adequate to reach an informed business judgment as to the fairness [of the price]" and the finding that the directors were grossly negligent.[114] Although the Delaware Supreme Court noted that "fairness opinions by independent investment bankers are [not] required as a matter of law,"[115] in practice, investment banking advice is obtained for any decision to sell and for many decisions not to sell. In the non-sale context, such advice is particularly helpful where there may be subsequent pressure to sell or disclosure concerning the board's decision not to sell is likely.

The advice of investment bankers is not, however, a substitute for the judgment of the directors. As the court pointed out in *Citron*, "in change of control situations, sole reliance on hired experts and management can 'taint[] the design and execution of the transaction'."[116] In addition, the timing, scope and diligence of the investment bankers may affect the outcome of subsequent judicial scrutiny. The cases in this latter respect involve decisions to sell, but may nevertheless be instructive for board deliberations which do not result in a sale decision:

---

110 *See Goodwin v. Live Entertainment, Inc.*, 1999 WL 64265, at *21 (Del. Ch. 1999) (citing *Barkan*, 567 A.2d at 1286).

111 *See Goodwin*, 1999 WL 64265, at *22 ("The fact that the Board relied on expert advice in reaching its decision not to look for other purchasers also supports the reasonableness of its efforts."); *In re Vitalink Communications Corp. Shareholders Litig.*, 1991 WL 238816, at *12 (Del. Ch. 1991) (citations omitted) (board's reliance on the advice of investment bankers supported a finding that the board had a "reasonable basis" to conclude that it obtained the best offer).

112 *See, e.g., In re Talley Indus., Inc. Shareholders Litig.*, 1998 WL 191939, at *11-12 (Del. Ch. 1998).

113 *Weinberger*, 457 A.2d at 713.

114 *Van Gorkom*, 488 A.2d at 878.

115 *Id.* at 876.

116 *Citron*, 569 A.2d at 66 (citation omitted).

(1) In *Weinberger*,[117] the Delaware Supreme Court held that the board's approval of an interested merger transaction did not meet the test of fairness.[118] The fairness analysis prepared by the investment bankers was criticized as "hurried" where due diligence was conducted over a weekend and the price was slipped into the opinion by the banking partner (who was also a director of the corporation) after a quick review of the assembled diligence on a plane flight.[119]

(2) In *Macmillan*,[120] the court enjoined defensive measures adopted by the board, including a lock-up and no-shop granted to an acquiror, to hinder competing bids from Mills. The court questioned an investment bank's conclusion that an $80 per share cash offer was inadequate when it had earlier opined that the value of the company was between $72 and $80 per share and faulted the lack of independence of the investment bankers who were retained by and consulted with financially interested management.[121]

(3) In *Technicolor*,[122] the court faulted the valuation package prepared by the investment bankers because they were given limited access to senior officers and directors of Technicolor.

b. **Value of Independent Directors, Special Committees.**

One of the first tasks of counsel in a takeover context is to assess the independence of the board. In responding to a suitor, a corporation that has significant independent directors may have an advantage over companies without such independent directors.[123] In a sale of control transaction, "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial."[124] As pointed out by the Delaware Supreme Court in *Unocal*, when enhanced scrutiny is applied by the court, "proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted [in good faith and after a reasonable investigation]."[125]

---

117 *Weinberger*, 457 A.2d 701.

118 *Id.* at 715.

119 *Id.* at 712.

120 *Macmillan*, 559 A.2d 1261.

121 *Id.* at 1271.

122 *Technicolor*, 634 A.2d 345.

123 *See, e.g., Kahn v. MSB Bancorp, Inc.*, 1998 WL 409355, at *3 (Del. Ch. 1998), *Aff'd* 734 A.2d 158 (Del. 1999) ("[T]he fact that nine of the ten directors are not employed by MSB, but are outside directors, strengthens the presumption of good faith.")

124 *QVC*, 637 A.2d at 44; *see also Macmillan*, 599 A.2d 1261.

125 *Unocal*, 493 A.2d at 955.

(1) *Characteristics of an Independent Director*. An independent director has been defined as a non-employee and non-management director.[126] In addition, a court may consider the sophistication of the individual board members in evaluating their independence and informed judgments. In *Van Gorkom*, the fact that no directors were investment bankers or financial analysts contributed to the evidence indicating that the board was uninformed.[127] Moreover, to be effective, outside directors cannot be dominated by financially interested members of management.[128] Care should also be taken to restrict the influence of other interested directors, which may include recusal of interested directors from participation in certain board deliberations.[129]

(2) *Need for Active Participation*. Active participation of the independent members of the board is important in demonstrating that the board did not simply follow management. In *Time*,[130] the Delaware Supreme Court considered Time's actions in recasting its previously negotiated merger with Warner into an outright cash and securities acquisition of Warner financed with significant debt to ward off Paramount's surprise all-cash offer to acquire Time. Beginning immediately after Paramount announced its bid, the Time board met repeatedly to discuss the bid, determined the merger with Warner to be a better course of action, and declined to open negotiations with Paramount. The outside directors met independently, and the board sought advice from corporate counsel and financial advisors. Through this process the board reached its decision to restructure the combination with Warner. The court viewed favorably the participation of certain of the board's 12 independent directors in the analysis of Paramount's bid. The Time board's process contrasts with *Van Gorkom*, where although one-half of Trans Union's board was independent, an absence of any inquiry by those directors as to the basis of management's analysis and no review of the transaction documents contributed to the court's finding that the board was grossly negligent in its decision to approve a merger.[131]

(3) *Use of Special Committee*. Where the board does not have a majority of independent directors, a special committee may be chartered to analyze the adequacy of a proposal. Although the cases addressing the use of special committees relate principally to management buyouts or other interested-director transactions, they provide useful guidance to a board considering any takeover

---

[126] *Unitrin*, 651 A.2d at 1375.

[127] *Van Gorkom*, 488 A.2d at 877-78.

[128] *See Macmillan*, 559 A.2d at 1266.

[129] *See Technicolor*, 634 A.2d at 366 n.35. *See also Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (in evaluating charge that directors breached fiduciary duties in approving employment and subsequent severance of a corporation's president, the Delaware Supreme Court held that the "issues of disinterestedness and independence" turn on whether the directors were "incapable, due to personal interest or domination and control, of objectively evaluating" an action), following in this respect and overruling the standards for appellate review set forth in *Aronson*.

[130] 571 A.2d 1140.

[131] *See also Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997), where the Delaware Supreme Court found that the three member special committee of outside directors was not fully informed, not active, and did not appropriately simulate an arm's-length transaction, given that two of the three members permitted the other member to perform the committee's essential functions and one of the committee members did not attend a single meeting of the committee.

proposal. They leave unresolved, however, the question of how much power a special committee must have in order to withstand judicial review. A special committee's charter should be broad enough to permit the special committee to establish that a rejected bid is inadequate or that an approved bid is the "best value reasonably available." But a judgment will be required as to whether this requires the committee to have the ability to negotiate the offer or shop for other bidders.

(i) The special committee used in *Barkan*[132] to evaluate the fairness of any acquisition proposal was instructed not to search for alternatives to the management buy-out proposal under consideration. The court upheld the committee's decision to approve the management buy-out, but:

> [D]id not condone in all instances the imposition of the sort of 'no-shop' restriction that bound [the] Special Committee. Where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids.[133]

(ii) In *Macmillan*,[134] the limited power conferred upon the special committee utilized contributed to the court's adverse ruling. The committee was not given any negotiating authority regarding the restructuring that involved a management equity position.[135]

(iii) In *Tremont*,[136] the Delaware Supreme Court found the selection and operation of a special committee to be lacking, finding that it did not "function in a manner which indicates that the controlling shareholders did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at arm's-length'."[137] All three committee members had previous affiliations with the controlling shareholder or companies he controlled and, as a consequence, received significant financial compensation or influential positions on the board of such shareholder's controlled companies.[138] Both legal counsel and the investment bankers for the committee were retained at the suggestion of the general counsel for the corporation, rather than the committee.[139] And the committee functioned effectively as a "single member committee," with one member even absent from all meetings with advisors and other

---

132 *Barkan*, 567 A.2d 1279.

133 *Id*. at 1288.

134 *Macmillan*, 559 A.2d 1261.

135 *Id*. at 1268.

136 *Tremont*, 694 A.2d 422.

137 *Id*. at 429.

138 *Id*. at 423.

139 *Id*. at 429.

committee members.[140] The court noted that two of the members had "abdicated their responsibility . . . by permitting . . . [the committee chairman], the member whose independence was most suspect, to perform the Special Committee's essential functions."[141]

(iv) In *Rand*,[142] the Delaware Chancery Court acknowledged that delegation of decision-making to a special committee is useful in a variety of situations, but is not required by statute or case law.

C. Value of Thorough Deliberation.

The Delaware cases repeatedly emphasize the importance of the process followed by directors in addressing a takeover proposal. The Delaware courts have frowned upon board decision-making that is done hastily or without prior preparation. Counsel should be careful to formulate and document a decision-making process that will withstand judicial review from this perspective.

Early in the process the board should be advised by counsel as to the applicable legal standards and the concerns expressed by the courts that are presented in similar circumstances. Distribution of a memorandum from counsel can be particularly helpful in this regard. Management should provide the latest financial and strategic information available concerning the corporation and its prospects. If a sale is contemplated or the corporation may be put "in play," investment bankers should be retained to advise concerning comparable transactions and market conditions, provide an evaluation of the proposal in accordance with current industry standards, and, if requested, render a fairness opinion concerning the transaction before it is finally approved by the board. The board should meet several times, preferably in person, to review reports from management and outside advisors, learn the progress of the transaction and provide guidance. Directors should receive reports and briefing information sufficiently before meetings so that they can be studied and evaluated. Directors should be active in questioning and analyzing the information and advice received from management and outside advisors. A summary of the material provisions of the merger agreement should be prepared for the directors and explained by counsel.[143]

(1) In *Van Gorkom*,[144] the Trans Union board approved the proposed merger at a meeting without receiving notice of the purpose of the meeting, no investment banker was invited to advise the board, and the proposed agreement was not available before the meeting and was not reviewed by directors. This action contributed to the court's conclusion that the board was grossly negligent.

---

[140] *Id.* at 429-30.

[141] *Id.* at 429.

[142] *Rand v. Western Air Lines, Inc.*, 1994 WL 89006 (Del. Ch. 1994), *aff'd* 659 A.2d 228 (Del. 1995).

[143] *See, e.g.*, *Moore Corp. Ltd. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995) for an in depth description of a decision-making process that withstood review under enhanced scrutiny.

[144] 488 A.2d 858.

(2) In *Technicolor*,[145] notice of a special board meeting to discuss and approve an acquisition proposal involving interested management was given to members of the board only one day prior to the meeting, and it did not disclose the purpose of the meeting. Board members were not informed of the potential sale of the corporation prior to the meeting, and it was questioned whether the documents were available for the directors' review at the meeting.

(3) In contrast is *Time*,[146] where the board met often to discuss the adequacy of Paramount's offer and the outside directors met frequently without management, officers or directors.[147]

D. The Decision to Remain Independent.

A board may determine to reject an unsolicited proposal. It is not required to exchange the benefits of its long-term corporate strategy for short-term gain. However, like other decisions in the takeover context, the decisions to "say no" must be adequately informed. The information to be gathered and the process to be followed in reaching a decision to remain independent will vary with the facts and circumstances, but in the final analysis the board should seek to develop reasonable support for its decision.

A common ground for rejection is that the proposal is inadequate. Moreover, the proposal may not reflect the value of recent or anticipated corporate strategy. Another ground is that continued independence is thought to maximize shareholder value. Each of these reasons seems founded on information about the value of the corporation and points to the gathering of information concerning value.

A decision based on the inadequacy of the proposal or the desirability of continuing a pre-existing business strategy is subject to the business judgment rule, in the absence of the contemporaneous adoption of defensive measures or another response that proposes an alternative means to realize shareholder value.[148] Defensive measures are subject to enhanced scrutiny, with its

---

145 634 A.2d 345.

146 571 A.2d 1140.

147 *See also Moran*, 500 A.2d 1346, where (i) before considering a rights plan as a preventative mechanism to ward off future advance, the board received material on the potential takeover problem and the proposed plan, (ii) independent investment bankers and counsel attended the board meeting to advise the directors, and (iii) ten of the board's sixteen members were outside directors; and *MSB Bancorp*, 1998 WL 409355, where during the period in question, the board met weekly, considered the offers, consulted with its legal and financial advisors, and then made its conclusion as to which offer to pursue. For a summary of guidelines for counsel to develop a suitable process for the board's deliberations, *see* Frankle, *Counseling the Board of Directors in Exploring Alternatives*, 1101 PLI/Corp. 261 (1998).

148 Whether the standards of review for a decision to remain independent are the same in the face of a cash bid that potentially involves "Revlon duties" or a stock transaction that does not is unsettled. *Compare, e.g.*, Wachtell, Lipton, Rosen & Katz, *Takeover Law and Practice*, 1212 PLI/Corp. 801, 888, citing no authority: "If the proposal calls for a transaction that does not involve a change in control within the meaning of *QVC*, it would appear that the traditional business judgment rule would apply to the directors' decision. If the acquisition proposal calls for a transaction that would involve a change within the meaning of *QVC*, the enhanced-scrutiny *Unocal* test would apply." Such a conclusion would subject all director decisions to a reasonableness standard merely because of what transaction has been proposed. In theory, at least, a well-informed, fully independent board ought to be

burden on the directors to demonstrate reasonableness. An alternative transaction can raise an issue as to whether the action should be reviewed as essentially a defensive measure. Moreover, the decision not to waive the operation of a poison pill or the protection of a state business combination statute such as DGCL Section 203 can be viewed as defensive.[149] A merger agreement that requires the merger to be submitted to shareholders, even if the board has withdrawn its recommendation of the merger, as permitted by the 1998 amendment to DGCL Section 251(c), may also be analyzed as defensive. In any case, and especially where it is likely that the suitor or a shareholder will turn unfriendly, the authorized response should be based on a developed record that demonstrates its reasonableness.

1. ***Judicial Respect for Independence.***

Delaware cases have acknowledged that directors may reject an offer that is inadequate or reach an informed decision to remain independent. Even in striking down a board's decision in *Lynch Communication*,[150] the Delaware Supreme Court acknowledged that:

> The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available.[151]

In a number of prominent cases, the Delaware courts have endorsed the board's decision to remain independent:

a. In *Time*,[152] the Delaware Supreme Court validated the actions of Time's board in the face of an all-shares cash offer from Paramount. The board had concluded that the corporation's purchase of Warner "offered a greater long-term value for the stockholders and, unlike Paramount's offer, did not pose a threat to Time's survival and its 'culture'."[153] In approving these actions, the court determined that the board, which "was adequately informed of the potential benefits of a transaction with Paramount," did not have to abandon its plans for corporate development in order to provide the shareholders with the option to realize an immediate control premium.[154] "Time's board was under no obligation to negotiate with Paramount."[155] According to the court, this conclusion

---

accorded more deference than this where it has not initiated a sale, even though the consideration for the sale presents advantages that are reasonable. On the other hand, in practice, it may be difficult to avoid the defensive responses to a proposal, which would involve a reasonableness review, where the bidder is persistent.

149 *See e.g., Moore*, 907 F. Supp. at 1556 (failure to redeem poison pill defensive).

150 638 A.2d 1110.

151 *Id*. at 1119 (citation omitted).

152 571 A.2d 1140.

153 *Id*. at 1149.

154 *Id*. at 1154.

155 *Id*.

was consistent with long-standing Delaware law: "We have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment."[156]

b. In *Unitrin*,[157] the Delaware Supreme Court considered defensive actions taken by Unitrin's board in response to American General's overtures. The board rejected the offer as financially inadequate and presenting antitrust complications, but did not adopt defensive measures to protect against a hostile bid until American General issued a press release announcing the offer.[158] Unitrin's board viewed the resulting increase in Unitrin's stock price as a suggestion that speculative traders or arbitrageurs were buying up Unitrin stock and concluded that the announcement constituted a "hostile act designed to coerce the sale of Unitrin at an inadequate price."[159] In response, the board adopted a poison pill and an advance notice bylaw provision for shareholder proposals.[160] The directors then adopted a repurchase program for Unitrin's stock.[161] The directors owned 23% of the stock and did not participate in the repurchase program.[162] This increased their percentage ownership and made approval of a business combination with a shareholder without director participation more difficult.[163] The Delaware Court of Chancery ruled that the poison pill was a proportionate defensive response to American General's offer, but that the repurchase plan exceeded what was necessary to protect shareholders from a low bid. The poison pill was not directly at issue when the Delaware Supreme Court reviewed the case. The court determined that the Court of Chancery used an incorrect legal standard and substituted its own business judgment for that of the board.[164] The court remanded to the Court of Chancery to reconsider the repurchase plan and determine whether it, along with the other defensive measures, was preclusive or coercive and, if not, "within the range of reasonable defensive measures available to the Board."[165]

c. In *Revlon*,[166] the Delaware Supreme Court looked favorably on the board's initial rejection of Pantry Pride's offer and its adoption of a rights plan in the face of a hostile takeover at a price it deemed inadequate.[167] The court did not suggest that Revlon's board had a duty to negotiate

---

[156] *Id*. at 1152 (citing *Macmillan*, 552 A.2d at 1285 n.35; *Van Gorkom*, 448 A.2d at 881; and *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

[157] 651 A.2d 1361.

[158] *Id*. at 1370.

[159] *Id*.

[160] *Id*.

[161] *Id*. at 1370-71.

[162] *Id*. at 1370.

[163] *Id*. at 1371-72.

[164] *Id*. at 1389.

[165] *Id*. at 1390.

[166] 506 A.2d 173.

[167] *Id*. at 180-81.

or shop the company before it "became apparent to all that the break-up of the company was inevitable" and the board authorized negotiation of a deal, thus recognizing that the company was for sale.[168]

d. In *Desert Partners*,[169] the court approved the USG board's refusal to redeem a poison pill to hinder an inadequate hostile offer and noted that the board had no duty to negotiate where it had neither put the company up for sale nor entertained a bidding contest.[170] "Once a Board decides to maintain a company's independence, Delaware law does not require a board of directors to put their company on the auction block or assist a potential acquiror to formulate an adequate takeover bid."[171]

e. In *MSB Bancorp*,[172] the Delaware Chancery Court upheld the board's decision to purchase branches of another bank in furtherance of its long-held business strategy rather than to negotiate an unsolicited merger offer that would result in short-term gain to the shareholders.[173] In reaching its conclusion, the court applied the business judgment rule because it determined that there was no defensive action taken by the board in merely voting not to negotiate the unsolicited merger offer which did not fit within its established long-term business plan.[174]

2. ***Defensive Measures.***

When a board makes a decision to reject an offer considered inadequate, the board may adopt defensive measures in case the suitor becomes unfriendly. Such a response will be subjected to the proportionality test of *Unocal*, that the responsive action taken is reasonable in relation to the threat posed.[175] This test was developed in *Unitrin* to make clear that defensive techniques that are "*coercive*" or "*preclusive*" will not be considered to satisfy the proportionality test:

> An examination of the cases applying Unocal reveals a direct correlation between findings of proportionality or disproportionality and the judicial determination of whether a defensive response was draconian because it was either coercive or preclusive in character. In *Time*, for example, [the Delaware Supreme Court] concluded that the Time board's defensive response was reasonable and proportionate since it was not aimed at 'cramming down' on its shareholders a management-sponsored alternative, *i.e.*, was not coercive, and because it did not

---

[168] *Id.* at 182.

[169] 686 F. Supp. 1289 (applying Delaware law).

[170] *Id.* at 1300.

[171] *Id.* at 1300.

[172] 1998 WL 409355.

[173] *Id.* at *4.

[174] *Id.* at *3.

[175] *See, e.g., Quickturn*, 721 A.2d at 1290.

preclude Paramount from making an offer for the combined Time-Warner Company, *i.e.*, was not preclusive.[176]

In *Moran*,[177] the Delaware Supreme Court considered a shareholder rights plan adopted by Household International not during a takeover contest, "but as a preventive mechanism to ward off future advances."[178] The court upheld the pre-planned poison pill but noted that the approval was not absolute.[179] When the board "is faced with a tender offer and a request to redeem the [rights plan], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."[180]

E. The Pursuit of a Sale.

The board which decides to pursue a sale of the corporation (involving a sale of control within the meaning of *QVC)*, whether on its own initiative or in response to a friendly suitor, has undertaken "to seek the best value reasonably available to the stockholders."[181] As the Delaware Supreme Court stated in *Technicolor*: "[I]n the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances."[182]

1. Value to Stockholders.

In *Revlon*, the Delaware Supreme Court imposed an affirmative duty on the board to seek the highest value reasonably available to the shareholders when a sale became inevitable.[183] The duty established in *Revlon* has been considered by the Delaware courts on numerous occasions, and was restated in *QVC* According to the Delaware Supreme Court in *QVC*, the duty to seek the highest value reasonably available is imposed on a board in the following situations:

> Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the

---

176 *Unitrin*, 651 A.2d at 1387 (citations omitted).

177 500 A.2d 1346.

178 *Id.* at 1349.

179 *Id.* at 1354.

180 *Id. See also Moore*, 907 F. Supp. 1545; *Desert Partners*, 686 F. Supp. 1289; *Unitrin*, 651 A.2d 1361; *Ivanhoe Partners v. Newmont Mining Corp.,* 535 A.2d 1334 (Del. 1987); and *Revlon*, 506 A.2d 173, where the court considered favorably a board's defensive measures to protect its decision to remain independent.

181 *QVC*, 637 A.2d at 48; *see also Matador*, 729 A.2d at 290.

182 *Technicolor*, 634 A.2d at 361.

183 *See Revlon*, 506 A.2d 173.

company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company.[184]

[W]hen a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders.[185]

2. ***Ascertaining Value.***

When the *Revlon* decision was first announced by the Delaware Supreme Court, many practitioners read the decision to mandate an auction by a target company in order to satisfy the board's fiduciary duties (the so-called "Revlon duties").[186] After interpreting *Revlon* in *Barkan, Macmillan, Time, Technicolor,* and *QVC*, however, the Delaware Supreme Court has clearly indicated that an auction is not the only way to satisfy the board's fiduciary duties. As the court in *Barkan* stated:

Revlon does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest. Revlon is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders.[187]

One court has noted that when the board is negotiating with a single suitor and has no reliable grounds upon which to judge the fairness of the offer, a canvas of the market is necessary to determine if the board can elicit higher bids.[188] However, the Delaware Supreme Court held in *Barkan* that when the directors "possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market."[189]

The following cases indicate situations in which a board was not required to engage in an active survey of the market. Most involve one-on one friendly negotiations without other bidders, although in some the target had earlier discussions with other potential bidders.

---

[184] *QVC*, 637 A.2d at 47 (citation omitted).

[185] *Id.* at 48.

[186] *See* McBride, *Revisiting Delaware Law and Mergers and Acquisitions: The Impact of QVC v. Paramount*, 2 PLI Course Handbook, 26th Ann. Inst. on Sec. Reg. 86 (1994).

[187] *Barkan*, 567 A.2d at 1286.

[188] *In re Fort Howard Corp. Shareholders Litig.*, 1988 WL 83147 (Del. Ch. 1988).

[189] *Barkan*, 567 A.2d at 1287.

a. In *Barkan*,[190] the corporation had been put "in play" by the actions of an earlier bidder.[191] Instead of taking an earlier offer, the corporation instituted a management buyout (the "*MBO*") through an employee stock ownership program.[192] In holding that the board did not have to engage in a market survey to meet its burden of informed decision-making in good faith, the court listed the following factors: (i) potential suitors had ten months to make some sort of offer (due to early announcements), (ii) the MBO offered unique tax advantages to the corporation that led the board to believe that no outside offer would be as advantageous to the shareholders, (iii) the board had the benefit of the advice of investment bankers, and (iv) the trouble the corporation had financing the MBO, indicating that the corporation would be unattractive to potential suitors.[193] In holding that an active market check was not necessary, however, the court sounded a note of caution:

> The evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured. However, the crucial element supporting a finding of good faith is knowledge. It must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders. *The situations in which a completely passive approach to acquiring such knowledge is appropriate are limited.*[194]

b. In *In re Vitalink*,[195] Vitalink entered a merger agreement with Network Systems Corporation.[196] While Vitalink had also conducted earlier discussions with two other companies, the court found that Vitalink had not discussed valuation with those two companies, and thus did not effectively canvas the market.[197] In holding that the Vitalink board nevertheless met its burden of showing that it acted in an informed manner in good faith, the court looked at the following factors: (i) no bidder came forward in the 45 days that passed between the public announcement of the merger and its closing; (ii) the parties negotiated for a number of months; (iii) the board had the benefit of a fairness opinion from its investment banker; and (iv) the investment banker's fee was structured to provide it an incentive to find a buyer who would pay a higher price.[198]

As the Delaware Supreme Court noted in *Van Gorkom*, failure to take appropriate action to be adequately informed as to a transaction violates the board's duty of due care. Without a firm

---

190 567 A.2d 1279 (Del. 1989).

191 *Id*. at 1287.

192 *Id*. at 1282-83.

193 *Id*. at 1287-88.

194 *Id*. at 1288 (emphasis added).

195 1991 WL 238816.

196 *Id*. at *3-4.

197 *Id*. at *7.

198 *Id*. at *11-12.

blueprint to build adequate information, however, the passive market check entails a risk of being judged as "doing nothing" to check the market or assess value.[199]

3. *Protecting the Merger.*

During the course of acquisition negotiations, it may be neither practicable nor possible to auction or actively shop the corporation. Moreover, even when there has been active bidding by two or more suitors, it may be difficult to determine whether the bidding is complete. In addition, there can remain the possibility that new bidders may emerge that have not been foreseen. In these circumstances, it is generally wise for the board to make some provision for further bidders in the merger agreement. Such a provision can also provide the board with additional support for its decision to sell to a particular bidder if the agreement does not forestall competing bidders, permits the fact gathering and discussion sufficient to make an informed decision and provides meaningful flexibility to respond to them. In this sense, the agreement is an extension of, and has implications for, the process of becoming adequately informed.

In considering a change of control transaction, a board should consider:

> [W]hether the circumstances afford a disinterested and well motivated director a basis reasonably to conclude that if the transactions contemplated by the merger agreement close, they will represent the best available alternative for the corporation and its shareholders. This inquiry involves consideration inter alia of the nature of any provisions in the merger agreement tending to impede other offers, the extent of the board's information about market alternatives, the content of announcements accompanying the execution of the merger agreement, the extent of the company's contractual freedom to supply necessary information to competing bidders, and the time made available for better offers to emerge.[200]

Management will, however, have to balance the requirements of the buyer against these interests in negotiating the merger agreement. The buyer will seek assurance of the benefit of its bargain through the agreement, especially the agreed upon price, and the corporation may run the risk of losing the transaction if it does not accede to the buyer's requirements in this regard. The relevant cases provide the corporation and its directors with the ability, and the concomitant obligation in certain circumstances, to resist.

The assurances a buyer seeks often take the form of a "no-shop" clause, a "lock-up" agreement for stock or assets, or a break-up fee. In many cases, a court will consider the effect of these provisions together. Whether or not the provisions are upheld may depend, in large measure, on whether a court finds that the board has adequate information about the market and alternatives to the offer being considered. The classic examples of no-shops, lock-ups and break-up fees occur, however, not in friendly situations, where a court is likely to find that such arrangements provide the benefit of keeping the suitor at the bargaining table, but rather in a bidding war between two suitors,

---

[199] *See Barkan*, 567 A.2d at 1287 (there is no single method that a board must employ to become informed).

[200] *Roberts v. General Instrument Corp.*, 1990 WL 118356, at *8 (Del. Ch. 1990).

where the court may find that such provisions in favor of one suitor prematurely stop an auction and thus do not allow the board to obtain the highest value reasonably attainable.

The fact that a buyer has provided consideration for the assurances requested in a merger agreement does not end the analysis. In *QVC*, the Delaware Supreme Court took the position that provisions of agreements that would force a board to violate its fiduciary duty of care are unenforceable. As the court stated:

> Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the . . . directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.[201]

Although this language provides a basis for directors to resist unduly restrictive provisions, it may be of little comfort to a board that is trying to abide by negotiated restrictive provisions in an agreement and their obligations under Delaware law, especially where the interplay of the two may not be entirely clear.

a. **No Shops**

The term "no-shop" is used generically to describe provisions that limit a corporation's ability to actively canvas the market or to respond to overtures from the market. No-shop clauses can take different forms. A strict no-shop allows no solicitation and also prohibits a target from facilitating other offers, all without exception. Such a strict no-shop clause would probably not be upheld.[202] A customary, and limited, no-shop clause contains some type of "fiduciary out," which allows a board to take certain actions to the extent necessary for the board to comply with its fiduciary duties to shareholders.[203] Board actions permitted can range from supplying confidential information about the corporation to unsolicited suitors, to negotiating with unsolicited suitors and terminating the existing merger agreement upon payment of a break-up fee, to actively soliciting other offers.[204] Each action is tied to a determination, by the board after advice of counsel, that it is required in the exercise of the board's fiduciary duties. Such "fiduciary outs," even when restrictively drafted, will likely be interpreted by the courts to permit the board to become informed about an unsolicited competing bid. "[E]ven the decision not to negotiate ... must be an informed one. A target can refuse to negotiate [in a transaction not involving a sale of control] but it should be informed when making such refusal."[205]

---

201 *QVC*, 637 A.2d at 48.

202 *See QVC*, 637 A.2d at 48.

203 *See, e.g., Matador*, 729 A.2d at 288-89; and Allen, "*Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*," 55 Bus. Law. 653 (2000).

204 *See Id.*

205 *Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, 1999 WL 1054255, (Del. Ch. 1999).

See Ace Ltd. v. Capital Re Corp.[206] for a discussion of restrictive "no shop" provisions. In *Ace*, which did not involve a change in control merger, the court interpreted a "no-talk" provision of a "no-shop" to permit the board to engage in continued discussions with a continuing bidder, notwithstanding the signing of a merger agreement, when not to do so was tantamount to precluding the stockholders from accepting a higher offer. The court wrote:

> *QVC* does not say that directors have no fiduciary duties when they are not in "Revlon-land." ...Put somewhat differently, *QVC* does not say that a board can, in all circumstances, continue to support a merger agreement not involving a change of control when: (1) the board negotiated a merger agreement that was tied to voting agreements ensuring consummation if the board does not terminate the agreement; (2) the board no longer believes that the merger is a good transaction for the stockholders; and (3) the board believes that another available transaction is more favorable to the stockholders. The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to set idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about. The logic of *QVC* itself casts doubts on the validity of such a contract.[207]

Although determinations concerning fiduciary outs are usually made when a serious competing suitor emerges, it may be difficult for a board or its counsel to determine just how much of the potentially permitted response is required by the board's fiduciary duties.[208] As a consequence, the board may find it advisable to state the "fiduciary out" in terms that do not only address fiduciary duties but also permit action when an offer reasonably believed to be "superior" is made.

As the cases that follow indicate, while in some more well-known situations no-shops have been invalidated, the Delaware courts have on numerous occasions upheld different no-shop clauses as not impeding a board's ability to make an informed decision that a particular agreement provided the highest value reasonably obtainable for the shareholders.

b. Lock-ups

Lock-ups can take the form of an option to buy additional shares of the corporation to be acquired, which benefits the suitor if the price for the corporation increases after another bidder

---

[206] 747 A.2d. 95 (Del. Ch. 1999).

[207] *Id.* at 107-108.

