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Editor's Note

I am pleased to offer to all Business Law Section members the Spring 2005 issue of the *New York Business Law Journal*. I am quite excited about the articles which follow, both in terms of depth and range of topic, and I hope that you will be as delighted as I am. One way to assure the continuing publication of quality, timely articles which are of interest and utility to Section members is for you, personally, to take up the pen or hit the keyboard when you happen upon a topic which might be of interest to all. As I have said before, this is *your* journal, and I wish you to consider it so. On with the program!

Our first piece, by **Martin J. Ricciardi** and **Bradley G. Allen**, of the firm of **Whiteman Osterman & Hanna LLP**, is entitled "Catch 'Em If You Can: Suing the Unknown Hacker." This important article discusses the ever-mounting problems of cybercrime in the form of hackers breaking into a company's computer security program, which can have devastating consequences for the company itself, its shareholders, clients, customers, and creditors. The piece analyzes relevant portions of the federal Computer Fraud and Abuse Act and the Electronic Communications Privacy Act, which permit cybercrime victims to bring private civil actions against hackers. This is a topic which should interest anyone who has a computer, which, I take it, in this day and age is just about all of us.

Our second article, by attorneys at **Fried, Frank, Harris, Shriver & Jacobson LLP**, commemorates the thirtieth anniversary of the Societas Europeae (the "SE"), a highly successful European form of limited liability company whose formation and structure are governed partially by European Union law, partially by the law of the EU member state in which the SE is organized, and partially by the SE's articles and bylaws. The SE is a notably flexible business entity which is able to operate freely throughout the EU and which may transfer its place of incorporation to any EU member state. Nevertheless, for reasons which the article explains, the SE is best considered as a European form of corporation established under national law, rather than as a truly European corporation. Anyone with a substantial international practice with connections to Europe will want to read this valuable piece.

It is indeed my pleasure to present as our third work an article written by my colleague at Albany Law School, **Professor James Gathii**, entitled "Balancing Sovereign Creditor and Debtor Rights under New York Law." In a quite trenchant piece, Professor Gathii analyzes the sensitive issue of state law abrogation of traditional international law concepts of comity and the act of state doctrine in sovereign debt litigation, arguing that the New York courts have tipped the balance in favor of New York creditors and against sovereign borrowers to an unwarranted degree. This timely article critiques the second circuit's *Allied Bank International v. Banco Credito Agricola De Cartago* decisions, and it is bound to be of interest to all Section members interested in this delicate aspect of international law.

It is equally my pleasure to offer next an article authored partly by the son of our distinguished and tireless Advisory Board Chair, Stuart Newman. This article, entitled "Fiduciary Responsibilities of Corporate Directors and Officers in the 'Zone of Insolvency,'" by **Steven H. Newman** and **George N. Stavis** of **Esanu Katsky Korins & Siger, LLP**, and by **M. Jacob Renick** of the accounting firm of **M. J. Renick & Associates LLC**, warns the reader of the heightened fiduciary duty that applies to officers and directors of corporations that are not yet actually insolvent, but which are on the brink of insolvency. Because there is precedent for the view that a corporation may have entered the "zone of insolvency" as early as three years prior to the actual declaration of bankruptcy, the article points out how important it is that corporate executives and those advising them realize that their responsibility to corporate constituencies, including creditors, may dramatically increase long before the actual filing of a bankruptcy petition. Corporate lawyers beware!

Our next article is a little piece by **Robert D. Bring** of New York City, whose fine article on the importance of maintaining personal records appeared in the last issue of the *Business Law Journal.* In this article, entitled "Guardianship of Your Children," Mr. Bring reminds us of the importance of making testamentary provision for the guardianship of minor children, a failing which, like the failure to maintain important records, is perhaps not as uncommon among lawyers as it should be.

Our next work, authored by attorneys at **Stroock & Stroock & Lavan LLP**, is entitled "'Consent to Record' Provisions in ISDA Master Agreements." This timely and important piece deals with the law governing the recording of telephone conversations with respect to derivatives transactions, and it discusses some of the salient issues which should be considered in drafting such consent to record provisions in an ISDA Master Agreement. The article emphasizes the importance of precise draftsmanship so as to avoid some of the pitfalls that might accompany any attempts to introduce such recordings into evidence in the event of a dispute over the transaction in question, and it also covers issues such as the obligation to obtain consent from the parties to the conversation, the standards for admissibility of the contents of the recording, and the obligation to deliver a copy of the recording to the other side. The authors also touch upon the ethical responsibility of attorneys in connection with the recording or participation in the recording of such conversations.

We have two important articles on the dramatic changes wrought in the securities law by the Sarbanes-Oxley Act of 2002. The first, by **Guy Lander**, of the firm of **Davies Ward Phillips & Vineberg LLP**, one of our most loyal and prolific contributors, discusses internal controls, certifications, and disclosure issues in the helpful context of the real-world experience of two corporations, Pfizer and Intel, that are attempting to comply with this rigorous and comprehensive law. The article also touches upon Securities and Exchange Commission enforcement matters under the new Act, foreign private issuer compliance concerns, SEC reviews, Form 8-K issues, and the ever-important area of new accounting controls and the work of the Public Company Accounting Oversight Board. As a complement to Mr. Lander's excellent article we have a piece by the **Winston & Strawn** firm which discusses what corporate directors and executives need to know about the Act, entitled "Life in the Post-SOX World." This article focuses on the heightened personal responsibility of corporate executives under Sarbanes-Oxley, including, again, the new certification requirements, but the article also discusses those provisions of the Act which govern the potential forfeiture by executives of certain bonuses and profits, pension fund blackout periods, the prohibition of personal loans to the executives, and the requirements for accelerated reporting of insider stock transactions. Next, as in the Lander article, there is a discussion of relevant new and/or heightened accounting controls, followed by an analysis of changes wrought by Sarbanes-Oxley in the important areas of board structure and the ethical responsibility of attorneys for the corporation. These two fine articles are of critical importance to corporate and securities attorneys.

Our ninth article for the Spring issue is an analysis by **William C. Snyder**, currently the Post-Graduate Fellow for Government Law and Policy at Albany Law School's Government Law Center, of the upcoming sunset provisions of New York's Procurement Stewardship Act. The article, like the Act itself, is of vital importance to attorneys who counsel clients selling products to the state of New York and to local governments. The Procurement Stewardship Act governs the entire process of state and local procurement of commodities and services, and the article points out that unless the June 30, 2005 sunset provisions of Section 163, which regulates such procurement, are removed, this area of New York law is likely to lapse into an uncertainty which will serve the interests of no one, including, most importantly, the people of New York.

The final article in this issue, again from the **Fried Frank** law firm, analyzes in depth the pending changes to the public offering process currently under consideration by the Securities and Exchange Commission ("SEC Proposes Dramatic Reforms to the Public Offering Process"). The Commission's well-known "Aircraft Carrier" has recently been floated off the reef of controversy on which it ran aground several years ago, and if the new proposals go into effect, they will work a most "dramatic" change to the registration process indeed. This excellent article discusses in detail the SEC's new communications proposals, the novel "free writing prospectus," the loosening of restrictions on the shelf registration process, changes to the prospectus delivery requirements, heightened liability provisions, and other major changes to the registration regime. This article should be of major interest to our securities practitioners, who will want to monitor the reforms as they take effect.

Finally, let me take this opportunity once again to urge Section members to consider authoring an article for the *Journal.* The pain of authorship, although perhaps not insubstantial on occasion, is well outweighed by the pleasure of seeing one's name in print, particularly when coupled with a contribution to the law which is of value to such a vast and knowledgeable audience as that which reads these pages. I invite interested parties to submit to me an article via e-mail, preferably in Microsoft Word format, at **jredw@mail.als.edu**. The deadline for the Fall 2005 issue is August 31.

James D. Redwood
Editor

Catch 'Em if You Can[1]: Suing the Unknown Hacker

By Martin J. Ricciardi and Bradley G. Allen

It is no overstatement to say that most businesses today would be lost without their computers. We have come to rely heavily on computers for communications, number crunching, word processing, computer aided design, and all manner of information storage, retrieval, and transmission. Because of this computer dependency, nearly every business is a potential victim of a computer security breach perpetrated by hackers. An annual survey of computer security personnel conducted by the Computer Security Institute showed that although computer security breaches are declining overall, they remain expensive. Among the 269 respondents willing to disclose how much their companies lost to security breaches in the last twelve months, the deficits totaled $141.5 million.[2]

Computer security breaches (or "cybercrime") can take several forms, including unauthorized access, distribution of harmful programs, and denial of service.[3] Unauthorized access may be carried out by an outsider who is able to hack into a computer system or by a current or former insider who uses a valid password to obtain access to an area of the employer's computer system that he or she has no authority to access. The hacker's goal may be to copy, steal, alter, or destroy data, but if the data accessed are sensitive or confidential, the damage may arise simply from the fact that the information was viewed.

Distribution of harmful programs involves distributing computer viruses or worms, often as attachments to e-mail messages. When an unsuspecting recipient opens the attachment, the virus may delete or destroy files on the infected computer, or, as with the highly publicized Melissa and Love Bug viruses, send a copy of itself to the people in the victim's address book, gobbling up computing power and flooding mail servers. Denial-of-service attacks have a similar goal in mind. Using any of a variety of techniques, a hacker sends improperly formed messages or bogus data to one or more computers in an effort to crash the server and shut down service on the system.

Criminal statutes directed at cybercrimes provide a means of prosecuting and punishing hackers, but punishment alone will not make an injured party whole. Victimized businesses often want to recover the costs of salvaging lost or corrupted data and restoring service and may want to obtain injunctive relief to prevent the hacker from striking again. Fortunately, two federal cybercrime statutes, the Computer Fraud and Abuse Act[4] and the Electronic Communications Privacy Act,[5] permit cybercrime victims to commence a private civil action against hackers. One or both may be applicable to a particular computer security breach, depending upon the circumstances.

"[N]early every business is a potential victim of a computer security breach perpetrated by hackers."