[208] *See* Johnston, *Recent Amendments to the Merger Sections of the DGCL Will Eliminate Some - But Not All - Fiduciary Out Negotiation and Drafting Issues*, 1 BNA Mergers & Acquisitions L. Rep. 777 (1998):

> [I]n freedom-of-contract jurisdictions like Delaware, the target board will be held to its bargain (and the bidder will have the benefit of its bargain) only if the initial agreement to limit the target board's discretion can withstand scrutiny under applicable fiduciary duty principles. The exercise of fiduciary duties is scrutinized up front -- at the negotiation stage. If that exercise withstands scrutiny, fiduciary duties will be irrelevant in determining what the target board's obligations are when a better offer, in fact, emerges; at that point its obligations will be determined solely by the contract.

Id. at 779.

emerges and discourages another bidder by making the corporation more expensive.[209] Lock-ups can also take the form of an option to acquire important assets (a company's "crown jewels") at a price that may or may not be a bargain for the suitor, which may so change the attractiveness of the corporation as to discourage or preclude other suitors. "[L]ock-ups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duty."[210] The Delaware Supreme Court has tended to look askance at lock-up provisions when such provisions, however, impede other bidders or do not result in enhanced bids. As the Delaware Supreme Court stated in *Revlon*,

> Such [lock-up] options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. . . . However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders detriment.[211]

As the cases that follow indicate, the Delaware courts have used several different types of analyses in reviewing lock-ups. In active bidding situations, the courts have examined whether the lock-up resulted in an enhanced bid (in addition to the fact that the lock-up ended an active auction).[212] In situations not involving an auction, the courts have examined whether the lock-up impeded other potential suitors, and if an active or passive market check took place prior to the grant of the lock-up.[213]

c. **Break-Up Fees.**

Break-up fees generally require the corporation to pay consideration to its merger partner should the corporation be acquired by a competing bidder that emerges after the merger agreement is signed. As with no-shops and lock-ups, break-up fees are not invalid unless they are preclusive or an

---

209 Such an option is issued by the corporation, generally to purchase newly issued shares for up to 19.9% of the corporation's outstanding shares at the deal price. The amount is intended to give the bidder maximum benefit without crossing limits established by the New York Stock Exchange (see Rule 312.03, NYSE Listed Company Manual) or NASD (see Rule 4310(c)(25)(H)(i), NASD Manual -- The Nasdaq Stock Market) that require shareholder approval for certain large stock issuances. Such an option should be distinguished from options granted by significant shareholders or others in support of the deal. Shareholders may generally grant such options as their self-interest requires. See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994). However, an option involving 15% of the outstanding shares makes applicable Section 203 of the DGCL that restricts certain transactions with shareholders who acquire such amount of shares without board approval. Any decision to exempt such an option from the operation of Section 203 involves the board's fiduciary duties.

210 *Revlon*, 506 A.2d at 176.

211 *Revlon*, 506 A.2d at 183.

212 *See Revlon*, 506 A.2d 173; *Macmillan*, 559 A.2d 1261.

213 *See Matador*, 729 A.2d at 291; Rand, 1994 WL 89006; *Roberts*, 1990 WL 118356. For a further discussion of the analytical approaches taken by the Delaware courts, *see* Fraidin and Hanson, *Toward Unlocking Lock-ups*, 103 Yale L. J. 1739, 1748-66 (1994).

impediment to the bidding process.[214] As the cases that follow indicate, however, break-up fees are not as disliked by the Delaware courts, and such fees that bear a reasonable relation to the value of a transaction so as not to be preclusive have been upheld.[215] In practice, counsel are generally comfortable with break-up fees that range from 1% to 3% of the transaction value (including the amount of any debt assumed in the deal). For this purpose, the value of any lock-up given by the corporation to the bidder should be included.

4. Specific Cases Where No-Shops, Lock-ups, and Break-Up Fees Have Been Invalidated.

a. In *Revlon*,[216] the court held that the no-shop along with a lock-up agreement and a break-up fee effectively stopped an active bidding process and thus was invalid.[217] The court noted that the no-shop is "impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder."[218] *Revlon* had also granted to Forstmann a "crown jewel" asset lock-up representing approximately 24% of the deal value (and apparently the crown jewel was undervalued), and a break-up fee worth approximately 1.2% of the deal. The court invalidated the lock-up and the break-up fee, noting that Forstmann "had already been drawn into the contest on a preferred basis, so the result of the lock-up was not to foster bidding, but to destroy it."[219]

b. In *Macmillan*,[220] the directors of the corporation granted one of the bidders a lock-up agreement for one of its "crown jewel" assets.[221] As in *Revlon*, the court held that the lock-up had

---

214 Alternatively, if parties to a merger agreement expressly state that the termination fee will constitute liquidated damages, Delaware courts will evaluate the termination fee under the standard for analyzing liquidated damages. For example, in *Brazen*, 695 A.2d 43, Bell Atlantic and NYNEX entered into a merger agreement which included a two-tiered termination fee of $550 million, which represented about 2% of Bell Atlantic's market capitalization and would serve as a reasonable measure for the opportunity cost and other losses associated with the termination of the merger. *Id.* at 45. The merger agreement stated that the termination fee would "constitute liquidated damages and not a penalty." *Id.* at 46. Consequently, the court found "no compelling justification for treating the termination fee in this agreement as anything but a liquidated damages provision, in light of the express intent of the parties to have it so treated." *Id.* at 48. Rather than apply the business judgment rule, the court followed "the two-prong test for analyzing the validity of the amount of liquidated damages: 'Where the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed.'" *Id.* at 48 (citation omitted). Ultimately, the court upheld the liquidated damages provision. *Id.* at 50. The court reasoned in part that the provision was within the range of reasonableness "given the undisputed record showing the size of the transaction, the analysis of the parties concerning lost opportunity costs, other expenses, and the arms-length negotiations." *Id.* at 49.

215 *See Goodwin*, 1999 WL 64265, at * 23; *Matador*, 729 A.2d at 291 n.15 (discussing authorities).

216 *Revlon*, 506 A.2d 173.

217 *Id.* at 182.

218 *Id.* at 184.

219 *Id.* at 183.

220 *Macmillan*, 559 A.2d 1261.

221 *Id.* at 1286.

the effect of ending the auction, and held that the lock-up was invalid. The court also noted that if the intended effect is to end an auction, "at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."[222]

> In this case, a lock-up agreement was not necessary to draw any of the bidders into the contest. Macmillan cannot seriously contend that they received a final bid from KKR that materially enhanced general stockholder interests. . . . When one compares what KKR received for the lock-up, in contrast to its inconsiderable offer, the invalidity of the [lock-up] becomes patent.[223]

The court was particularly critical of the "crown jewel" lock-up. "Even if the lock-up is permissible, when it involves 'crown jewel' assets careful board scrutiny attends the decision. . . . Thus, when directors in a *Revlon* bidding contest grant a crown jewel lock-up, serious questions are raised, particularly where, as here, there is little or no improvement in the final bid."[224]

c. In *QVC*,[225] which like *Revlon* involved an active auction, the no-shop provision provided that Paramount would not:

> [S]olicit, encourage, discuss, negotiate, or endorse any competing transaction unless: (a) a third party "makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing"; and (b) the Paramount board determines that discussions or negotiations with the third party are necessary for the Paramount Board to comply with its fiduciary duties.[226]

The break-up fee arrangement provided that Viacom would receive $100 million (between 1% and 2% of the front-end consideration) if (i) Paramount terminated the merger agreement because of a competing transaction, (ii) Paramount's stockholders did not approve the merger, or (iii) Paramount's board recommended a competing transaction.[227] In examining the lock-up agreement between Paramount and Viacom (for 19.9% of the stock of Paramount), the court emphasized two provisions of the lock-up as being both "unusual and highly beneficial" to Viacom: "(a) Viacom was permitted to pay for the shares with a senior subordinated note of questionable marketability instead of cash, thereby avoiding the need to raise the $1.6 billion purchase price" and "(b) Viacom could elect to require Paramount to pay Viacom in cash a sum equal to the difference between the purchase price and the market price of Paramount's stock."[228] The court held that the

---

222 *Id.*

223 *Id.* at 1286.

224 *Id.*

225 *QVC*, 637 A.2d 34.

226 *Id.* at 39 (citations omitted).

227 *Id.*

228 *Id.*

lock-up, no-shop and break-up fee were "impeding the realization of the best value reasonably available to the Paramount shareholders."[229]

d. In *Holly Farms*,[230] the board of Holly Farms entered into an agreement to sell the corporation to ConAgra which included a lock-up option on Holly Farms' prime poultry operations and a $15 million break-up fee plus expense reimbursement.[231] Tyson Foods was at the same time also negotiating to purchase Holly Farms. In invalidating the lock-up and the break-up fee, the court noted that "[w]hile the granting of a lock up may be rational where it is reasonably necessary to encourage a prospective bidder to submit an offer, lock-ups 'which end an active auction and foreclose further bidding operate to the shareholders' detriment' are extremely suspect."[232] The court further stated that "the lock up was nothing but a 'show stopper' that effectively precluded the opening act."[233] The court also invalidated the break-up fee, holding that it appeared likely "to have been part of the effort to preclude a genuine auction."[234]

5. Specific Cases Where No-Shops, Lock-ups and Break-Up Fees Have Been Upheld.

a. In *Goodwin*,[235] the plaintiff shareholder argued that the board of Live Entertainment violated its fiduciary duties by entering into a merger agreement with Pioneer Electronics.[236] The merger agreement contained a 3.125% break-up fee.[237] While the plaintiff did not seek to enjoin the transaction on the basis of the fee and did not attack any other aspect of the merger agreement as being unreasonable, the court noted "this type of fee is commonplace and within the range of reasonableness approved by this court in similar contexts."[238] Ultimately, the Chancery Court upheld the merger agreement.

b. In *Matador*,[239] Business Records Corporation entered into a merger agreement with Affiliated Computer Services which contained four "defensive" provisions, including a no-shop provision with a fiduciary out and termination fee.[240] Three BRC shareholders also entered into

---

229 *Id.* at 50.

230 *In re Holly Farms Corp. Shareholders Litig.*, 564 A. 2d 342 (Del. Ch. 1989).

231 *Id.* at *2.

232 *Id.* at *6 (citations omitted).

233 *Id.*

234 *Id.*

235 *Goodwin*, 1999 WL 64265.

236 *Id.* at *21.

237 *Id.* at *23.

238 *Id.*

239 *Matador*, 729 A.2d 280.

240 *Id.* at 289.

lock-up agreements with ACS to tender their shares to ACS within five days of the tender offer of ACS.[241] The Chancery Court upheld these provisions reasoning that "these measures do not foreclose other offers, but operate merely to afford some protection to prevent disruption of the Agreement by proposals from third parties that are neither bona fide nor likely to result in a higher transaction."[242] The court also noted that because the termination fee is not "invoked by the board's receipt of another offer, nor is it invoked solely because the board decides to provide information, or even negotiates with another bidder," it can hardly be said that it prevents the corporation from negotiating with other bidders.[243]

c. In *Rand*,[244] Western had been considering opportunities for fundamental changes in its business structure since late 1985.[245] In the spring of 1986, Western had discussions with both American and Delta, as well as other airlines.[246] When Western entered into a merger agreement with Delta in September 1986, the agreement contained a no-shop clause providing that Western could not "initiate contact with, solicit, encourage or participate in any way in discussions or negotiations with, or provide an information or assistance to, or provide any information or assistance to, any third party . . . concerning any acquisition of . . . [Western]."[247] Western also granted Delta a lock-up agreement for approximately 30% of Western's stock. The court stated that the market had been canvassed by the time the merger agreement was signed, and that by having a lock-up and a no-shop clause Western "gained a substantial benefit for its stockholders by keeping the only party expressing any interest at the table while achieving its own assurances that the transaction would be consummated."[248]

d. In *Vitalink*,[249] the court held that the break-up fee, which represented approximately 1.9% of the transaction, did not prevent a canvass of the market.[250] The merger agreement in Vitalink also contained a no-shop which prohibited the target from soliciting offers, and a lock-up for NSC to purchase 19.9% of the shares of Vitalink.[251] In upholding the no-shop clause, the court noted that the no-shop clause "was subject to a fiduciary out clause whereby the Board could shop the company so as to comply with, among other things, their *Revlon* duties (i.e., duty to get the

---

241 *Id.*

242 *Id.* at 291.

243 *Id.* at 291 n.15.

244 *Rand*, 1994 WL 89006.

245 *Id.* at *1.

246 *Id.*

247 *Id.* at *2.

248 *Id.* at *7.

249 *In re Vitalink*, 1991 WL 238816.

250 *Id.* at *7.

251 *Id.* at *3.

highest price reasonably attainable for shareholders)."[252] The court also held that the lock-up at issue did not constitute a "real impediment to an offer by a third party."[253]

e. In *Roberts*,[254] General Instrument entered into a merger agreement with a subsidiary of Forstmann Little & Co.[255] The merger agreement contained a no-shop clause providing that the corporation would not "solicit alternative buyers and that its directors and officers will not participate in discussions with or provide any information to alternative buyers except to the extent required by the exercise of fiduciary duties."[256] General Instrument could terminate the merger agreement if it determined that a third party's offer was more advantageous to the shareholders than Forstmann's offer.[257] Forstmann also agreed to keep the tender offer open for 30 business days, longer than required by law, to allow time for alternative bidders to make proposals. General Instrument was contacted by two other potential acquirors, and provided them with confidential information pursuant to confidentiality agreements.[258] Neither made offers. The court held that the no shop did not impede any offers, noting that the merger agreement contained a sufficient fiduciary out.[259] The transaction in *Roberts* also included a $33 million break-up fee in the event that the General Instrument board chose an unsolicited bid over that of the bidder in the exercise of the board's fiduciary duties.[260] The court held that the break-up fee was "limited", approximately 2% of the value of the deal, and would not prevent the board from concluding that it had effected the best available transaction.[261]

f. In *Fort Howard*,[262] the board decided to enter into a merger agreement with a subsidiary of the Morgan Stanley Group. The agreement contained a no-shop clause that allowed Fort Howard to respond to unsolicited bids and provide potential bidders with information. Fort Howard received inquiries from eight potential bidders, all of whom were provided with information.[263] None of the eight made a bid.[264] The agreement also contained a break-up fee of

---

252 *Id*. at *7.

253 *Id*.

254 *Roberts*, 1990 WL 118356.

255 *Id*. at *6.

256 *Id*.

257 *Id*.

258 *Id*.

259 *Id*. at *9.

260 *Id*. at *6.

261 *Id*. at *9.

262 *In re Fort Howard*, 1988 WL 83147.

263 *Id*. at *8.

264 *Id*. at *8-9.

approximately 1% of the consideration. The court believed that Fort Howard conducted an active market check, noting that the:

> [A]lternative "market check" that was achieved was not so hobbled by lock-ups, termination fees or topping fees, so constrained in time or so administered (with respect to access to pertinent information or manner of announcing "window shopping" rights) as to permit the inference that this alternative was a sham designed from the outset to be ineffective or minimally effective.[265]

The court noted that it was "particularly impressed with the [window shopping] announcement in the financial press and with the rapid and full-hearted response to the eight inquiries received."[266]

F. Dealing with a Competing Acquiror.

Even in the friendly acquisition, a board's obligations do not cease with the execution of the merger agreement.[267] If a competing acquiror emerges with a serious proposal offering greater value to shareholders (usually a higher price), the board should give it due consideration.[268] Generally the same principles that guided consideration of an initial proposal (being adequately informed and undertaking an active and orderly deliberation) will also guide consideration of the competing proposal.[269]

1. Flexibility in the Merger Agreement.

A board should seek to maximize its flexibility in responding to a competing bidder in the no shop provision of the merger agreement. It will generally be advisable for the agreement to contain provisions permitting the corporation not only to provide information to a bidder with a superior proposal, but also to negotiate with the bidder, enter into a definitive agreement with the bidder and terminate the existing merger agreement upon the payment of a break-up fee. Without the ability to terminate the agreement, the board may find, at least under the language of the agreement, that its response will be more limited.[270] In such circumstances, there may be some doubt as to its ability to negotiate with the bidder or otherwise pursue the bid. This may in turn force the competing bidder to take its bid directly to the shareholders through a tender offer, with a concomitant loss of board control over the process.

---

265 *Id.* at *13.

266 *Id.*

267 *See e.g., Emerson Radio Corp. v. Int'l Jensen Inc.*, 1996 WL 48306 (Del. Ch. 1996) (bidding and negotiations continued more than six months after merger agreement signed).

268 *See Phelps Dodge*, 1999 WL 1054255 and *Ace*, 747 A.2d at 107-108.

269 *See Macmillan*, 559 A.2d at 1282 n.29.

270 *See Van Gorkom*, 488 A.2d at 888 ("Clearly the . . . Board was not 'free' to withdraw from its agreement . . . by simply relying on its self-induced failure to have [negotiated a suitable] original agreement. . . .") *But see also QVC*, 637 A.2d at 51 (a board cannot "contract away" its fiduciary duties) and *Ace*, 747 A.2d at 107-108.

Bidders may seek to reduce the board's flexibility by negotiating for an obligation in the merger agreement to submit the merger agreement to stockholders even through the board subsequently withdraws its recommendation to the stockholders. Such an obligation is now permitted by DGCL Section 251(c). The decision to undertake such submission, however, implicates the board's fiduciary duties. Because of the possibility of future competing bidders, this may be a difficult decision.[271]

2. Level Playing Field.

If a bidding contest ensues, a board cannot treat bidders differently unless such treatment enhances shareholder interests. As the court in *Barkan* stated, "[w]hen multiple bidders are competing for control, this concern for fairness [to shareholders] forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another."[272] In *Macmillan*, however, the court stated that the purpose of enhancing shareholder interests "does not preclude differing treatment of bidders when necessary to advance those interests. Variables may occur which necessitate such treatment."[273] The *Macmillan* court cited a coercive two-tiered bust-up tender offer as one example of a situation that could justify disparate treatment of bidders.[274]

In all-cash transactions disparate treatment will not likely be permitted. In the context of keeping bidders on a level playing field, the court in Revlon stated that:

> Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions.[275]

The court in *QVC* restated this concept and applied the *Unocal* test in stating that in the event a corporation treats bidders differently, "the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced. In any event the board's action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests."[276]

---

[271] *See* John F. Johnston, *Recent Amendments to the Merger Sections of the DGCL Will Eliminate Some - But Not All - Fiduciary Out Negotiation and Drafting Issues*, 1 BNA Mergers & Acquisitions L. Rep. 777 (1998).

[272] Barkan, 567 A.2d at 1286-87; *see also QVC*, 637 A.2d at 45.

[273] *Macmillan*, 559 A.2d at 1286-87.

[274] *Id*. at 1287 n.38.

[275] *Revlon*, 506 A.2d at 184.

[276] *QVC*, 637 A.2d at 45 (quoting *Macmillan*, 559 A.2d at 1288).

3. Best Value.

In seeking to obtain the "best value" reasonably available, the Delaware Supreme Court has stated that the "best value" does not necessarily mean the highest price.

In *Citron*,[277] Fairchild was the subject of a bidding contest between two competing bidders, Schlumberger and Gould.[278] The Fairchild board had an all cash offer of $66 per share from Schlumberger, and a two-tier offer of $70 per share from Gould, with the terms of the valuation of the back-end of Gould's offer left undefined.[279] The board was also informed by its experts that a transaction with Schlumberger raised substantially less antitrust concern than a transaction with Gould. The board accepted Schlumberger's offer. In upholding the agreement between Fairchild and Schlumberger, the court stated that Gould's failure to present a firm unconditional offer precluded an auction.[280] The court also stated that Fairchild had a duty to consider "a host of factors," including "the nature and timing of the offer," and "its legality, feasibility and effect on the corporation and its stockholders," in deciding whether to accept or reject Gould's claim.[281] Nevertheless, the *Citron* court specifically found that Fairchild "studiously endeavored to avoid 'playing favorites'" between the two bidders.[282]

A decision not to pursue a higher price, however, necessarily involves uncertainty, the resolution of which depends on a court's view of the facts and circumstances specific to the case. In *In re Lukens Inc. Shareholders Litig.*,[283] the court sustained a board decision to sell to one bidder, notwithstanding the known possibility that a "carve up" of the business between the two bidders involved incremental stockholder value. The court placed great weight on the approval of the transaction by the stockholders after disclosure of the carve-up possibility.[284]

In the final analysis, in many cases, the board may not know that it has obtained the best value reasonably available until after the merger agreement is signed and competing bids are no longer proposed. In several cases, the Delaware courts have found as evidence that the directors obtained the best value reasonably available the fact that no other bidders came forward with a competing offer once the transaction was public knowledge.[285]

---

[277] 569 A.2d 53.

[278] *Id.* at 54.

[279] *Id.*

[280] *Id.* at 68-69.

[281] *Id.* at 68.

[282] *Id.*

[283] 757 A.2d 720 (Del. Ch. 1999).

[284] *Lukens*, 757 A.2d at 738.

[285] *See, e.g., Barkan* 567 A.2d at 1287 ("when it is widely known that some change of control is in the offing and no rival bids are forthcoming over an extended period of time, that fact is supportive of the board's decision to proceed"); *Goodwin*, 1999 WL 64265, at *23 ("Given that no draconian defenses were in place and that the merger

V. Dealing With Existing Defenses.

A. Certain Defenses.

Shareholder rights plans and state anti-takeover laws developed in response to abusive takeover tactics and inadequate bids and have become a central feature of most major corporations' takeover preparedness. For example, over 2,300 companies have adopted rights plans.

Rights plans and state anti-takeover laws do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. They are intended to cause bidders to deal with the target's board of directors and ultimately extract a higher acquisition premium than would otherwise have been the case. If a bidder takes action that triggers the rights or the anti-takeover laws, however, dramatic changes in the rights of the bidder can result.

In a negotiated transaction the board can let down the defensive screen afforded by a rights plan or state anti-takeover law to allow the transaction to proceed. Doing so, however, requires strict compliance with the terms of the rights plan and applicable statutes, as well as compliance with the directors fiduciary duties of care and loyalty.

B. Rights Plans.

The Basic Design. The key features of a rights plan are the "flip-in" and "flip-over" provisions of the rights, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on the acquiror. The risk of dilution, combined with the authority of a board of directors to redeem the rights prior to a triggering event (generally an acquisition of 15% or 20% of the corporation's stock), gives a potential acquiror a powerful incentive to negotiate with the board of directors rather than proceeding unilaterally.

Basic Case Law Regarding Rights Plans. There is now no doubt as to the legality of poison-pill rights plans. *See Leonard Loventhal Account v. Hilton Hotel Corp.*,[286] in which the Chancery Court, citing *Moran*,[287] wrote:

> The Delaware courts first examined and upheld the right of a board of directors to adopt a poison pill rights plan fifteen years ago in *Moran v. Household International, Inc*. Since that decision, others have followed which affirmed the validity of a board of directors' decision to adopt a poison pill rights plan. Today, rights plans have not only become commonplace in Delaware, but there is not a single state that does not permit their adoption.

Federal courts applying Texas law have upheld the concept of rights plans.[288]

---

was consummated three months after its public announcement, the fact that no bidders came forward is important evidence supporting the reasonableness of the Board's decision."); *Matador*, 729 A.2d at 293 (failure of any other bidder to may a bid within one month after the transaction was announced "is evidence that the directors, in fact, obtained the highest and best transaction reasonably available").

286 C.A. No. 17803, 2000 WL 1528909 (Del. Ch. Oct. 10, 2000).

287 500 A.2d at 1346.

The litigation concerning rights plans now focuses on whether or not a board of directors should be required to redeem the rights in response to a particular bid. In this respect, courts applying Delaware law have upheld, or refused to enjoin, determinations by boards of directors not to redeem rights in response to two-tier offers[289] or inadequate 100% cash offers[290] as well as to protect an auction or permit a target to explore alternatives.[291] On the other hand, some decisions have held that the rights may not interfere with shareholder choice at the conclusion of an auction[292] or at the "end stage" of a target's attempt to develop alternatives.[293] Both *Pillsbury* and *Interco* involved circumstances in which the board of directors, rather than "just saying no," had pursued a restructuring that was comparable to the pending all-cash tender offer.[294]

Many rights plans adopted shortly after creation of these protective measures in 1984 were scheduled to expire and have generally been renewed. Renewal of a rights plan involves essentially the same issues as the initial adoption of a plan.

"Dead Hand" Pills. In the face of a "Just Say No" defense, the takeover tactic of choice has become a combined tender offer and solicitation of proxies or consents to replace target's board with directors committed to redeeming the poison pill to permit the tender offer to proceed. Under DGCL Section 228, a raider can act by written consent of a majority of the shareholders without a meeting of stockholders, unless such action is prohibited in the certificate of incorporation (under TBCA art. 9.10A, unanimous consent is required for shareholder action by written consent unless the articles of incorporation otherwise provide). Under DGCL a raider can call a special meeting between annual meetings only if permitted under the target's bylaws, whereas under TBCA art. 2.24C any holder of at least 10% of the outstanding shares can call a special meeting unless the articles of incorporation specify a higher percentage (not to exceed 50%). If the target has a staggered board, a raider can generally only replace a majority of the target's board by waging a proxy fight at two consecutive annual meetings.

---

288 See *Gearhart Industries v. Smith International*, 741 F.2d 707 (5th Cir. 1984); and *A. Copeland Enterprises, Inc. v. Guste*, 706 F. Supp. 1283 (W.D. Tex. 1989).

289 *Desert Partners, L.P. v. USG Corp.*,686 F. Supp. 1289 (N.D. Ill. 1988).

290 *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp. v. Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995).

291 *CRTF Corp. v. Federated Dept. Stores, Inc.*, 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of poison pill during auction); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988); *In re Holly Farms Corp. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,181 (Del. Ch. 1988).

292 *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

293 *City Capital Associates Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 798-800 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988).

294 *See TW Services v. SWT Acquisition Corp.*, C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at 24-25 (Mar. 2, 1989); *Paramount Communications Inc. v. Time Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch.) (in *Pillsbury* and *Interco*, management sought to "'cram down' a transaction that was the functional equivalent of the very leveraged 'bust up' transaction that management was claiming presented a threat to the corporation"), *aff'd*, 571 A.2d 1140 (Del. 1989).

A target cannot rely on an ordinary poison pill to give much protection in the face of a combined tender offer/proxy fight. The predicament faced by such targets has spawned variants of the so-called "continuing director" or "dead hand" pill.

"Pure" dead hand pills permit only directors who were in place prior to a proxy fight or consent solicitation (or new directors recommended or approved by them) to redeem the rights plan. Once these "continuing directors" are removed, no other director can redeem the pill.

Modified dead hand provisions come in a variety of forms. So called "nonredemption" or "no hand" provisions typically provide that no director can redeem the rights plan once the continuing directors no longer constitute a majority of the board. This limitation on redemption may last for a limited period or for the remaining life of the pill. The rights plan at issue in the *Quickturn* case discussed below included such a provision.

Another variant is the "limited duration," or "delayed redemption," dead hand pill. This feature can be attached to either the pure dead hand or no hand rights plan. As the name indicates, these pills limit a dead hand or no hand restriction's effectiveness to a set period of time, typically starting after the continuing directors no longer constitute a majority of the board. These rights plans delay, but do not preclude, redemption by a newly elected board.

The validity of dead hand provisions depends in large part upon the state law that applies. Delaware recently has made clear that dead hand provisions – even of limited duration – are invalid.[295]

The Delaware Supreme Court held that the dead hand feature of the rights plan ran afoul of DGCL Section 141(a), which empowers the board of directors to manage the corporation. Relying on the requirement in Section 141(a) that any limitation on the board's power must be stated in the certificate of incorporation, the court found that dead hand provision would prevent a newly elected board "from completely discharging its fundamental management duties to the corporation and its stockholders for six months" by restricting the board's power to negotiate a sale of the corporation. The reasoning behind the *Quickturn* holding leaves little room for dead hand provisions of any type in Delaware.[296]

Not all states have come down against dead hand rights plans.[297] The rights plan upheld in *Copeland*, supra, involved dead hand features, although the opinion did not focus on the validity of the dead hand feature.

---

[295] *See Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. Supr. 1998), which involved a "no hand" pill provision of limited duration that the target's board had adopted in the face of a combined proxy fight and tender offer by raider. The pill provision barred a newly elected board from redeeming the rights plan for six months after taking office if the purpose or effect would be to facilitate a transaction with a party that supported the new board's election.

[296] *See also Carmody v. Toll Brothers, Inc.*, C.A. No. 15983, 1998 Del. Ch. LEXIS 131 (July 24, 1998).

[297] *See Invacare Corporation v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997) (court rejected the offeror's contention that a dead hand pill impermissibly restricts the power of future boards of directors – including a board elected as part of a takeover bid – to redeem a rights plan, relying upon the "plain language" of a Georgia

C. Business Combination Statutes.

Both Delaware and Texas provide protections to shareholders of public companies against interested shareholder transactions that occur after a shareholder has acquired a 15% to 20% ownership interest. The Delaware limitations are found in Section 203 of the DGCL and the Texas limitations are found in Part Thirteen of the TBCA.

Section 203 of the DGCL. Section 203 of the DGCL imposes restrictions on transactions between public corporations and certain stockholders defined as "interested stockholders" unless specific conditions have been met. In general, Section 203 provides that a publicly held Delaware corporation may not engage in a business combination with any interested stockholder for a period of three years following the date the stockholder first became an interested stockholder unless (i) prior to that date the board of directors of the corporation approved the business combination or the transaction that resulted in the stockholder becoming an interested stockholder, (ii) the interested stockholder became an interested stockholder as a result of acquiring at least 85% of the voting stock of the corporation, excluding shares held by directors and officers and employee benefit plans in which participants do not have the right to determine confidentially whether their shares will be tendered in a tender or exchange offer, or (iii) the transaction is approved by stockholders by an affirmative vote of at least two-thirds of the outstanding shares excluding the shares held by the interested stockholder. In the context of a corporation with more than one class of voting stock where one class has more votes per share than another class, there is an "interesting interpretative challenge" whether "85% of the voting stock" refers to the number of shares or the number of votes.[298]

An interested stockholder is generally defined under DGCL Section 203(c)(3) as any person that directly or indirectly owns or controls or has beneficial ownership or control of at least 15% of the outstanding shares of the corporation. A business combination is defined under DGCL Section 203 to include (i) mergers, (ii) consolidations, (iii) direct or indirect sales, leases, exchanges, mortgages, transfers and other dispositions of assets to the interested stockholder having an aggregate market value greater than 10% of the total aggregate market value of the assets of the corporation, (iv) various issuances of stock and securities to the interested stockholder that are not issued to other stockholders on a similar basis and (v) various other transactions in which the interested stockholder receives a benefit, directly or indirectly, from the corporation that is not proportionally received by other stockholders.

The provisions of DGCL Section 203 apply only to public corporations (*i.e.*, corporations the stock of which is listed on a national securities exchange, authorized for quotation on interdealer quotation system of a registered national securities association or held of record by more than 2,000 stockholders).[299] The provisions of Section 203 also will not apply to certain stockholders who held their shares prior to the adoption of Section 203 or to stockholders whose acquisition of shares is

---

statute that expressly grants a corporation's board the "sole discretion" to determine the terms contained in a rights plan); *AMP Incorporated v. AlliedSignal Inc.*, C.A. Nos. 98-4405, 98-4058, and 98-4109, 1998 U.S. Dist. LEXIS 15617 (E.D. Penn. 1998).