Civil Actions under the Computer Fraud and Abuse Act (CFAA)

The CFAA is the primary federal enforcement weapon to combat cybercrime. It delineates seven separate offenses that encompass most computer-related crimes. Briefly stated, a person or entity is in violation of CFAA by:

(1) willfully disclosing sensitive national defense, foreign relations, or nuclear technology information obtained by unauthorized access to a computer;

(2) obtaining information from a "protected computer" through unauthorized access;

(3) accessing without authorization a computer belonging to the federal government;

(4) accessing a "protected computer" without authorization to engage in fraudulent conduct;

(5) damaging a "protected computer" by either transmitting a harmful program (such as a virus) or by accessing the computer without authorization;

(6) trafficking in passwords that affect interstate commerce or passwords for government computers; and

(7) threatening to damage a "protected computer" in an effort to extort money or any thing of value.[6]

A "protected computer" is one that is used by a financial institution or the federal government or that is "used in interstate or foreign commerce or communication, including a computer located outside the United States that is used in a manner that affects interstate or foreign commerce or communication of the United States."[7] As one commentator has noted, any computer that is connected to the Internet is arguably involved in interstate commerce, so this definition seemingly applies to the vast majority of computers used in homes and businesses.[8]

A private party may bring a civil action for any violation of CFAA, but only if the conduct that leads to the damage or loss falls into one of five specific categories. The conduct leading to the violation must have caused:

(1) loss to one or more persons during any one-year period aggregating at least $5,000 in value;

(2) modification or impairment of the medical examination, diagnosis, treatment, or care of one or more individuals;

(3) physical injury to any person;

(4) a threat to public health or safety; or

(5) damage to a government computer.[9]

Obviously, the first of these jurisdictional thresholds is the most important for those businesses outside the health care industry. As defined by CFAA, "loss" includes not only the cost of responding to an offense and restoring data, but also any revenue lost or "other consequential damages incurred because of interruption of service."[10] A plaintiff must present some evidence that the $5,000 threshold has been met; unquantified damages are unlikely to survive a motion for summary judgment.[11]

Plaintiffs may obtain injunctive or other equitable relief.[12] A civil action must be commenced "within two years of the act complained of or the date of the discovery of the damage."[13]

Civil Actions under the Electronic Communications Privacy Act (ECPA)

As the name implies, ECPA is directed at protecting the privacy of electronic communications, but it also contains a provision making it a crime to obtain unlawful access to stored electronic communications. In particular, this anti-hacking provision of ECPA is violated when a person or entity:

> (1) intentionally accesses without authorization a facility through which an electronic communication service is provided; or
>
> (2) intentionally exceeds an authorization to access that facility; and thereby obtains, alters, or prevents authorized access to . . . [an] electronic communication while it is in electronic storage in such system . . . .[14]

"Electronic communication" is defined as "any transfer of signs, signals, writing, images, sounds, data, or intelligence of any nature transmitted in whole or in part by a wire, radio, electromagnetic, photoelectronic or photooptical system that affects interstate or foreign commerce. . . ."[15] This definition is broad enough to capture pretty much all computerized data.

Private parties may bring a civil action against anyone who violates ECPA "with a knowing or intentional state of mind."[16] This scienter requirement ensures that those who inadvertently or accidentally trespass into a computer system will not be subject to liability. Because the lack of authorization is a necessary element of an ECPA violation, a plaintiff must be sure to "proffer sufficient proofs to create a colorable claim that [defendant's] access was unauthorized."[17] A civil suit must be brought within two years of the date that plaintiff discovered or had reasonable opportunity to discover the violation.[18]

ECPA specifically authorizes injunctive and declaratory relief and compensatory damages.[19] Such damages will be calculated as the actual loss suffered by the plaintiff *plus* the profits made by the violator.[20] Moreover, successful plaintiffs may recover reasonable attorney's fees and litigation expenses.[21] In addition, punitive damages are available where the violation is willful or intentional.[22]

Causes of Action Under New York State Law

Cybercrime often involves the global reach of the Internet, and a federal action may be the most effective means to seek redress. But a business that has suffered an attack may also want to bring state law claims, either in a federal action or in a state court action, assuming the court has jurisdiction over the hacker defendant.

New York has its own cybercrime statute, contained in Article 156 of the Penal Law, which defines five computer crimes. A person is in violation of Article 156 when he or she:

(1) without authorization, knowingly uses a computer programmed with a device or coding system to prevent unauthorized use;[23]

(2) without authorization, knowingly uses a computer and either (i) acts with intent to commit a felony or (ii) thereby knowingly gains access to confidential information;[24]

(3) uses a computer and without authorization intentionally alters or destroys the computer data of another;[25]

(4) without authorization, copies a computer program (i) with intent to deprive the owner of the

program of economic benefit in excess of $2,000 or (ii) with intent to commit a felony;[26]

(5) without authorization, knowingly possesses an illegal copy of a computer program with intent to derive benefit therefrom.[27]

Although New York's criminal statute does not explicitly provide for civil liability, at least one trial-level court has recognized that victims of cybercrime have a private right of action.[28] The court noted that recognizing a private right of action under the particular circumstances of the case would "promote the legislative purpose of combating the use of computers to commit crimes upon businesses."[29]

Depending upon the circumstances of the particular computer security breach suffered, a business may also consider bringing other state law claims, such as trespass to chattels or conversion.

Bringing a Federal Civil Action Against an Unknown Hacker

Federal civil actions ordinarily must begin with the filing of a complaint that identifies all parties to the action.[30] Once the complaint is filed, a plaintiff has 120 days to serve the defendant with a summons and a copy of the complaint, although the time limit may be extended if the plaintiff can show good cause for failure to serve.[31] When the identity of a defendant cannot be ascertained before commencing an action, most federal courts permit plaintiffs to bring an action against an unknown "John Doe" defendant in certain circumstances.[32]

If a cybercrime victim is not able to learn the identity of the hacker defendant through its own investigation, it may be able to obtain identifying information by serving a subpoena pursuant to Rule 45 of the Federal Rules of Civil Procedure after the action has been commenced.[33] If that process fails to provide the information needed, a plaintiff could file a request for pre-service discovery with the court.[34] Depending on how long obtaining the required information may take, it may be necessary to ask the court for an extension of time in which to serve the defendant. Courts generally disfavor permitting discovery before a defendant has been served, but in *Columbia Insurance Co. v. Seescandy.Com*, the U.S. District Court for the Northern District of California held that a plaintiff could obtain some limited pre-service discovery to ascertain a defendant's identity provided the plaintiff satisfy certain requirements prior to requesting pre-service discovery.[35] The approach taken in *Seescandy.Com* has recently been followed in a handful of similar cases.[36]

First, the allegations in the complaint must be specific enough to permit the identity of the party to be ascertained after reasonable discovery.[37] This requirement is necessary to ensure that the discovery requested could uncover the identity of a person over whom the court has jurisdiction.[38]

"If a cybercrime victim is not able to learn the identity of the hacker defendant through its own investigation, it may be able to obtain identifying information by serving a subpoena pursuant to Rule 45 of the Federal Rules of Civil Procedure after the action has been commenced."

Second, the plaintiff should explain all the steps it took to locate the elusive defendant.[39] This requires plaintiff to show a good faith effort to comply with service of process, which might include an attempt to discover defendant's identity by serving a subpoena on an Internet service provider likely to have the identifying information.[40]

Third, the plaintiff should establish that its suit against defendant could withstand a motion to dismiss.[41] A conclusory pleading is not sufficient since "pre-service discovery is akin to the process used during criminal investigations to obtain warrants."[42] As the court in *Seescandy.Com* noted:

> The requirement that the government show probable cause, is, in part, a protection against the misuse of *ex parte* procedures to invade the privacy of one who has done no wrong. A similar requirement is necessary here to prevent abuse of this extraordinary application of the discovery process and to ensure that plaintiff has standing to pursue an action against defendant.[43]

Finally, the fourth requirement mandates that plaintiff file a request for discovery with the court showing that it satisfied the previous three requirements.[44] The request should include a statement justifying the specific discovery requested and identify "a limited number of persons or entities on whom discovery process might be served and for which there is a reasonable likelihood that the discovery process will lead to identifying information about defendant that would make service of process possible."[45]

Upon determining defendant's identity, plaintiff must amend its pleading by substituting "John Doe" with the defendant's true name.[46] Such substitution amounts to adding a new party and not a "mistake concerning the identity of the proper party."[47] Consequently, the amendment will not relate back to the original filing date of the complaint for purposes of the statute of limitations.[48] Businesses seeking to sue an unknown hacker should therefore initiate the action well before the two-year statute of limitations in order to have sufficient time to discover the identity of the defendant.

> *"[C]ourts have begun to demonstrate a willingness to permit use of pre-service discovery, which may allow victims of hacker attacks to identify their cyberassailants and seek redress for their damages."*

Conclusion

Bringing suit against unknown defendants is difficult and time consuming under the best of circumstances, such as where a plaintiff is suing unknown police officers for violating her civil rights. At least in that case, an attorney can be sure that the identity of the officers is capable of being discovered (even though the officers may have an immunity shield). But hackers don't operate in the open. They use the anonymity of cyberspace and their expertise at covering their tracks in the same way a bank robber uses a ski mask. And then, even if one unmasks the hacker, the hacker's assets may not justify the cost of bringing a suit to judgment. Nevertheless, courts have begun to demonstrate a willingness to permit use of pre-service discovery, which may allow victims of hacker attacks to identify their cyberassailants and seek redress for their damages.

Endnotes

1. With apologies to Frank W. Abagnale, author of *The Art of the Steal* and subject of the film and book, *Catch Me if You Can*.
2. Computer Security Institute, 2004 CSI/FBI Computer Crime and Security Survey 10 fig. 15 (2004), *available at* <http://i.cmpnet.com/gocsi/db_area/pdfs/fbi/FBI2004.pdf> (last visited Nov. 30, 2004).
3. For a more complete analysis of these three types of cybercrime, see A. Hugh Scott, Computer and Intellectual Property Crime: Federal and State Law 20-26 (2001).
4. 18 U.S.C. § 1030.
5. 18 U.S.C. §§ 2510-2522, 2701-2712.
6. 18 U.S.C. § 1030(a)(1)-(7).
7. 18 U.S.C. § 1030(e)(2).
8. *See* Scott, *supra* note 3, at 40 (Supp. 2003).
9. 18 U.S.C. §§ 1030(g) and 1030(a)(5)(B).
10. 18 U.S.C. § 1030(e)(11).
11. *Compare America Online, Inc. v. National Health Care Discount, Inc.*, 121 F. Supp. 2d 1255, 1274 (N.D. Iowa 2000) (finding that AOL demonstrated its damages by multiplying the cost of each e-mail by the number of spam e-mails the defendant had sent) *with Pearl Investments, LLC v. Standard I/O, Inc.*, 257 F. Supp. 2d 326, 349 (D. Maine 2003) (granting defendant partial summary judgment where plaintiff failed to proffer any evidence of damage in a quantifiable amount).
12. 18 U.S.C. § 1030(g).
13. *Id.*
14. 18 U.S.C § 2701(a).
15. 18 U.S.C. § 2510(12).
16. 18 U.S.C. § 2707(a).
17. *In re Doubleclick Inc. Privacy Litigation*, 154 F. Supp. 2d 497, 510 (S.D.N.Y. 2001) (dismissing complaint where plaintiff had made only bare assertions regarding lack of authorization without proffering proofs that access was unauthorized) (citation omitted).
18. 18 U.S.C. § 2707(f).
19. 18 U.S.C. § 2707(b).
20. 18 U.S.C. § 2707(c).
21. 18 U.S.C. § 2707(b).
22. 18 U.S.C. § 2707(c).
23. N.Y. Penal Law § 156.05.
24. N.Y. Penal Law § 156.10.
25. N.Y. Penal Law § 156.20.
26. N.Y. Penal Law § 156.30.
27. N.Y. Penal Law § 156.35.
28. *Blissworld, LLC v. Kovack*, 2001 WL 940210 (Sup. Ct., N.Y. Co. 2001) (following the rule for imposing civil liability based on violations of criminal statutes articulated in *Sheehy v. Big Flats Community Day, Inc.*, 73 N.Y.2d 629, 634 (1989)).
29. *Id*. at *6.
30. Federal Rules of Civil Procedure ("F.R.C.P.") 3, 7, 10(a). In addition, F.R.C.P. 17(a) provides that "[e]very action shall be prosecuted in the name of the real party in interest."
31. F.R.C.P. 4(m).
32. *Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics*, 403 U.S. 388, 390, n.2 (1971). Although the matter was addressed only in a footnote, this case is often cited as the primary authority for permitting a cause of action against Doe defendants. *Lowenstein v. Rooney*, 401 F. Supp. 952, 960 (E.D.N.Y. 1975). *See also Dean v. Barber*, 951 F.2d 1210, 1215-16 (11th Cir. 1992) (reversing district court's denial of motion to join fictitious defendant); *Gillespie v. Civiletti*, 629 F.2d 637, 642-43 (9th Cir. 1980) (reversing district court's dismissal of complaint prior to receipt of response to interrogatories that may have provided names of John Doe defendants).
33. A plaintiff might, for example, serve a subpoena pursuant to F.R.C.P. 45 on a non-party, such as the Internet service provider ("ISP") (such as AOL or Yahoo) that is known to host the hacker. Many ISPs have particular policies and procedures for responding to subpoenas. *See, e.g.*, <http://www.timewarnercable.com/centralny/customer/policies/twacandispssubscriberprivacynotice.html> (last visited Nov. 22, 2004); <http://biz.verizon.net/policies/civil_subpoena.asp> (last visited Nov. 22, 2004).

34. *See generally, Parker v. John Doe #1*, 2002 WL 32107937 (E.D. Pa. 2002); *Columbia Ins. Co. v. Seescandy.Com*, 185 F.R.D. 573 (N.D. Cal. 1999). If a victim of cybercrime wanted to bring a civil action in New York state court, limited discovery to identify the proper defendant prior to commencing the action might be available pursuant to N.Y. Civil Practice Law and Rules § 3102(c).

35. 185 F.R.D. at 577 ("As a general rule, discovery proceedings take place only after the defendant has been served; however, in rare cases, courts have made exceptions, permitting limited discovery to ensue after filing of the complaint to permit the plaintiff to learn the identifying facts necessary to permit service on the defendant.").

36. *See Sony Music Entertainment Inc. v. Does 1-40*, 326 F. Supp. 2d 556 (S.D.N.Y. 2004) (using the rule set out in *Seescandy.Com* to deny defendant Does' motion to quash subpoena); *Dendrite Int'l, Inc. v. John Doe No. 3*, 342 N.J. Super. 134, 775 A.2d 756 (N.J. Super. Ct. App. Div. 2001) (approving Superior Court's reliance on *Seescandy.Com* in denying plaintiff's pre-service discovery request).

37. *Seescandy.Com*, 185 F.R.D. at 577 (citing *Maclin v. Paulson*, 627 F.2d 83, 87 (7th Cir. 1980)); *Dean v. Barber*, 951 F.2d 1210, 1216 (11th Cir. 1992) (holding that district court erred by denying motion to join John Doe defendant where such defendant was adequately described and could be identified for service).

38. *Seescandy.Com*, 185 F.R.D. at 578 (citing *Plant v. Does*, 19 F. Supp.2d 1316 (S.D. Fla. 1998)); *Gillespie v. Civiletti*, 629 F.2d 637, 642 (9th Cir. 1980).

39. *Seescandy.Com*, 185 F.R.D. at 579.

40. *See Parker v. John Doe #1*, 2002 WL 32107937 at *1-*2 (E.D. Pa. 2002) (declining to issue court order to ISPs for release of John Doe defendants' identities when plaintiff had failed to attempt to secure such information by serving subpoenas).

41. *Seescandy.Com*, 185 F.R.D. at 579. *See also Sony Music Entertainment Inc. v. Does 1-40*, 326 F. Supp. 2d 556, 565-66 (S.D.N.Y. 2004) (holding that plaintiffs had made a showing of a *prima facie* claim of copyright infringement sufficient to defeat defendants' motion to quash subpoena); *Plant v. Does*, 19 F. Supp 2d 1316, 1321 n.2 (S.D. Fla. 1998) (expressing doubt that plaintiff could show injury sufficient for court to grant preliminary injunctive relief against unknown defendants who might potentially sell bootleg merchandise); *Dendrite Int'l, Inc. v. John Doe No. 3*, 342 N.J. Super. 134, 152-58, 775 A.2d 756, 768-71 (N.J. Super. Ct. App. Div. 2001) (concluding that plaintiff had failed to make out a *prima facie* case of defamation against an unknown defendant).

42. *Seescandy.Com*, 185 F.R.D. at 579.

43. *Id.* at 579-80. *See also* Joshua R. Furman, Comment, *Cybersmear or Cyber-SLAPP: Analyzing Defamation Suits Against Online John Does as Strategic Lawsuits Against Public Participation*, 25 Seattle U. L. Rev. 213, 227 (2001) (noting that the adjudication of online issues requires heightened procedural safeguards to prevent frivolous suits against anonymous online "netizens").

44. *Seescandy.Com*, 185 F.R.D. at 580.

45. *Id.*

46. Under F.R.C.P. 15(a), amendment is allowed once "as a matter of course before a responsive pleading is served." Otherwise the court's permission must be sought and is freely given when justice so requires.

47. *Garrett v. Fleming*, 362 F.3d 692, 696 (10th Cir. 2004); F.R.C.P. 15(c).

48. *Garrett*, 362 F.3d at 696.

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The Societas Europeae, Thirty Years Later

By Eric Cafritz and James Gillespie

Introduction

After more than thirty years of debate, European Union legislation establishing a European Company (formally, the "Societas Europeae," or "SE") officially entered into effect throughout Europe on October 8, 2004. The new legislation, which consists of two documents, the Council Regulation on the Statute for a European Company (the "Regulation")[1] and the Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees (the "Directive"),[2] is a significant extension of the legal framework for Europe's internal market.

Institutional and scholarly debate concerning the creation of a European-wide corporate form has been ongoing since at least 1967. The structure of the SE reflects compromises entailed by contentious negotiations and the clear influence of rigid 1970s-era conceptions of the functioning of corporations.

Overview

The SE is a limited liability corporation. It may be closely held or publicly listed. Its formation and corporate structure are partially governed directly by EU law (the Regulation and the Directive), partially by the law of the EU Member State in which it is incorporated, and partially by its articles and bylaws.

The SE is designed to serve as a vehicle for corporations active throughout the EU. It will be able to operate freely throughout the EU, either through subsidiaries or branches established in various Member States, and it may transfer its place of incorporation to any EU Member State.

In setting out the legislative framework for the SE, the Regulation refers frequently to the national law of the Member State in which the SE is formed.[3] Because corporate laws vary significantly across the EU, there will therefore be major differences in the structure and operation of an SE depending on its jurisdiction. For this reason, there will in fact be 25 different forms of SE, one per Member State. The SE is best seen as a European form of corporation established under national law, rather than a truly European corporation.[4]

Formation of an SE

An SE can be formed in one of four ways: merger of two or more existing corporations from at least two different Member States; establishment of a holding company; formation of a subsidiary; or the transformation of an existing corporation. On its face, the Regulation does not provide for an SE to be created directly by a simple contribution of capital by individuals. However, this approach could be adopted voluntarily by Member States as they transpose the Regulation's provisions onto national law.[5]

Formation by Merger

Previously, mergers between corporations incorporated in different Member States have posed numerous legal and practical issues. Because of the lack of EU legislation that would determine which country's laws prevail in the event of a cross-border merger, such combinations have been rare and costly.[6]

Pursuant to the Regulations, two or more corporations may merge to form an SE, so long as at least two of the merging companies are incorporated in different Member States.[7] The SE can be formed either by a vertical merger, in which the surviving entity is transformed into an SE, or by both companies merging into a newly created SE.

The Regulation provides detailed guidelines for both internal and external pre-merger approvals. All issues not dealt with directly by the Regulation will be governed, for each company, by the national law of that company's place of incorporation.[8] The newly formed SE will be bound by the law of the jurisdiction in which it is incorporated.

With the introduction of the SE, cross-border mergers will be possible in jurisdictions where they are not currently allowed.[9] In the majority of cases, however, where mergers between companies from different jurisdictions are permitted but difficult, companies will continue to be subject to the legal and administrative requirements of each jurisdiction involved. Many substantive issues (such as the percentage shareholder vote necessary to approve a merger) are referred to national law, and serious inconsistencies between national laws will remain. The Regulation will not alleviate the obligation of complying with multiple national merger rules.

Formation by Creation of a Holding Company or Subsidiary, or by Transformation

An SE may be created as a holding company by two or more corporations, provided that at least two of them are incorporated in different Member States, or by a single corporation having had a subsidiary or branch in another Member State for at least two years.[10]

An SE may also be created as a subsidiary by any two or more companies or legal entities, so long as at least two of them are incorporated in different Member States.[11]

Finally, an SE may be created by the transformation of an existing corporation into an SE.[12] The Regulation provides that the transformed corporation may not transfer its registered office (and therefore its place of incorporation) to another Member State at the time of the transformation, but it does not specify how much time must elapse before such a transfer is possible, and this point must be determined by implementing decrees under national law.

For the formation of an SE by merger, creation of a holding company, or transformation, the Regulation sets out certain formalities and notifications that must be accomplished. In the case of a merger, the Regulation provides a detailed calendar and list of requirements; for the incorporation of a holding company or transformation of an existing corporation, the formal requirements are more limited. In each case, shareholder approval is necessary. For creation by merger or establishment of a holding company, a court, notary, or other authorized body must also confirm that any national legal requirements for incorporation of a holding company have been met. By contrast, for the incorporation of an SE as a subsidiary, the Regulation refers all questions concerning formalities and other requirements to the corporate law of the Member State where the SE will be incorporated.

Formation of an SE Subsidiary by an SE

An SE may itself incorporate SE subsidiaries in any Member State. Such SE subsidiaries will be exempt from any national laws requiring that companies have more than one shareholder. For example, in France, the Commercial Code currently requires at least seven shareholders in order to incorporate an SA (société anonyme), which therefore cannot be a wholly owned subsidiary.[13] The SE form provides a means of circumventing this restriction, and will thus facilitate the restructuring of corporate groups.

Participation of Non-EU Companies in an SE

In principle, at least two of the companies participating in the formation of an SE must be incorporated in an EU Member State and have their head offices within the EU, though not necessarily in the Member State in which they are incorporated. The Regulation provides that Member States may, but are not required to, allow a company to participate in the formation of an SE even though its head office is not within the EU, so long as the company is incorporated in a Member State and has a "real and continuous link with a Member State's economy."[14]

Even if no Member State ultimately decides to allow non-EU based companies to participate in the formation of an SE, there are no restrictions on an SE being majority (or wholly) controlled by a non-EU company. Similarly, the SE statutes do not provide for anti-takeover measures, and nothing would seem to prohibit a non-US company from acquiring an existing SE, subject to any national foreign investment authorization regulations.

Taxation

Harmonization of tax issues remains an extremely sensitive issue within the EU, and it was clear from the legislative debates that any attempt at creating a trans-European system for SE taxation would have brought the entire SE project to a halt.[15] The Regulation therefore specifies that it is not intended to address taxation issues, and as a result the adoption of an SE form (as opposed to an SA form in France, for example) will not have any impact from a tax perspective.

The lack of harmonized tax treatment limits the utility of the SE form.[16] While there is ongoing discussion concerning some form of pan-European tax harmonization, such as the establishment of a consolidated tax base for multinational firms, there has been relatively little progress in reaching political agreement.