298 *In Re: Digex, Inc. Shareholders Litigation*, C.A. No. 18336, 2000 WL 1847679 (Del Ch. Dec. 13, 2000).

299 DGCL Section 203(b).

approved by the corporation prior to the stockholder becoming an interested stockholder. In addition, Section 203 will not apply if the certificate of incorporation of the corporation or the bylaws approved by stockholders provides that the statute will not apply; provided that if the corporation is subject to Section 203 at the time of adoption of an amendment eliminating the application of Section 203, the amendment will not become effective for 12 months after adoption and the section will continue to apply to any person who was an interested stockholder prior to the adoption of the amendment.

A vote to so waive the protection of Section 203 is sometimes referred to as a "Section 203 waiver" and requires that the directors act consistently with their fiduciary duties of care and loyalty.[300]

Part Thirteen of the TBCA. Part Thirteen of the TBCA, like Section 203 of the DGCL, imposes a special voting requirement for the approval of certain business combinations and related party transactions between public corporations and affiliated shareholders unless the transaction or the acquisition of shares by the affiliated shareholder is approved by the board of directors prior to the affiliated shareholder becoming an affiliated shareholder.[301]

In general, Part Thirteen prohibits certain mergers, sales of assets, reclassifications and other transactions (defined as business combinations) between shareholders beneficially owning 20% or more of the outstanding stock of a Texas public corporation (such shareholders being defined as affiliated shareholders) for a period of three years following the shareholder acquiring shares representing 20% or more of the corporation's voting power unless two-thirds of the unaffiliated shareholders approve the transaction at a meeting held no earlier than six months after the shareholder acquires that ownership. The provisions requiring the special vote of shareholders will not apply to any transaction with an affiliated shareholder if the transaction or the purchase of shares by the affiliated shareholder is approved by the board of directors before the affiliated shareholder acquires beneficial ownership of 20% of the shares or if the affiliated shareholder was an affiliated shareholder prior to December 31, 1996, and continued as such through the date of the transaction. Part Thirteen does not contain the Delaware 85% unaffiliated share tender offer exception, which was considered by the drafters to be a major loophole in the Delaware statute, and attempts to attempts to clarify various uncertainties and ambiguities contained in the Delaware statute.

Part Thirteen applies only to an "issuing public corporation", which is defined to be a corporation organized under the laws of Texas that has: (i) 100 or more shareholders, (ii) any class or series of its voting shares registered under the Securities Exchange Act of 1934, as amended, or similar or successor statute, or (iii) any class or series of its voting shares qualified for trading in a national market system.[302] For the purposes of this definition, a shareholder is a shareholder of record as shown by the share transfer records of the corporation.[303] Part Thirteen also contains an

---

300 *See Digex*, 2000 WL 1847679.

301 *See* TBCA arts. 13.01-13.08.

302 *Id.* at art. 13.02A(b).

303 *Id.*

opt-out provision that allows a corporation to elect out of the statute by adopting a by-law or charter amendment prior to December 31, 1997.

VI. Director Responsibilities and Liabilities.

A. Limitation of Director Liability — Article 1302-7.06 of the TMCL and Section 102(b)(7) of the DGCL.

In response to the director and officer liability insurance crisis of the 1980s and a concern about the ability of corporations to attract and retain qualified persons willing to serve as directors in light of the holding of *Van Gorkum* (holding outside directors liable for a hasty and imprudent business decision),[304] both Texas and Delaware adopted statutes expressly authorizing corporations to limit the liability of their directors for certain matters. The limitations permitted by the Texas and Delaware statutes are based on long-standing fiduciary and contract principles that permit parties to establish by contract the duties of a fiduciary subject to public policy limitations.

The Texas limitation on director liability is set forth in article 1302-7.06 of the Texas Miscellaneous Corporation Laws (the "*TMCL*").[305] A Texas corporation may include a provision in its articles of incorporation that eliminates or limits the liability of a director to his corporation and the corporation's shareholders for monetary damages for any act or omission in the director's capacity as a director except where the director is found liable under one of the following four circumstances. Those circumstances are where the director is found to be liable for (i) a breach of the director's duty of loyalty, (ii) an act or omission not in good faith that constitutes a breach of duty of the director or an act or omission that involves intentional misconduct or a knowing violation of law, (iii) a transaction from which the director received an improper personal benefit, and (iv) an act or omission for which liability of a director is expressly provided by an applicable statute.[306] Article 1302-7.06, through its description of exceptions, is essentially a codification of the standard of liability of directors articulated in *Gearhart*.[307] It assures corporations that include this provision in their articles of incorporation that the *Gearhart* standards of liability (fraud, *ultra vires,* and breach of duty of loyalty) will be the applicable standard for their directors even if the standard of liability for a director under the business judgment rule in Texas is ultimately determined to be gross negligence as envisioned by *Resolution Trust Corp. v. Norris*[308] and *FDIC v. Brown*.[309]

Section 102(b)(7) of the DGCL similarly provides a means for a corporation to limit the liability of a director through a provision contained in the corporation's certificate of incorporation.[310] Like the Texas statute, DGCL § 102(b)(7) permits the elimination or limitation of

---

304 *See supra* note [?] and accompanying text.

305 Tex. Rev. Civ. Stat. Ann. art. 1302-7.06 (Vernon 1980 & Supp. 1999-2000).

306 *Id.* art. 1302-7.06(B).

307 *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719-22 (5th Cir. 1984).

308 830 F. Supp. 351, 357-58 (S.D. Tex. 1993).

309 812 F. Supp. 722, 725-26 (S.D. Tex. 1992).

310 DGCL § 102(b)(7).

liability of a director for breaches of fiduciary duty except under enumerated circumstances: (i) a breach of a duty of loyalty, (ii) an act or omission not in good faith or involving "intentional misconduct or a knowing violation of law," (iii) certain unlawful distributions, and (iv) transactions in which the director derived "an improper benefit."[311]

B. Indemnification — Article 2.02-1 of the TBCA and Section 145 of the DGCL.

Both Texas and Delaware permit corporations to indemnify their directors and officers for liabilities incurred by serving as directors or officers of their corporations or of other corporations and entities at the request of their corporations.

Under TBCA art. 2.02-1, there are two standards for indemnification for directors depending on whether the indemnification arrangement has been approved by shareholders.[312] Where the indemnification has not been approved by shareholders, the scope and right to indemnification will be limited by law and be dependent on whether the conduct of the director met certain specified standards.[313] Where the indemnification is approved by shareholders, the corporation will be permitted to provide indemnification for acts of the director that may not otherwise be subject to indemnification under the statute.[314] As a result, under Texas law, a corporation and its shareholders may in essence establish its own standards and criteria for defining when and under what terms and circumstances indemnification will be made available. Expenses may also be advanced to a director in respect of a proceeding if the corporation receives a written affirmation of the director's good faith belief that the director has met the standards for indemnification and undertakes to reimburse the corporation for the expenses if it is ultimately determined that the director did not meet the standard or is otherwise not entitled to indemnity.[315] Indemnification of officers and other persons other than directors in Texas is restricted only by concepts of public policy.

Sections B and C of article 2.02-1 of the TBCA sets forth the general standard of conduct that will permit a corporation to provide indemnification when shareholder approval is not obtained.[316] These provisions provide that a corporation may indemnify a director for liabilities and expenses in respect of actions brought against the director by reason of serving as a director or officer of the corporation (or of another entity at the request of the corporation) if the conduct of the

---

311 *Id.*; *see Malipede v. Thompson,* 780 A2d 1075 (Del. 2001) (en banc) in which the court held that director defendants may rely upon DGCL § 102(b)(7) exculpatory provisions in the company's certificate of incorporation in the context of a motion to dismiss a monetary damage claim for failure to state a cause of action prior to discovery; the court held that the duty of care claim was barred by the DGCL § 102(b)(7) exculpatory provisions and that the shareholder claim that the board breached its Revlon duty to maximize shareholder value is not a duty of loyalty claim (the board had terminated an auction and selected a winning bidder for a merger despite a higher offer from a third party).

312 TBCA art. 2.02-1 (Vernon Supp. 1999-2000).

313 *Id.* art. 2.02-1(K).

314 *Id.* art. 2.02-1(B).

315 *Id.* art. 2.02-1(K).

316 *Id.* art. 2.02-1(B), (C).

director was in good faith and the director reasonably believed that (i) in the case of conduct in the director's official capacity as a director, the director's conduct was in the corporation's best interests, and (ii) in all other cases, the director's conduct was at least not opposed to the best interest of the corporation.[317] Indemnification for criminal actions also requires a director to have had no reasonable cause to believe the director's conduct was unlawful.[318] In addition, if a director is found liable to the corporation or on the basis that a personal benefit was improperly received by him, indemnification will be limited to expenses actually incurred and will not be available if the director is found liable for willful or intentional misconduct in the performance of the director's duty to the corporation.[319]

Although the scope of indemnification is subject to limitation where shareholder approval has not been obtained, article 2.02-1(R) provides a broad exception to this rule. Under TBCA art. 2.02-1(R), a corporation with the approval of its shareholders may adopt any form of indemnification arrangement with its directors covering all forms of liability and standards of conduct, including conduct and liabilities that the corporation would not otherwise lack power to indemnify under article 2.02-1.[320] This provision was adopted to address the difficulties experienced by many corporations in obtaining liability insurance for directors and officers and provides corporations with substantial flexibility in establishing indemnification arrangements to cover liabilities that could be insured against but would not otherwise be within the scope of indemnity permitted by the statute. Section R also specifically authorizes alternative forms of indemnification arrangements, including self-insurance, the creation of trust funds to pay indemnification claims, and indemnification contracts.[321] In the absence of fraud, the judgment of directors as to the terms of an indemnification arrangement adopted in accordance with article 2.02-1 will be conclusive and will not be voidable or subject the directors to liability on any ground.[322] This exculpatory provision is intended to address the potential conflict of interest issues that arise when directors approve indemnification arrangements that benefit themselves and overrides the provisions of article 2.35 -1 of the TBCA (discussed below).

In contrast to the TBCA, the DGCL provides only one standard for indemnification, whether or not approved by stockholders. Under section 145 of the DGCL, a director or officer may be indemnified if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the interest of the corporation, and, in the case of a criminal action or proceeding, had no reasonable ground to believe his conduct was unlawful.[323] If the action is in the name of the corporation, no indemnification may be provided if the person is adjudged liable unless the court

---

317 *Id.* art. 2.02-1(B)(1), (2).

318 TBCA art. 2.02-1(B)(3) (Supp. 1999-2000).

319 *Id.* art. 2.02-1(E).

320 *Id.* art. 2.02-1(R).

321 *Id.* art. 2.02-1(R).

322 *Id.* art. 2.02-1(R).

323 DGCL § 145(a) (1991 & Supp. 1998).

determines that such indemnification is proper.[324] Expenses may also be advanced to a director or officer on an undertaking that the amounts advanced will be repaid if it is ultimately determined that the director or officer is not entitled to indemnification.[325] Like the TBCA, DGCL § 145(f) provides that the indemnification permitted by statute is not exclusive.[326] However, unlike the TBCA, uncertainties exist as to the ability of a corporation to expand the scope of conduct for which indemnification may be provided beyond the statute, particularly where the indemnification relates to a proceeding by or in the name of the corporation.

C. Interested Director Transactions — Article 2.35-1 of the TBCA and § 144 of the DGCL.

Both Texas and Delaware have embraced the principle that a transaction or contract between a director and the director's corporation is presumed to be valid and will not be voidable solely by reason of the director's interest as long as certain conditions are met.

Section 144 of the DGCL provides that a contract between a director and the director's corporation will not be voidable due to the director's interest if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, and (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.[327] In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that a transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation even if approved by the corporation's board or shareholders as contemplated by the statute.[328]

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted article 2.35-1 of the TBCA.[329] In general, TBCA art. 2.35-1 provides that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.[330] Because TBCA art. 2.35-1 was essentially identical to § 144 of the DGCL, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Flieger*'s interpretation of § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in article 2.35-1 uncertain.

---

324 *Id.* § 145(b).

325 *Id.* § 145(e).

326 *Id.* § 145(f).

327 *Id.* § 144(a).

328 *See Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

329 TBCA art. 2.35-1 (Supp. 1996).

330 *Id.*

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Flieger* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.[331] Under the statute, if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.[332] Article 2.35-1 relies heavily on the statutory definition of "disinterested" contained in TBCA art. 1.02.[333] Under the definition, a director will be considered "disinterested" if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.[334]

Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met.[335] Although the difference between the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are structured. However, article 2.35-1 does not eliminate a director's or officer's fiduciary duty to the corporation.

D. Director Consideration of Long-Term Interests.

It has been implicit under Texas law that a director may consider the long-term interests of the corporation. However, because short-term market valuations of a corporation may not always reflect the benefits of long-term decisions and inherent long-term values, article 13.06 was added to the TBCA in 1997 to expressly allow directors to consider the long-term interests of a corporation and its shareholders when considering actions that affect the interest of the corporations.[336] Although this provision was viewed as a mere codification of existing law, it was intended to eliminate any ambiguity that might exist as to the right of a board of directors to consider long-term interests when evaluating a takeover proposal. There is no similar provision in the DGCL.

---

[331] Id. art. 2.35-1 (Supp. 2000).

[332] *Id.* art. 2.35-1(A).

[333] *Id.* art. 1.02(A)(12).

[334] *Id.; see infra* Part VII.B.3 regarding NYSE, NASDAQ and other director independence requirements in the context of directors eligible to serve on audit committees.

[335] *Compare* TBCA art. 2.35-1(A) (Supp. 1996) *with* TBCA art. 2.35-1(A) (Supp. 2000).

[336] TBCA art. 13.06 (Supp. 2000).

E. Liability for Unlawful Distributions.

Both Texas and Delaware impose personal liability on directors who authorize the payment of distributions to shareholders (including share purchases) in violation of the statutory requirements.[337]

Under Delaware law, liability for an unlawful distribution extends for a period of six years to all directors other than those who expressly dissent, with the standard of liability being negligence.[338] Section 172 of the DGCL, however, provides that a director will be fully protected in relying in good faith on the records of the corporation and such other information, opinions, reports, and statements presented to the corporation by the corporation's officers, employees and other persons. This applies to matters that the director reasonably believes are within that person's professional or expert competence and have been selected with reasonable care as to the various components of surplus and other funds from which distributions may be paid or made.[339] Directors are also entitled to receive contribution from other directors who may be liable for the distribution and are subrogated to the corporation against shareholders who received the distribution with knowledge that the distribution was unlawful.[340] Under the TBCA, liability for an unlawful distribution extends for two years instead of six years and applies to all directors who voted for or assented to the distribution (assent being presumed if a director is present and does not dissent).[341] A director will not be liable for an unlawful distribution if *at any time* after the distribution, it would have been lawful.[342] A similar provision does not exist in Delaware. A director will also not be liable under the TBCA for an unlawful distribution if the director:

(i) relied in good faith and with ordinary care on information relating to the calculation of surplus available for the distribution under TBCA art. 2.38-3;

(ii) relied in good faith and with ordinary care on financial and other information prepared by officers or employees of the corporation, a committee of the board of directors of which he is not a member or legal counsel, investment bankers, accountants and other persons as to matters the director reasonably believes are within that person's professional or expert competence;

(iii) in good faith and with ordinary care, considered the assets of the corporation to have a value equal to at least their book value; or

(iv) when considering whether liabilities have been adequately provided for, relied in good faith and with ordinary care upon financial statements of, or other information

---

337 TBCA art. 2.41(A)(i) (Vernon Supp. 1999-2000); DGCL § 174(a) (Supp. 1998).

338 DGCL § 174 (1991 & Supp. 1998).

339 *Id.*

340 DGCL § 174(b) (1991).

341 TBCA art. 2.41(A) (Vernon Supp. 1999-2000).

342 *Id.*

> concerning, any other person that is contractually obligated to pay, satisfy, or discharge those liabilities.[343]

As in Delaware, a director held liable for an unlawful distribution under the TBCA will be entitled to contribution from the other directors who may be similarly liable. The director can also receive contribution from shareholders who received and accepted the distribution knowing it was not permitted in proportion to the amounts received by them.[344] The TBCA also expressly provides that the liability of a director for an unlawful distribution provided for under article 2.41 is the only liability of the director for the distribution to the corporation or its creditors, thereby negating any other theory of liability of the director for the distribution such as a separate fiduciary duty to creditors or a tortious violation of the Uniform Fraudulent Transfer Act.[345] No similar provision is found in the DGCL.

F. Reliance on Reports and Opinions.

Both Texas and Delaware provide that a director in the discharge of his duties and powers may rely on information, opinions and reports prepared by officers and employees of the corporation and on other persons as to matters that the director reasonably believes are within that person's professional or expert competence.[346] In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.[347] In Texas, reliance must be made both in good faith and with ordinary care.[348]

G. Inspection of Records.

Both Texas and Delaware have codified the common law right of directors to examine the books and records of a corporation for a purpose reasonably related to the director's service as a director.[349]

H. Right to Resign.

Directors of corporations in trouble may be tempted to resign, especially when they sense that legal action may be imminent which would be time consuming and possibly result in personal liability. The general rule is that a director may resign at any time, for any reason.[350] There is,

---

343 TBCA art. 2.41(C), (D).

344 *Id.* art. 2.41(E), (F).

345 *Id.* art. 2.41(G).

346 *See id.* art. 2.41(D) (Vernon Supp. 1999-2000); DGCL § 141(e) (Supp. 1998).

347 DGCL § 141(e) (Supp. 1998); *see also Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

348 TBCA art. 2.41(D) (Vernon Supp. 1999-2000).

349 TBCA art. 2.44(B) (Vernon Supp. 1999-2000); DGCL § 220(d) (Supp. 1998).

350 DGCL § 141(b) provides "[a]ny director may resign at any time upon notice given in writing or by electronic transmission to the corporation"; *see In re Telesport Inc.*, 22 B.R. 527, 532-3, fn. 8 (Bankr. E.D. Ark. 1982) ("Corporate officers [are] entitled to resign . . . for a good reason, a bad reason or no reason at all, and are entitled

however, an exception in circumstances where that resignation would cause immediate harm to the corporation, allow such harm to occur, or leave the company's assets vulnerable to directors known to be untrustworthy.[351] While the judicial expressions of this exception appear broad, an analysis of the cases suggests that liability results only when the harm to the company is rather severe and foreseeable. Further and regardless of the timing of the resignation, a director is still liable for breaches of the fiduciary duty made during his tenure.[352] Resignation does not free a director from the duty not to misuse information received while a director.[353] Finally, a director may have an interest in staying on the board of directors to help the corporation work through its difficulties in the hope that by helping the corporation survive he is reducing the chances that he will be sued in connection with the corporation's troubles.

VII. Committees of the Board.

A. General.

Both Texas and Delaware provide that boards of directors may delegate authority to committees of the board subject to limitations on delegation for fundamental corporate

---

to pursue their chosen field of endeavor in direct competition with [the corporation] so long as there is no breach of a confidential relationship with [it]."); *Frantz Manufacturing Co. et al. v. EAC Industries*, 1985 Del. LEXIS 598 at 22 (Del. 1985); ("Directors are also free to resign."); *see also 2 Fletcher Cyclopedia on Corporations* § 345 (1998) ("A director or other officer of a corporation may resign at any time and thereby cease to be an officer, subject to any express charter or statutory provisions to which he or she has expressly or impliedly assented in accepting office, and subject to any express contract made with the corporation"); Medford, *Preparing for Bankruptcy; Director Liability in the Zone of Insolvency*, 2001 Am. Bk. Inst. Jnl. LEXIS 73 at 30 ("A Delaware corporate director typically has the right to resign without incurring any liability or breaching any fiduciary duty").

351 *See Gerdes v. Reynolds*, 28 N.Y.S. 2d 622, 651 (N.Y. S.Ct. 1941) (In the context of a business combination, the court wrote that it "gravely doubt[s]" whether the directors could avoid liability if they sell their shares for a premium, resign and allow a transfer of control of a corporation to a purchaser before the full purchase price is paid and the transferee owns enough shares to elect its own slate of directors, suggesting that "officers and directors . . . cannot terminate their agency or accept the resignation of others if the immediate consequence would be to leave the interests of the company without proper care and protection"); *Xerox Corp. v. Genmoora Corp.*, 888 F.2d 345, 355 (5th Cir.1989), in a situation where a Texas corporation sold most of its assets and set up a liquidating trust to distribute the proceeds to shareholders and then four of the five directors resigned as liquidating trustees, leaving the liquidating trust in control of the fifth director known to be incompetent and dishonest, Judge Brown referred to the defense that the directors had resigned before the corporate abuse took place as the "Geronimo theory" and wrote "[u]nder this theory, by analogy, if a commercial airline pilot were to negligently aim his airplane full of passengers at a mountain, and then bail out before impact, he would not be liable because he was not at the controls when the crash occurred"; citing *Gerdes*, Judge Brown postulated that "[a] director can breach his duty of care – hence his fiduciary duty – by knowing a transaction that will be dangerous to the corporation is about to occur but taking no steps to prevent it or make his objection known;" *DePinto v. Landoe*, 411 F.2d 297 (9th Cir. 1969) (director found liable for resigning instead of opposing a raid on his corporation's assets); *Benson v. Braun*, 155 N.Y.S.2d 622, 624-6 ("officers and directors may not resign their offices and elect as their successors persons who they knew intended to loot the corporation's treasury.").

352 *FDIC v. Wheat*, 970 F. 2d 124, 128 (5th Cir. 1992); *District 65 UAW v. Harper & Roe Publishers*, 576 F. Supp. 1468 (S.D.N.Y 1983).

353 *Quark Inc. v. Harley*, 1998 U.S. App. LEXIS 3864 (10th Cir. 1998); *T.A. Pelsue Co. v. Grand Enterprises Inc.*, 782 F. Supp. 1476 (D. Colo. 1991).

transactions.[354] Among the matters that a committee of a board of directors will not have the authority to approve are (i) charter amendments, except to the extent such amendments are the result of the issuance of a series of stock permitted to be approved by a board of directors, (ii) approving a plan of merger or similar transaction, (iii) recommending the sale of all or substantially all of the assets of the corporation outside the ordinary course of its business, (iv) recommending a voluntary dissolution of the corporation and (v) amending bylaws or creating new bylaws of the corporation.[355] In addition, under Texas law, a committee of a board of directors may not fill any vacancy on the board of directors, remove any officer, fix the compensation of a member of the committee or amend or repeal a resolution approved by the whole board to the extent that such resolution by its terms is not so amendable or repealable.[356] Further, under both Texas and Delaware law, no committee of a board of directors has the authority to authorize a distribution (a dividend in the case of Delaware law) or authorize the issuance of stock of a corporation unless that authority is set forth in the charter or bylaws of the corporation.[357] Alternative members may also be appointed to committees under both states' laws.[358]

B. Audit Committees.

1. Role of Audit Committee

In general, the responsibility for a corporation's financial reporting is divided as follows:

- Management is responsible for the preparation of the company's financial statements, including the principles and practices to be followed within the boundaries prescribed by generally accepted accounting principles ("*GAAP*"), and the company's internal control arrangements.

- The corporation's internal auditors (if any) are usually involved in monitoring the corporation's internal controls.

- The independent auditors are responsible for auditing and publicly attesting to the fairness of the financial statements in GAAP terms and evaluating the company's internal control systems.

---

[354] TBCA art. 2.36 (Vernon Supp. 1999-2000); DGCL § 141(c) (1991).

[355] TBCA art. 2.36 (Vernon Supp. 1999-2000); DGCL § 141(c) (1991).

[356] TBCA art. 2.36(B) (Vernon supp. 1999-2000).

[357] TBCA art. 2.36(C) (Vernon Supp. 1999-2000); DGCL § 141(c)(1). See infra note 317 and accompanying text for information regarding the Delaware and Texas provisions governing dividends and distributions to shareholders. DGCL § 141(c)(1) (Supp. 1998).

[358] TBCA art. 2.36(A) (Vernon Supp. 1999-2000); DGCL § 141(c)(1).

- The audit committee is generally delegated by the board of directors the responsibility for overseeing the other participants in the financial reporting process. The role and responsibility of the audit committee has been enhanced by SOB.[359]

An audit committee composed of independent directors is typically assigned responsibilities to oversee the corporation's financial reporting process and internal controls. Although required by state law only in Connecticut, the New York Stock Exchange ("*NYSE*"), the American Stock Exchange ("*ASE*") and the NASDAQ National Market System ("*NASDAQ NMS*") all require listed companies to establish and maintain audit committees consisting exclusively (in the case of the NYSE) or primarily (in the case of the ASE and the NASDAQ NMS) of independent directors.[360] These exchanges require that boards of directors of listed companies adopt charters ("*audit committee charters*") for their audit committees. Securities and Exchange Commission ("*SEC*") rules require that listed companies disclose in their proxy statements descriptions of the membership and functions of their audit committees and include the audit committee charter in the proxy statement every three years.[361]

The ABA Corporate Director's Guidebook[362] recognizes that the responsibilities of the audit committee will vary from company to company, but suggests the following list of audit committee responsibilities:

- Recommend which firm to engage as the corporation's external auditor and whether to terminate that relationship.

- Review the external auditor's compensation, the proposed terms of its engagement, and its independence.

- Review the appointment and replacement of the senior internal auditing executive, if any.

- Serve as a channel of communication between the external auditor and the board and between the senior internal auditing executive, if any, and the board.

- Review the results of each external audit, including any qualifications in the external auditor's opinion, any related management letter, management's responses to recommendations made by the external auditor in connection with the audit, reports submitted to the audit committee by the internal auditing department that are material to the corporation as a whole, and management's responses to those reports.

---

359 See Appendix D: Summary of Sarbanes-Oxley Act of 2002 and Related SEC Rulemaking.

360 *ABA Corporate Directors Guidebook* (2nd Ed. 1994) 27; *ALI Principles of Corporate Governance* § 3.05 (Supp 2002).

361 SEC Release No. 34-42266 (the "*SEC December 1999 Audit Committee Release*"), which can be found on the SEC's web site (http://www.sec.gov/rules/final/34-42266.htm).

362 *ABA Corporate Directors Guidebook* (2nd Ed. 1994) 34-35.

- Review the corporation's annual financial statements and any significant disputes between management and the external auditor that arose in connection with the preparation of those financial statements.

- Consider, in consultation with the external auditor and the senior internal auditing executive, if any, the adequacy of the corporation's internal financial controls. Among other things, these controls must be designed to provide reasonable assurance that the corporation's publicly reported financial statements are presented fairly in conformity with generally accepted accounting principles.

- Consider major changes and other major questions of choice regarding the appropriate auditing and accounting principles and practices to be followed when preparing the corporation's financial statements.

- Review the procedures employed by the corporation in preparing published financial statements and related management commentaries.

- Meet periodically with management to review the corporation's major financial risk exposures.

2. Effects of SOB on Audit Committees.

Audit Committees. The SOB (§301) requires the SEC by rule to require that stock exchanges, within 270 days after the enactment of the SOB (April 26, 2003), deny listing of any company unless its audit committee has direct responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services and that its audit committee members are independent directors. In order to be considered independent, the committee 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 from the issuer or (ii) be an officer or other affiliate of the issuer. Subject to the foregoing, to restrictions on loans discussed elsewhere herein and to director fiduciary duties, directors are not prohibited from transacting business with the issuer, either directly or through relationships with another person.

Audit Committee Financial Experts. The SOB (§407) requires the SEC to promulgate rules no later than 180 days after enactment of SOB (January 26, 2003) mandating reporting company disclosure regarding whether (and, if not, why not) its audit committee comprises at least one member who is a "financial expert." On October 22, 2002 the SEC proposed[363] rules regarding

---

[363] SEC Release No. 34-46701 (October 22, 2002). Comments with respect to the proposed rules must be received by the SEC within 30 days of publication of the proposed rules in the Federal Register.

audit committee financial experts to implement SOB § 407[364] and would require reporting companies to disclose in Form 10-K:[365]

- The number and names of persons that the board of directors has determined to be "financial experts" serving on the issuer's audit committee;[366] and, if there is no financial expert serving on the audit committee, that fact and why it has no financial expert; and

- Whether the financial expert or experts are "independent,"[367] and if not, an explanation of why they are not.[368]

The SEC intends in the future to propose rules directing the national securities exchanges and NASDAQ to require that reporting companies have a completely independent audit committee as a condition to listing.

The proposed rules under SOB §407 define the term "financial expert" to mean a person who, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such position, was a reporting company, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the issuer's board of directors, in the person's having similar expertise and experience), has the following attributes:

---

[364] SOB § 407 requires the SEC to adopt rules: (1) requiring a reporting company to disclose whether its audit committee includes at least one member who is a "financial expert"; and (2) defining the term "financial expert." The SOB § 407 requirements are not applicable until the SEC's implementing rules are adopted.

[365] The proposed rules discussed in this memorandum 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 Release also proposed rules with similar requirements for investment companies.

[366] Section 3(a)(58) of the Exchange Act, as amended by SOB § 205 defines the term "audit committee" as "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 . . . if no such committee exists with respect to an issuer, the entire board of directors of the issuer."

[367] SOB § 301 added a new § 10A(m)(3) to the 1934 Act providing as follows with respect to audit committee independence:

"(3) INDEPENDENCE.—

"(A) IN GENERAL.—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

"(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

"(ii) be an affiliated person of the issuer or any subsidiary thereof.

[368] Proposed Regulation S-K Item 309.

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

- Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the issuer's financial statements;

- Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the issuer's financial statements;

- Experience with internal controls and procedures for financial reporting; and

- An understanding of audit committee functions.

To be a financial expert, an individual must possess all of the five specified attributes, and exposure to the rigors of preparing or auditing financial statements of a reporting company is important. The board of directors, however, can conclude that an individual possesses the required attributes without having the specified experience. If the board of directors makes such a determination on the basis of alternative experience, the company must disclose the basis for the board's determination. While no such disclosure is required where the individual has the specified experience, disclosure would be appropriate in cases where there is any question. In any event, the board should maintain adequate minutes or other records showing the basis for its judgments.

In determining whether a potential financial expert has all of the requisite attributes, the board of directors of an issuer should evaluate the totality of an individual's education and experience. The board would be encouraged to consider a variety of factors in making its evaluation, including:

- The level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;

- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person has actively practiced as a certified public accountant, or the equivalent;

- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether the person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having such expertise;

- Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file periodic reports pursuant to the Exchange Act and, if so, the length of any such service;

- The person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;

- The person's level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements required to be included in periodic reports filed under the Exchange Act;

- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements required to be included in periodic reports filed under the Exchange Act;

- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to the Exchange Act;

- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and

- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the issuer's financial statements and other financial information and in making knowledgeable and thorough inquiries whether:

  -- The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and

  -- The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

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 a financial expert under the proposed rules.

The proposed attributes of a "financial expert" described above are more detailed and rigorous than those reflected in the current NYSE, NASDAQ, AMEX, PCX and other self-regulatory organization rules. Therefore, it is possible that a person who previously qualified as a financial expert under the current guidelines included in the rules of self-regulatory organizations may not have sufficient expertise to be considered a financial expert under these proposed rules. If the proposed rules are adopted, it will be important for reporting companies to re-evaluate whether an audit committee member who has the requisite level of financial expertise for purposes of the self-regulatory organizations also qualifies as a financial expert under the SEC rules.