For purposes of French corporate tax, an SE will be treated like any other EU-based corporation.[17] In general, French tax laws impose strict territoriality requirements, and prohibit consolidation of profits and losses between a French parent and its foreign subsidiaries or branches.[18] If an SE incorporated outside of France owns a subsidiary in France, that subsidiary's profits will be taxed on the same basis as a French corporation. If, on the other hand, the SE operates through an unincorporated branch in France, French tax rules concerning permanent establishments of foreign corporations will apply. Under these rules, the profits and losses attributable to that permanent establishment will be subject to French taxes.[19]

In addition, French tax law currently considers that the transfer of a French company's registered office outside of France constitutes a dissolution of the business, which is subject to an immediate tax on profits and unrealized capital gains.[20] One of the primary benefits of the SE form was intended to be flexibility in the transfer of registered offices among EU Member States, so tax penalties for relocation will limit the usefulness of the SE if they remain in place.[21]

Internal Structure of the SE

The Regulation provides that an SE may have either a one- or two-tiered board structure: a single administrative board, or separate management and supervisory boards. The same options are available in an ordinary SA or société par actions simplifiée (SAS) in France.

In either case, directors are named by the shareholders. Directors' terms of office are to be set by the company's bylaws, but may not exceed six years, which may be renewed. In the two-tier system, the members of the management board are named by the supervisory board. Member States may set the minimum and maximum number of directors. An administrative board must meet at least every three months; in the case of a two-tiered structure, the management board must report to the supervisory board at least every three months.

The Regulation specifies that the SE's bylaws may designate what types of decisions will require specific authorization by the administrative board, or by the supervisory board in a two-tiered system. Member States may also designate certain actions as requiring board approval. It is possible that some states will differentiate between a more flexible system for non-listed companies and a more rigid, formal system for public companies.[22]

There are no restrictions in the Regulation on who may own shares in an SE, although national restrictions on foreign investments by non-EU nationals will continue to apply. Subject to such restrictions, non-EU companies may take majority positions in an SE, and as mentioned above, an SE may be wholly owned. The Regulation provides that where separate classes of shares exist, any decision requires the approval of the relevant majority of each class of shares. There are no provisions for shares with multiple votes, or for shares with limited voting powers.

An SE must have minimum stated capital of Euro 120,000, but this amount may be set higher by the Member States. All accounting rules and audit requirements are to be determined by the Member States, on the basis of the rules applied to existing "public" limited companies.[23]

An SE incorporated in one Member State may operate in other jurisdictions either through branches or subsidiaries, which may take the form of either a subsidiary SE or another corporate entity. A branch of an SE, however, will be treated as the same as a branch of any other foreign corporation, and will have to be registered. Operational and administrative savings from the use of a branch, therefore, may be limited, and a branch of an SE will have no advantage over a branch of any other form of foreign corporation.

Overall, the SE corporate governance structure is fairly rigid, a reflection of its origins in the 1970s, when European corporate law was less flexible than at the present. The ability to vary the basic constitutional and voting rules by particular provisions in the bylaws is limited. The relatively high capital requirements create a barrier to incorporation that will reduce the utility of the SE form for many small- and medium-sized businesses, and the formalized structure will make it less interesting for corporate groups accustomed to highly contractualized shareholder relationships.

Location of an SE

One of the major benefits expected from the SE was the ability for a corporation to freely transfer its seat of incorporation from one Member State to another. Prior to the Regulation, such a transfer was effectively impossible. The European Court of Justice has in fact held that the right of free mobility of capital, granted by the European Treaty, did not extend to a corporation's ability to transfer its place of incorporation.[24]

Most European countries have adopted a "real incorporation" theory, under which a corporation must be incorporated under the laws of the Member States in which it has its administrative headquarters. Further, transferring the headquarters from one Member State to another entails the dissolution of the existing corporation.

The Regulation adopts the real incorporation doctrine, and provides that an SE must be located in the same Member State as its administrative office.[25] However, the Regulation also provides that the SE may be transferred to another Member State without losing its legal persona. This process requires certain notifications and publications.[26]

The transferability of the SE represents a genuine advance under European law. At the moment, the formation of an SE will often present the only possibility for companies to transfer their incorporation and corporate headquarters between Member States.[27] Commentators have speculated that companies may use the SE form for venue shopping, to take advantage of changes in various Member States' national corporate laws. The process for relocation laid out in the Regulation appears practicable, and some multinational companies have begun exploring its advantages.[28]

Labor Law

The issue of employee participation in the oversight of a business was one of the most difficult points in the negotiation of the SE. This is reflected in the fact that while the formation and internal regulation of an SE are set out in the Regulation, which has direct effect in all Member States, the labor law implications of the SE are provided by way of the Directive. Member States have considerable freedom to innovate or vary specific provisions in transposing the Directive requirement into national law.[29]

The basic premise of the Directive is the maintenance of the status quo for employee rights: creation of an SE must not reduce or circumvent the existing rights of employees in the Member State in which the SE is established.[30] However, incorporation of an SE does not give rise to a right of employee participation on the board of a company where such a right did not previously exist.

The scope of the employee rights is determined at the time the SE is formed. In principle, these rights are to be determined before the company's incorporation by negotiation between management and employee representatives. An SE cannot be incorporated without a negotiated agreement for employee involvement, unless the company adopts the default rules described below.

When two or more companies decide to create an SE, regardless of the manner of its formation, they must form a "Special Negotiating Body," composed of employee representatives from the various companies involved in the transaction. Representation on the Special Negotiating Body is allocated according to the nationality of the employees concerned, with one seat per 10% of the total number of employees located in a given country.[31] A number of matters, such as the role of the management of the companies forming the SE and the method of selecting the members of the Special Negotiating Body, are left to national law.[32]

The Special Negotiating Body negotiates with management of the companies creating the SE, with the aim of reaching a written agreement on employee rights. Negotiations may last up to six months, and may be extended by unanimous consent for an additional six months.

The Standard Rules

If the parties fail to arrive at an agreement by the end of the negotiation period, the Directive specifies certain "Standard Rules" which may be imposed by default. The rules are fairly technical and are subject to modification during the process of transposition into national law.

To prevent employee representatives from forcing the adoption of the Standard Rules by simply refusing to negotiate, the Directive provides that if the Special Negotiating Body never enters into discussion with management, or breaks off negotiations prior to the expiration of the six-month negotiating period, the Standard Rules will not apply. In such a case, national labor law on employee rights would presumably apply.

The Standard Rules specify the composition of the SE shop committee, which would be made up of employees of the SE, as well as all of its subsidiaries and branches, with seats allocated on the basis of proportional representation of the nationality of the companies concerned. Election or appointment of employee representatives would be in accordance with national legislation.

The Standard Rules also specify the information and consultation rights of the shop committee. Such rights would be limited in scope to questions concerning the SE itself and its foreign subsidiaries and branches, and other questions that exceed the powers of the shop committees in a single Member State. The shop committee would have the right to all documents provided to the general shareholders meetings and to the agenda of board meetings. Employee representatives would have the right to meet with the board at least once a year for consultations, and must be informed and consulted concerning exceptional circumstances, such as relocations, transfers, downsizing, or plant closures, that would have a considerable impact on employees' interests.

The Standard Rules set out procedures for employee participation in company decisions. Employees will have the right to name representatives to sit as directors on the board of the SE. The number of board seats is determined on the basis of the highest proportion of employee representation existing in the companies that participated in the formation of the SE. Such employee designated board members will have the same rights as board members elected by the shareholders, including the right to vote.

Employee participation, in the sense of appointing directors, will apply only (i) in an SE created by transformation, when the pre-existing corporation allowed such participation; (ii) in an SE created by merger, when participation rights existed in the merging companies and covered more than 25% of the total employees of those companies;[33] or (iii) in an SE created by formation of a holding company or subsidiary, when participation rights existed in the companies creating the SE and covered more than 50% of the total employees of those companies.

The participation rights granted to employees under the Directive will be a primary concern for companies in jurisdictions where such participation is not typical.[34] The 25% threshold for requiring employee participation after a merger is fairly low, and would impact, for example, many mergers with German or French companies.

Negotiation between the Special Negotiating Body and management prior to the creation of an SE, especially in a merger situation, will essentially be conducted "in the shadow" of the Standard Rules, and the default participation requirements will serve as an incentive for management to seek a compromise agreement. In addition, the mandatory six month to one year pre-incorporation period for negotiations could significantly hamper the ease of use of the SE form.

Status of Implementation

In theory, both the Regulation and the Directive became directly effective throughout the EU on October 8, 2004. EU regulations do not require transposition into national law, and in theory the Regulation is now directly applicable in France.

In practice, however, implementation of the Regulation will require legislation on the part of the French government. Until this transposition is complete, companies will not be able to make use of the SE form, as the various national registries will almost certainly refuse SE incorporation papers until the SE form has been specifically legislated into national law. Less than half of the Member States have enacted the national laws that would make it possible to incorporate an SE.[35]

French company law currently provides for two main forms of share corporation: the SA, a form of corporation that may be publicly listed; and the SAS, a simplified form of corporation that cannot be listed, and which offers far greater flexibility in the structuring of the company's bylaws. The Regulation effectively requires that the SE in France take the form of an SA.

In France, two separate sets of bills have been introduced in the Senate to implement the Regulation and the Directive under French law.[36] This legislation will not come up for consideration, however, until the spring of 2005, and actual implementation will probably not be possible until the following summer or fall.

Though the pending bills differ in various details,[37] implementation of the Regulation will entail general changes to French company law. For example, both sets of bills would eliminate the current requirement that an SA have at least seven shareholders, and would allow some freedom in the structuring of a single-shareholder SA. However, under either of the proposals being considered, a closely held SA will be less flexible than an SAS. The provisions for a single-shareholder SA are intended primarily to permit the creation of a single-shareholder SE, rather than to provide an attractive alternative form for purely French companies. As a result, in some cases the SAS form will still be of more use than the SE in restructuring international groups operating in France.

Conclusion

The provisions in the Regulation concerning international mergers and the cross-border transfer of companies' registered offices are concrete advances in European corporate law, although the Regulation will not alleviate the burden of complying with the national merger rules of each jurisdiction in which a participating company is incorporated.

The failure to establish uniform EU-wide tax treatment for the SE is a handicap. The SE will effectively be taxed in the same way as any other corporation established in an EU Member State, and the SE's ability to establish branches or subsidiaries in other countries will therefore provide no special advantage over other corporate forms. The corporate governance structure for the SE is not particularly well suited to joint ventures or closely held groups, where contractual flexibility in drawing up a company's bylaws is required.

The primary function of the SE, for the near future, will probably be in the merger of large, listed companies from different EU countries. Such countries are already accustomed to corporate governance regimes fixed by law and stringent employee participation requirements. For these companies, the ability to freely seek jurisdictions with favorable corporate, financial, and administrative environments may be beneficial.

Endnotes

1. Council Regulation (EC) No. 2157/2001 dated October 8, 2001, OJEC 10.11.2001, L 294/1.
2. Council Directive 2001/86/EC dated October 8, 2001, OJEC 10.11.2001, L 294/22.
3. All matters not expressly covered by the Regulation, or specifically reserved for treatment in the Company's bylaws by the Regulation, will be governed either by national law concerning the SE or national law relating to a "public limited-liability company" incorporated under national law. The companies that qualify as such are set out in Annex I to the Regulation, and for France, the list includes only the société anonyme (SA). It should be noted that "public" companies, as the term is used in the Regulation, are not necessarily listed companies, but rather companies of a form that may be listed, pursuant to national law. Similarly, the phrase "private limited-liability companies" as used in the Regulation includes only the corporate forms specifically listed in the Regulation. For example, in France, only the société à responsabilité limitée (SARL) is listed as a private limited-liability company. The société par actions simplifiée, a relatively recent corporate form created in France to allow more flexibility in corporate governance, and the société en commandité par actions, a corporate form in which management control and economic rights are separated, are not included in the Regulation as either a public or private limited-
liability company.
4. Monique Luby and Anne Marmisse, *Droit européen des affaires - Les politiques communes*, RTDcom, January/March 2004, 178.
5. Jean-Philippe Dom, La *société européene - Aspects de droit des sociétés*, Droit et Patrimoine, No. 125, April 2004, p. 77.
6. Jean-Marc Bischoff, *Aspects de droit international privé*, Petites affiches, February 7, 2002, p. 43. A draft Directive on Cross-Border Mergers of Companies with Share Capital was approved by the European Council on November 25, 2004. Com(2003)0277 (COD). This Directive, if ratified by the European Parliament, would provide that cross-border mergers shall be governed by the national law of the respective countries in which the companies are located, and is intended primarily for use by small- and medium-sized enterprises that would not want to incorporate as an SE.
7. Only companies categorized in the Regulation as "public limited-liability companies" may form an SE by merger. Article 2, paragraph 1 of the Regulation. *See supra* note 3.
8. Article 17 of the Regulation.
9. The European Commission has noted that cross-border mergers are not legally possible in the Netherlands, Sweden, Ireland, Greece, Germany, Finland, and Denmark. European Commission, press release, November 18, 2003, MEMO/03/233.
10. Only companies categorized in the Regulation as "public and private limited companies" may create a holding SE. Article 2, paragraph 2 of the Regulation. The list of both types of companies in Annex II to the Regulation includes, with regard to France, the SA and the SARL forms. *See supra* note 3.
11. The Regulation allows a subsidiary SE to be created by all "companies and firms within the meaning of the second paragraph of Article 48 of the Treaty and other legal bodies governed by public or private law." This very broad scope is in contrast to the restrictions imposed on the creation of an SE by merger or as a holding company.
12. The Regulation provides that transformation is available only to corporate forms categorized in the Regulation as "public limited-liability companies," and therefore in France transformation is only possible for an SA. *See supra* note 3.
13. French Commercial Code, Article L 225-1. However, as discussed below, the bills currently pending before the French Senate would eliminate this requirement.
14. As discussed below, one of the bills pending before the French Senate would allow this more permissive approach.

15. Thierry Schmitt, *Aspects fiscaux de le Société Européenne*, Petites affiches, April 16, 2002, No. 76, p. 29; Jean-Claude Parot, *La société européenne-Aspects de droit fiscal*, Droit & Patrimoine, No. 125, April 2004, 93.
16. The Secretary General of UNICE, the European employers' association, commented publicly that "it is the view of business that without a proper tax-system, the SE will be like a stillborn child." One proposal for partially remedying this situation is to allow European companies to utilize a common tax base, while permitting individual Member States to continue to apply different tax rates. This concept, however, is still far from realization. *EU pushes forward with consolidation tax base plans*, International Tax Review, June 1, 2002, 4.
17. In fact, the SE is not yet included in the scope of several existing tax harmonization directives, including that concerning cross-border mergers (Council Directive 90/434/CEE dated July 23, 1990), which will need to be modified to take account of the SE. The directive concerning parent-subsidiary dividend payments (Council Directive 90/435/CEE dated July 23, 1990) was brought up to date in late 2003 (Council Directive 2003/123/EC dated December 22, 2003), and corresponding changes will be needed in the French tax regulations.
18. French Tax Code, Article 209-1. The same is true for the majority of bilateral tax treaties signed by France, which generally exempt foreign establishment income taxed in the state of origin from being taxed in France as well; the exceptions provide for French taxation of foreign establishment income in France, with double taxation being avoided by tax credits. Schmitt, *supra* note 15, at 31.
19. French Tax Code, Article 209-1.
20. French Tax Code, Article 167 bis, 201 and 221-2; Schmitt, *supra* note 15, at 32.
21. The draft Financial Law for 2005, currently pending before the French Senate, would rectify this situation. If the bill is enacted as drafted, transfer of a company's place of incorporation from France to another Member State will not be deemed a dissolution, and the company will not be subject to accelerated taxes. This provision would apply equally to an SE and to any other French corporation that transfers its incorporation outside of France. First Part, Article 17, Projet de loi de finance pour 2005.
22. Jean-Philippe Dom, *supra* note 5, at 85.
23. As discussed in footnote 3, *supra*, an SE is not necessarily a listed company. It may be wholly or closely owned. However, as the Commission's primary goal was to create a corporate vehicle for large, trans-European companies that would often be listed, the Regulation requires that rules governing annual reports, auditing, and the preparation of annual and consolidated accounts for an SE must be the same as for "public limited-liability companies" incorporated under national law (i.e., in France, the rules applicable to an ordinary SA).
24. ECJ, September 27, 1998, AFF 81/87; The Queen c/ HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust Pic, Rec-5483, RTD Europ. 1990, 357.
25. As regards the formation of an SE, the Regulation provides that both the registered and administrative offices of the companies creating an SE must be located within the EU, though not necessarily, for any given company, within the same Member State. After incorporation, individual Member States may require that the SE have its registered office in the same place as its administrative offices.
26. The Regulation limits governmental restrictions on transfers of incorporation to only those measures necessary to protect creditors, minority shareholders, and the "public interests."
27. The European Commission has launched several public consultations concerning a 14th Company Law Directive, which would aim to allow all European businesses to transfer the place of incorporation across EU borders. However, plans for such a directive have been under discussion for at least 7 years, and no immediate action can be foreseen. *Commission Consults on the cross-border transfer of companies' registered offices*, European Commission press release, February 26, 2004, IP/04/270.
28. General Motors, for example, has reportedly considered relocating its corporate headquarters from Switzerland to Brussels, and restructuring as an SE. *GM Considers Moving European HQ to Belgium as German Unions Show No Signs of Let-Up*, WMRC Daily Analysis, October 25, 2004 WL 93607941.
29. For example, Member States have some room for maneuver in designating how the Special Negotiation Body is to be chosen, and in limiting the information obligations of the board of directors. Francis Collin, *La Société européenne*, Actes pratiques – Sociétés - Editions du Juris-Classeur, Mal/Juin 2002, 10.
30. Directive, Whereas Clause 3; Collin, *supra* note 29, at 11.
31. In the case of a merger, additional seats may be granted so as to insure that all companies that will cease to exist after the merger are represented.
32. In France, it seems probable that transposition of the Directive will follow the model of the European Enterprise Committee, and therefore will grant considerable power to union representatives. Francis Collin, *La société européenne - Aspects de droit social*, Droit & Patrimoine, No. 125, April 2004, p. 88.
33. Member States may, in the transposition of the Directive, waive the application of the employee participation rights.
34. Germany, Austria, Luxembourg, and the Scandinavian countries generally provide for strong employee participation and co-decision; Belgium, Italy, and the United Kingdom provide for very few such powers; and the remaining EU Member States typically fall in between. However, the specific range of powers and responsibilities granted to employees varies widely by country, sector, and corporate form, and the interaction of these different systems at the level of the SE will be complex. Evelyne Pichot, *Participation des salariés aux organs des sociétés en Europe*, Petites affiches, No. 76, April 16, 2002.
35. As of October 2004, only Austria, Belgium, Finland, Denmark, Iceland and Sweden had taken the necessary steps to transpose the Regulation and the Directive.
36. Proposition de loi, presented by Senators Jean-Guy Branger and Jean-Jacques Hyest, No. 152, Ordinary Session 2003-2004, July 29, 2004, and Proposition de loi, presented by Senators Jean-Guy Branger and Jean-Jacques Hyest, No. 438, Ordinary Session, 2003-2004 (the "Branger-Hyest Bills"); Proposition de loi, presented by Senator Philippe Marini, No. 11, Ordinary Session 2003-2004, October 9, 2003 (the "Marini Bill"). However, only the Branger-Hyest Bill addresses the transposition of the labor law issues set out in the Directive. Significantly, this bill would require employee participation in any SE formed by merger, as a holding company or as a subsidiary, if any employee participation was previously granted in any company participating in the creation of the SE. This provision eliminates the 25% threshold set out for employee participation in mergers and the 50% threshold for holding companies and subsidiaries, dramatically expanding the scope of employee participation rights.
37. Only the Branger-Hyest Bills, for example, would allow companies having their administrative offices outside the EU to participate in the formation of an SE, so long as the company is incorporated and has its registered office in an EU Member State and has significant economic ties to the EU.

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Balancing Sovereign Creditor and Debtor Rights Under New York Law

By James Gathii

Since the mid-1980s when the *Allied Bank International v. Banco Credito Agricola De Cartago*[1] decision was handed down by the second circuit, the sanctity of sovereign loan contracts became the reigning paradigm guiding decisions in enforcement litigation. As a result, New York and federal courts deciding cases on sovereign debt involving New York creditors were stripped of their discretion to use balancing considerations such as comity and the act of state doctrine. Since then, these courts have also progressively eliminated statutory, equitable and other defenses previously available to sovereign borrowers.

A primary manner in which sovereign debt litigation has turned in favor of New York creditors and against sovereign borrowers is by courts' upholding the unimpeachability of hell-or-high water clauses in sovereign loan contracts. Thus, while default is a foreseeable contingency in sovereign debt lending involving largely poor countries, hell-or-high water clauses now make it inexcusable to default even if a default was inadvertent and the defaulting sovereign had made immediate efforts to cure the default. Yet, a non-sovereign borrower who has made immediate efforts to cure an inadvertent default is generally entitled to relief against acceleration.[2]

Allied became the first case to characterize defaults of sovereign debt as a repudiation or a taking. This mischaracterized the nature of sovereign defaults, which are all too common and foreseeable and are treated in most legal systems and under international commercial law as inadvertent unless they were part of a country's desire to disavow or repudiate its debt. In fact, before *Allied* was decided, the policy of cooperative debt adjustment had been designed precisely on the premise that defaults would occur and as such to provide a framework under which creditor and sovereign debtor interests would be balanced. Under this framework, defaults would lead to cooperative readjustment or refinancing of sovereign debt between lenders and borrower countries with the blessing and support of the International Monetary Fund (IMF), and the richest countries of the world. Banks would continue lending new money. Under this arrangement, the IMF would bail out the indebted economies; the indebted countries would at the direction of the IMF on a case-by-case basis renegotiate and refinance their loans with the voluntary participation of the commercial lenders; and indebted countries undertook to commit to stringent macroeconomic stabilization programs as a precondition to qualifying for new money.

A large part of sovereign debt held under New York law traces its origin to the 1989 Brady Plan, named after the then U.S. Treasury Secretary who initiated the securitization of sovereign debt. Under this plan a sovereign's loans were pooled together from several banks and then repackaged as bonds. These were then offered to the public in the secondary market. The indebted country would then make cyclic payments to a trustee for distribution to bondholders. One of the advantages of securitization was that it reduced servicing obligations where the bonds were discounted. Big lenders who held a huge portion of sovereign debt could sell some of it off, and the SEC allowed them not to reflect the difference between the par value of the securitized loan and its recorded value as a loss.[3]

Securitization also introduced small investors into the sovereign debt market. Prior to the debt crisis this market was dominated by large lenders with long-term relationships with foreign borrowers. These lenders wanted to see sovereign borrowers succeed economically so that they could pay old debt and borrow new money. By contrast, many new small players in the sovereign debt market bought bonds for short-term profit. Unlike the big banks, these small investors were not committed to cooperative debt adjustment. In addition, they were not often susceptible to the peer pressure that large lenders exert between themselves to prevent defections from restructuring loans when the very foreseeable likelihood of default occurs.