As to the role of a financial expert on an audit committee and the effect on the liability of an individual designated as a financial expert and other members of the audit committee and the board of directors, the SEC has commented:

> The primary benefit of having a financial expert serving on a company's audit committee is that the person, with his or her enhanced level of financial sophistication or expertise, can serve as a resource for the audit committee as a whole in carrying out its functions. The mere designation of the financial expert should not impose a higher degree of individual responsibility or obligation on a member of the audit committee. Nor do we intend for the financial expert designation to decrease the duties and obligations of other audit committee members or the board of directors. Furthermore, in order to avoid any confusion in the context of Section 11 of the Securities Act, we do not intend for such a person to be considered an expert for purposes of Section 11 solely as a result of his or her designation as a financial expert on the audit committee. The role of the financial expert is to assist the audit committee in overseeing the audit process, not to audit the company. A conclusion that a financial expert is an "expert" for purposes of Section 11 might suggest a higher level of due diligence than is consistent with the audit committee's oversight responsibilities.[369]

3. Audit Committee Charters.

In late 1999 the NYSE, ASE and NASDAQ NMS adopted rules requiring audit committees to have charters.[370] In December 1999, the SEC issued a release[371] adopting rules that established new requirements about audit committees and effectively required each public company audit committee to have a charter. These SEC rules specify:

- Interim financial statements must be reviewed by independent auditors before being included in quarterly reports filed with the SEC.

- All proxy and information statements relating to votes of shareholders must:

  - Include a report[372] from the audit committee that discloses whether the audit committee reviewed and discussed certain matters with management and the

---

369 SEC Release No. 34-46701 (October 22, 2002).

370 NYSE Company Manual § 303.01 (2002); ASE Listing Standards Policies and Requirements § 121 (2002); NASD Manual & Notices to Members – The NASDAQ Stock Market § 4350(d) (2002).

371 *Id.*

372 The SEC December 1999 Audit Committee Release discusses the SEC's adoption of Item 306 to Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A to require the audit committee to provide a report in the company's proxy statement, which must state whether the audit committee:

- has reviewed and discussed the audited financial statements with management;
- has discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards (SAS) 61;

auditors, and whether it recommended to the board of directors that the audited financial statements be included in the Annual Report on Form 10-K or 10-KSB for filing with the SEC.

- Disclose whether the audit committee has a written charter,[373] and, if so, include a copy of the charter every three years.

- has received written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1, and has discussed with the auditors the auditors' independence; and
- recommended to the board of directors that the financial statements be included in the annual report on Form 10-K or 10-KSB for the last fiscal year for filing with the SEC, based upon the review and discussions with independent auditors noted above.

Like the present practice with regard to reports of compensation committees, the new disclosures will appear over the names of each member of the audit committee.

[373] The SEC rules also require companies to disclose in their proxy statements whether their audit committee is governed by a Charter, and if so, include a copy of their Charter as an appendix to the proxy statement at least every three years. See Item 7(e)(3) of SEC Regulation 14A.

Under the current NYSE, ASE and NASDAQ NMS listing standards, listed companies must adopt an audit committee charter that:

- describes the scope of the audit committee's responsibilities and how they are carried out (including structure, processes and membership requirements);
- states that the outside auditors are ultimately accountable to the board and to the audit committee and that the board and the audit committee have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement);
- states that the audit committee is responsible for ensuring that the outside auditors submit a formal written statement regarding all relationships between the outside auditors and the company;
- states that the audit committee is responsible for maintaining an active dialogue with the outside auditors regarding any disclosed relationships or services that could affect the objectivity and independence of the outside auditors; and
- under the NYSE listing requirements, states that the audit committee is responsible for recommending that the board take appropriate action in response to the outside auditors' report to satisfy itself of the auditors' independence, or under the NASDAQ NMS/ASE listing requirements, states that the audit committee is responsible for taking, or recommending that the board take, appropriate action to oversee the outside auditors' independence.

On August 16, 2002 the NYSE submitted a rule filing titled "Corporate Governance Rule Proposals" to the SEC proposing new corporate governance standards, as well as related changes made to certain other NYSE rules. These proposed NYSE rules, which are currently subject to a comment period and are expected to become effective, subject to changes recommended by the SEC, in the first quarter of 2003, increase the authority and responsibilities of the audit committee of an NYSE listed company. If adopted in their current form, the proposed rules would grant the audit committee of an NYSE company the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors.

If adopted in their current form, the proposed NYSE rules would require the audit committee to have a written charter that addresses:

(i) the committee's purpose, which at minimum must be to:

  - Disclose whether the audit committee members are "independent" and provide information about any audit committee member who is not "independent."

- The 1999 revised listing standards of NYSE, ASE and NASDAQ NMS requiring listed companies to:

  - Adopt written charters for their audit committees by June 14, 2000.

(A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

(B) prepare the report that SEC rules require be included in the company's annual proxy statement.

(ii) the duties and responsibilities of the audit committee – which at a minimum must be to:

(A) retain and terminate the company's independent auditor's (subject, if applicable, to shareholder ratification);

(B) at least annually, obtain and review a report by the independent auditor describing the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationship's between the independent auditor and the company;

(C) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations;"

(D) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

(E) as appropriate, obtain advice and assistance from outside legal, accounting or other advisors;

(F) discuss policies with respect to risk assessment and risk management;

(G) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

(H) review with the independent auditor any audit problems or difficulties and managements' response;

(I) set clear hiring policies for employees or former employees of the independent auditors;

(J) report regularly to the board of directors;

(iii) an annual performance evaluation of the audit committee;

In addition, each NYSE listed company would be required to have an internal audit function. This requirement does not necessarily mean that a company must establish a separate internal audit department or dedicate employees to the task on a full-time basis; it is enough for a company to have in place an appropriate control process for reviewing and approving its internal transactions and accounting. A company may choose to outsource this function to a firm other than its independent auditor.

- Have audit committees of at least three members, each of whom is "independent" and "financially literate" and at least one of whom has accounting or financial management expertise.[374]

---

[374] The current NYSE, ASE and NASDAQ NMS listing standards specify requirements for audit committee structure and membership which are similar but take slightly different approaches.

NYSE

The current NYSE listing standards mandate that audit committees consist of at least three directors who are both "independent" and "financially literate."

Independent Directors. The NYSE listing standards now require that all audit committee members be "independent" directors. The rules broadly define "independent" as having "no relationship to the company that may interfere with the exercise of [the director's] independence from management and the company." In addition to this definition, a director will not be considered independent for purposes of appointment to an audit committee if the director:

- is an employee (including non-employee executive officers) of the company or its affiliates or has been an employee within the last three years (if the employment relationship is with a former parent or predecessor of the company, a director may be appointed if the relationship between the company and the former parent or predecessor terminated more than three years prior);
- is a partner, controlling shareholder or executive officer of an organization that has a business relationship with the company;
- has a direct business relationship with the company (the director's relationship could be direct or the director could be a partner, officer or employee of an organization that has the business relationship);
- is employed as an executive officer of another corporation where any of the company's executives serve on that corporation's compensation committee; or
- is an immediate family member of a person who is or has been an executive officer of the company or its affiliates within the last three years.

The NYSE rules currently provide some limited exceptions to these specific independence requirements:

- the board may appoint a director who has a direct business relationship with the company if it determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment; and
- the board may appoint one director who is a former employee of the company, or who is an immediate family member of a former executive of the company, who is restricted from service on the audit committee because of the three year time limitation, if the board determines in its business judgment that the individual's service on the committee is required by the corporation's and the shareholders' best interests. If the board appoints a director under this exception, the company must disclose the nature of the director's relationship and the reasons for the appointment in the company's next annual proxy statement.

On August 16, 2002 the NYSE submitted a rule filing titled "Corporate Governance Rule Proposals" to the SEC proposing new corporate governance standards, as well as related changes made to certain other NYSE rules. The proposed rules would still require that all audit committee members be "independent" directors. However, the proposed rules would state that no director qualifies as "independent" unless the board of directors of the listed company as a whole affirmatively determines that the director has "no material relationship to the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)." Under the proposed rules:

- No director who is a former employee of the listed company can be "independent" until five years after the employment has ended (although a director who serves as an interim Chairman or CEO may be

excluded from the definition of a "former employee" and thus be deemed independent immediately after his or her service as interim CEO ends).

- No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until fie years after the end of either the affiliation or the auditing relationship.
- No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director.
- Directors with immediate family members in the foregoing categories are likewise subject to the five-year "cooling-off" provisions for purposes of determining "independence."
- Additionally, the proposed NYSE rules would require that in order to be considered independent, director's fees must be the only compensation an audit committee member may receive from the company (this requirement would not apply to non-audit committee directors).

Financial Literacy. The NYSE listing standards also require all directors serving on audit committees to be "financially literate." The rules do not provide a standard of financial literacy, but rather leave this determination to the board in its business judgment. If a director is not financially literate, he or she must become financially literate within a reasonable period of time after appointment.

Although all members of the committee must be financially literate, at least one of the members must have accounting or related financial management expertise. Again, the rules do not provide a standard for applying this requirement, but leave it to the board to assess each director's qualifications.

Like the independence requirements, the financial literacy requirements do not apply to directors already serving on audit committees, but will apply when they are reelected or replaced.

Disclosure to the NYSE. The NYSE circulates a form to listed companies that is used to confirm annually:

- any determination by the board regarding the independence of audit committee members;
- the financial literacy of audit committee members;
- the determination that at least one audit committee member has accounting or related financial managerial expertise; and
- the annual review and reevaluation of the adequacy of the audit committee Charter.

The NYSE requires companies to submit this written affirmation within one month after a company's annual meeting.

NASDAQ NMS/ASE

The new NASDAQ NMS/ASE listing standards mandate that audit committees consist of at least three members, all of whom must be "independent directors" and "financially literate." The membership and structural requirements of the rules do not apply to small business issuers who file reports under SEC Regulation S-B. However, these issuers must maintain an audit committee of at least two members which must contain a majority of members who are independent.

Independent Directors. An "independent director" is a person, other than an officer of the company, who does not have any relationship that would interfere with the exercise of independent judgment. The NASDAQ NMS/ASE rules further provide that a director with the following relationships will not qualify as independent:

- is employed by the company or its affiliates or has been an employee within the last three years;
- received compensation from the company or its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan or non-discretionary compensation;
- is an immediate family member of a person who is or has been an executive officer of the company or its affiliates within the last three years;

a. **Proxy Statement Disclosure.**

NYSE, ASE and NASDAQ NMS listed companies must disclose in proxy statements for shareholder meetings whether members of the audit committee meet the applicable independence standard. Public companies that are not so listed must nevertheless disclose whether members of the audit committee are independent.

b. **Audit Firm Non-Audit Services.**

Annual financial statements filed with the SEC must be accompanied by an opinion of "independent" auditors to the effect that the financial statements were audited according to auditing standards generally accepted in the U.S. and fairly present, in all material respects, the financial position of the company as at the year-end dates specified and for the annual periods then ended. Auditor independence has long been the underpinning of the integrity of audited financial statements and, while its focus is upon the auditors' mental state of objectivity and lack of bias, its litmus is objective: whether the auditor had any of a number of specified relationships with the company which are deemed to compromise independence.

On November 27, 2000 and after a lengthy public comment process, the SEC issued a release adopting amendments to its rules regarding auditor independence (the "*SEC Auditor Independence Release*").[375] The amendments revised the SEC's rules for determining whether an auditor is "independent" in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients.[376]

- is a partner, controlling shareholder or executive officer of a for-profit business to which the company made, or from which the company received, payments in excess of 5% of the company's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the past three years; or
- is employed as an executive officer of another company where any of the company's executives serve the other company's compensation committee.

Notwithstanding these independence requirements, the board may appoint, under exceptional and limited circumstances, one audit committee member who is not independent under the above rules if he or she is not a current employee or an immediate family member of an employee. However, the board may only make such an appointment if it is required by the best interests of the corporation and its shareholders. The board must also disclose the nature of the director's relationship and the reasons for the appointment in the company's next annual proxy statement.

Financial Literacy. The NASDAQ NMS/ASE listing standards mandate that all audit committee members be able to read and understand fundamental financial statements (including the company's balance sheet, income statement and cash flow statement), or will become able to do so within a reasonable time after being appointed to the committee.

Furthermore, at least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience resulting in financial sophistication (including having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities).

[375] Release No. 33-7919 (November 27, 2000).

[376] Rule 2-01 of SEC Regulation S-X (2000).

The amendments, among other things, identified certain non-audit services that, if provided by an auditor to public company audit clients, would be deemed to impair the auditor's independence, and require companies to include information in their proxy statements regarding non-audit services being provided by the company's auditors. The impetus behind the change was the SEC's belief that consolidation and other major changes in the accounting profession and the types of services that auditors provide to their audit clients, as well as increases in the absolute and relative size of the fees charged for non-audit services, had exacerbated long standing concerns about the effects on independence when auditors provide both audit and non-audit services to their audit clients.[377]

The amended SEC rules[378] identified nine non-audit services that, when provided by the auditor to the audit client, generally would be deemed to impair auditor independence:

(i) Bookkeeping or other services related to the audit client's accounting records or financial statements.[379]

(ii) Financial information systems design and implementation.

(iii) Appraisal or valuation services or fairness opinions.[380]

(iv) Actuarial services.[381]

(v) Internal audit services.[382]

---

[377] In 1999 the Big Five accounting firms received non-audit fees estimated to aggregate more than $15 billion, which represented half of their total revenues. SEC Auditor Independence Release at 7.

[378] SEC Regulation S-X § 2.01 (2000).

[379] An auditor should not be put in the position of auditing its own work when it is auditing client financial statements. SEC Auditor Independence Release at 48.

[380] An exception is provided "for appraisal or valuation services where the accounting firm reviews and reports on work done by the audit client itself or an independent, third-party specialist employed by the audit client, and the audit client or specialist provides the primary support for the balance recorded in the client's financial statements." SEC Auditor Independence Release at 52.

[381] An auditor's independence is deemed impaired if the audit firm provides certain actuarially oriented advisory services involving the determination of insurance company policy reserves and related accounts, unless three conditions are met: (1) the audit client must use its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities; (2) management must accept responsibility for any significant actuarial methods and assumptions employed by the accountant in performing or providing the actuarial services; and (3) the accountant cannot render the actuarial services to the audit client on a continuous basis. If these conditions are met, the accountant can perform four types of actuarial services for an insurance company audit client without impairing the accountant's independence: (i) assisting management to develop appropriate methods, assumptions, and amounts for policy and loss reserves and other actuarial items presented in financial reports, based on the company's historical experience, current practice, and future plans; (ii) assisting management in the conversion of financial statements from a statutory basis to one conforming with GAAP; (iii) analyzing actuarial considerations and alternatives in federal income tax planning; and (iv) assisting management in the financial analyses of various matters, such as proposed new policies, new markets, business acquisitions, and reinsurance needs. SEC Auditor Independence Release at 53.

(vi) Management functions

(vii) Human resources.

(viii) Broker-dealer or securities underwriting services.

(ix) Legal services.[383]

In order to assist investors in evaluating the independence of the auditors of the companies in which they invest, the SEC Auditor Independence Release adopted amendments to the SEC proxy rules requiring companies to provide three kinds of proxy statement disclosures: (1) disclosure regarding the employment of leased personnel in connection with the audit; (2) disclosure regarding fees billed for services rendered by the principal auditors;[384] and (3) disclosure regarding whether the audit committee considered the compatibility of the non-audit services the company received from its auditor and the independence of the auditor.[385] Since the SEC required issuers to disclose only whether the audit committee considered whether the principal accountant's provision of non-audit services is compatible with maintaining the principal accountant's independence and did not require issuers to disclose the conclusions of the audit committee deliberations, the SEC said it saw "little possibility of private liability arising from these disclosures."[386]

c. **Liability Concerns.**

Safe Harbor. The SEC in the SEC December 1999 Audit Committee Release also adopted limited safe harbors for the new proxy statement disclosures.[387] Following the practice for compensation committee reports included in proxy statements or information statements, the additional audit committee disclosures are not considered "soliciting material," "filed" with the SEC, subject to Regulation 14A (for proxy statements) or 14C (for information statements), and therefore

---

382 An exception is provided for issuers with $200 million or less in assets. SEC Auditor Independence Release at 54.

383 In the SEC's view "there is a fundamental conflict between the role of an independent auditor and that of an attorney. The auditor's charge is to examine objectively and report, regardless of the impact on the client, while the attorney's fundamental duty is to advance the client's interests." SEC Auditor Independence Release at 58.

384 As adopted in the SEC Auditor Independence Release, Item 9 of Schedule 14A requires registrants to separately disclose the fees paid for (1) the annual audit and for the review of the company's financial statements included in the company's SEC quarterly reports for the most recent fiscal year, (2) information technology services and (3) other non-audit services, including fees for tax-related services.

385 Since audit committees play an important role in overseeing the financial reporting process and the auditor's independence, Item 9 of Schedule 14A requires disclosure of whether the audit committee considered whether the principal accountant's provision of the information technology services and other non-audit services to the registrant is compatible with maintaining the principal accountant's independence.

386 SEC Auditor Independence Release at 60.

387 *See* Item 306(c) of SEC Regulations S-K and S-B and paragraph (e)(v) of SEC Schedule 14A.

are not subject to the antifraud provisions of Rule 14a-9 or 14c-6 or to the liabilities of Section 18 of the Securities Exchange Act of 1934 (the "*1934 Act*").[388]

Private Litigation. While several commentators urged the SEC to adopt a safe harbor from private litigation, the SEC declined to do so, stating that an additional safe harbor was neither necessary or appropriate. The SEC indicated that it did not intend to subject companies or their directors to increased exposure to liability under federal securities laws or to create new standards for directors to fulfill their duties under state corporation laws. In its promulgating release the SEC reasoned: "To the extent the disclosure requirements would result in more clearly defined procedures for, and disclosure of, the operation of the audit committee, liability claims alleging breach of fiduciary duties under state law actually may be reduced."[389]

Liability for Breach of Listing Standards. There is generally no express private cause of action for breaches of stock exchange rules, and courts have held that there is no implied private right of action under these rules as well. Such breaches could nevertheless be asserted as evidence for alleged liability under another theory, such as breach of the duty of care, as defined by the duties set forth in the audit committee charter, or as evidence of recklessness (scienter) in a securities fraud case. Of course, there is also the possibility that litigation will arise over whether the SEC rules themselves create an implied right of action.

Liability for Breach of Audit Committee Charter. An audit committee's membership and operation are governed by its charter. A charter which fails to specify adequately the responsibilities of audit committee members leaves the company and the board open to investor criticism and the audit committee without a road map through its responsibilities. However, a charter that sets unrealistic duties and aspirational standards could lead to liability for failure to meet the specified duties and standards. The safe harbor described above is limited to SEC disclosure only and has no bearing on potential liability of audit committee members or the company for failure to conform to the standards of the audit committee charter.

C. Compensation Committee.

The Compensation Committee typically is composed of independent directors and focuses on executive compensation and administration of stock options and other incentive plans. While the duties of the Compensation Committee will vary from company to company, the *ALI's Principles of Corporate Governance*[390] recommend that the Compensation Committee should:

(1) Review and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect, of the senior executives.

(2) Review new executive compensation programs; review on a periodic basis the operation of the corporation's executive compensation programs to determine whether they are properly coordinated; establish and periodically review policies for

---

[388] *Id.*

[389] SEC December 1999 Audit Committee Release at 11.

[390] *ALI Principles of Corporate Governance* § 3A.05 (Supp 2002).

the administration of executive compensation programs; and take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance.

(3) Establish and periodically review policies in the area of management perquisites.

Under SEC Rule 16b-3, the grant and exercise of employee stock options, and the making of stock awards, are generally exempt from the short-swing profit recovery provisions of § 16(b) under the 1934 Act if approved by a committee of independent directors. Further, under Section 162(m) of the Internal Revenue Code of 1980, as amended, corporations required to be registered under the 1934 Act are not able to deduct compensation to specified individuals in excess of $1,000,000 per year, except in the case of performance based compensation arrangements approved by the shareholders and administered by a compensation committee consisting of two or more "outside directors" as defined.[391]

VIII. Shifting Duties When Company on Penumbra of Insolvency.

A. Insolvency Changes Relationships.

Directors owe fiduciary duties to the owners of the corporation.[392] When the corporation is solvent, the fiduciary duties are owed to the corporation and the shareholders of the corporation. The creditors relationship to the corporation is contractual in nature. Their rights in relation to the corporation are those that they have bargained for and memorialized in their contracts. A solvent corporation's directors do not owe any fiduciary duties to the corporation's creditors. When the corporation is insolvent and there is no value left for the shareholders, the corporation's creditors become its owners and the directors owe fiduciary duties to the creditors as the owners of the business.[393]

---

[391] Treas. Reg. § 1.162-27 (2002).

[392] Comments of Delaware Vice Chancellor Leo J. Strine in Galveston, Texas on February 22, 2002 at the 24th Annual Conference on Securities Regulation and Business Law Problems sponsored by University of Texas School of Law, et al.

[393] *Plas-Tex v. Jones*, 2000 WL 632677 (Tex. App.-Austin 2002; not published in S.W.3d) ("As a general rule, corporate officers and directors owe fiduciary duties only to the corporation and not to the corporation's creditors, unless there has been prejudice to the creditors. . . . However, when a corporation is insolvent, a fiduciary relationship arises between the officers and directors of the corporation and its creditors, and creditors may challenge a breach of the duty. . . . Officers and directors of an insolvent corporation have a fiduciary duty to deal fairly with the corporation's creditors, and that duty includes preserving the value of the corporate assets to pay corporate debts without preferring one creditor over another or preferring themselves to the injury of other creditors. . . . However, a creditor may pursue corporate assets and hold directors liable only for 'that portion of the assets that would have been available to satisfy his debt if they had been distributed pro rata to all creditors'."; *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 787 (Del.Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . . e.g., fraud, insolvency or a violation of a statute….' [citation omitted]. Furthermore, [no one] seriously disputes that when the insolvency does arise, it creates fiduciary duties for directors for the benefit of creditors. Therefore, the issue…is when do directors' fiduciary duties to creditors arise via insolvency."); *see* Terrell and Short, *Directors Duties in Insolvency: Lessons From Allied Riser*, 14 BNA Bkr. L. Reptr. 293 (March 14, 2002).

There are degrees of insolvency (e.g., a corporation may be unable to pay its debts as they come due because of troubles with its lenders or its liabilities may exceed the book value of its assets, but the intrinsic value of the entity may significantly exceed its debts). Sometimes it is unclear whether the corporation is insolvent. In circumstances where the corporation is on the penumbra of insolvency, the directors may owe fiduciary duties to the "whole enterprise."[394] Owing fiduciary duties to the "whole enterprise" puts the directors in the uncomfortable position of owing duties to multiple constituencies having conflicting interests.[395]

B. When is a Corporation Insolvent or in the Vicinity of Insolvency?

It is the fact of insolvency, rather than the commencement of statutory bankruptcy or other insolvency proceedings, that causes the shift in director duties.[396] Delaware courts define

---

[394] *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992) ("The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when the shareholders' wishes should not be the directors only concern"); *see Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150, 1991 Del. Ch. LEXIS 215 at n. 55 (Del. Ch. 1991) in which Chancellor Allen expressed the following in *dicta*:

> n. 55 The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that [based on] the array of probable outcomes of the appeal [25% chance of affirmance, 70% chance of modification and 5% chance of reversal] the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal $12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million - $12 million $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that the shareholders would prefer rejection of both settlement offers.
>
> But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

[395] *See Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386 (Del. Ch. 1999).

[396] *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992).

insolvency as occurring when the corporation "is unable to pay its debts a they fall due in the usual course of business . . . or it has liabilities in excess of a reasonable market value of assets held."[397]

Under the "balance sheet" test used for bankruptcy law purposes, insolvency is defined as when an entity's debts exceed entity's property at fair valuation,[398] and the value at which the assets carried for financial accounting or tax purposes is irrelevant.

Fair value of assets is the amount that would be realized from the sale of assets within a reasonable period of time.[399] Fair valuation is not liquidation or book value, but is the value of the assets considering the age and liquidity of the assets, as well as the conditions of the trade.[400] For liabilities, the fair value assumes that the debts are to be paid according to the present terms of the obligations.

The directors duties, however, begin the shift even before the moment of insolvency. Where the corporation may not yet be technically insolvent but "is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bears, but owes its duty to the corporate enterprise".[401] In cases where the corporation has been found to be in the vicinity of insolvency, the entity was in dire financial straits with a bankruptcy petition likely in the minds of the directors.[402]

C. Director Liabilities to Creditors.

The business judgment rule is applicable to actions of directors even while the corporation is insolvent or on the penumbra thereof in circumstances where it would have been applicable.[403] Where directors are interested, presumably the conduct of directors were likewise be judged by the standards that would have otherwise have been applicable. A director's stock ownership, however, may call into question a director's independence where the fiduciary duties are owed to the creditors, for the stock ownership would tend to ally to director with the interests of the shareholders rather

---

397 *Id.*

398 11 U.S.C. § 101(32) (2001). A "balance sheet" test is also used under the fraudulent transfer statutes of Delaware and Texas. *See* Del. Code § 1302 and Tex. Bus. & Com. Code § 24.003. For general corporate purposes, TBCA art. 1.02(16) (2001) defines insolvency as the "inability of a corporation to pay its debts as they become due in the usual course of its business." For transactions covered by the U.C.C., Tex. Bus. & Com. Code 1.201(23) (2001) defines an entity as "insolvent" who either has ceased to pay its debts in the ordinary course of business or cannot pay its debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

399 *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

400 *In re United Finance Corporation*, 104 F.2d 593 (7th Cir. 1939).

401 *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150 Mem. Op., Del. Ch. LEXIS 215 (Del. Ch. 1991).

402 In the *Credit Lyonnais* case, *supra*, a bankruptcy petition had recently been dismissed, but the corporation continued to labor "in the shadow of that prospect" *Id. See also Equity-Linked Investors LP v. Adams*, 705 A.2d 1040, 1041 (Del. Ch. 1997) (corporation found to be on "lip of insolvency" where a bankruptcy petition had been prepared and it had only cash sufficient to cover operations for one more week).

403 *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

than the creditors, but relatively insubstantial amounts of stock ownership should not impugn a directors independence.[404]

When the conduct of the directors is being challenged by the creditors on fiduciary duty grounds, the directors do not have the benefit of the statutes limiting director liability in duty of care cases.[405]

D. Conflicts of Interest.

Conflicts of interest are usually present in closely held corporations where the shareholders are also directors and officers. While the TBCA allows transactions with interested parties after disclosure and disinterested director or shareholder approval,[406] when the insolvency arises, the conflict of interest rules change.

After insolvency, Texas directors begin to owe a fiduciary duty to the creditors and cannot rely on the business judgment rule or disclosure to the disinterested directors as a defense.[407] Instead, the disclosure must include the creditors.[408]

After insolvency, Delaware law dictates a similar result.[409] The Delaware duty of fairness on transactions with interested parties runs to the creditors when the corporation is insolvent.[410]

A developing issue involves the application of the conflict of interest rules to parties that are related to the director or officer. While the courts are not uniform in their definition, the conflict of interest rules usually extend to family members.

E. Fraudulent Transfers.

Both state and federal law prohibit fraudulent transfers.[411] All require insolvency at the time of the transaction. Texas and Delaware are identical to the Uniform Fraudulent Transfer Act, except Delaware adds the following provision: "Unless displaced by the provisions of this chapter, the principles of law and equity, including the law merchant and the law relating to principal and agent,

---

404 *Cf. Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corporation, et al.*, 2002 Del. Ch. LEXIS 11.

405 *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del.Ch. 1992); see discussion of DGCL § 102(b)(7) and TMCA art. 1302-7.06 under Part VI.A *supra.*

406 *See* discussion of TBCA art. 2.35-1 under Part VI.C *supra.*

407 *Weaver v. Kellog*, 216 B.R. 563 (S.D. Tex. 1997).

408 *Id.*

409 *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1115 (Del. 1984).

410 *Id.*

411 Tex. Bus. & Com. Code Chap. 24; Delaware Code § 1301 et seq., 11 U.S.C. § 548.

estoppel, laches, fraud, misrepresentation, duress, coercion, mistake, insolvency or other validating or invalidating cause, supplement its provisions."

The applicable statute of limitation varies with the circumstances and the applicable law. Generally, the statute of limitations for state laws may extend to four years, while bankruptcy law dictates a one year limitation starting with the petition filing date.

IX. Post Enron Issues of Special Concern.

A. Outside Director Independence.

Under Texas law, a director is considered "interested" only in respect of matters in which he has a financial interest.[412] The Fifth Circuit in *Gearhart* summarized Texas law with respect to the question of whether a director is "interested" as follows:

---

[412] TBCA art. 1.02A(12) defines "disinterested" director as follows:

> (12) "Disinterested," when used to indicate a director or other person is disinterested in a contract, transaction, or other matter for purposes of approval of a contract or transaction under Article 2.35-1 of this Act and for purposes of considering the disposition of a claim or challenge with respect to a particular contract or transaction or to particular conduct means the director or other person, or an associate of the director (other than the corporation and its associates) or other person, is not a party to the contract or transaction or is not materially involved in the conduct that is subject to the claim or challenge and does not otherwise have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge. A director or other person is not to be considered to be materially involved in conduct that is subject to a claim or challenge or to otherwise have a material financial interest in the outcome of a contract or transaction or the disposition of the claim or challenge solely by reason of the existence of one or more of the following circumstances:
>
> (a) the person was nominated or elected as a director by persons who are interested in the contract or transaction or who are alleged to have engaged in the conduct that is subject to the claim or challenge;
>
> (b) the person receives normal director's fees or similar customary compensation, expense reimbursement, and benefits as a director of the corporation;
>
> (c) the person has a direct or indirect equity interest in the corporation;
>
> (d) the corporation or its subsidiaries has an interest in the contract or transaction or was affected by the alleged conduct;
>
> (e) the person or an associate or affiliate of the person receives ordinary and reasonable compensation for services rendered to review, make recommendations, or decide on the disposition of the claim or challenge; or
>
> (f) in the case of a review by the person of alleged conduct that is subject to a claim or challenge:
>
> (i) the person is named as a defendant in the derivative proceeding with respect to such matter or as a person who engaged in the alleged conduct; or
>
> (ii) the person approved of, voted for, or acquiesced in, as a director, the act being challenged if the act resulted in no material personal or financial benefit to the person and the challenging party fails to allege with particularity facts that, if true, raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders by reason of that conduct.

> A director is considered 'interested' if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . .; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated . . .; or (4) transacts business in his director's capacity with a family member.[413]

Under Delaware law, an independent director is one whose decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence.[414] A controlled director is not an independent director.[415] Control over individual directors is established by facts demonstrating that "through personal or other relationships the directors are beholden to the controlling person."[416]

Under the current NYSE rules defining who is "independent" for purposes of eligibility to serve on an audit committee, "independent" is defined in terms of having "no relationship to the company that may interfere with the exercise of their independence from management and the company."[417] Without modifying the generality of the foregoing definition of "independent," the NYSE rules provide that a director will not be considered independent for purposes of appointment to an audit committee if the director:

- is an employee (including non-employee executive officers) of the company or its affiliates or has been an employee within the last three years (if the employment relationship is with a former parent or predecessor of the company, a director may be appointed if the relationship between the company and the former parent or predecessor terminated more than three years prior);

- is a partner, controlling shareholder or executive officer of an organization that has a business relationship with the company;

- has a direct business relationship with the company (the director's relationship could be direct or the director could be a partner, officer or employee of an organization that has the business relationship);

---

413 *Gearhart*, 741 F.2d at 719-20 (citations omitted).

414 *Aronson v. Lewis*, 473 A.2d 805, 816 (Del.Supr. 1984); *Odyssey Partners v. Fleming Companies*, 735 A.2d 386 (Del.Ch. 1999).