The *Allied* case arose from a syndicate of lenders that had advanced money to three Costa Rican state-owned banks. Allied International was the trustee for the 39 bondholders in the syndicate. In July 1981 the Central Bank of Costa Rica suspended all external debt payments as a result of escalating economic problems in the country. In November 1981, the Costa Rican President issued an executive decree conditioning all external debt payments on express approval by the Central Bank. This resulted in non-payment of amounts due and owing to Allied. Allied then sought to accelerate payment as provided in the loan contract. In July 1982, the District Court dismissed Allied's summary judgment motion and applied the act of state doctrine to foreclose the acceleration. In September 1983 a refinancing agreement was signed between Costa Rica and Allied as an agent for 38 of Costa Rica's 39 external creditors.

Fidelity Union Trust Company of New Jersey, the 39th member of the syndicate, refused to accept the refinancing agreement and defected from it. The refinancing nevertheless went into effect, and Costa Rica began making payments to the remaining 38 creditors with the exception of Fidelity Union. Upon appeal by Fidelity

Union, on April 23, 1984, the second circuit affirmed the district court's dismissal of Allied's motion and applied the comity doctrine to foreclose acceleration, likening Costa Rica's refinancing to a domestic bankruptcy proceeding.

The application of the comity doctrine by the court was condemned by an unusual coalition of banking and foreign business organizations. The financial press criticized the decision denying relief to Fidelity Trust as an example of how courts were legitimating the unilateral repudiation of sovereign loan contracts by foreign sovereigns at the expense of the rights of New York creditors. New York law was declared to be unsafe for creditors in the financial press. In an unprecedented action, the Department of Justice joined Fidelity Trust in seeking a rehearing of the motion by the second circuit. The second circuit agreed to a rehearing by a three-judge panel rather than *en banc*. Amicii involved in the rehearing who supported Fidelity Trust were the Rule of Law Committee, the National Foreign Trade Association and the New York Clearing House. As a result of the rehearing, the second circuit reversed itself and held for Fidelity Trust. This decision, like many to follow, heralded the sanctity of contracts doctrine in sovereign debt litigation. To reach this result, the second circuit re-characterized the act of state and comity doctrines as well as the policy of cooperative debt adjustment. Let us examine how the second circuit achieved these re-characterizations.

Re-Characterizing the Act of State Doctrine

I will first examine the re-characterization of the act of state doctrine. In its decision, the district court had applied the act of state doctrine because it found that the immediate cause of the default was the public as opposed to commercial conduct of the Costa Rican government and that the conduct of the Costa Rican government in this regard was a response to an economic crisis. Two, the court had found that the policy on cooperative debt adjustment, which the U.S. Congress and Executive branches supported, precluded judicial review of the Executive's conduct of foreign relations in a situation involving a foreign sovereign. However, on re-hearing the second circuit agreed with Fidelity and its amicii that U.S. citizens should be able to enforce their rights in U.S. courts, especially where a taking of their property has occurred abroad. In addition, on re-hearing Allied and its amicii argued that the act of state doctrine ought to be redefined to apply only where the issue is the legality of a foreign sovereign's action, and that it should not be invoked merely to avoid sitting in judgment on a foreign sovereign's conduct as proscribed under the doctrine. Further, they asserted that where a foreign sovereign's conduct violates international law, as in confiscation of the property of others, the discriminatory illegal and arbitrary nature of such conduct ought not to receive recognition by other states through the act of state doctrine.

Even assuming that the act of state doctrine did not preclude judicial review of extra-territorial confiscations of tangible property, it is unclear whether it followed that judicial review was automatically available where the property was intangible, as is the case with sovereign loan contracts. This is still an unsettled question.[4] In addition, the analysis debunking the application of the act of state doctrine was inaccurately premised on the view that a default on a sovereign loan constitutes a confiscation or a taking, a rather controversial view as already noted.

Thus, in *Allied* the court was invited to re-characterize the act of state doctrine in at least three ways. First, that it was available only where a taking or confiscation took place exclusively within the territory of the foreign state—a strictly territorialist and strange requirement in a highly globalized international financial order. Thus, unlike in *Sabbatino*,[5] where the Supreme Court found that the act of state doctrine was available where the foreign state had territorial jurisdiction, the DOJ and Fidelity's amicii argued that if any part of the transaction took place within the U.S., or if the place of performance, enforcement or collection was the U.S., the doctrine was unavailable. Next, the act of state doctrine was re-characterized in a case involving a federal question as arising under New York conflict of law rules. Thus, where a foreign sovereign's conduct is in the remotest way connected to New York, such conduct could be evaluated for its consistency with New York law and policy. Where such conduct was inconsistent with either New York law or policy or both, the act of state doctrine could not protect the act of a foreign state from judicial review. By the *Allied* court characterizing the act of state doctrine this way, the distinction between reasons precluding justiciability (to avoid embarrassing foreign sovereigns) and conditions for obtaining jurisdiction in federal courts collapsed.

Re-Characterizing the Comity Doctrine

Next I turn to the re-characterization of the comity doctrine. In its first decision, in favor of Costa Rica, the second circuit applied comity on the grounds that judicial review of the Costa Rican government's conduct was precluded for four reasons. First, the Costa Rican government's conduct was consistent with the policy of the U.S. in supporting cooperative debt adjustment as evidenced by a Presidential certification under the Foreign Assistance Act, as well as congressional support of Costa Rica's restructuring and the U.S.'s concurrence on an IMF agreed minute on the restructuring. Second, the court had held that the Costa Rican government had acted as a sovereign as opposed to a commercial actor since it was exercising a sovereign competence to address a national economic disaster. Third, and most controversially, the second circuit had analogized the Costa Rican prohibition on default and its efforts to restructure its debt to a reorganization of a business under Chapter 11, which the court argued should be given deference under the comity doctrine. Fourth, the court had held that Costa Rica had acted in good faith since immediately upon default it set in motion efforts to cure the default by re-organizing it and beginning to make payments to creditors.

On rehearing, Allied, the DOJ and its amicii argued that the earlier decision legitimized the unilateral repudiation and taking of debt by a foreign sovereign and that it gave foreign sovereigns the power to unilaterally impose terms on creditors. Further, they argued that the decision effectively made New York law unsafe for lenders since these lenders forever lost their right to enforce defaulted/repudiated debt through litigation. A major clarion call for reversing this decision was that it would result in a major financial meltdown—New York banking houses would come crashing down as borrowers would have a field day defaulting and repudiating their debts. Such a consequence, Allied and its amicii argued, was not warranted because, in their view, creditors' participation in debt restructuring was voluntary, and judicial recognition of such restructuring plans as a defense to acceleration was inconsistent with the non-binding nature of the debt restructuring process and of the sovereign debt contracts they had signed with indebted sovereigns that made default inexcusable.

Rather than proceeding from the premise that comity conferred discretion on courts to enable them to interfere with Executive conduct of foreign affairs, thereby avoiding embarrassing foreign governments, Allied and its amicii apparently convinced the court that comity in this case was governed by New York law. Under this understanding of comity, the public policy of New York was to promote predictability of result in international transactions and to bar foreign law from defeating justified expectations of New York creditors. Further, comity under New York law, according to Allied and its amicii, did not preclude courts from examining whether exchange control regulations imposed by foreign governments and debt re-negotiations constituted confiscating moratoriums, repudiations or takings of the property of New York creditors, even if these arrangements had validity under the IMF's Articles of Agreement.

Under this understanding of the comity doctrine, foreign conduct cannot extinguish the rights of a New York citizen since this would be in violation of the liberty of contract doctrine. In effect comity became re-characterized solely as a check-off list inviting judicial scrutiny of foreign sovereign conduct for its compatibility with New York law and policy, rather than as a way of preserving judicial discretion to balance the interests of New York creditors and of foreign sovereign debtors.

Assuming for a moment that this re-characterization of comity is accurate, it is unclear whether a simple default, as in the case of Costa Rica in *Allied*, could be construed as being so egregious as to violate some fundamental principle of law or conception of morality under prevailing New York law. In other words, a default under New York law in a case involving a domestic as opposed to a sovereign borrower does not rise to a violation of a fundamental principle of law justifying the kind of relief Allied was granted by the second circuit on rehearing.[6] Further, this re-characterization of comity as a conflict of law rule where the act of a foreign state is involved incorrectly characterizes comity as a matter of state law rather than as a matter of federal law.

Finally, Fidelity succeeded in having the second circuit reverse itself because the DOJ argued that cooperative debt adjustment only applied to public and not private debt and that cooperative debt adjustment did not support leaving U.S. creditors without due process safeguards upon restructuring. Although the system of cooperative debt adjustment was designed to balance, and continues to be widely acknowledged as balancing, that the rights of private creditors and sovereign borrowers, the coalition of creditor groups in the *Allied* case argued that was only one of several policies of the U.S. government and that the policy of the U.S. government in supporting the contractual rights of U.S. creditors prevailed over the U.S. policy in support of cooperative debt adjustment.

Since the *Allied* decision, several decisions on sovereign debt in New York courts and in the second circuit have progressively enhanced creditor rights by holding that sovereign debt contracts are irrevocable and that defaults are inexcusable even in the face of defenses otherwise available to borrowers of New York credit, with the exception of sovereign borrowers. Thus, sovereign borrowers have been stripped of defenses such as impossibility of performance, financial difficulty, *force majeure* and generally any form of equitable relief even where a default was the direct result of an act of a foreign state to meet a public emergency and to repair the impairment of public credit.

A Conclusion and a Reform Proposal

Thus, New York courts, the executive branch and New York creditors in a variety of ways have demonstrated a reluctance to resort to cooperative, transnational solutions in a manner that balances the rights of New York creditors against the competing interests of foreign sovereigns. A major consequence of the jettisoning of cooperative debt adjustment through the judicial process is that it has undermined the IMF's programs in indebted economies that are designed to help them repair their economies with a view to enabling them to attract more credit through refinancing and to avoid the politically troublesome consequences of disrupting basic services like education and health.

The decision in *Allied* also gave the executive branch the power to construe the meaning of sovereign debt contracts. In fact, *Allied* was a perfect case in which a court abdicated its role to impartially determine a legal dispute by acquiescing in the intervention of the Department of Justice and reversed itself in a commercial dispute that was not within the traditional domain of the foreign affairs power. After all, in *Allied*, as in many cases of sovereign default, there had been no expropriation or repudiation to justify executive intervention to protect the rights of citizens.

A major consequence of *Allied* and its progeny is that it exacerbated problems of debt servicing for sovereign debtors. For these debtors, access to capital is now all the more expensive, which makes it harder for them to achieve the goals of economic growth and poverty reduction. In essence, a significant consequence of *Allied* was that it passed on most of the risks of sovereign borrowing to sovereign borrowers and removed the risk to New York creditors like Fidelity Trust, who are engaged in speculative purchases of sovereign bonds, or to the big lending houses that were involved in the over-lending practices of the 1970s and 80s that in part contributed to the Third World debt crisis. Thus, under the sanctity of contracts view that has emerged since *Allied*, the role of contracts is to merely allocate risk without regard to the nexus of rights and correlative duties implicit in the cooperative enterprise of debt adjustment.

A possible remedy for this unbalanced allocation of risk is the multiplication of choice of law and venue options in sovereign debt contracts to combat the New York court's re-characterization of sovereign debt contracts as solely governed by New York law without regard to the concerns or interests of foreign sovereigns, in the hope of avoiding a clash between different legal systems predicated on distinct social and political priorities. Under this proposal, sovereign borrowers and creditors would have the option to resort to international commercial law and arbitration, not because these regimes of law are unproblematic, but because they offer the possibility of a more balanced consideration of the law, equities and interests of both the creditor and the debtor. For example, international commercial law defines repudiation as the intention not to make any interest and principal payments, and unlike a simple default, repudiation entitles a creditor to acceleration. While there is Supreme Court jurisprudence exhibiting reluctance to disturb the balance of interests between creditors and borrowers and expressing concern over the financial impact of litigation on struggling creditors,[7] such concerns might be best addressed outside the U.S. judicial system where U.S. creditors have the weight of precedent in their favor.

In conclusion, as the Supreme Court stated in *Bremen v. Zapata*,[8] which it upheld a forum selection and choice of law clause, "the expansion of American business industry will hardly be encouraged, if American courts insist on a parochial concept that all disputes must be resolved under our laws and in our Courts."[9]

Endnotes

1. 757 F. 2d 516 (1985).
2. *Fifty States Mgmt. Corp. v. Pioneer Auto Parks Inc.*, 46 N.Y. 2d 573, 577-8 (1979).
3. The SEC did this by endorsing a FASB suggestion on how to treat loan loss to the effect that a recording of a loss was unnecessary if the total future discounted cash receipts of the new loan equaled or exceeded the book value of the loan.
4. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS OF THE UNITED STATES § 444 reporters' n.4, cmt. e (1987). The following cases illustrate this lack of clarity: *French v. Banco Nacional de Cuba*, where the N.Y. Court of Appeals held that "It is plain enough on the face of the Statute [Second Hickenlooper Amendment]—and absolutely clear from its legislative history—the Congress was not attempting to assure a remedy in American Courts for every monetary loss resulting from actions, even unjust actions, of foreign governments. *French v. Banco Nacional de Cuba*, 242 N.E.2d 704 (1968). The law is restricted, manifestly, to the kind of problem exemplified by the *Sabbatino* case itself, a claim of title or other right to specific property which had been expropriated." *Id*. at 711–13. By contrast, in *West v. Multibanco Comermex*, the Ninth Circuit did not concur with the French decision, which it argued was inconsistent with the underlying principles of the Hickenlooper Amendment. *West v. Multibanco Comermex*, 807 F.2d 829 (9th Cir. 1987), *cert. denied* 482 U.S. 906. The Circuit Court declined to agree with the proposition that ownership interests in certificates of deposits were contractual and thus not tangible property that could be expropriated within the terms of the Amendment. Instead, the court held that the "tangibleness" of property was not a dispositive factor. *Id. See also Hunt v. Coastal States Gas Prod. Co.*, 583 S.W.2d 322 (Tex. Sup. Ct. 1979), *cert. denied*, 444 U.S. 992 (1979) (holding that the right to explore for and extract oil is not a property right).
5. *Banco Nacional de Cuba v. Sabbatino*, 376 US 398 (1964).
6. *Locuks v. Standard Oil Co.*, 224 N.Y. 99, 11 (1918); RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 90 cmt. c (1971) (substantially all commentators agree that foreign-based rights should be enforced unless judicial enforcement of such a contract would constitute approval of a transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense, citing *Intercontinental Hotels Corp (Puerto Rico) v. Golden*, 15 N.Y. 2d 9, 13 (1964)).
7. *Grupo Mexicana de Desarrolo, S.A. v. Alliance Bond Fund Inc*., 527 U.S. 308 (1999) (where the court declined to grant a mareva injunction to a non-judgment creditor because doing so would "radically alter the balance between debtor's and creditor's rights which has been developed over many centuries . . . [and] such a remedy might induce creditors to engage in a 'race to the courthouse' in cases involving insolvent or near-insolvent debtors, which might prove financially fatal to the struggling debtor," *id* at 331).
8. 407 U.S. 1 (1972).
9. *Id*.

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Fiduciary Responsibilities of Corporate Directors and Officers in the "Zone of Insolvency"

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Introduction

The board of directors of a corporation is responsible for oversight and decision-making with respect to the financial health and well-being of the corporation. The board appoints and supervises the corporation's officers, who in turn implement the board's policies. In the case of solvent corporations, the board owes fiduciary duties to the corporation and its stockholders. However, when a corporation is insolvent or bankrupt, the board's duties expand to include creditors and other stakeholders in the corporation, such as employees and pensioners. Evolving case law, primarily in Delaware, the state of incorporation for many corporations, has held that the expansion of the board's fiduciary responsibilities to creditors and others commences prior to actual insolvency or bankruptcy, to a period called the "vicinity" or "zone" of insolvency, when the finances of the corporation are deemed to be inadequate to assure an ongoing enterprise. The definition of this period has been held to be as much as three years prior to any actual insolvency, placing boards in a position of uncertainty as to whom their duties are owed. Judicial review of directors' action always occurs after the fact. Therefore, the examination of board conduct when the corporation entered the "vicinity of insolvency" is necessarily a retrospective scrutiny, which holds the potential of a reduction or elimination of the deference traditionally accorded to directors pursuant to the "business judgment rule," a doctrine allowing wide latitude for corporation decision makers. In addition, the common indemnification provision for corporation directors for their corporate acts may be ineffective against creditors. Accordingly, directors of corporations should carefully review all available information and document the analysis and review conducted by the board prior to making decisions which could be perceived as leading to the corporation's insolvency, and it should continue to engage in such reviews and gather the relevant documentation during the corporation's insolvency.

I. The Role of Corporate Directors

Directors of a solvent corporation owe fiduciary duties of care and loyalty to the corporation and its stockholders.[1] Directors of a solvent corporation generally do not owe such duties to a corporation's creditors.[2] However, when a corporation becomes insolvent, or is on the verge of insolvency, courts have expanded the application of such duties, especially to include the creditors of the corporation. As a leading Delaware case has observed:

> The general rule is that directors do not owe creditors duties . . . absent 'special circumstances . . . e.g. fraud, insolvency, or a violation of a statute' . . . when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.[3]

Accordingly, once a corporation enters the "vicinity of insolvency," the responsibility of the board shifts from protecting the interests of stockholders to that of a fiduciary protecting the interests of creditors and the entire corporation enterprise, in addition to the stockholders. The actions of the board taken during this period will be subject to judicial scrutiny to determine if the board properly performed its fiduciary duties and protected all of the various corporate constituencies.[4]

"[D]irectors of corporations should carefully review all available information and document the analysis and review conducted by the board prior to making decisions which could be perceived as leading to the corporation's insolvency. . . ."

This expansion of duties is both extremely significant and not well defined. Classically, the relationship between a corporation and various interested parties, such as creditors, employees, pensioners and others is contractual: the terms and conditions of the contract spell out the obligations of the parties, which are subject to legal enforcement. In the world of the "vicinity of insolvency," when there is a significant likelihood that the corporation will have insufficient resources to satisfy all of its constituents, courts have announced that corporate boards owe duties to persons other than solely the stockholders. Courts will determine whether directors have put the interests of stockholders, directors and corporate officers above those of others who rely on the solvency of the corporation. Under this analysis, at a certain point in time, when the solvency of the corporation is determined to have been at risk, the duties of the members of a corporate board shift from the corporation and its stockholders to the corporate enterprise as a whole, including creditors and other parties. The determination of just when this shift takes place is obviously a critical element in corporate governance, and courts are just beginning to define the timing of such a shift.

II. Defining the Zone of Insolvency

Unfortunately, there is no precise definition of the "vicinity" or "zone" of insolvency. In the seminal case of *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications*,[5] the Delaware Chancery Court held that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [i.e., the stockholders], but owes its duty to the corporate enterprise."[6] Interpreting this decision a year later, another Delaware Chancery Court case, *Geyer v. Ingersoll Publications Company*, defined the timing of the creation of the duties of directors to creditors as the "moment of insolvency in fact"[7] (that is, the point at which the entity is unable to pay its debts in the ordinary course of business or has an excess of liabilities over assets) rather than the filing of an actual bankruptcy proceeding or other insolvency pleading. Building on *Credit Lyonnais* and *Geyer*, the Massachusetts District Court, applying Delaware law in *In re Healthco International, Inc.*, held that duties to creditors may arise *prior to the moment of insolvency*, when a corporate transaction authorized by the directors leaves the corporation with "unreasonably small capital . . . which creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency."[8] Most recently, U.S. District Court Judge Robert Sweet of the Southern District of New York, in *Pereira v. Cogan*, concluded that the "zone of insolvency" period for a corporation extended to over three years prior to a bankruptcy filing because its capital was inadequate to provide a "reasonable cushion to cover the variability of its business needs over time."[9] In *Cogan*, the Court determined that waiting until the actual moment of insolvency was too late, because "[b]y the time a corporation cannot pay its current maturing debts—or is in the vicinity of not being able to pay its current maturing debts—it would be too late to protect a creditor's interest in such a way as to give the fiduciary duty any meaning."[10]

For corporate directors, the expanding definition of the "vicinity of insolvency" requires substantial vigilance on the part of directors with respect to analyzing the financial strength of a corporation. Certain corporate actions are especially subject to judicial review if the company eventually becomes insolvent: leveraged buyouts, which often weaken a company's balance sheet by expanding debt and reducing equity, while simultaneously enriching stockholders, directors, and/or officers, have been the subject of many of the cases discussed in this article.

III. Determination of Insolvency

Insolvency does not have a single meaning. First, there is "balance sheet insolvency," which describes the situation where the corporation's liabilities exceed the fair value of its assets. This is the standard under the Bankruptcy Code.[11]

Cash flow or "equitable" insolvency is another definition of insolvency, and refers to a situation in which an entity is unable to meet its current obligations as they come due, even though the value of its assets exceeds its liabilities.[12] The Uniform Commercial Code ("UCC") essentially applies both standards: a person is insolvent under the UCC when he has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they fall due, or when he is insolvent within the meaning of the Federal Bankruptcy Law.[13]

One of the more difficult problems for board members in determining solvency is the application of financial standards in valuing the non-cash assets of the company, in order to determine the "fair value" of the company. The company's historical balance sheet is ordinarily used as the starting point of the fair value determination and is then adjusted accordingly. The fair value of the company (i) generally assumes going concern and not liquidation value, and (ii) contemplates a conversion of assets into cash during a reasonable period of time.

Consequently, certain assets that cannot be converted into cash in a reasonable period of time might have to be valued differently for a solvent entity compared with an entity which is approaching insolvency or which would become insolvent as the result of certain actions by its board. In a significant Third Circuit case, *Trans World Airlines*,[14] the court determined that the proper point of reference for a "reasonable time" was the financial interests of the creditors: "not so short a period that the value of the goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price."[15] In *Trans World Airlines*, the court held that a 12 to 18 month period was reasonable.[16]

Other tools available to corporate directors in analyzing the financial status of their corporations are the Financial Accounting Standards ("FAS"), which are widely accepted methods employed in valuing the assets of a company. For example, FAS 121, *Accounting for Impairment of Long-Lived Assets and for Long-lived Assets to be Disposed of*, discusses valuation techniques in determining if an asset has been impaired, including the example of the present value of estimated future cash flows. The valuation of deferred tax assets and goodwill, assets whose valuation could significantly change as an entity becomes insolvent, is discussed in FAS 109, *Accounting for Income Taxes,* and FAS 142, *Accounting for Goodwill and Intangible Assets*.