415 *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995) ("To be considered independent, a director must not be dominated or otherwise controlled by an individual or entity interested in the transaction.").

416 *Aronson*, *supra*, 473 A.2d at 815; *see Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.Supr. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

417 NYSE Company Manual § 303.01(B)(2)(a) (2002); see VII.B.3. above regarding proposed changes to NYSE rules relating to audit committee.

- is employed as an executive officer of another corporation where any of the company's executives serve on that corporation's compensation committee; or

- is an immediate family member of a person who is or has been an executive officer of the company or its affiliates within the last three years.

Following a request by then SEC Chairman Harvey Pitt that the NYSE review its corporate governance listing standards, the NYSE Board appointed a Corporate Accountability and Listing Standards Committee which on June 6, 2002 issued a report that made sweeping proposals for changes to the NYSE's corporate governance listing standards.[418] The Board of Directors of the NYSE approved an amended version of that report titled "Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee" which it filed with the SEC on August 1, 2002.[419] The proposals include the following:

1. Require listed companies to have a majority of independent directors.

2. Tighten the NYSE definition of "independent director."

   - No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

   - In addition:

   – No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.

   – No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.

   – No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.

   – Directors with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."

[418] Report of NYSE Corporate Accountability and Listing Standards Committee (June 6, 2002) (http://www.newyorkstockexchange.com/press/NT00565884.html).

[419] Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors August 1, 2002 (http://www.nyse.com/pdfs/corp_gov_pro_b.pdf).

3. To empower non-management directors to serve as a more effective check on management, provide that the non-management directors of each company must meet at regularly scheduled executive sessions without management.

4. Require listed companies to have a nominating/corporate governance committee composed entirely of independent directors.

   The nominating/corporate governance committee must have a written charter that addresses:

   - the committee's purpose – which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation.

   - the committee's goals and responsibilities – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management.

   - an annual performance evaluation of the committee.

5. Require listed companies to have a compensation committee composed entirely of independent directors.

   The compensation committee must have a written charter that addresses:

   - the committee's purpose – which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.

   - the committee's duties and responsibilities – which, at minimum, must be to:

   – review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.

   – make recommendations to the board with respect to incentive-compensation plans and equity-based plans.

   - an annual performance evaluation of the compensation committee.

6. Require members of the audit committee to adhere to a higher standard of independence than other members of a listed company's board of directors, including a requirement that director's fees are the only compensation an audit committee member may receive from the company:

- An audit committee member may receive his or her fee in cash and/or company stock or options or other in-kind consideration ordinarily available to directors, as well as all of the regular benefits that directors receive.

- Because of the significantly greater time commitment of audit committee members, they may receive reasonable compensation greater than that paid to other directors (as may other directors for other time-consuming work).

- Disallowed compensation for an audit committee member includes fees paid directly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to a director's firm for such consulting or advisory services even if the director is not the actual provider.

- Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or other business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis.

To eliminate any confusion, note that the foregoing requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.

7. Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors.

   The audit committee must have a written charter that addresses:

- the committee's purpose – which, at minimum, must be to: (a) assist board oversight of (i) the integrity of the company's financial statements, (ii) the company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and independent auditors; and (b) prepare the report that SEC rules require be included in the company's annual proxy statement.

- the duties and responsibilities of the audit committee – which, at minimum, must be to:

– retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).

– at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional

authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

– discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

– discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

– as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.

– discuss policies with respect to risk assessment and risk management.

– meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors.

– review with the independent auditor any audit problems or difficulties and management's response.

– set clear hiring policies for employees or former employees of the independent auditors.

– report regularly to the board of directors.

- an annual performance evaluation of the audit committee.

Each listed company must have an internal audit function.

8. Increase shareholder control over equity-compensation plans.

- Shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans relating to mergers or acquisitions, and tax qualified and excess benefit plans.

- A broker may not vote a customer's shares on any equity-compensation plan unless the broker has received that customer's instructions to do so.

9. Require listed companies to adopt and disclose corporate governance guidelines, which must address the following subjects:

- Director qualification standards.

- Director responsibilities.
- Director access to management and, as necessary and appropriate, independent advisors.
- Director compensation.
- Director orientation and continuing education.
- Management succession.
- Annual performance evaluation of the board.

10. Require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- Conflicts of interest.
- Corporate opportunities.
- Confidentiality.
- Fair dealing.
- Protection and proper use of company assets.
- Compliance with laws, rules and regulations (including insider trading laws).
- Encouraging the reporting of any illegal or unethical behavior.

11. Require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

12. Require each listed company CEO to certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.

13. In addition, the proposed rules would authorize the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties.

NASDAQ has already approved changes in its corporate governance standards and forwarded them to the SEC for approval. The definition of an independent director, which currently prohibits independent directors from receiving more than $60,000 in compensation, will be extended to prohibit any payments, including political contributions, in excess of $60,000 and will extend to

receipt of such payments by a family member of the director.[420] Furthermore, a director will not be considered independent if the company makes payments to a charity where the director is an executive officer and such payments exceed the greater of $200,000 or five percent of either the company's or the charity's gross revenues.

Ordinarily director fees are not considered sufficient to affect a director's independent judgment and, therefore, not to stigmatize his status as an independent director. The level of director compensation in the Enron case may raise questions as to whether it would compromise his independent judgment.[421] The Enron case is causing director independence to be questioned in situations where the director has no personal financial interest, but has relationships that could affect his independent judgment (e.g. the independence of a university president may be questioned if the university receives substantial contributions from the corporation).[422] While the legal concepts of independence may not change, institutional investors may use their influence to force changes in board composition.

B. Codes of Conduct.

Generally. The oversight responsibilities of directors articulated in the *Caremark* case discussed above,[423] together with the Sentencing Guidelines for Organization Defendants under U.S. criminal laws which provide for reduced penalties where the defendant entity has an effective program to prevent and detect violations of law, suggest that corporations would be well advised to adopt Codes of Conduct containing policies which employees are expected to follow. The SOB (§406) directs the SEC to issue rules requiring a code of ethics[424] for senior financial officers of an issuer applicable to the CFO, comptroller or principal accounting officer and to require the immediate disclosure on its Form 8-K of any change in or waiver of the code of ethics for senior financial officers.

Scope. Code of Conduct policies may include one or more of the following:[425]

- Conflicts of Interest and Disclosure of Certain Interests

---

420 The Nasdaq Stock Market Inc. Press Release May 24, 2002 (www.nasdaqnews.com).

421 Comments of Delaware Vice Chancellor Leo J. Strine in Galveston, Texas on February 22, 2002 at the 24th Annual Conference on Securities Regulation and Business Law Problems sponsored by University of Texas School of Law, et al.

422 *Id.*

423 *See* discussion of *Caremark* case in *Part II.D.2(c), supra.*

424 A "code of ethics" is expected to contain 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.

425 *See* Form of Code of Conduct attached as Appendix C.

- Disclosure and Confidentiality
- Human Rights
- Business Ethics
- Safety
- Internet Usage
- Compliance with Anti-Trust Laws
- Compliance with Environmental Laws
- Compliance with Foreign Corrupt Practices
- Political Contributions
- Responsibility for Reporting Violations of Code
- Consequences of Violating Code

The Codes of Conduct also may set forth that disciplinary action will be taken if an employee does not comply with the policy and that the Code does not create any contract of employment, which is at the will of the employer.

A Code of Conduct will achieve its legal objectives only if it is actually followed and enforced by the corporation. A Code of Conduct which is not followed or enforced may be worse than no Code at all, for it may tend to help a plaintiff establish that the conduct complained of was in fact considered wrongful by the company. A board, therefore, would be well advised to consider the mechanisms available for monitoring compliance before adopting any Code of Conduct.

SOB Codes of Ethics. On October 22, 2002 the SEC proposed[426] rules to implement SOB § 406[427] that would require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a written 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
- If the issuer has not adopted such a code of ethics, the reasons it has not done so.[428]

---

426 SEC Release No. 34-46701 (October 22, 2002).

427 The SOB § 406 requirements are not applicable until the SEC's implementing rules are adopted.

428 Proposed Regulation S-K Item 406.

In the proposed SOB §406 rules, "code of ethics" would mean a codification of standards that is reasonably designed to deter wrong doing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
- 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;[429] and
- Accountability for adherence to the code.[430]

The proposed SEC rules indicate that in addition to providing the required disclosure, an issuer would be required to file a copy of its ethics code as an exhibit to its Form 10-K.

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

- A change to an issuer's code of ethics that applies to the specified officers; or
- Waiver of application of the ethics code provision to a specified officer.

The issuer would be required to file the Form 8-K within two business days after it made the change or granted the waiver. As an alternative to filing a Form 8-K, the proposed rules would permit an issuer to use its website a means of disseminating this disclosure if the issuer has disclosed in its most recently filed Form 10-K:

- That it intends to disclose these events on its Internet website; and
- Its Internet website address.

---

429 The company would retain discretion to choose the person to receive reports of code violations, but Release No. 34-46701 (October 22, 2002) 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.

430 Instructions to Proposed Regulation SK Item 406.

C. Record Retention.

Corporations often adopt policies ("*Document Retention Policies*") advising employees how long documents must be retained in compliance with applicable law and under what circumstances documents can and should be destroyed.[431] For this purpose, "documents" include electronically stored materials (e.g., emails, computer networks, laptops and personal electronic devices, whether at the office or at home and including deleted items that can be retrieved) as well as those in paper form.[432] Premature destruction of documents can have serious adverse consequences for the company.

Under Texas and Delaware law, when a party prematurely destroys evidence, either through negligence or intentional acts, then the court may impose sanctions against that party.[433] We leave for another day the criminal sanctions that also may be imposed upon the destroying party.

The doctrine of spoliation refers to the improper destruction of evidence which is relevant to a case.[434] Remedies for the spoliation of evidence serve three purposes:[435] (i) they punish the spoliator for destroying relevant evidence; (ii) they deter future spoliators;[436] and (iii) they serve an evidentiary function.[437] When evidence spoliation prejudices nonspoliating parties, courts can levy a sanction or submit a presumption that levels the evidentiary playing field and compensates the nonspoliating party.[438]

The legal inquiry involves considering: (1) whether there was a duty to preserve evidence; (2) whether the alleged spoliator either negligently or intentionally spoliated evidence; and (3) whether the spoliation prejudiced the nonspoliator's ability to present its case or defense. A party may have a statutory, regulatory, or ethical duty to preserve evidence.[439] Thus, if a party violates a statutory, regulatory, or ethical duty to preserve evidence, the party may be subject to either sanctions or a spoliation presumption. The potential consequences give substance to these duties.

---

[431] *See* Form of Arthur Andersen LLP Document Retention Policy attached as Appendix D.

[432] *See* Longino, *Taking a Byte Out of Discovery*, 27 Litigation News 10 (2001).

[433] *Trevino v. Ortega*, 969 S.W.2d 950 (Tex. 1998); *Burris v. Kay Bee Toy Stores*, 1999 Del. Super. LEXIS 536, Del. Super., C.A. No. 96C-O1-036, *Witham, J.* (Sept. 17, 1999) (Letter Op.).

[434] *Clements v. Conard*, 21 S.W.3d 514 (Tex. App. – Amarillo 2000, pet. denied); *Whiteside v. Watson*, 12 S.W.3d 614 (Tex. App.–Eastland 2000, pet. granted, vacated pursuant to settlement).

[435] *Trevino v. Ortega*, 969 S.W.2d 950, 955 (Tex. 1998) (J. Baker, concurring).

[436] *See Nation-Wide Check Corp. v. Forest Hills Distribs.*, 692 F.2d 214, 218 (1st Cir. 1982).

[437] *See Sacramona v. Bridgestone/Firestone, Inc.*, 106 F.3d 444, 446 (1st Cir. 1997).

[438] *See Turner v. Hudson Transit Lines*, 142 F.R.D. 68, 75 (S.D.N.Y. 1991); *Bachmeier v. Wallwork Truck Ctrs.*, 507 N.W.2d 527, 533 (N.D. 1993).

[439] *Trevino v. Ortega*, 969 S.W.2d 950, 955 (Tex. 1998) (J. Baker, concurring); *cf.*, e.g., TEX. HEALTH & SAFETY CODE § 241.103 (2002).

The first part of the duty inquiry involves determining when the duty to preserve evidence arises.[440] There is no question that a party's duty to preserve relevant evidence arises during pending litigation. Courts, however, have been less clear about whether a duty exists prelitigation and, if so, at what point during prelitigation does the duty arise.[441] Courts that have imposed a prelitigation duty to preserve have held that once a party is on "notice" of potential litigation a duty to preserve evidence exists.[442]

In *National Tank Co. v. Brotherton*,[443] the Texas Supreme Court defined "anticipation of litigation" in the context of whether a party should be allowed to assert an investigative privilege. In focusing on how to determine when a party reasonably foresees or anticipates litigation, the court did not require actual notice of the potential litigation for a party to anticipate litigation, commenting that "common sense dictates that a party may reasonably anticipate suit being filed . . . before the plaintiff manifests an intent to sue."[444] To determine when a party reasonably anticipates or foresees litigation, trial courts must look at the totality of the circumstances and decide whether a reasonable person in the party's position would have anticipated litigation and whether the party actually did anticipate litigation.[445]

Once a trial court determines when a duty to preserve evidence arises, the court should then look to the second part of the duty inquiry—what evidence a party must preserve.[446] A party that is on notice of either potential or pending litigation has an obligation to preserve evidence that is relevant to the litigation.[447] While a litigant is under no duty to keep or retain every document in its possession, it is under a duty to preserve what it knows, or reasonably should know is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery, or is the subject of a pending discovery sanction.[448]

If the trial court finds that a party has a duty to preserve evidence, it should then decide whether the party breached its duty.[449] Parties need not take extraordinary measures to preserve evidence; however, a party should exercise reasonable care in preserving evidence.[450] Because parties have a duty to reasonably preserve evidence, they may be held accountable for either

---

440 *Trevino v. Ortega*, 969 S.W.2d 950, 955 (Tex. 1998) (J. Baker, concurring).

441 *Trevino v. Ortega*, 969 S.W.2d 950, 955 (Tex. 1998) (J. Baker, concurring); *see* TEX. R. CIV. P. 215.

442 *See*, e.g., *Glover v. BIC Corp.*, 6 F.3d 1318, 1329 (9th Cir. 1992).

443 851 S.W.2d 193 (Tex. 1993).

444 *National Tank*, *supra*, 851 S.W.2d at 204.

445 *See National Tank*, *supra*, 851 S.W.2d at 207.

446 *Trevino v. Ortega,supra* , at 956-57.

447 *Id.*

448 *Id.*

449 *Id.*

450 *See Hirsch v. General Motors Corp.*, 266 N.J. Super. 222, 628 A.2d 1108, 1122 (N.J. Super. Ct. Law Div. 1993).

negligent or intentional spoliation. A spoliator can defend against an assertion of negligent or intentional destruction by providing other explanations for the destruction.[451] If the destruction of the evidence was beyond the spoliator's control or done in the ordinary course of business as pursuant to a document retention policy, the court may find that the spoliator did not violate a duty to preserve evidence. However, when a party's duty to preserve evidence arises before the destruction or when a policy is at odds with a duty to maintain records, the policy will not excuse the obligation to preserve evidence.[452]

Title XI of the SOB is entitled the "Corporate Fraud Accountability Act of 2002" and provides in §1102 for up to 20 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.

D. Recent Proposals for Change.

In the wake of Enron's collapse, there have been a number of proposals made to address perceived causes of the excesses of the 1990s and the collapse of Enron, including the following:

1. Accounting for and Approval of Stock Options.

Stock options, which give employees the right to buy company stock in the future at the price on the date of grant, have for years been applauded as a means to encourage and facilitate employee stock ownership, thereby aligning the interests of shareholders and employees, and criticized as diluting the stockholders and encouraging employees to manipulate reported corporate earnings.[453] The last major effort to force companies to account for options as an expense like wages and salaries was defeated by industry in 1994, but the issue is now being resurrected.[454] Warren Buffett has commented that options do not align employee and shareholder interests because optionees do not have their capital at risk in their options and has argued that if options are part of compensation, they should be expensed as compensation.[455] Alan Greenspan has said that forcing companies to treat stock options as expenses would be a step toward better financial reporting.[456] Legislation has been introduced that would deny tax deductions for option exercises that are not accounted for as expenses.[457]

---

451 *Trevino v. Ortega,supra* , at 957.

452 *Id.*; *see*, Starr and Lippner, *Spoliation by Oversight*, National L. J. (Nov. 12, 2001 at A19) (discussing case where employment record destruction pursuant to a document retention policy was intentional and enough to establish the culpable state of mind needed for spoliation).

453 *Perk Police: Stock Options Come Under Fire in Wake of Enron's Collapse*, Wall Street Journal (March 26, 2002) at A-1.

454 *Id.*

455 *Id.*

456 *Greenspan Warns Against Too Much Regulation*, Wall Street Journal (March 27, 2002) at A-3.

457 *Id.*

There have been sweeping NYSE and other proposals that plans for stock options and other equity based compensation be subject to shareholder approval and that such matters be removed from the list of routine proposals on which brokers have the discretion to vote if not instructed by the beneficial owner.[458] The issue over options is thus rejoined.[459]

2. Accelerated Filing of SEC Reports.

"Financial transparency" is the SEC's regulatory prescription for Enron induced ills:

> Financial transparency means timely, meaningful and reliable disclosures about a company's financial performance. Companies need to provide transparent financials to raise capital. Investors need transparent financials to make informed investment decisions.[460]

In an effort to mandate "financial transparency," the SEC has adopted or proposed major changes to its corporate disclosure regulations, including accelerated timetables for filing quarterly and annual reports and reports of insider transactions under the 1934 Act.[461] Specifically, the SEC has adopted or proposed rules that would:

- Provide accelerated reporting of transactions by corporate insiders in their company's securities.[462]

---

[458] The SEC has issued two releases containing rule changes proposed by the NYSE. (Release No. 34-46620 (October 8, 2002)) and NASDAQ (Release No. 34-46649 (October 11, 2002)) regarding stockholder approval of equity-compensation plans. Subject to certain specifically enumerated exceptions, the proposed rules contained in both the NYSE and NASDAQ releases would require stockholders to approve all new equity-compensation plans and all material changes to existing equity-compensation plans. In addition to the stockholder approval rules, the NYSE release (but not the NASDAQ release) provides that NYSE Rule 452 will be revised to "preclude [NYSE] member organizations from giving a proxy to vote on equity compensation plans unless the beneficial owner of the shares has given voting instructions." Thus, brokers would not be permitted to vote uninstructed shares. NYSE-listed companies would need to take this into account for purposes of achieving a quorum as well as for purposes of obtaining stockholder approval of equity-compensation plans.

[459] *See Time for Accountability at the Corporate Candy Store*, The New York Times (March 31, 2002), Section 3 at 1.

[460] SEC Commissioner Cynthia A. Glassman, *Opening Remarks before the Symposium on Enhancing Financial Transparency* (Washington, D.C. June 4, 2002) (http://www.sec.gov/news/speech/spch565.htm).

[461] 34 SEC. Reg. & L. Rept. 261 (Feb. 18, 2002); the text of the SEC release on the SEC's Web site at http://www.sec.gov/news/press/2002-22.txt.

[462] SEC Release No. 34-46421 (August 27, 2002) implements SOB §403 which amends Section 16(a) of the1934 Act, effective August 29, 2002, to require officers, directors and 10% shareholders (collectively, "*insiders*") of companies with securities registered under Section 12 of the 1934 Act to file with the SEC Forms 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...*", whereas previously Forms 4 were required to be filed by the 10th day of the month following the month in which the transaction was executed. The release also adopts final amendments to SEC rules and forms implementing the accelerated filing deadlines described above for transactions subject to Section 16(a) to subject all transactions between officers or directors and the issuer exempted from Section 16(b) short swing profit recovery by Rule 16b-3, which were previously reportable on an annual basis on Form 5

- Accelerate filing of corporate quarterly and annual reports.[463]

- Require a company's principal executive officer and principal financial officer to certify that, to their knowledge, the information in the company's quarterly and annual reports is true in all important respects and that the reports contain all information about the company of which they are aware that they believe is important to a reasonable investor, and require the company to maintain procedures to provide reasonable assurance that the company is able to collect, process and disclose the information required in the company's quarterly and annual reports, as well as current reports on Form 8-K, and also to require periodic review and evaluation of these procedures.[464]

- Expand the list of significant events requiring current disclosure on 1934 Act Form 8-K, including changes in rating agency decisions, creation of material direct or contingent financial obligations and lock-out periods affecting employee stock ownership plans, and

---

(including stock option grants, cancellations, regrants and repricings), to the new two business day reporting requirement on Form 4. The SEC has adopted two narrow exceptions to the new two business day reporting requirement which apply only if the insider does not select the date of execution of the transaction: (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, transactions pursuant to employee benefit plans and dividend and interest reinvestment plans that are not already exempt from Section 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 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. Other transactions exempt from Section 16(b) previously reportable on Form 5 will remain reportable on Form 5. These transactions include small acquisitions not from the issuer and gifts.

[463] SEC Release No. 33-8128 (September 5, 2002) amends the SEC's rules and forms to accelerate the filing of Form 10-Q quarterly and Form 10-K annual reports under the 1934 Act by domestic reporting companies that have a public float of at least $75 million, that have been subject to the 1934 Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report ("*accelerated filers*"). The changes for accelerated filers will be phased-in over three years. The Form 10-K annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The Form 10-Q quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. The phase-in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002. The release also adopted amendments to require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the SEC.

[464] SEC Release No. 33-8124 (August 29, 2002) adopting rules under SOB §302(a) to require an issuer's CEO and CFO to certify the financial and other information in the issuer's Form 10-Q quarterly reports and Form 10-K annual reports); SEC Release No. 34-46079 (June 17, 2002); SEC Commissioner Harvey Pitt, *Remarks Before the New York Financial Writers Association* (June 13, 2002) (the rules to impose personal responsibility on corporate leaders for their corporations' disclosures were proposed because the SEC believes that "[i]t is unthinkable, in this, the 21st Century, that any CEO or senior corporate officer could even contemplate saying that he or she wasn't focused on the details of what was, and was not, disclosed to investors. . . . where corporate leaders disserve those to whom they owe a fiduciary's duties, we are seeking meaningful penalties, stripping them of corporate offices, salaries, bonuses and stock options.").

shorten the Form 8-K filing deadline to two business days after the report triggering event.[465]

- Require disclosure of critical accounting policies in the Management's Discussion and Analysis section ("*MD&A*") of 1934 Act Form 10-K reports with a focus upon two areas: (i) accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation;[466] and (ii) as to the initial adoption of an accounting policy with a

---

465 SEC Release No. 33-8106 (June 17, 2002) in which the SEC proposed to add the following 11 new items to the list of events that require a company to file a current report on Form 8-K:

- Entry into a material agreement not made in the ordinary course of business;
- Termination of a material agreement not made in the ordinary course of business;
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues;
- Creation of a direct or contingent financial obligation that is material to the company;
- Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation;
- Exit activities including material write-offs and restructuring charges;
- Any material impairment;
- A change in a rating agency decision, issuance of a credit watch or change in a company outlook;
- Movement of the company's securities from one exchange or quotation system to another, delisting of the company's securities from an exchange or quotation system, or a notice that a company does not comply with a listing standard;
- Conclusion or notice that security holders no longer should rely on the company's previously issued financial statements or a related audit report; and
- Any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

The SEC also proposed moving the following two items from other 1934 Act reports to Form 8-K:

- Unregistered sales of equity securities by the company; and
- Material modifications to rights of holders of the company's securities.

The SEC further proposed to expand the current Form 8-K item that requires disclosure about the resignation of a director to also require disclosure regarding the departure of a director for reasons other than a disagreement or removal for cause, the appointment or departure of a principal officer, and the election of new directors. The current Form 8-K item regarding a change in a company's fiscal year would be combined with a new requirement to disclose any material amendment to a company's articles of incorporation or bylaws.

466 "[A] company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations. A company's disclosure about these critical accounting estimates would include a discussion of: the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates." SEC Release No. 33-8098 (May 10, 2002).

material impact, the company would have to disclose information that includes: what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles.[467] The SEC is considering requiring that MD&A sections be in "plain English" and with tabular presentations as part of its efforts to make corporate financial statements more transparent.[468]

- Require disclosure in MD&A of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, including a comprehensive explanation of its off-balance sheet arrangements, an overview of its aggregate contractual obligations in a tabular format and an overview of its contingent liabilities and commitments in either a textual or tabular format. [469]

In addition, the SEC has approved NASD and NYSE rules changes designed to make securities analysts more independent and their research more transparent.[470] The new rules *inter*

---

[467] SEC Release No. 33-8098 (May 10, 2002).

[468] SEC Release No. 33-8098 (May 10, 2002); *cf. United States v. Simon*, 425 F.2d 796 (1969) (in an appeal from a criminal conviction of three accountants with Lybrand, Ross Bros. & Montgomery for conspiring to knowingly draw up false and misleading financial statements that failed to adequately disclose looting by the corporate president and that receivables from an affiliate booked as assets were from an insolvent entity and secured by securities of the company (which itself was in a perilous predicament), the defendants called eight expert independent accountants (an impressive array of leaders of the profession) who testified generally that the financial statements were in no way inconsistent with generally accepted accounting principles or generally accepted auditing standards since the financial statements made all the informative disclosures reasonably necessary for fair presentation of the financial position of the company as of the close of the fiscal year in question, Judge Henry J. Friendly wrote:

> We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material to overall fair presentation . . . it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. * * * The jury could reasonably have wondered how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts. . . . the claim that generally accepted accounting practices do not require accountants to investigate and report on developments since the date of the statements being certified has little relevance.)

[469] SEC Release No. 33-8144 (November 4, 2002) available at http://www.sec.gov/rules/proposed/33-8144.htm. The 1934 Act is amended by SOB §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.

[470] 34 Sec. Reg. & L. Rept. 743 (May 13, 2002).

alia prohibit analyst compensation that is linked to a "specific investment banking services transaction."[471]

The SEC has also been active to ensure that those who it believes have misled investors are held accountable. Through June 4, 2002, the SEC Enforcement Division had filed 77 financial reporting and issuer disclosure actions in 2002 compared to 112 for all of 2001.[472] The SEC staff has also been active in reviewing financial and non-financial disclosures by public companies, including the annual report filed by all Fortune 500 companies.[473]

3. Increased Liability for Directors.

Legislative proposals have been put forth that would:

- Authorize the SEC to ban individuals from serving as officers or directors of publicly held corporations if they engage in serious misconduct (such a remedy currently can be only obtained by the SEC from a court).
- The standard for punishing corporate executives be reduced from recklessness to negligence.
- Prohibiting executives from using insurance to defray the legal costs arising from their malfeasance.[474]

4. Overhaul Regulation of Auditors.

A variety of legislative and SEC proposals have emerged that would create a new body to regulate the public accounting profession and impose additional restrictions on non-audit services which auditors can provide for their clients.[475] The proposals would enhance the role of the audit committee.

5. There is Nothing New Under the Sun.

The various proposals for change, while made in reaction to the collapse of Enron, are largely variants on issues that have been around and have influential constituencies for and against. How these and other proposals will fare remains to be seen, but there is certainty that a lot of time will be devoted to discussing the need for change and the various proposals.

---

[471] 34 Sec. Reg. & L. Rept. 795 (May 20, 2002).

[472] SEC Commissioner Cynthia A. Glassman, Opening Remarks before the Symposium on Enhancing Financial Transparency (Washington, D.C. June 4, 2002) (http://www.sec.gov/news/speech/spch565.htm).

[473] *Id.*

[474] 34 Sec. Reg. & L. Rept. 377-78 (March 11, 2002).

[475] *See* SEC Release 2002-63 (May 8, 2002, modified May 15, 2002), http://www.sec.gov/news/press/2002-63.htm; SEC Chairman Harvey L. Pitt, Auditing Reform Can't Wait for Congress to Act, Wall Street Journal (June 19, 2002) at A18.

REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE
OF THE
BOARD OF DIRECTORS OF ENRON CORP.

William C. Powers, Jr., Chair

Raymond S. Troubh

Herbert S. Winokur, Jr.

Counsel
Wilmer, Cutler & Pickering

February 1, 2002

EXECUTIVE SUMMARY AND CONCLUSIONS

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors. In accordance with our mandate, the Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer, and by other Enron employees who worked with Fastow.

The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the most significant transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. We were not asked, and we have not attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications activities, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

There were some practical limitations on the information available to the Committee in preparing this Report. We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. We have had only limited access to certain workpapers of Arthur Andersen LLP ("Andersen"), Enron's outside auditors, and no access to materials in the possession of the Fastow partnerships or their limited partners. Information from these sources could affect our conclusions.

This Executive Summary and Conclusions highlights important parts of the Report and summarizes our conclusions. It is based on the complete set of facts, explanations and limitations described in the Report, and should be read with the Report itself. Standing alone, it does not, and cannot, provide a full understanding of the facts and analysis underlying our conclusions.

Background

On October 16, 2001, Enron announced that it was taking a $544 million after-tax charge against earnings related to transactions with LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. It also announced a reduction of shareholders' equity of $1.2 billion related to transactions with that same entity.

Less than one month later, Enron announced that it was restating its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. ("LJM1"), and an additional related-party entity, Chewco Investments, L.P. ("Chewco"). Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow.

The LJM1- and Chewco-related restatement, like the earlier charge against earnings and reduction of shareholders' equity, was very large. It reduced Enron's reported net income by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $893 million total), and by $99 million in 2000 (of $979 million total). The restatement reduced reported shareholders' equity by $258 million in 1997, by $391 million in 1998, by $710 million in 1999, and by $754 million in 2000. It increased reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000. Enron also revealed, for the first time, that it had learned that Fastow received more than $30 million from LJM1 and LJM2. These announcements destroyed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.

Summary of Findings

This Committee was established on October 28, 2001, to conduct an investigation of the related-party transactions. We have examined the specific transactions that led to the third-quarter 2001 earnings charge and the restatement. We also have attempted to examine all of the approximately two dozen other transactions between Enron and these related-party entities: what these transactions were, why they took place, what went wrong, and who was responsible.

Our investigation identified significant problems beyond those Enron has already disclosed. Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received—Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each, and still two more by amounts we believe were at least in the hundreds of thousands of dollars. We have seen no evidence that any of these employees, except Fastow, obtained the permission required by Enron's Code of Conduct of Business Affairs to own interests in the partnerships. Moreover, the extent of Fastow's ownership and financial windfall was inconsistent with his representations to Enron's Board of Directors.

This personal enrichment of Enron employees, however, was merely one aspect of a deeper and more serious problem. These partnerships—Chewco, LJM1, and LJM2—were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off of its balance sheet; but the transactions did not follow those rules.

Other transactions were implemented—improperly, we are informed by our accounting advisors—to offset losses. They allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported.

Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in

structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.

Many of the transactions involve an accounting structure known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Summary and in the Report). A company that does business with an SPE may treat that SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related. It was the technical failure of some of the structures with which Enron did business to satisfy these requirements that led to Enron's restatement.

Summary of Transactions and Matters Reviewed

The following are brief summaries of the principal transactions and matters in which we have identified substantial problems:

The Chewco Transaction

The first of the related-party transactions we examined involved Chewco Investments L.P., a limited partnership managed by Kopper. Because of this transaction, Enron filed inaccurate financial statements from 1997 through 2001, and provided an unauthorized and unjustifiable financial windfall to Kopper.

From 1993 through 1996, Enron and the California Public Employees' Retirement System ("CalPERS") were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Because Enron and CalPERS had joint control of the partnership, Enron did not consolidate JEDI into its consolidated financial statements. The financial statement impact of non-consolidation was significant: Enron would record its contractual share of gains and losses from JEDI on its income statement and would disclose the gain or loss separately in its financial statement footnotes, but would *not* show JEDI's debt on its balance sheet.

In November 1997, Enron wanted to redeem CalPERS' interest in JEDI so that CalPERS would invest in another, larger partnership. Enron needed to find a new partner, or else it would have to consolidate JEDI into its financial statements, which it did not want to do. Enron assisted Kopper (whom Fastow identified for the role) in forming Chewco to purchase CalPERS' interest. Kopper was the manager and owner of Chewco's general partner. Under the SPE rules summarized above, Enron could only avoid consolidating JEDI onto Enron's financial statements if Chewco had

some independent ownership with a minimum of 3% of *equity* capital at risk. Enron and Kopper, however, were unable to locate any such outside investor, and instead financed Chewco's purchase of the JEDI interest almost entirely with debt, not equity. This was done hurriedly and in apparent disregard of the accounting requirements for nonconsolidation. Notwithstanding the shortfall in required equity capital, Enron did not consolidate Chewco (or JEDI) into its consolidated financial statements.

Kopper and others (including Andersen) declined to speak with us about why this transaction was structured in a way that did not comply with the non-consolidation rules. Enron, and any Enron employee acting in Enron's interest, had every incentive to ensure that Chewco complied with these rules. We do not know whether this mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or others putting their own interests ahead of their obligations to Enron.

The consequences, however, were enormous. When Enron and Andersen reviewed the transaction closely in 2001, they concluded that Chewco did not satisfy the SPE accounting rules and—because JEDI's non-consolidation depended on Chewco's status—neither did JEDI. In November 2001, Enron announced that it would consolidate Chewco and JEDI retroactive to 1997. As detailed in the Background section above, this retroactive consolidation resulted in a massive reduction in Enron's reported net income and a massive increase in its reported debt.

Beyond the financial statement consequences, the Chewco transaction raises substantial corporate governance and management oversight issues. Under Enron's Code of Conduct of Business Affairs, Kopper was prohibited from having a financial or managerial role in Chewco unless the Chairman and CEO determined that his participation "does not adversely affect the best interests of the Company." Notwithstanding this requirement, we have seen no evidence that his participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors.

While the consequences of the transaction were devastating to Enron, Kopper reaped a financial windfall from his role in Chewco. This was largely a result of arrangements that he appears to have negotiated with Fastow. From December 1997 through December 2000, Kopper received $2 million in "management" and other fees relating to Chewco. Our review failed to identify how these payments were determined, or what, if anything, Kopper did to justify the payments. More importantly, in March 2001 Enron repurchased Chewco's interest in JEDI on terms Kopper apparently negotiated with Fastow (during a time period in which Kopper had undisclosed interests with Fastow in both LJM1 and LJM2). Kopper had invested $125,000 in Chewco in 1997. The repurchase resulted in Kopper's (and a friend to whom he had transferred part of his interest) receiving more than $10 million from Enron.

The LJM Transactions

In 1999, with Board approval, Enron entered into business relationships with two partnerships in which Fastow was the manager and an investor. The transactions between Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense.

The two members of the Special Investigative Committee who have reviewed the Board's decision to permit Fastow to participate in LJM notwithstanding the conflict of interest have concluded that this arrangement was fundamentally flawed.[1] A relationship with the most senior financial officer of a public company—particularly one requiring as many controls and as much oversight by others as this one did—should not have been undertaken in the first place.

The Board approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. The Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were done on terms fair to Enron. In taking this step, the Board thought that the LJM partnerships would offer business benefits to Enron that would outweigh the potential costs. The principal reason advanced by Management in favor of the relationship, in the case of LJM1, was that it would permit Enron to accomplish a particular transaction it could not otherwise accomplish. In the case of LJM2, Management advocated that it would provide Enron with an additional potential buyer of assets that Enron wanted to sell, and that Fastow's familiarity with the Company and the assets to be sold would permit Enron to move more quickly and incur fewer transaction costs.

Over time, the Board required, and Management told the Board it was implementing, an ever-increasing set of procedures and controls over the related-party transactions. These included, most importantly, review and approval of all LJM transactions by Richard Causey, the Chief Accounting Officer; and Richard Buy, the Chief Risk Officer; and, later during the period, Jeffrey Skilling, the President and COO (and later CEO). The Board also directed its Audit and Compliance Committee to conduct annual reviews of all LJM transactions.

These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels. No one in Management accepted primary responsibility for oversight; the controls were not executed properly; and there were structural defects in those controls that became apparent over time. For instance, while neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored his responsibilities, they interpreted their roles very narrowly and did not give the transactions the degree of review the Board believed was occurring. Skilling appears to have been almost entirely uninvolved in the process, notwithstanding representations made to the Board that he had undertaken a significant role. No one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention.

As we discuss further below, the Board, having determined to allow the related-party transactions to proceed, did not give sufficient scrutiny to the information that was provided to it thereafter. While there was important information that appears to have been withheld from the Board, the annual reviews of LJM transactions by the Audit and Compliance Committee (and later also the Finance Committee) appear to have involved only brief presentations by Management (with Andersen present at the Audit Committee) and did not involve any meaningful examination of the

[1] One member of the Special Investigative Committee, Herbert S. Winokur, Jr., was a member of the Board of Directors and the Finance Committee during the relevant period. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of the other two members of the Committee, Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh.

nature or terms of the transactions. Moreover, even though Board Committee-mandated procedures required a review by the Compensation Committee of Fastow's compensation from the partnerships, neither the Board nor Senior Management asked Fastow for the amount of his LJM-related compensation until October 2001, after media reports focused on Fastow's role in LJM.

From June 1999 through June 2001, Enron entered into more than 20 distinct transactions with the LJM partnerships. These were of two general types: asset sales and purported "hedging" transactions. Each of these types of transactions was flawed, although the latter ultimately caused much more harm to Enron.

Asset Sales. Enron sold assets to LJM that it wanted to remove from its books. These transactions often occurred close to the end of financial reporting periods. While there is nothing improper about such transactions if they actually transfer the risks and rewards of ownership to the other party, there are substantial questions whether any such transfer occurred in some of the sales to LJM.

Near the end of the third and fourth quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. These transactions appeared consistent with the stated purpose of allowing Fastow to participate in the partnerships—the transactions were done quickly, and permitted Enron to remove the assets from its balance sheet and record a gain in some cases. However, events that occurred after the sales call into question the legitimacy of the sales. In particular: (1) Enron bought back five of the seven assets after the close of the financial reporting period, in some cases within a matter of months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999 (apparently including one hedging transaction). (The details of the transactions are discussed in Section VI of the Report.) Although we have not been able to confirm Fastow's calculation, Enron's reported earnings for that period were $570 million (pre-tax) and $549 million (after-tax).

We have identified some evidence that, in three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against loss. If this was in fact the case, it was likely inappropriate to treat the transactions as sales. There also are plausible, more innocent explanations for some of the repurchases, but a sufficient basis remains for further examination. With respect to those transactions in which risk apparently did not pass from Enron, the LJM partnerships functioned as a vehicle to accommodate Enron in the management of its reported financial results.

Hedging Transactions. The first "hedging" transaction between Enron and LJM occurred in June 1999, and was approved by the Board in conjunction with its approval of Fastow's participation in LJM1. The normal idea of a hedge is to contract with a creditworthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here. Instead, Enron transferred its own stock to an SPE in exchange for a note. The Fastow partnership, LJM1, was to provide the outside equity necessary for the SPE to qualify for non-consolidation. Through the use of options, the SPE purported to take on the risk that the price of the stock of Rhythms NetConnections Inc. ("Rhythms"), an interact service provider, would decline. The idea was to

"hedge" Enron's profitable merchant investment in Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms stock declined. If the SPE were required to pay Enron on the Rhythms options, the transferred Enron stock would be the principal source of payment.

The other "hedging" transactions occurred in 2000 and 2001 and involved SPEs known as the "Raptor" vehicles. Expanding on the idea of the Rhythms transaction, these were extraordinarily complex structures. They were funded principally with Enron's own stock (or contracts for the delivery of Enron stock) that was intended to "hedge" against declines in the value of a large group of Enron's merchant investments. LJM2 provided the outside equity designed to avoid consolidation of the Raptor SPEs.

The asset sales and hedging transactions raised a variety of issues, including the following:

Accounting and Financial Reporting Issues. Although Andersen approved the transactions, in fact the "hedging" transactions did not involve substantive transfers of economic risk. The transactions may have looked superficially like economic hedges, but they actually functioned only as "accounting" hedges. They appear to have been designed to circumvent accounting rules by recording hedging gains to offset losses in the value of merchant investments on Enron's quarterly and annual income statements. The economic reality of these transactions was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron.

Enron used this strategy to avoid recognizing losses for a time. In 1999, Enron recognized after-tax income of $95 million from the Rhythms transaction, which offset losses on the Rhythms investment. In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with the Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of $532 million (including net interest income). Enron's reported pre-tax earnings for the last two quarters of 2000 totaled $650 million. "Earnings" from the Raptors accounted for more than 80% of that total.

The idea of hedging Enron's investments with the value of Enron's capital stock had a serious drawback as an economic matter. If the value of the investments fell at the same time as the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This is precisely what happened in late 2000 and early 2001. Two of the Raptor SPEs lacked sufficient credit capacity to pay Enron on the "hedges." As a result, in late March 2001, it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect the shortfall in credit capacity. Rather than take that loss, Enron "restructured" the Raptor vehicles by, among other things, transferring more than $800 million of contracts to receive its own stock to them just before quarter-end. This transaction apparently was not disclosed to or authorized by the Board, involved a transfer of very substantial value for insufficient consideration, and appears inconsistent with governing accounting rules. It continued the concealment of the substantial losses in Enron's merchant investments.

However, even these efforts could not avoid the inevitable results of hedges that were supported only by Enron stock in a declining market. As the value of Enron's merchant investments continued to fall in 2001, the credit problems in the Raptor entities became insoluble. Ultimately, the SPEs were terminated in September 2001. This resulted in the unexpected announcement on

October 16, 2001, of a $544 million after-tax charge against earnings. In addition, Enron was required to reduce shareholders' equity by $1.2 billion. While the equity reduction was primarily the result of accounting errors made in 2000 and early 2001, the charge against earnings was the result of Enron's "hedging" its investments—not with a creditworthy counter-party, but with itself.

Consolidation Issues. In addition to the accounting abuses involving use of Enron stock to avoid recognizing losses on merchant investments, the Rhythms transaction involved the same SPE equity problem that undermined Chewco and JEDI. As we stated above, in 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation. At the same time, Enron and Andersen also concluded that the LJM1 SPE in the Rhythms transaction failed the same threshold accounting requirement. In recent Congressional testimony, Andersen's CEO explained that the firm had simply been wrong in 1999 when it concluded (and presumably advised Enron) that the LJM1 SPE satisfied the non-consolidation requirements. As a result, in November 2001, Enron announced that it would restate prior period financials to consolidate the LJM1 SPE retroactively to 1999. This retroactive consolidation decreased Enron's reported net income by $95 million (of $893 million total) in 1999 and by $8 million (of $979 million total) in 2000.

Self-Dealing Issues. While these related-party transactions facilitated a variety of accounting and financial reporting abuses by Enron, they were extraordinarily lucrative for Fastow and others. In exchange for their passive and largely risk-free roles in these transactions, the LJM partnerships and their investors were richly rewarded. Fastow and other Enron employees received tens of millions of dollars they should not have received. These benefits came at Enron's expense.

When Enron and LJM1 (through Fastow) negotiated a termination of the Rhythms "hedge" in 2000, the terms of the transaction were extraordinarily generous to LJM1 and its investors. These investors walked away with tens of millions of dollars in value that, in an arm's-length context, Enron would never have given away. Moreover, based on the information available to us, it appears that Fastow had offered interests in the Rhythms termination to Kopper and four other Enron employees. These investments, in a partnership called "Southampton Place," provided spectacular returns. In exchange for a $25,000 investment, Fastow received (through a family foundation) *$4.5 million* in approximately two months. Two other employees, who each invested $5,800, each received *$1 million* in the same time period. We have seen no evidence that Fastow or any of these employees obtained clearance for those investments, as required by Enron's Code of Conduct. Kopper and the other Enron employees who received these vast returns were all involved in transactions between Enron and the LJM partnerships in 2000—some representing Enron.

Public Disclosure

Enron's publicly-filed reports disclosed the existence of the LJM partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the

significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influenced substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen.

The Participants

The actions and inactions of many participants led to the related-party abuses, and the financial reporting and disclosure failures, that we identify in our Report. These participants include not only the employees who enriched themselves at Enron's expense, but also Enron's Management, Board of Directors and outside advisors. The factual basis and analysis for these conclusions are set out in the Report. In summary, based on the evidence available to us, the Committee notes the following:

Andrew Fastow. Fastow was Enron's Chief Financial Officer and was involved on both sides of the related-party transactions. What he presented as an arrangement intended to benefit Enron became, over time, a means of both enriching himself personally and facilitating manipulation of Enron's financial statements. Both of these objectives were inconsistent with Fastow's fiduciary duties to Enron and anything the Board authorized. The evidence suggests that he (1) placed his own personal interests and those of the LJM partnerships ahead of Enron's interests; (2) used his position in Enron to influence (or attempt to influence) Enron employees who were engaging in transactions on Enron's behalf with the LJM partnerships; and (3) failed to disclose to Enron's Board of Directors important information it was entitled to receive. In particular, we have seen no evidence that he disclosed Kopper's role in Chewco or LJM2, or the level of profitability of the LJM partnerships (and his personal and family interests in those profits), which far exceeded what he had led the Board to expect. He apparently also violated and caused violations of Enron's Code of Conduct by purchasing, and offering to Enron employees, extraordinarily lucrative interests in the Southampton Place partnership. He did so at a time when at least one of those employees was actively working on Enron's behalf in transactions with LJM2.

Enron's Management. Individually, and collectively, Enron's Management failed to carry out its substantive responsibility for ensuring that the transactions were fair to Enron—which in many cases they were not—and its responsibility for implementing a system of oversight and controls over the transactions with the LJM partnerships. There were several direct consequences of this failure: transactions were executed on terms that were not fair to Enron and that enriched Fastow and others; Enron engaged in transactions that had little economic substance and misstated Enron's financial results; and the disclosures Enron made to its shareholders and the public did not fully or accurately communicate relevant information. We discuss here the involvement of Kenneth Lay, Jeffrey Skilling, Richard Causey, and Richard Buy.

For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not

appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.

Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship.

Skilling was Enron's President and Chief Operating Officer, and later its Chief Executive Officer, until his resignation in August 2001. The Board assumed, and properly so, that during the entire period of time covered by the events discussed in this Report, Skilling was sufficiently knowledgeable of and involved in the overall operations of Enron that he would see to it that matters of significance would be brought to the Board's attention. With respect to the LJM partnerships, Skilling personally supported the Board's decision to permit Fastow to proceed with LJM, notwithstanding Fastow's conflict of interest. Skilling had direct responsibility for ensuring that those reporting to him performed their oversight duties properly. He likewise had substantial responsibility to make sure that the internal controls that the Board put in place—particularly those involving related-party transactions with the Company's CFO—functioned properly. He has described the detail of his expressly-assigned oversight role as minimal. That answer, however, misses the point. As the magnitude and significance of the related-party transactions to Enron increased over time, it is difficult to understand why Skilling did not ensure that those controls were rigorously adhered to and enforced. Based upon his own description of events, Skilling does not appear to have given much attention to these duties. Skilling certainly knew or should have known of the magnitude and the risks associated with these transactions. Skilling, who prides himself on the controls he put in place in many areas at Enron, bears substantial responsibility for the failure of the system of internal controls to mitigate the risk inherent in the relationship between Enron and the LJM partnerships.

Skilling met in March 2000 with Jeffrey McMahon, Enron's Treasurer (who reported to Fastow). McMahon told us that he approached Skilling with serious concerns about Enron's dealings with the LJM partnerships. McMahon and Skilling disagree on some important elements of what was said. However, if McMahon's account (which is reflected in what he describes as contemporaneous talking points for the discussion) is correct, it appears that Skilling did not take action (nor did McMahon approach Lay or the Board) after being put on notice that Fastow was pressuring Enron employees who were negotiating with LJM—clear evidence that the controls were not effective. There also is conflicting evidence regarding Skilling's knowledge of the March 2001 Raptor restructuring transaction. Although Skilling denies it, if the account of other Enron employees is accurate, Skilling both approved a transaction that was designed to conceal substantial losses in Enron's merchant investments and withheld from the Board important information about that transaction.

Causey was and is Enron's Chief Accounting Officer. He presided over and participated in a series of accounting judgments that, based on the accounting advice we have received, went well

beyond the aggressive. The fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact.

Causey was also charged by the Board of Directors with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between Enron and the LJM partnerships, and he was to review those transactions with the Audit and Compliance Committee annually. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions and did not give those transactions the level of scrutiny the Board had reason to believe he would. He did not provide the Audit and Compliance Committee with the full and complete information about the transactions, in particular the Raptor III and Raptor restructuring transactions, that it needed to fulfill its duties.

Buy was and is Enron's Senior Risk Officer. The Board of Directors also charged him with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between them. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions. Perhaps more importantly, he apparently saw his role as more narrow than the Board had reason to believe, and did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.

The Board of Directors. With respect to the issues that are the subject of this investigation, the Board of Directors failed, in our judgment, in its oversight duties. This had serious consequences for Enron, its employees, and its shareholders.

The Board of Directors approved the arrangements that allowed the Company's CFO to serve as general partner in partnerships that participated in significant financial transactions with Enron. As noted earlier, the two members of the Special Investigative Committee who have participated in this review of the Board's actions believe this decision was fundamentally flawed. The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." We do note, however, that the Committee was told that Andersen was "comfortable" with the transaction. As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of the LJM transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead, these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function. The Compensation Committee was given the role of reviewing Fastow's compensation from the LJM entities, and did not carry out this review. This remained the case even after the Committees were on notice that the LJM transactions were contributing very large percentages of Enron's earnings. In sum, the Board did not effectively meet its obligation with respect to the LJM transactions.

The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the Report lies with Management, the participating members of this Committee believe those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant.

Outside Professional Advisors. The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions. Andersen has admitted that it erred in concluding that the Rhythms transaction was structured properly under the SPE non-consolidation rules. Enron was required to restate its financial results for 1999 and 2000 as a result. Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective accounting judgment that should have prevented these transactions from going forward. According to Enron's internal accountants (though this apparently has been disputed by Andersen), Andersen also reviewed and approved the recording of additional equity in March 2001 in connection with this restructuring. In September 2001, Andersen required Enron to reverse this accounting treatment, leading to the $1.2 billion reduction of equity. Andersen apparently failed to note or take action with respect to the deficiencies in Enron's public disclosure documents.

According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen had concerns about Enron's disclosures of the related-party transactions. A week after that e-mail, however, Andersen's engagement partner told the Audit and Compliance Committee that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion. From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions. The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the Report. It also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and

the footnotes to the financial statements in Enron's periodic SEC filings.[2] Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not within its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.

Enron Employees Who Invested in the LJM Partnerships. Michael Kopper, who worked for Fastow in the Finance area, enriched himself substantially at Enron's expense by virtue of his roles in Chewco, Southampton Place, and possibly LJM2. In a transaction he negotiated with Fastow, Kopper, and his co-investor in Chewco received more than $10 million from Enron for a $125,000 investment. This was inconsistent with his fiduciary duties to Enron and, as best we can determine, with anything the Board—which apparently was unaware of his Chewco activities—authorized. We do not know what financial returns he received from his undisclosed investments in LJM2 or Southampton Place. Kopper violated Enron's Code of Conduct not only by purchasing his personal interests in Chewco, LJM2, and Southampton, but also by secretly offering an interest in Southampton to another Enron employee.

Ben Glisan, an accountant and later McMahon's successor as Enron's Treasurer, was a principal hands-on Enron participant in two transactions that ultimately required restatements of earnings and equity: Chewco and the Raptor structures. Because Glisan declined to be interviewed by us on Chewco, we cannot speak with certainty about Glisan's knowledge of the facts that should have led to the conclusion that Chewco failed to comply with the non-consolidation requirement. There is, however, substantial evidence that he was aware of such facts. In the case of Raptor, Glisan shares responsibility for accounting judgments that, as we understand based on the accounting advice we have received, went well beyond the aggressive. As with Causey, the fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact. Moreover, Glisan violated Enron's Code of Conduct by accepting an interest in Southampton Place without prior disclosure to or consent from Enron's Chairman and Chief Executive Officer—and doing so at a time when he was working on Enron's behalf on transactions with LJM2, including Raptor.

Kristina Mordaunt (an in-house lawyer at Enron), Kathy Lynn (an employee in the Finance area), and Anne Yaeger Patel (also an employee in Finance) appear to have violated Enron's Code of Conduct by accepting interests in Southampton Place without obtaining the consent of Enron's Chairman and Chief Executive Officer.

* * *

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-

[2] Because of the relationship between Vinson & Elkins and the University of Texas School of Law, the portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates that many of those consequences could and should have been avoided.

Appendix B

FORM OF

AUDIT COMMITTEE CHARTER

FOR NYSE COMPANY

The Board of Directors (the "*Board*") of _________________ (the "*Company*") approves and adopts the following Audit Committee Charter to specify the composition, roles and responsibilities of the Audit Committee. [NYSE 303.01(B)(1)] As used in this Charter, (i) "*Company*" includes the Company and its subsidiaries unless the context otherwise requires, (ii) "*NYSE*" means the New York Stock Exchange and (iii) "*SEC*" means the Securities and Exchange Commission.

Purpose

- The function of the Audit Committee is to assist the Board in fulfilling its oversight responsibilities with respect to the accounting, financial reporting and related matters described below.

Composition

- The Audit Committee shall consist of not less than three non-employee directors, each of whom shall have no relationship to the Company that may interfere with the exercise of his independence from management and the Company and shall be financially literate and at least one of whom shall have accounting or related financial management expertise. [NYSE 303.01(B)(1)(a), (b) and (c)] The qualifications required of Audit Committee members shall be interpreted in conformity with Section 303.01(B) of the NYSE Company Manual.
- The Chairman of the Audit Committee shall be designated by the Board; provided that if a Chairman is not designated by the Board or present at a meeting, the Audit Committee may designate a Chairman by majority vote of the Audit Committee members then in office.

Roles and Responsibilities

Relationship With the Outside Auditors

- The Company's outside auditors are ultimately responsible to the Board and the Audit Committee. [NYSE 303.01(B)(1)(b)]
- The Board has the ultimate authority and responsibility to select and replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement). The Audit Committee has the authority and responsibility to evaluate and make recommendations to the Board regarding the selection and replacement of outside auditors (or the nomination of the outside auditors to be proposed for shareholder approval in any proxy statement). [NYSE 303.01(B)(1)(b)]
- The Audit Committee has the further authority and responsibility to review the fees charged by the outside auditors, the scope of their engagement and

proposed audit approach and to recommend such review or auditing steps as the Audit Committee may consider desirable.

- The Audit Committee shall review and confirm the independence of the outside auditors by requiring that the outside auditors submit to the Audit Committee on a periodic basis a formal written statement delineating all relationships between the outside auditors and the Company, engaging in a dialogue with the outside auditors with respect to any disclosed relationships or services that may impact their objectivity and independence, and recommending that the Board take appropriate action to ensure the independence of the outside auditors. [NYSE 303.01(B)(1)(c); SEC SK § 306(a)(3)]
- Management is responsible for preparing the Company's financial statements. The Company's outside auditors are responsible for auditing the financial statements. The activities of the Audit Committee are in no way designed to supersede or alter these traditional responsibilities.

Relationship With Internal Auditors

- The internal audit department shall have a direct reporting responsibility to the Board through the Audit Committee.
- The Audit Committee shall review the budget, plan, changes in plan, activities, organizational structure and qualifications of the internal audit department, as needed.
- The Audit Committee shall review the appointment, performance and replacement of the senior internal audit executive.
- The Audit Committee shall review significant reports prepared by the internal auditors, together with management's response and follow-up to these reports.

Internal Controls

- The Audit Committee shall evaluate whether management is setting the appropriate tone at the top by communicating the importance of internal controls.
- In consultation with management, the outside auditors and the internal auditors, the Audit Committee shall consider the Company's significant financial risk exposures and the steps management has taken to monitor, control and report such exposures.
- The Audit Committee shall focus on the extent to which internal auditors and outside auditors review computer systems and applications, the security of such systems and applications, and the contingency plan for processing financial information in the event of a systems breakdown.
- The Audit Committee shall consider the extent to which internal control recommendations made by outside auditors have been implemented by management.
- The Audit Committee shall request that the internal auditors and outside auditors keep the Audit Committee informed about fraud, illegal acts and deficiencies in internal controls that come to their attention and such other

matters as either the internal auditors or the outside auditors conclude should be brought to the attention of the Audit Committee.

Financial Reporting

General

- The Audit Committee shall review with management, the outside auditors and the internal auditors significant accounting and reporting issues applicable to the Company, including recent professional and regulatory pronouncements, and their impact on the financial statements.

Annual Financial Statements

- The Audit Committee shall meet with management and the outside auditors to review the annual financial statements and the results of the annual audit prior to the release to the public of the results of operations for each fiscal year. [SEC SK § 306(a)(1)]
- The Audit Committee shall review the annual financial statements prior to release to the public or filing with the SEC. [SEC SK § 306(a)(1)]
- The Audit Committee shall obtain explanations from management or from the outside auditors on whether:
    - Actual financial results for the year varied significantly from budgeted or projected results.
    - Changes in financial ratios and relationships in the annual financial statements are consistent with changes in the Company's operations and financing practices.
    - Generally accepted accounting principles have been consistently applied in the annual financial statements.
    - There are any actual or proposed changes in accounting or financial reporting practices.
    - There are any significant or unusual events or transactions.
    - The Company's financial and operating controls are functioning effectively.
    - The Company has complied with the terms of loan agreements.
    - The annual financial statements contain adequate and appropriate disclosures.
- The Audit Committee shall focus on complex or unusual transactions and on judgmental areas such as those involving valuation of assets and liabilities.
- The Audit Committee shall consider management's handling of proposed audit adjustments identified by the outside auditors.
- The Audit Committee shall consider the outside auditors' judgments about the quality and appropriateness of the Company's accounting principles as applied in its financial reporting.
- The Audit Committee shall discuss with management and the outside auditors any significant changes to the Company's accounting principles, the degree of aggressiveness or conservatism of the accounting principles and underlying estimates used in the preparation of the Company's financial statements, and any items required to be communicated by the outside

auditors in accordance with Statement of Auditing Standards ("SAS") No. 61. [SEC SK § 306(a)(2) and note 29 to SEC Release 34-42266]]

- Based on the review and discussions with management and outside auditors contemplated by this Charter, the Audit Committee shall recommend to the Board whether the audited annual financial statements be included in the Company's Form 10-K Annual Report. [SEC SK § 306(b)(4)]
- The Audit Committee shall review the Management's Discussion and Analysis and other sections of the Company's Form 10-K Annual Report before its release and consider whether the information is adequate and consistent with members' knowledge about the Company and its operations.

Interim Financial Statements

- The Audit Committee shall meet with management and the outside auditors to review the interim financial statements and the results of the auditors' review thereof prior to the release to the public of the results for each quarter.
- The Audit Committee shall review the quarterly financial statements prior to release to the public or filing with the SEC.
- Obtain explanations from management or from the outside auditors on whether:
    - Actual financial results for the quarter or interim period varied significantly from budgeted or projected results.
    - Changes in financial ratios and relationships in the interim financial statements are consistent with changes in the Company's operations and financing practices.
    - Generally accepted accounting principles have been consistently applied in the quarterly financial statements.
    - There are any actual or proposed changes in accounting or financial reporting practices.
    - There are any significant or unusual events or transactions.
    - The Company's financial and operating controls are functioning effectively.
    - The Company has complied with the terms of loan agreements.
    - The interim financial statements contain adequate and appropriate disclosures.

Compliance with Laws and Regulations

- The Audit Committee shall review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation of and follow-up (including disciplinary action) on any fraudulent acts or accounting irregularities.
- The Audit Committee shall periodically obtain updates from management regarding compliance.
- The Audit Committee shall be satisfied that regulatory compliance matters have been considered in the preparation of the financial statements.
- The Audit Committee shall review the findings of any examinations of the Company by regulatory agencies which have authority over the Company.

Compliance with Codes of Conduct

- The Audit Committee shall evaluate whether management is setting the appropriate tone at the top by communicating the importance of the Company's codes of conduct and the guidelines for acceptable business practices.
- The Audit Committee shall review the program for monitoring compliance with the codes of conduct.

Other Responsibilities

- The Audit Committee may meet with the outside auditors, the senior internal audit executive, consultants, management and any employee seeking to meet with the Audit Committee about any matter within its purview in separate executive sessions to discuss any matters that the Committee or these persons believe should be discussed privately.
- The Audit Committee shall request that significant findings and recommendations made by the internal and outside auditors be received and discussed on a timely basis.
- The Audit Committee shall review, with the Company's counsel, any legal matters that could have a significant impact on the Company's financial statements.
- The Audit Committee shall review the policies and procedures in effect for considering officers' expenses and perquisites.
- The Audit Committee shall perform other oversight functions as requested by the Board.

Charter Scope

- The Audit Committee shall review and reassess the adequacy of this Charter at least annually.
- The Audit Committee shall submit this Charter to the Board for approval, and have the Charter published at least every three years in accordance with the rules of the SEC from time to time in effect. [SEC Schedule 14A Item 7(e)(iv)(A)]

Reporting Responsibilities

- The Audit Committee shall regularly update the Board about Audit Committee activities and make appropriate recommendations.
- The Audit Committee shall annually prepare a report to shareholders as required by SEC rules for inclusion in the Company's proxy statement. [SEC SK § 306; SEC Schedule 14A Item 7(e)(3)]

Meetings

- The Audit Committee shall meet at least four times annually and may meet more frequently as circumstances dictate.
- Meetings of the Audit Committee may be in person or by conference call in accordance with the Bylaws of the Company.

- Meetings of the Audit Committee shall be held at such time and place, and upon such notice, as the Chairman of the Audit Committee may from time to time determine.
- The Chairman of the Audit Committee shall develop the agenda for each meeting and in doing so may consult with management, the internal auditors and the outside auditors.
- Except as specifically provided in this Charter, the provisions of the Bylaws of the Company with respect to committees of the Board shall apply to the Audit Committee.

Authority

- The Audit Committee shall have the authority to conduct any investigation appropriate to fulfilling its responsibilities and shall have direct access to the outside auditors and the internal auditors as well as anyone in the Company.
- The Audit Committee shall have the ability to retain, at the Company's expense, such special legal, accounting or other consultants or experts it deems necessary in the performance of its duties.
- The Audit Committee may from time to time delegate to its Chairman or any of its members the responsibility for any particular matters.

[company name]
CODE OF CONDUCT

I. CONFLICTS OF INTEREST AND DISCLOSURE OF CERTAIN INTERESTS[1]

This conflict of interest policy is designed to help directors, officers and employees of the Company identify situations that present potential conflicts of interest and to provide the Company with a procedure which, if observed, will allow a transaction to be treated as valid and binding even though a director, officer or employee has or may have a conflict of interest with respect to the transaction. All capitalized terms are defined in Part 2 of this policy.

1. Conflict of Interest Defined. For purposes of this policy, the following circumstances shall be deemed to create Conflicts of Interest:

A. Outside Interests.

(i) A Contract or Transaction between the Company and a Responsible Person or Family Member.

(ii) A Contract or Transaction between the Company and an entity in which a Responsible Person or Family Member has a Material Financial Interest or of which such person is a director, officer, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator or other legal representative.

B. Outside Activities.

(i) A Responsible Person competing with the Company in the rendering of services or in any other Contract or Transaction with a third party.

(ii) A Responsible Person's having a Material Financial Interest in; or serving as a director, officer, employee, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator or other legal representative of, or consultant to; an entity or individual that competes with the Company in the provision of services or in any other Contract or Transaction with a third party.

C. Gifts, Gratuities and Entertainment. A Responsible Person accepting gifts, entertainment or other favors from any individual or entity that:

(i) does or is seeking to do business with, or is a competitor of the Company; or

---

[1] Enron's Code of Conduct provided that no full-time officer or employee should "[o]wn an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company." Powers Report 44 at note 8.

(ii) has received, is receiving or is seeking to receive a loan or grant, or to secure other financial commitments from the company;

(iii) is a charitable organization operating in the United States of America;

under circumstances where it might be inferred that such action was intended to influence or possibly would influence the Responsible Person in the performance of his or her duties. This does not preclude the acceptance of items of nominal or insignificant value or entertainment of nominal or insignificant value which are not related to any particular transaction or activity of The Company.

2. Definitions.

A. A "Conflict of Interest" is any circumstance described in Part 1 of this Policy.

B. A "Responsible Person" is any person serving as an officer, employee or member of the Board of Directors of the Company.

C. A "Family Member" is a spouse, parent, child or spouse of a child, brother, sister, or spouse of a brother or sister, of a Responsible Person.

D. A "Material Financial Interest" in an entity is a financial interest of any kind, which, in view of all the circumstances, is substantial enough that it would, or reasonably could, affect a Responsible Person's or Family Member's judgment with respect to transactions to which the entity is a party.

E. A "Contract or Transaction" is any agreement or relationship involving the sale or purchase of goods, services, or rights of any kind, the providing or receipt of a loan or grant, the establishment of any other type of pecuniary relationship, or review of a charitable organization by the Company. The making of a gift to the Company is not a Contract or Transaction.

3. Procedures.

A. Prior to board or committee action on a Contract or Transaction involving a Conflict of Interest, a director or committee member having a Conflict of Interest and who is in attendance at the meeting shall disclose all facts material to the Conflict of Interest. Such disclosure shall be reflected in the minutes of the meeting.

B. A director or committee member who plans not to attend a meeting at which he or she has reason to believe that the board or committee will act on a matter in which the person has a Conflict of Interest shall disclose to the chair of the meeting all facts material to the Conflict of Interest. The chair shall report the disclosure at the meeting and the disclosure shall be reflected in the minutes of the meeting.

C. A person who has a Conflict of Interest shall not participate in or be permitted to hear the board's or committee's discussion of the matter except to disclose material facts and to respond to questions. Such person shall not attempt to exert his or her personal influence with respect to the matter, either at or outside the meeting.

D. A person who has a Conflict of Interest with respect to a Contract or Transaction that will be voted on at a meeting shall not be counted in determining the presence of a quorum for purposes of the vote. The person having a conflict of interest may not vote on the Contract or Transaction and shall not be present in the meeting room when the vote is taken, unless the vote is by secret ballot. Such person's ineligibility to vote shall be reflected in the minutes of the meeting. For purposes of this paragraph, a member of the Board of Directors of the Company has a Conflict of Interest when he or she stands for election as an officer or for re-election as a member of the Board of Directors.

E. Responsible Persons who are not members of the Board of Directors of the Company, or who have a Conflict of Interest with respect to a Contract or Transaction that is not the subject of Board or committee action, shall disclose to the Chair or the Chair's designee any Conflict of Interest that such Responsible Person has with respect to a Contract or Transaction. Such disclosure shall be made as soon as the Conflict of Interest is known to the Responsible Person. The Responsible Person shall refrain from any action that may affect the Company's participation in such Contract or Transaction.

In the event it is not entirely clear that a Conflict of Interest exists, the individual with the potential conflict shall disclose the circumstances to the Chair or the Chair's designee, who shall determine whether there exists a Conflict of Interest that is subject to this policy.

4. Confidentiality. Each Responsible Person shall exercise care not to disclose confidential information acquired in connection with such status or information the disclosure of which might be adverse to the interests of the Company. Furthermore, a Responsible Person shall not disclose or use information relating to the business of the Company for the personal profit or advantage of the Responsible Person or a Family Member.

5. Review of Policy.

A. Each new Responsible Person shall be required to review a copy of this policy and to acknowledge in writing that he or she has done so.

B. Each Responsible Person shall annually complete a disclosure form identifying any relationships, positions or circumstances in which the Responsible Person is involved that he or she believes could contribute to a Conflict of Interest arising. Such relationships, positions or circumstances might include service as a Director of or consultant to a nonprofit organization, or ownership of a business that might provide goods or services to the Company. Any such information regarding business interests of a Responsible Person or a Family Member shall be treated as confidential and shall generally be made available only to the Chair, the President, and any committee appointed to address Conflicts of Interest, except to the extent additional disclosure is necessary in connection with the implementation of this Policy.

C. This policy shall be reviewed annually by each member of the Board of Directors. Any changes to the policy shall be communicated immediately to all Responsible Persons.

II. DISCLOSURE AND CONFIDENTIALITY

1. Policy Statement. The Company is involved from time to time in matters which are sensitive in nature and important to the Company, its employees and its shareholders. The federal securities laws impose certain obligations on the Company regarding the disclosure of information to the investing public. To comply with these laws and facilitate the preservation of its competitive position, the Board of Directors has established the following policies and procedures set forth in paragraphs 1-5 which are applicable to all of the Company's directors, officers and employees.

2. Maintaining Confidentiality. The Company's ability to discharge effectively its disclosure obligations under the federal securities laws can be adversely affected by the premature or otherwise unauthorized disclosure of internal information relating to the Company. Each employee, therefore, must make every effort to maintain the confidentiality of the Company's financial, operating, marketing and other internal information. These efforts should include securely handling and storing any sensitive documents.

3. Designated Spokesperson. The Board of Directors has designated the Chairman of the Board, the President and the Vice President of Finance as the sole spokespersons for the Company and to communicate with analysts and investors as representatives of the Company. No other directors, officers or employees of the Company are authorized to speak on behalf of the Company with respect to corporate actions affecting the Company. Therefore, unless you have been expressly authorized to make such disclosure, if you receive any inquiry from a third party (whether a securities analyst, a member of the media, shareholder or other person) regarding the Company, you must immediately refer the inquiry to the Chairman of the Board, the President or the Vice President of Finance.

4. Trading of Securities. The federal securities laws prohibit any person from trading in the Company's securities while in possession of significant information concerning the Company which has not already been disclosed to the investing public, or from disclosing such information to another person who is likely to trade in the Company's securities. You must comply with the federal securities laws regarding the handling of non-public information.

To facilitate such compliance, the President will determine when director, officer and employee stock transactions are generally restricted. Directors, officers and employees should not effect stock transactions without determining from him whether any restrictions are in effect. The restrictions will generally be in effect (i) during the period commencing with the last day of each fiscal quarter and continuing until at least 72 hours after results for the quarter have been released to the public and (ii) at other times when the President concludes that pending developments (which may be positive or negative) would make stock transactions inadvisable. These restrictions are in addition to those applicable to any person in possession of inside information, but do not apply to the exercise of stock options granted by the Company. Directors, officers and employees should not buy or sell securities of the Company without determining from the President whether any restrictions are in effect.

5. Responding to Rumors. Rumors concerning the business and affairs of the Company may circulate from time to time. It is the Company's general policy not to comment upon such rumors. Individual directors, officers and employees, too, should refrain from commenting upon or responding to rumors and should refer any requests for comments or responses to the Chairman of the Board, the President or the Vice President of Finance.

III. OTHER POLICIES OFTEN FOUND IN CODES OF CONDUCT

- Human Rights
- Business Ethics
- Safety
- Internet Usage
- Compliance with Anti-Trust Laws
- Compliance with Environmental Laws
- Compliance with Foreign Corrupt Practices
- Political Contributions
- Responsibility for Reporting Violations of Code
- Consequences of Violating Code

Appendix D

SUMMARY OF SARBANES-OXLEY ACT OF 2002 AND RELATED SEC RULEMAKING

On July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (the "*SOB*") intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. This is the "tough new corporate fraud SOB" being trumpeted by the politicians and in the media. Among other things, the SOB amends the Securities Exchange Act of 1934 (the "*1934 Act*") and the Securities Act of 1933 (the "*1933 Act*").

Although the SOB does have some specific provisions, and generally establishes some important public policy changes, it will be implemented in large part through rules to be adopted by the Securities and Exchange Commission (*"SEC"*) in various designated periods of time after July 30, 2002 – generally, 30 days (August 29, 2002), 180 days (January 26, 2003) and 270 days (April 26, 2003). As is always the case with broad grants of authority to a regulatory body, the rules may well contain some surprises. Further, the SEC will have opportunity through rulemaking under the SOB, as well as action on corporate governance proposals of the stock exchanges, to delve much farther into corporate governance than it has in the past.

SUMMARY

To What Companies Does SOB Apply. The SOB 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*"). Some of the SOB provisions apply only to companies listed on a national securities exchange ("*listed companies*"), such as the New York Stock Exchange ("*NYSE*") or NASDAQ Stock Market ("*NASDAQ*"), but not to companies traded on the NASD Bulletin Board. Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOB 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).

Accounting Firm Regulation. The SOB creates a five-member board to be appointed by the SEC and called the Public Company Accounting Oversight Board (the *"PCAOB"*) to oversee the accounting firms that serve public companies and to establish accounting standards and rules. The SOB does not address the accounting for stock options, but the PCAOB would have the power to do so. The PCAOB will be funded by assessing fees from public companies based on their market capitalization. It will have the authority to subpoena documents from public companies. The PCAOB is required to notify the SEC of any pending PCAOB investigations involving potential violations of the securities laws. Additionally, the SOB provides that the PCAOB should coordinate its efforts with the SEC's enforcement division as necessary to protect ongoing SEC investigations.

The SOB restricts the services accounting firms may offer to clients. Among the services that audit firms could not provide for their audit clients are (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems

design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.

CEO/CFO Certifications. The SOB contains *two* different provisions that require the chief executive officer ("*CEO*") and chief financial officer ("*CFO*") of each reporting company to sign and certify company SEC periodic reports, with possible criminal and civil penalties for false statements. The result is that CEOs and CFOs must each sign two separate certifications in their companies' periodic reports, one certificate being under rules adopted by the SEC under an amendment to the 1934 Act (the "*SOB §302 Certification*") and the other being under an amendment to the Federal criminal code (the "*SOB §906 Certification*"). Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

Enhanced Attorney Responsibilities. The SOB sets forth 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 counsel or the chief executive officer of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the audit committee of the board of directors.

Insider Loans. The SOB prohibits companies from making loans to directors or executive officers. There are exceptions for existing loans, for credit card companies to extend credit on credit cards issued to their employees and for securities firms to maintain margin account balances.

Disclosure Issues. Public companies will be required to publicly disclose in "plain English" additional information concerning material changes in their financial condition or operations on a "real time" basis. SEC rulemaking will define the specific requirements of the enhanced reporting.

The SOB also requires the SEC to regularly and systematically review corporate filings. Each issuer must be reviewed at least every three years. Material restatements, the level of market capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.

Criminal and Civil Sanctions. The SOB mandates maximum sentences of 20 years for such crimes as mail and wire fraud, and maximum sentences of up to 25 years for securities fraud. Civil penalties are also increased. The SOB restricts the discharge of such obligations in bankruptcy.

Trading Blackouts. Company executives and directors would also be restricted from trading stock during periods when employees cannot trade retirement fund-held company stock ("*blackout periods*"). These insiders would be prohibited from engaging in transactions in any equity security of the issuer during any blackout period when at least half of the issuer's individual account plan participants are not permitted to purchase, sell or otherwise transfer their interests in that security. The SOB also calls for adding a 30-day advance notice period of any blackouts to be added to existing ERISA legislation.

The SOB is organized in eleven titles which are summarized below with emphasis on those parts most relevant to public companies. Rules adopted by the SEC to date under the SOB are generally discussed below in relation to the SOB provisions being implemented thereby.

TITLE I: PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The SOB establishes the Public Company Accounting Oversight Board (the *"PCAOB"*) to: (1) oversee the audit of public companies that are subject to the securities laws; (2) establish audit report standards and rules; and (3) investigate, inspect, and enforce compliance relating to registered public accounting firms, associated persons, and the obligations and liabilities of accountants.

The PCAOB consists of 5 members appointed by the SEC, of whom no more than two may be certified public accountants. On October 24, 2002, the SEC appointed the following founding members of the PCAOB: Judge William H. Webster (chairman), Kayla J. Gillan, Daniel L. Goelzer, Willis D. Gradison Jr., and Charles D. Niemeier.[1] Judge Webster subsequently tendered his resignation. The members will serve on a full-time basis for five-year periods (though the first appointees each have staggered terms so that the positions expire in annual increments). Although members are prohibited from outside business or professional activities, the PCAOB is to establish compensation levels that are intended to be competitive with those in private industry. The PCAOB will be funded by assessing fees from public companies based on their market capitalization. SOB requires that the SEC certify that the PCAOB has the capacity to perform its functions by April 26, 2003.

Beginning 180 days after the SEC certifies that the PCAOB has the capacity to perform its functions, any public accounting firm that issues or participates in any audit report with respect to any public company must register with the PCAOB and renew such registration annually. The PCAOB is empowered to impose disciplinary or remedial sanctions upon registered public accounting firms and their associated persons. Subject to the SEC's oversight and enforcement authority over it, the PCAOB is to establish auditing, quality control and ethical standards that will require retention of records for seven years, concurring partner review of audit reports and inclusion within audit reports of information about the auditor's internal control testing of the issuer. It also is to regularly inspect each registered accounting firm to assess its compliance with SOB and the PCAOB's rules (firms that audit more than 100 public companies will be inspected annually, and other firms are to be inspected at least once every three years). In June 2002, the SEC issued a proposal that contains an outline of how it would like the PCAOB to operate, and it is likely that many of the operating rules in that proposal will be adopted.[2]

TITLE II: AUDITOR INDEPENDENCE; NON-AUDIT SERVICES

The SOB amends the 1934 Act to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with an audit, and requires audit

---

1 SEC Press Release 2002-153 (October 24, 2002), which sets forth biographical information about the founding members of the PCAOB.

2 SEC Release No. 34-46120 (June 26, 2002), *Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process*.

committee preapproval for other non-audit services. While the SEC must issue rules to carry out the provisions of Title II by January 26, 2003, the SOB provisions are effectively limits on registered public accounting firms and will only apply once the PCAOB is functioning and the particular accounting firm has registered with the PCAOB.

SOB §201 prohibits a registered public accounting firm from providing to a public company, contemporaneously with the audit, the following non-audit services:

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

(2) financial information systems design and implementation;

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

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser, or investment banking services; and

(8) legal services and expert services unrelated to the audit.

The SOB (§202) requires audit committee preapproval of all auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services provided by the auditor. The audit committee may delegate the preapproval responsibility to a subcommittee of one or more independent directors. 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 5 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 by the issuer at the time of the engagement to be non-audit services; 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 1 or more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee.

The SOB (§203) mandates lead audit partner rotation every five years, but does not require rotation of registered public accounting firms, although the PCAOB may do so. Because many lead engagement partners have been working on their current audit clients for five years already, they will have to rotate immediately on their firms' registration with the PCAOB. Since provision applies only to registered firms, the effective date of the provision is the date a firm becomes registered, which would be sometime in mid- to late 2003. However, the SOB says an individual cannot serve on an audit as a lead or review partner if he or she "has performed audit services for that issuer in each of the five previous fiscal years of that issuer." As there is no indication in either the statute or

the legislative history that the five-year period should start running after the enactment of SOB, the five year SOB look-back is effectively retroactive from the date the audit firm's registration becomes effective.

The SOB requires (§204) 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 (*"GAAP"*) that have been discussed with management.

The SOB (§206) prohibits a registered public accounting firm from performing audit services for a public company if any of the issuer's senior management officials 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.

Under the rulemaking directive of SOB §208, the SEC recently proposed rules[3] to effectuate the auditor independence provisions of SOB §§201-204 and §206. The proposed rules comport with their corresponding provisions in Title II, with only the following differences: (1) after partners on the audit engagement teams who had provided audit services for a client for five consecutive years are rotated off of the audit engagement, they may not perform any audit services for the client for a period of five years thereafter; (2) issuers will be required to disclose in Form 10-K information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements for audits, tax preparation and all other services provided, for the year covered by the filing and for the previous year; and (3) an accountant would not be independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review and attest services.

TITLE III: CORPORATE RESPONSIBILITY

Audit Committees. SOB §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. 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. Although the audit committee is to 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 SOB §302 and criminal certification in SOB §906. Audit committees must also establish procedures to ensure that their members are independent, and must hear and act on employee complaints regarding accounting, internal controls, and auditing issues. These rules are the complement to the restrictions on registered firms' activities in SOB §201, and are considered an important step in ensuring auditor independence and preserving the integrity of the audit process.

---

[3] SEC Press Release 2002-165 (November 19, 2002).

By April 26, 2003, each national stock exchange and NASDAQ must adopt rules obligating each issuer to assure that the responsibilities of the audit committee comply with the new requirements of the SOB. Noncompliance would result in delisting, although the rules must provide procedures to permit issuers an opportunity to cure defects that would otherwise result in delisting. The specific requirements are:

- Oversight. The audit committee must have direct responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services.

- Independence. Its 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 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 any accounting or auditing matters.

- Funding and Authority. The audit committee shall have the authority to hire independent counsel and other advisers to carry out its duties.

Also, each 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. Once each adopts its specific rules, each issuer should amend its charter to state the above responsibilities specifically.

Subject to the foregoing, to restrictions on loans discussed elsewhere herein and to director fiduciary duties, directors are not prohibited from transacting business with the issuer, either directly or through relationships with another person.

CEO/CFO Certifications. The SOB contains two separate certification requirements, which are applicable to all public companies regardless of size and are in addition to the 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.

SOB §906 Certification. The SOB (§906) amended Federal criminal law to require the CEO and CFO to certify in writing in each SEC periodic report filed containing financial statements that the financial statements and the disclosures therein fairly present in all material aspects the operations and financial condition of the issuer.[4] It provides that the criminal penalties

[4] A form of SOB §906 Certification follows:

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

are (1) 20 years in prison for willful violation; and (2) 10 years for reckless and knowing violation. The §906 certification requirement was effective July 30, 2002 and was not predicated on any SEC rulemaking.

SOB §302 Certification. On August 27, 2002, the SEC adopted rules pursuant to SOB §302 requiring the CEO and CFO of each public company filing a Form 10-Q or 10-K after August 27, 2002, to certify that the financial statements filed with the SEC fairly present, in all material respects, the operations and financial condition of the issuer and as to the adequacy of "disclosure controls and procedures" and "internal controls," and as to certain other matters. The mandated CEO/CFO certification for a Form 10-Q is as follows:

> I, [identify the certifying individual], certify that:
>
> 1. I have reviewed this quarterly report on Form 10-Q of [identify registrant];
>
> 2. Based on my knowledge, this quarterly 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 quarterly report;
>
> 3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
>
> 4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14[5]) for the registrant and we have:

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]

5 For purposes of this certification, the term "disclosure controls and procedures" means 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 officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

a) designed such disclosure controls and procedures 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 quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date[6];

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and[7]

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Clauses (1) and (2) of the SOB §302 mandated CEO/CFO certification are identical to the certification required by the SEC's Order Requiring the Filing of Sworn Statements, File No. 4-460 (June 27, 2002), available at http://www.sec.gov/rules/other/4-460.htm; clauses (3)-(6) are new and additative.

Misleading Statements to Auditors. The SOB (§303) makes it unlawful, in contravention of rules to be 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 October 18, 2002 the SEC proposed a new Rule 13b2-2 under the 1934 Act which would prohibit officers or directors of an issuer, or persons acting under their direction, from

---

6 This certification mirrors the requirements in new 1934 Act Rules 13a-15 and 15d-15 which will require an issuer to establish and maintain an overall system of disclosure controls and procedures 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.

7 This certification relates to the direction in SOB §404 that the SEC prescribe rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The SOB further requires the public accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls. See discussion of SOB §404 *infra*.

subverting the auditor's responsibilities to investors to conduct a diligent audit of the issuer's financial statements and to provide a true report of the auditor's findings.[8]

Types of conduct that the SEC suggests might constitute improper influence 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,
- 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.

Proposed Rule 13b2-2 would apply 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 the proposed rule.

CEO/CFO Reimbursement. The SOB (§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.

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."[9] Because there is no relationship between the restatement and any misconduct of the CEO or CFO, the CEO and CFO could conceivably be responsible for misconduct of any employee of the issuer. SEC rules are expected to address such issues as what constitutes "misconduct", what kinds of restatements trigger this provision, how material the noncompliance with securities laws must be, how to measure profits, whether the disgorgement is limited to SEC action or a new private cause of action is created, etc.

---

8 SEC Release No. 34-46685 (October 18, 2002).

9 Senate Report at 107-205.

D&O Bars. The SOB (§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-SOB standard was "substantial unfitness").

Insider Trading Freeze During Blackout. The SOB (§306) prohibits insider trades during pension fund blackout periods and states that profits realized from such trades shall inure to and be recoverable by the issuer irrespective of the intent of the parties to the transaction and directs the SEC in conjunction with the Labor Department to adopt implementing rules within 180 days of the effective date of SOB (January 26, 2003). On November 6, 2002, the SEC proposed rules[10] restricting trading by a reporting company's executive officers and directors[11] when employees are subject to a pension plan blackout that bars them from engaging in trades involving company securities held in their plan accounts.

The Enron scandal provided impetus for SOB §306(a) when insiders were able to liquidate their company 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. The SOB §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.

The statutory trading prohibition of SOB §306(a) is limited to equity securities that a director or executive officer acquired in connection with his or her service or employment as a director or executive officer. The proposed SOB §306 rule would specify instances where an acquisition of equity securities by a director or executive officer was "in connection" with his or her service or employment with an issuer. Acquisitions or dispositions of equity securities by family members, partnerships, corporations, limited liability companies, and trusts would be deemed acquisitions or dispositions by a director or executive officer if he or she had a "pecuniary interest" in the equity securities.

The trading prohibition of SOB §306(a) would be triggered only if a blackout period lasts more than three consecutive business days and temporarily suspends the ability of at least 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to acquire or transfer an interest in issuer equity securities held in an account plan. The proposed SOB §306 rules would clarify that the 50% test is met only if at least 50% of U.S. plan participants are restricted in their trading. The restricted employees also would have to represent at least 15% of the issuer's shareholders.

---

[10] SEC Release No. 34-46778 (November 6, 2002).

[11] The term "director" in the proposed rules would have the same meaning as under the general 1934 Act rules, and the term "executive officer" would have the same meaning as the term "officer' under the insider reporting requirements of 1934 Act Section 16(a). This approach would enable security holders to monitor the trading activities of an issuer's directors and executive officers using the Section 16(a) reporting forms. Similarly, the proposed rules would cover "equity securities" of the issuer, including derivative securities relating to an equity security (as defined in the 1934 Act §16 rules) whether or not issued by the issuer.

Foreign issuers' outside directors would not be subject to the proposed rule. In addition, plan participants generally would get a 30-day notice of a blackout under rules recently adopted by the Labor Department, which calculated that there is a blackout once in every four or five years.

For violations of SOB §306(a), the SEC can bring an enforcement action against a director or executive officer. In addition, the statute provides that an issuer, or a security holder on behalf of an issuer, may bring an action to recover the profits realized by a director or executive officer from a prohibited transaction during a blackout period.

Enhanced Attorney Responsibilities. The SOB (§307) provides that, within 180 days after enactment of SOB (January 26, 2003), 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 counsel ("*CLO*") or the CEO of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the audit committee of the board of directors. The SEC has proposed rules implementing provisions of SOB §307 that prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers."[12]

The proposed SOB §307 rules would apply to all attorneys, whether in-house counsel or outside counsel and those in foreign jurisdictions, and would define "appearing and practicing" before the SEC to include, without limitation: (1) transacting any business with the SEC, including communication with commissioners, the SEC or its staff; (2) representing any party to, or the subject of, or a witness in an SEC administrative proceeding; (3) representing any person in connection with any SEC investigation, inquiry, information request, or subpoena**,** (4) preparing, or participating in the process of preparing, any statement, opinion, or other writing that the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff; or (5) advising any party that: (i) a statement, opinion or other writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff; or (ii) the party is not obligated to submit or file any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff.

The proposed 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, and that the attorney is obligated to act in the best interests of the issuer and its shareholders.

The reporting obligation under the proposed SOB §307 rules would be triggered when an attorney "reasonably believes" (not just "knows") that a material violation has occurred, is occurring

---

12 SEC Release No. 33-8150 (November 21, 2002). The proposed SOB §307 rules would constitute a new Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission.

or is about to occur. The proposed does not confine an attorney's duty to matters within the scope of the attorney's representation or as to matters as to which the attorney has formed a legal conclusion that there has been a material violation.

The attorney would be initially directed to make this report to the issuer's CLO, or to the issuer's CLO and CEO. The attorney also would be obligated to take reasonable steps under the circumstances to document the report and the response thereto, and to retain such documentation for a reasonable time.

When presented with a report of a possible material violation, the SOB §307 rules would obligate the issuer's CLO to determine whether to conduct an inquiry into the reported material violation to ascertain whether in fact a violation has occurred, is occurring or about to occur. A CLO who reasonably concludes that there has been no material violation would have to provide notice to the reporting attorney of this conclusion, and take reasonable steps to preserve relevant documentary evidence. A CLO who concludes that a material violation has occurred, is occurring or is about to occur would be required to take reasonable steps to ensure that the issuer adopts appropriate remedial measures or sanctions - including appropriate disclosures. Furthermore, the CLO would be required to report "up the ladder" within the issuer what remedial measures have been adopted, and to advise the reporting attorney of his or her conclusions.

The obligation of an attorney who has not received an appropriate response from the issuer differs for in-house attorneys and outside counsel. If outside counsel reasonably believes that the reported material violation is ongoing or is about to occur and is likely to result in substantial injury to the issuer or to investors, he must withdraw from the representation, notify the SEC of his withdrawal (a "*noisy withdrawal*"), and disaffirm any submission to the SEC he has participated in preparing that is tainted by the violation. In-house attorneys who reasonably believe that the reported violation is ongoing or is about to occur and is likely to result in substantial injury to the issuer or to investors need not resign, but must disaffirm any submission to the SEC he has participated in preparing that is tainted by the violation. If either in-house or outside counsel reasonably believes that a material violation has already occurred and has no ongoing effect, he is *permitted*, *but not required*, to take these steps, as long as he *also* reasonably believes that the reported material violation is likely to have caused substantial injury to the financial interest of the issuer or of investors. Finally, an attorney formerly employed or retained by an issuer who reasonably believes that he was discharged because he complied with the rule's reporting obligations *may*,*but is not required* to, notify the SEC of his belief he was so discharged and also disaffirm in writing any submission to the SEC that he participated in preparing that is tainted by the violation. Where an attorney files a notification with the SEC as part of a "noisy withdrawal," no violation or waiver of the attorney/client privilege would occur in the SEC's view.

As an alternative process for considering reports of material violations, an issuer may (but is not required to) establish a qualified legal compliance committee (*"QLCC"*) comprised of at least one member of the issuer's audit committee, and two or more members of the issuer's board, all of whom must be independent, for the purpose of investigating reports made by attorneys of evidence of a material violation. The QLCC would be authorized to require the issuer to take remedial action. If the issuer were to fail to act as directed by the QLCC, each QLCC member would have the

responsibility to notify the SEC. Attorneys who report evidence of a material violation to a QLCC would not be subject to the rule's "noisy withdrawal" requirement.

An attorney would be allowed to use the contemporaneous records he or she creates to defend against charges of attorney misconduct and to reveal confidential information to the SEC to the extent necessary to prevent the commission of an illegal act that he believes will either result in the perpetration of a fraud on the SEC or in substantial injury to the financial or property interests of the issuer or investors.

Finally, the proposed SOB §307 rule would provide 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.

TITLE IV: ENHANCED FINANCIAL DISCLOSURES; PROHIBITION ON INSIDER LOANS

Off-Balance Sheet Transactions. The SOB (§401) instructs the SEC to require by rule within 180 days of SOB's enactment (January 26, 2003): (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; 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. Also under SOB §401, each financial report must "reflect" all material adjustments proposed by the auditors, which we interpret to mean that 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. Pending PCAOB rules on this issue, we suggest considering disclosure of all material suggested auditor adjustments other than those that management agreed with and incorporated into the financials.

On November 5, 2002, the SEC issued a rule proposal "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments"[13] to require disclosure of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The new disclosure would be located in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("*MD&A*") section in a company's disclosure documents. The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposed rule also would require a registrant (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

[13] SEC Release No. 33-8144 (November 4, 2002) available at http://www.sec.gov/rules/proposed/33-8144.htm.

Prohibition on Loans to Directors or Officers. The SOB (§402) generally prohibits, effective July 30, 2002, a corporation from directly or indirectly making or arranging for personal loans to its directors and executive officers.[14] There are exceptions for the continuation without modification of existing loans and for extensions of credit made in the ordinary course of business by credit card companies on credit cards and brokerage firms on margin accounts, in each case on terms that are no more favorable than those offered to the general public. The SEC to date has not provided guidance as to the interpretation of SOB §402, although a number of interpretative issues have surfaced.

The prohibitions of SOB §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. 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.[15]

Cashless stock option exercises raise issues in SOB §402 and have led a number of issuers to suspend cashless exercise programs. 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 SOB §402.[16] 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.[17]

---

[14] SOB §402(a) provides: "It shall be unlawful for any issuer (as defined in [SOB §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."

[15] See outline dated October 15, 2002, authored jointly by a group of 25 law firms and posted at www.TheCorporateCounsel.net as "Sarbanes-Oxley Act: Interpretative Issues Under §402 – Prohibition of Certain Insider Loans."

[16] See *Cashless Exercise and Other SOXmania*, The Corporate Counsel (September-October 2002).

[17] 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 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

Accelerated Section 16(a) Reporting. SOB §403 amends Section 16(a) of the 1934 Act, effective August 29, 2002, to require officers, directors and 10% shareholders (collectively, "*insiders*") of companies with securities registered under Section 12 of the 1934 Act to file with the SEC Forms 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...*"[18]

On August 27, 2002, the SEC issued a release (the "*16(a) Release*")[19] adopting final amendments to its rules and forms implementing the accelerated filing deadlines described above for transactions subject to Section 16(a). As anticipated, the rule amendments also subject all transactions between officers or directors and the issuer exempted from Section 16(b) short swing profit recovery by Rule 16b-3, which were previously reportable on an annual basis on Form 5 (including stock option grants, cancellations, regrants and repricings), to Section 16(a) and the new two business day reporting requirement on Form 4.

The SEC has enacted two narrow exceptions to the new two business day reporting requirement which apply only if the insider does not select the date of execution of the transaction.[20] 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 Section 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. 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. Other transactions exempt from Section 16(b) previously reportable on Form 5 will remain reportable on Form 5. These transactions include small acquisitions not from the issuer and gifts.

---

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 SOB §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 SOB §402 assuming the issuer is not involved in arranging the credit.

18 Previously, Forms 4 were required to be filed by the 10th day of the month following the month in which the transaction was executed.

19 SEC Release No. 34-46421 (August 27, 2002).

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

In order to comply with these accelerated filing requirements, issuers need to create an early notification system which ensures that the issuer is promptly made aware of Section 16(a) transactions by both insiders and administrators of their broad-based employee benefit plans. 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.

Additionally, the SEC's rules now reflect that Form 4 is not a monthly reporting form, but must be filed within two business days of the date of execution of the reported transaction. The SEC indicates that prior to publication of a new Form 4, insiders should use the old form, modifying Box 4 to state the month, date and year of the transaction, and, if applicable, including a footnote to include a deemed execution date in addition to the trade date.

The SEC has indicated that it expects to release rules requiring mandatory electronic filing of Section 16(a) change in ownership reports (but not initial statements of beneficial ownership reports on Form 3), and website posting of such reports by the SEC and issuers, in the next few months, well before the first anniversary of the enactment of the SOB (July 30, 2003). In the meantime, the SEC encourages insiders to file such reports electronically.[21]

---

[21] Summarized below are some of the procedures applicable in filing insider trading reports on EDGAR.

A. EDGAR Access Codes

A prerequisite to filing the reports electronically on EDGAR is obtaining a set of EDGAR access codes. This is done by filing with the SEC a Form ID, which is available on the SEC website at http://www.sec.gov/about/forms/formid.pdf. It is very important that a separate Form ID be completed for each insider whose filings will be made via EDGAR. According to representatives in the SEC's Filer Support office, an individual who is an insider for more than one company need only file for one set of EDGAR access codes. It is also important to protect the integrity and security of the data sent by limiting the number of people who know the sender's CCC, password, and PMAC. Likewise, it may be prudent to apply for a certificate for added security purposes. [See the EDGAR Filer Manual for more information on certificates. The latest version of the EDGAR Filer Manual can be downloaded at http://www.sec.gov/info/edgar/filermanual.htm.] One should also take note that the SEC has discontinued the acceptance of requests for access codes for EDGAR on Form ID through the mail. Effective, November 6, 2001, all requests for these codes must come via fax. Fax Form ID to:

US Securities and Exchange Commission
ATTN: Filer Support
(202) 504-2474; or
(703) 916-7624

The SEC will also no longer return a hard copy of the access codes through the mail but will notify the applicant of the codes via telephone call. If a written confirmation of the codes is desired, include either an e-mail address or a fax number on the request.

Four EDGAR access codes will be created after filing the Form ID. One of the codes created is the Central Index Key ("CIK") code. The CIK code uniquely identifies each filer, filing agent, and training agent. The CIK is assigned after the filing of an initial application. This code cannot be changed. Another code that will be created is the CIK Confirmation Code ("CCC"). The CCC is used in the header of filings in conjunction with the CIK to ensure that the filing is authorized . The third code that is created is the password. The password allows a person to log onto the EDGAR system, submit filings, and change the CCC. Finally, holders of access codes will receive a Password Modification Authorization Code ("PMAC"). The PMAC allows a person to change their password.

B. Use of a Filing Service

Once the EDGAR access codes have been obtained and the necessary information for the applicable form has been compiled, an insider may electronically file the form with the assistance of a filing agent such as a printer or law firm. There are several companies that provide electronic filing services, websites for some of these companies include:

http://www.section16.net;

http://www.erestrictedstock.com;

http://www.realcorporatelawyer.com/RRDFilerNet.pdf; and

http://www.bowne.com/financialprint/bowne_file_16.asp

C. Filing By or On Behalf of Insider

If an insider wishes to file on his own behalf or the issuer desires to file on behalf of the insider, [In addition to this memorandum, one will need to refer to Regulation S-T (17.C.F.R. § 232) which sets forth the rules for filing electronically and the EDGAR Filer Manual which describes the procedures and technical formatting requirements of EDGAR.] her or she will need to go to the EDGAR Login page at https://www.edgarfiling.sec.gov and enter the CIK and password and click the Login to EDGAR button. Once EDGAR has been entered, if it has not already been done, Modernized EDGARLink Software should be installed. The filer will need to click on EDGARLink Software located on the EDGAR Welcome page. The EDGARLink Software Download page will appear whereon the filer will need to click on the Download EDGARLink button and follow the instructions.

Once Modernized EDGARLink Software has been downloaded, the filer will need to download the templates for the requested submission types he or she wishes to file. In the EDGAR menu, under the Downloads section, click on Submission Templates. By clicking on Submission Templates, the Submission Template Download Options page is opened. From this page the filer can scroll through the Submission Types list and select a submission by clicking on it. The submission types for Forms 3, 4 and 5 are 3, 4 and 5, respectively. Select the applicable submission type and then click Get it. The Submission Template Download Confirmation page will appear. Click on Download Template 2. The template should be saved before entering any data. One can access the template by double clicking the template from one's Window Explorer window, or the Template Viewer icon on one's desktop.

In order to make an insider report filing via EDGAR, the insider or person filing on behalf of the insider will need to prepare the insider report and save the document in an acceptable format such as ASCII or HTML. [Review the EDGAR Filer Manual for specific technical requirements of ASCII and HTML text.] Each document should be created in separate files. For example, if the filer wishes to create a cover letter for the filing and an insider report on Form 4, the filer should create the cover letter and Form 4 as separate files. The submission document, the document that will be used to transmit the insider report, may be created by clicking on the Template Viewer located on the desktop and then selecting the appropriate template file. The filer may then enter the information in the fields of the Main Page. In order to add the insider report to the submission document, the filer will need to click on the Documents button to go to the Documents page. The filer will then select Add Document, and then select Attach and find the file. Then the filer will select Open and Done. Do this for each document to be added to the submission and save the submission document once all documents have been attached. The submission documents may be reviewed by using the View Document button on the Document page. One may also check and correct errors using the Submission Validation button.

When the submission has been completed and validated, it can then be transmitted. The filer will need to enter the EDGAR website and click on Transmit, which will bring up the Transmit Submission page. Then click on Transmit as a LIVE Submission. The filer will then click on the Browse… button and then double click the submission. When the filer is ready to transmit a LIVE filing, click on the Transmit LIVE Filing button. Once the filer clicks this button, EDGAR will process the submission. The filer may find out the status of the submission through e-mail or by performing a Submission query on the Filing website.

EDGAR accepts direct transmissions of electronic submissions each business day, Monday through Friday, from 8:00 a.m. to 10:00 p.m. Eastern time, excluding Federal holidays. Transmissions started but not completed by 10:00 p.m. Eastern time will be canceled, and will have to be resubmitted on the next business

Internal Controls. The SOB (§404) directs the SEC to prescribe rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The SOB further requires the public accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls. On October 22, 2002 the SEC proposed rules[22] regarding internal control reports to implement SOB §404[23] that would require reporting companies to include in Form 10-K an internal control report of management that includes:

---

day. If a filer begins direct transmission of a live submission after 5:30 p.m. Eastern time and the submission is accepted, it will have a filing date as of the next business day.

Please take note that an insider must submit a paper copy of his first electronic filing. Send the paper copy to the following address:

Operation Location
ATTN: Filer Support
US Securities and Exchange Commission
Mail Stop 0-7
6432 General Green Way
Alexandria, VA 22312

D. Additional Points to Consider

The following points should also be considered in preparing to file an insider report via EDGAR:

- A person cannot use the company's password for his or her insider trading report. If an insider uses the company's EDGAR password, even if the filing is initially accepted by EDGAR, it will not "count" as being filed by the individual. Further, each individual or company filing on behalf of an individual needs to make sure that it has only one EDGAR password for the individual in advance of any filing.
- Individuals should apply for EDGAR access codes well in advance. Historically it has taken 2 to 3 business days to receive EDGAR access codes, but due to the new two day requirement for Forms 4, it may take longer.
- If an insider wishes to file on his own behalf or the issuer desires to file on behalf of the insider without the aid of a filing service, it is recommended that the applicable persons prepare the submissions well in advance of the filing and utilize the Submission Validation features on EDGARLink.
- When a person prepares an ASCII document for submission, he or she must limit line width to 80 characters for text and 132 for tabular material (between tab tags).
- Keep a manually signed signature page (or equivalent document) on file for five years.
- Make a backup copy of the SEC-provided EDGAR Installation software downloaded from the Internet in case it needs to be re-loaded on the system.
- Filer Support Staff are available each business day from 8:00 a.m. to 7:00 p.m., Eastern time. They can be reached at (202) 942-8900.

[22] SEC Release No. 34-46701 (October 22, 2002).

[23] SOB §404 requires the SEC to adopt rules requiring a company's management to present an internal control report in the company's annual report containing: (1) a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's

- A statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;

- Conclusions about the effectiveness of the issuer's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures in accordance with 1934 Act Rules 13a-15 or 15d-15, as of the end of the issuer's most recent fiscal year; and

- A statement that the registered public accounting firm that prepared or issued the issuer's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting.

Additionally, the proposed rules would require the referenced attestation by the issuer's registered independent public accounting firm to be filed as an exhibit to Form 10-K.

The SEC's proposed rules to implement the internal control report requirements included in SOB §404 also includes several conforming revisions to the SEC's recently adopted certification rules and related requirements.

The proposed rules would define "internal controls and procedures for financial reporting" as controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards §319 or any superseding definition or other literature that is issued or adopted by the PCAOB.

The proposed reporting as to internal controls, if adopted, would not take effect until the PCAOB adopts standards for attestations by auditors and, therefore, is proposed to apply only to fiscal years that end on or after September 15, 2003.

Codes of Ethics. The SOB (§406) directs the SEC to issue rules requiring a code of ethics[24] for senior financial officers of an issuer applicable to the CFO, comptroller or principal accounting officer and to require the immediate disclosure on its Form 8-K of any change in or waiver of the code of ethics for senior financial officers.

---

internal control structure and procedures for financial reporting. SOB §404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment. The SOB §404 requirements are not applicable until the SEC's implementing rules are adopted.

[24] A "code of ethics" is expected to contain 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.

Code of Ethics Disclosures. On October 22, 2002, the SEC proposed[25] rules to implement SOB §406[26] that would require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a written 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
- If the issuer has not adopted such a code of ethics, the reasons it has not done so.[27]

In the proposed SOB §406 rules, "code of ethics" would mean a codification of standards that 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;
- Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
- 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;[28] and
- Accountability for adherence to the code.[29]

The proposed SEC rules indicate that in addition to providing the required disclosure, an issuer would be required to file a copy of its ethics code as an exhibit to its Form 10-K.

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

---

25 SEC Release No. 34-46701 (October 22, 2002).

26 The SOB §406 requirements are not applicable until the SEC's implementing rules are adopted.

27 Proposed Regulation S-K Item 406.

28 The company would retain discretion to choose the person to receive reports of code violations, but Release No. 34-46701 (October 22, 2002) 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.

29 Instructions to Proposed Regulation SK Item 406.

- A change to an issuer's code of ethics that applies to the specified officers; or
- Waiver of application of the ethics code provision to a specified officer.

The issuer would be required to file the Form 8-K within two business days after it made the change or granted the waiver. As an alternative to filing a Form 8-K, the proposed rules would permit an issuer to use its website a means of disseminating this disclosure if the issuer has disclosed in its most recently filed Form 10-K:

- That it intends to disclose these events on its Internet website; and
- Its Internet website address.

Audit Committee Financial Experts. The SOB (§407) requires the SEC to promulgate rules no later than 180 days after enactment of SOB (January 26, 2003) mandating reporting company disclosure regarding whether (and, if not, why not) its audit committee comprises at least one member who is a "financial expert." On October 22, 2002, the SEC proposed[30] rules regarding audit committee financial experts to implement SOB §407[31] and would require reporting companies to disclose in Form 10-K:[32]

- The number and names of persons that the board of directors has determined to be "financial experts" serving on the issuer's audit committee;[33] and, if there is no financial expert serving on the audit committee, that fact and why it has no financial expert; and
- Whether the financial expert or experts are "independent,"[34] and if not, an explanation of why they are not.[35]

---

[30] SEC Release No. 34-46701 (October 22, 2002). Comments with respect to the proposed rules must be received by the SEC within 30 days of publication of the proposed rules in the Federal Register.

[31] SOB §407 requires the SEC to adopt rules: (1) requiring a reporting company to disclose whether its audit committee includes at least one member who is a "financial expert"; and (2) defining the term "financial expert." The SOB §407 requirements are not applicable until the SEC's implementing rules are adopted.

[32] The proposed rules discussed in this memorandum 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 Release also proposed rules with similar requirements for investment companies.

[33] Section 3(a)(58) of the 1934 Act, as amended by SOB §205, defines the term "audit committee" as "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 . . . if no such committee exists with respect to an issuer, the entire board of directors of the issuer."

[34] SOB §301 added a new § 10A(m)(3) to the 1934 Act providing as follows with respect to audit committee independence:

"(3) INDEPENDENCE.—

"(A) IN GENERAL.—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

The SEC intends in the future to propose rules directing the national securities exchanges and NASDAQ to require that reporting companies have a completely independent audit committee as a condition to listing.

The proposed rules under SOB §407 define the term "financial expert" to mean a person who, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such position, was a reporting company, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the issuer's board of directors, in the person's having similar expertise and experience), has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the issuer's financial statements;
- Experience preparing or auditing financial statements that present accounting issues thatare generally comparable to those raised by the issuer's financial statements;
- Experience with internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

To be a financial expert, an individual must possess all of the five specified attributes, and exposure to the rigors of preparing or auditing financial statements of a reporting company is important. The board of directors, however, can conclude that an individual possesses the required attributes without having the specified experience. If the board of directors makes such a determination on the basis of alternative experience, the company must disclose the basis for the board's determination. While no such disclosure is required where the individual has the specified experience, disclosure would be appropriate in cases where there is any question. In any event, the board should maintain adequate minutes or other records showing the basis for its judgments.

In determining whether a potential financial expert has all of the requisite attributes, the board of directors of an issuer should evaluate the totality of an individual's education and experience. The board would be encouraged to consider a variety of factors in making its evaluation, including:

"(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

"(i) accept any consulting advisory, or other compensatory fee from the issuer; or

"(ii) be an affiliated person of the issuer or any subsidiary thereof.

[35] Proposed Regulation S-K Item 309.

- The level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;

- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person has actively practiced as a certified public accountant, or the equivalent;

- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether the person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having such expertise;

- Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file periodic reports pursuant to the 1934 Act and, if so, the length of any such service;

- The person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;

- The person's level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements required to be included in periodic reports filed under the 1934 Act;

- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements required to be included in periodic reports filed under the 1934 Act;

- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to the 1934 Act;

- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and

- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the issuer's financial statements and other financial information and in making knowledgeable and thorough inquiries whether:

    -- The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and

-- The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

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 a financial expert under the proposed rules.

The proposed attributes of a "financial expert" described above are more detailed and rigorous than those reflected in the current NYSE, NASDAQ, AMEX, PCX and other self-regulatory organization rules. Therefore, it is possible that a person who previously qualified as a financial expert under the current guidelines included in the rules of self-regulatory organizations may not have sufficient expertise to be considered a financial expert under these proposed rules. If the proposed rules are adopted, it will be important for reporting companies to re-evaluate whether an audit committee member who has the requisite level of financial expertise for purposes of the self-regulatory organizations also qualifies as a financial expert under the SEC rules.

As to the role of a financial expert on an audit committee and the effect on the liability of an individual designated as a financial expert and other members of the audit committee and the board of directors, the SEC has commented:

> The primary benefit of having a financial expert serving on a company's audit committee is that the person, with his or her enhanced level of financial sophistication or expertise, can serve as a resource for the audit committee as a whole in carrying out its functions. The mere designation of the financial expert should not impose a higher degree of individual responsibility or obligation on a member of the audit committee. Nor do we intend for the financial expert designation to decrease the duties and obligations of other audit committee members or the board of directors. Furthermore, in order to avoid any confusion in the context of Section 11 of the Securities Act, we do not intend for such a person to be considered an expert for purposes of Section 11 solely as a result of his or her designation as a financial expert on the audit committee. The role of the financial expert is to assist the audit committee in overseeing the audit process, not to audit the company. A conclusion that a financial expert is an "expert" for purposes of Section 11 might suggest a higher level of due diligence than is consistent with the audit committee's oversight responsibilities.[36]

Systematic SEC Review of 1934 Act Filings. The SOB (§408) requires the SEC to review disclosures made by listed companies on a regular and systematic basis and in no event shall a public company be reviewed less frequently than once every three years. In scheduling the required reviews, the SEC is expected to focus upon:

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

---

[36] SEC Release No. 34-46701 (October 22, 2002).

(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.

Accelerated Disclosure in Plain English. The 1934 Act is amended by SOB §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.

Although no particular effective date was established for the SEC to issue these rules, this is a *major shift* from the prior law, which allowed issuers flexibility in disclosing material information to the public, as long as insiders were not trading in issuer securities and the issuer was not otherwise filing a report with the SEC that would be misleading without the additional information. It puts significant pressure on issuers to evaluate, almost on a daily basis, whether it should make a disclosure of a material event.

TITLE V: ANALYST CONFLICTS OF INTEREST

The SOB requires the SEC to adopt rules governing securities analysts' potential conflicts of interest, including: (1) restricting the prepublication clearance or approval of research reports by persons either engaged in investment banking activities, or not directly responsible for investment research; (2) limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities; (3) prohibiting a broker or dealer involved with investment banking activities from retaliating against a securities analyst as a result of an unfavorable research report that may adversely affect the investment banking relationship of the broker or dealer with the subject of the research report; and (4) establishing safeguards to assure that securities analysts are separated within the investment firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

TITLE VI: SEC RESOURCES AND AUTHORITY

The SOB increases the SEC's budget (§601). It also grants the SEC censure authority in connection with appearance and practice before the SEC (§602) of any person the SEC finds to be unqualified, to be lacking in integrity or to have engaged in improper professional conduct or to have willfully violated, or willfully aided and abetted, any violation of securities laws.

TITLE VII: STUDIES AND REPORTS

The SOB mandates various studies and reports to Congress regarding the consolidation of public accounting firms and the role and function of credit rating agencies.

The SEC is required to do four studies and the Comptroller General to do three. The SEC is to report on (i) the role and function of credit rating agencies in the securities markets, including how well they are doing their job, (ii) all enforcement actions over the last 5 years involving violations of reporting requirements and financial statement restatements, to identify the areas most susceptible to fraud, (iii) the number of securities professionals practicing before the SEC who have been found to be primary violators and also secondary aiders and abettors who have not been sanctioned, and what their violations were (all of which are due by January 26, 2003), and lastly (iv) a study of issuer filings to determine the extent of off-balance sheet transactions and use of special purpose entities (*"SPE's"*) and whether GAAP results in financials statements of those issuers reflecting the off-balance sheet financing transactions in a transparent fashion. The report on SPE's and off-balance sheet financing is due by July 31, 2004.

The Comptroller General's three studies, all due by January 26, 2003, are on (i) the effect of requiring the mandatory rotation of registered public accounting firms, (ii) the consolidation of public accounting firms and its effect on the securities markets, and (iii) whether banks and financial advisors assisted public companies in earnings manipulation and financial statement misstatement and opaqueness.

TITLE VIII: CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY

Records Retention. Title VIII of the SOB 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); and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities. The SEC is directed to promulgate regulations regarding the retention of audit records containing conclusions, opinions, analyses, or financial data.

The SEC has proposed rules that would add Section 210.2-06 to Regulation S-X (under "Qualifications and Reports of Accountants"),[37] that would require accountants who review or audit an issuer's financial statements to retain, for five years after the end of the fiscal period in which an accountant audits or reviews an issuer's financial statements, workpapers and other documents that form the basis of the audit or review of an issuer's financial statements, and 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. Non-substantive materials that are not part of the workpapers and other documents that do not contain relevant financial data or the

---

[37] SEC. Rel. No. 34-46869 (November 21, 2002).

auditor's conclusions, opinions or analyses would not meet the second of these criteria and would not have to be retained.

Note that the PCAOB is directed in SOB §103 to require auditors to retain for a period of seven years workpapers to support the auditor's conclusions. Many documents may be subject to both retention requirements, though this five-year retention requirement applies to a broader range of documents that does not necessarily just support conclusions. "Workpapers" means "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." The materials retained under paragraph are not only those that support an auditor's conclusions about the financial statements but also those materials that may "cast doubt" on those conclusions. This requirement is intended to ensure the preservation of those records that reflect differing professional judgments and views (both within the accounting firm and between the firm and the issuer) and how those differences were resolved.

Non-dischargeable Fraud Judgments. The SOB (§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.

Extension of Statute of Limitation for Securities Fraud Claims. The SOB (§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.

Sentencing Guidelines. The SOB (§805) directs the United States 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.

Whistleblower Protection. The SOB (§806) prohibits a publicly traded company from discharging or otherwise discriminating against an employee because of any lawful act by the employee to: (1) assist in an investigation of prohibited conduct by Federal regulators, Congress, or supervisors; or (2) file or participate in a proceeding relating to fraud against shareholders. Remedies for such aggrieved employee include reinstatement, back pay, and compensatory damages.

Enhanced Fraud Penalties. The SOB (§807) subjects to a fine and imprisonment up to 25 years any person who defrauds shareholders of publicly traded companies.

TITLE IX: WHITE-COLLAR CRIME PENALTY ENHANCEMENTS

Title IX of the SOB is called the "White-Collar Crime Penalty Enhancement Act of 2002." The SOB (§902) amends Federal criminal law to provide that conspiracy to commit an offense is

subject to the same penalties as the offense and increase criminal penalties for mail and wire fraud from 5 years to 20 years.

The SOB (§905) directs the United States Sentencing Commission to review Federal Sentencing Guidelines to: (1) ensure that they reflect the serious nature of the offenses and the penalties set forth in the SOB, the growing incidence of serious fraud offenses, and the need to deter and punish such offenses; and (2) consider whether a specific offense characteristic should be added in order to provide stronger penalties for fraud committed by a corporate officer or director.

The SOB (§906) amends Federal criminal law to require the CEO and CFO to certify in writing that financial statements and the disclosures therein fairly present in all material aspects the operations and financial condition of the issuer.[38] It provides that the criminal penalties are (1) 20 years in prison for willful violation; and (2) 10 years for reckless and knowing violation.

TITLE X: CORPORATE TAX RETURNS

The SOB expresses the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation. This is not required by the Internal Revenue Code, and the effect of this provision by itself without any penalty provision is advisory only.

TITLE XI: CORPORATE FRAUD ACCOUNTABILITY

Title XI of the SOB is entitled the "Corporate Fraud Accountability Act of 2002" and provides in §1102 for up to 20 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. The SOB (§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.

---

[38] See CEO/CFO Certifications under Title III: Corporate Responsibility above regarding the certifications mandated by SOB §§302 and 906.

Appendix E

NYSE PROPOSED RULES COMPARISON CHART

The NYSE Corporate Accountability and Listing Standards Committee submitted a report to the NYSE Board of Directors on June 6, 2002, proposing changes to various NYSE listing standards. The NYSE received written comments on the proposed rules, reviewed the recommendations of the Standards Committee and submitted a rule filing to the SEC on August 15, 2002 which includes proposed corporate governance standards that differ in a number of respects from those proposed June 6, 2002 and attempts to address the new requirements imposed by the Sarbanes-Oxley Act of 2002. This chart is designed to compare the proposed rules to the rules as they currently stand. The rule filing is subject to review and approval by the SEC, which includes an additional public comment period. References to "[§___]" are to subsections of the proposed NYSE Company Manual Section 303A as filed with the SEC on August 15, 2002.

NYSE Proposed Rules as Filed with the SEC	**Effective Date**	**Rules Currently in Existence**
Independent directors must comprise a majority of a board. [§1]	Within 24 months of SEC approval.	Listed company must have an audit committee composed of at least three independent directors.
For a director to be deemed "independent," the board must affirmatively determine the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). The NYSE does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding. A board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. [§2(a)]	Not applicable.	Existing definition precludes any relationship with the company that may interfere with the exercise of a director's independence from management and the company.
Independence also requires a five-year "cooling-off" period for former employees of the listed company, or of its independent auditor; for former employees of any company whose compensation committee includes an	Not applicable.	Cooling-off period is three years; does not specifically apply to former employees of the auditor or any company

NYSE Proposed Rules as Filed with the SEC	Effective Date	Rules Currently in Existence
officer of the listed company; and for immediate family members of the above. The NYSE has clarified that employment of a family member in a non-officer position does not preclude a director's independence.[1] If an executive officer dies or becomes incapacitated, his or her immediate family members may be classified as independent immediately after such death or determination of incapacity, provided that they themselves are otherwise independent. [§2(b)]		whose compensation committee includes an officer of the listed company. Board of directors can make an exception of one former officer, provided the reason is explained in the next proxy statement.
Non-management directors must meet without management in regular executive sessions.[2] However, there does not have to be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the annual proxy statement. Alternatively, a company may wish to rotate the presiding position among the chairs of board committees. In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group. [§3]	Within 6 months of SEC approval.	No such requirement.
Listed companies must have an audit committee, a nominating committee and a compensation committee, each comprised solely of independent directors. [§§4, 5 & 6]	The nominating committee and compensation committee must exist within 6 months of SEC	Listed companies must have an audit committee comprised solely of independent directors. No requirement for establishment or

[1] The term "officer" is defined in Section 1 of the Listed Company Manual (as it is SEC Rule 16a-1(f)) to mean an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions of the issuer. Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy-making functions for the issuer.

[2] Non-management directors are those directors who are not company officers. The term includes non-officer directors who are not independent by virtue of a material relationship, former status or family membership or for any other reason.

NYSE Proposed Rules as Filed with the SEC	Effective Date	Rules Currently in Existence
	approval. The nominating and compensation committees must have at least one independent director within 12 months of SEC approval, and be composed entirely of independent directors within 24 months of SEC approval. The audit committee members must all be independent according to the new standards within 24 months of SEC approval.	composition of nominating or compensation committees.
Each of the committees referred to above must have a written charter. [§§4, 5 & 7]	Within 6 months of SEC approval.	Audit committee is currently required to have a written charter, but the new charter will have additional elements. Nominating and compensation committee charter requirements do not currently exist.
The Standards Committee originally proposed that the chair of the audit committee must have accounting or financial management experience. However, in light of the express provision in the Sarbanes-Oxley Act that at least one member of the audit committee qualify as a "financial expert," and the <u>existing</u> NYSE requirements that at least one	No action has been taken on this recommendation yet.	All committee members must be financially literate and at least one must have accounting or financial management expertise.

NYSE Proposed Rules as Filed with the SEC	Effective Date	Rules Currently in Existence
member of the audit committee have “accounting or related financial management expertise” and that all members of the audit committee be financially literate, the NYSE has determined to await the SEC’s interpretation of the definition of “financial expert” before acting this recommendation.[3] [§6 at n.6]		
Audit committee must have sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management. The NYSE received comments from about a quarter of the commentators objecting to this recommendation, suggesting that the entire board should be able to act on the recommendation of the audit committee because the majority independence requirement would protect against governance problems. The NYSE was not swayed by those comments. [§7]	Within 6 months of SEC approval.	Audit committee charter must provide that selection and firing of the independent auditor is subject to the “ultimate” authority of the audit committee and the board of directors.
Director’s fees must be the sole compensation an audit committee member receives from the listed company. Initially, the Standards Committee recommended prohibiting an audit committee member associated with a major shareholder (one owning 20% or more of the listed company’s equity) from voting in audit committee proceedings. However, in light of the fact that Sarbanes-Oxley Act prohibited affiliated persons from serving on the audit committee, the NYSE determined not to propose this provision at this time.[4] [§6]	Within 24 months of SEC approval.	No current requirement.

[3] See Section 407 of the Sarbanes-Oxley Act and Section 303.01(B)(2)(b) of the Listed Company Manual.

[4] See Section 301 of the Sarbanes-Oxley Act.

NYSE Proposed Rules as Filed with the SEC	Effective Date	Rules Currently in Existence
Listed companies must adopt corporate governance guidelines. [§9]	Within 6 months of SEC approval.	No current requirements.
Listed companies must adopt a code of business conduct and ethics, and must promptly disclose any waivers of the code for directors or executive officers. [§10]	Within 6 months of SEC approval.	No current requirements.
Listed companies must publish on their web sites codes of business conduct and ethics, corporate governance standards and key committee charters. Waivers of such codes for directors or executive officers must be promptly disclosed [§§9 & 10]	Within 6 months of SEC approval.	No current requirements.
Initially, the Standards Committee recommended that shareholders must be given the opportunity to vote on all equity-based compensation plans. However, in its rule filing submitted to the SEC, the NYSE excepted inducement options, plans relating to mergers or acquisitions, and tax qualified and excessbenefit plans from this requirement. Brokers may only vote customer shares on proposals for equity-based compensation plans pursuant to customer instructions.[5] [§8]	Upon SEC approval.	Shareholder approval required of equity-compensation plans in which officers or directors may participate, but broad-based plans and one-time employment inducements are exempt. Broker can vote customer shares except when given instructions from the customer, or when the action is contested.
CEOs must certify annually that they are not aware of any company violations of NYSE listing standards. [§5] Initially, the Standards Committee recommended that each listed-company's CEO be required to certify annually that the company has established and complied with procedures for verifying the accuracy and	Within 6 months of SEC approval.	No current requirements.

[5] During the comment period, many large companies strongly urged the NYSE to maintain its existing rules, fearing primarily the increased proxy costs and increased uncertainty that the proposed change would entail. Large and small companies alike cited quorum difficulties and solicitation expenses that result when brokers are not allowed to vote uninstructed shares after a 10-day period. One such commentator warned that because of retail investor confusion about voting mechanics, there is a risk that the elimination of the discretionary broker vote will disenfranchise investors if not accompanied by an aggressive and vigorous program to educate them about how to vote their shares. These concerns did not sway the NYSE.

NYSE Proposed Rules as Filed with the SEC	Effective Date	Rules Currently in Existence
completeness of information provided to investors and that he or she has no reasonable cause to believe that the information is not accurate and complete. The Standards Committee also recommended that the CEO be required to certify that he or she has reviewed with the board those procedures and the company's compliance with them. Given the SEC June 27 order applicable to 947 companies and the provisions of the Sarbanes-Oxley Act regarding CEO certifications relating to the quality of financial disclosure, the Standards Committee later recommended, and the NYSE agreed, that there was no purpose to requiring under NYSE rules a similar but separate certification regarding a company's public disclosure.[6]		
Upon finding a violation of an Exchange rule, the NYSE may issue a public reprimand letter to any listed company and ultimately suspend or de-list an offending company. [§12]	Upon SEC approval.	No current provision for a public reprimand.

[6] See File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (June 27, 2002) and Sections 302 and 906 of the Sarbanes-Oxley Act. The Standards Committee noted to the NYSE Board of Directors that there has been a great deal of concern expressed by commentators regarding the additional potential liability created by the various certification proposals and the Standards Committee recommended, and the NYSE agreed, that the SEC should have exclusive authority to enforce the requirement of a CEO and CFO certification and that no certification should give rise to private rights of action.

Appendix F

ARTHUR ANDERSEN DOCUMENT RETENTION POLICY

On electronic form:

www.washingtonpost.com/wp-srv/business/daily/transcripts/anderson_policy020100.pdf