IV. Fiduciary Duties of Directors and Officers of a Solvent Corporation

Corporations[17] and their governing boards are creatures of the law of the state of incorporation. Accordingly, state courts, applying their own law, and federal courts applying state laws and decisions, determine the relationship between a corporation and its board. Historically, the State of Delaware has been the leading state of incorporation for U.S. business corporations, and as a consequence, Delaware courts have become the leading interpreters of corporate law for the country as a whole.

In Delaware and most other jurisdictions, directors and officers owe two essential fiduciary duties to the corporation: the duties of care and loyalty. "[I]t is hornbook law that a corporate director owes the corporation fiduciary obligations of care and loyalty."[18]

A. The Duty of Care

The duty of care requires that the directors must inform themselves of all material information reasonably available to them, and then act with requisite care in the discharge of their duties.[19] This duty requires that in making a business decision, directors act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the corporation. Delaware courts take a view similar to that contained in the New York statute: "the directors 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."[20]

These duties have consequences for directors, and require proper diligence. The more significant the topic, the more the directors should probe and examine alternatives. Indeed, one court has ruled that "when the decision is to sell the company or to engage in a recapitalization that will change control of the firm, the gravity of the transaction places a special burden on the directors to make sure they have a basis for an informed view."[21]

Directors must affirmatively perform their duties, and if the directors abdicate their functions, are not informed (or choose not to obtain adequate information), or fail to act, they do not properly exercise their duty of care to the corporation, unless the inaction was a conscious decision reasonably made after a careful review of all material information.[22]

There are risks as well: Directors of solvent corporations may be indemnified by the corporation for their failure to exercise their duty of care.[23] However, in two recent cases, courts have held that indemnification is ineffective in connection with creditors' suits, as distinguished from stockholder actions.[24] Needless to say, the potential loss of indemnification, and consequent personal exposure, could be financially devastating to a director.

B. The Duty of Loyalty

The second principal fiduciary duty of directors of a corporation is the duty of loyalty. Directors must not "put their personal financial interests above the interests of the corporation."[25] The standard of the duty of loyalty was famously described in *Meinhard v. Salmon*[26] where Judge Cardozo wrote, in the context of a joint venture, that

> Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[27]

Courts have ruled that when a director has a financial interest in a transaction, he has the burden of proving the entire fairness of the transaction. "Where a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court's satisfaction."[28]

The corollary to this rule is that the normal presumption that the board of directors has acted in good faith and in the interests of the corporation is rebutted by the financial interest of directors, unless a majority of disinterested directors approve the transaction.[29] Sometimes, it may be uncertain whether directors have a financial interest, direct or indirect. In such cases, courts will again inquire as to the substance of the decision: The test of a potential conflict of interest is whether the independence of judgment of a reasonable person would be affected by the financial interest in question.[30]

As we have noted, the corporation may indemnify a director for negligence in failing to adequately satisfy the duty of care,[31] although such indemnification may not be effective in the case of a creditor's suit. However, indemnification is not available to directors who violate the duties of loyalty and good faith to the corporation, regardless of the plaintiff in a suit.[32]

V. The Business Judgment Rule: Limitations on Court Review of Directors' Actions

The business judgment rule is a court-made presumption that when directors of a corporation act on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation, the judgment of the corporate directors will be respected by the courts.[33] This is a fundamental principle of corporate governance, and it protects corporate directors from routine judicial second-guessing.

However, the presumption is rebuttable, and the standards for such rebuttal are based on violations of the duties of care and loyalty. A leading case of the Delaware Supreme Court, *Aronson v. Lewis*, held that the party challenging the actions of the directors has the burden of proof to establish facts rebutting the presumption.[34] The *Aronson* Court then set forth widely accepted standards for the rebuttal of the business judgment rule:

> If [self-interest] is present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatever. . . .
>
> To invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. . . . [D]irector liability is predicated upon concepts of gross negligence . . . the business judgment rule operates only in the context of director action . . . it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act . . . [however] a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment.[35]

Thus, the business judgment rule, while a substantial bulwark against strike suits and other complaints against corporate directors, is not absolute: corporate directors must take their duties seriously, or face potential liability.

VI. Duties of Directors of Corporations in the "Zone of Insolvency"

The duties of directors of insolvent corporations are essentially similar to those of directors of solvent corporations, except that there are additional obligations to the creditors and other stakeholders in the entire corporate enterprise.[36] As we have previously noted, "it is hornbook law that a corporate director owes the corporation fiduciary obligations of care and loyalty."[37] The extension to insolvency cases is found, for example, in *Healthco*, where the court found that "directors breach their fiduciary obligations when they authorize a transaction which prejudices creditors."[38] In the *Cogan* cases, the Court found that the directors were liable for their breach of the duty of care by passively approving the chairman's agreements during the entire insolvency period. The court noted that although the directors had not engaged in self-dealing, they "had a duty to exercise due care to prevent self-dealing from happening."[39] In short, once in the "zone," courts will tend to examine the facts more closely to determine if the directors properly performed their fiduciary duties.

Directors of corporations in the zone of insolvency owe fiduciary duties to creditors, because when the insolvency exception does arise, "it creates fiduciary duties for directors for the benefit of creditors."[40] In *Healthco*, the court emphasized both the timing and the change in the duties of the directors: "when a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount."[41]

Healthco involved a leveraged buyout (LBO) of a company which had sustained large losses, a proxy contest, and management failures. The board approved a buyout, largely financed with debt assumed by the company, and received an opinion from Lazard Frères & Co. that the transaction was "fair, from a financial point of view, to [the] stockholders."[42] The board had received advice from the company's counsel that there was potential director liability to creditors in the event of insolvency, but it nonetheless proceeded with the transaction.[43] Within a month of the buyout, the company began experiencing severe cash shortfalls, and filed for bankruptcy relief two years later.[44] Reviewing the record, the court found that the LBO left the company with "unreasonably small capital," because, among other things, the "projections lacked reality [and] left no margin for error."[45] The court held that the directors relied on, but failed to exercise active oversight over, the buyer's projections, which were not reviewed by either the board or the board's financial advisor, Lazard, and that it had also inappropriately relied on a solvency opinion, offered by a firm retained by the buyer, which ignored known losses. Because of these derelictions of duty, among other things, the directors were found to be grossly negligent with respect to their duty of care for actions taken in connection with the LBO.[46]

In *Cogan*,[47] the directors of an insolvent company approved, ratified, or were simply unaware of a series of employment compensation, loan, stock redemption and other transactions which mostly benefited the majority stockholder, who was also the CEO, as well as certain of his family members, some employees, and a lender. These transactions included (i) compensation for the CEO from the company and its affiliates in excess of $42,000,000 for a seven-year period (of which $25,755,000 was deemed reasonable compensation by the Court); (ii) a redemption of $3,000,000 in stock from a lender without board approval, when there was no surplus to pay for the redemption, as required by law; (iii) loans to the CEO of over $13,000,000; (iv) loans to the CEO's wife and other employees; (v) $460,000 in compensation paid to the daughter of the CEO, without any evidence of the value of her services to the company; and (vi) payment of over $1,000,000 for a birthday party for the CEO. The board members did not benefit directly from the transactions, but owed their employment and director positions to the CEO. The court found that the directors knew, or should have known, of many of the transactions, and that they violated their duty of care because they (i) "failed to monitor" the situation[48] and (ii) took no action, abdicating their non-delegable managerial functions.[49] The "abdication of directorial duty" also implicated breach of the duty of loyalty, because it had the effect of putting the interests of a controlling stockholder above the interests of the stockholders generally.[50] Although the company filed for bankruptcy in 1999, the court found that the company had been insolvent since at least 1995.[51] In discussing the insolvency question during continued litigation, the court adopted a three-year "cash flow and capital adequacy" model for determining solvency.[52] One commentator has noted that if the *Cogan* standard is adopted by other courts, "managers of small closely held corporations will have to change the way they do their jobs" because of potentially continuous liability to creditors for acts taken (or not taken) long before a bankruptcy filing.[53]

As we have previously noted, indemnification for negligence in the performance of a director's duty of care is not effective against creditors of a corporation in the zone of insolvency. The reason for this is that indemnity provisions are part of the certificate of incorporation, which has aspects of a contract between the corporation and its stockholders. Because of this, at least two courts construing Delaware law have found that the exculpatory clause did not bind the creditors, because "they were not parties to the contract."[54]

Since many corporate formation documents routinely provide blanket indemnification language for directorial negligence, directors of corporations in the zone of insolvency must recognize that such indemnification clauses may not provide protection in the event of a creditor suit, and they should take additional steps to ensure that their duty of care is properly carried out. Directors' and officers' insurance policies should be reviewed to ensure that indemnity is included for negligence with respect to creditors and other stakeholders, in addition to the stockholders.

VII. Aiding and Abetting Liability of Third Parties

Lastly, there are additional parties who may be exposed to liability in connection with their activities with corporations in the zone of insolvency. Such liability may be based on aiding and abetting others in breaches of their fiduciary duties.[55] The elements of an aiding and abetting claim are: (i) existence of a fiduciary relationship, (ii) breach of fiduciary duty, and (iii) knowing participation in that breach by the non-fiduciary defendant.[56] Thus, liability may be imposed on directors, officers, controlling stockholders or any other parties, such as accountants and financial advisors, who actually breached their fiduciary duties or who aided and abetted other parties in such a breach.[57]

"Court decisions in the past decade have increasingly reduced the protection of the business judgment rule for corporate directors, officers and their advisors, particularly in creditors' suits against insolvent corporations."

Summary

Court decisions in the past decade have increasingly reduced the protection of the business judgment rule for corporate directors, officers and their advisors, particularly in creditors' suits against insolvent corporations. Directors face increasing personal liability for negligence in implementing their fiduciary duties, and for affirmative decisions which, in hindsight, put the corporation at risk of insolvency. The holdings in *Credit Lyonnais*, *Geyer*, *Healthco*, and *Cogan* and their progeny reveal an increasingly expansive time frame in which directors' decisions may be reviewed, and it is likely that future judicial decisions will continue to refine, and perhaps expand, the law of director liability for corporations which eventually file for bankruptcy. Board members should be especially alert when a leveraged buyout is suggested, as courts have intensively reviewed situations in which board members and stockholders have benefited financially from such transactions while the corporation is stripped of its equity and creditors are left with crumbs to divide in a later bankruptcy. Corporate directors of troubled companies will be well advised to consider themselves fiduciaries of potential creditors in bankruptcy, at the same time that they continued to serve the traditional constituencies of the corporation, its stockholders.

Endnotes

1. *See United States v. Jolly*, 102 F.3d 46, 49 (2d Cir. 1996).
2. *See, e.g.*, *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989) (holding that bondholders are unsecured creditors, not stockholders, and that therefore the corporation owed the bondholders contractual rights, not fiduciary duties); *see also Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975) (similar holding with respect to debenture holders).
3. *Geyer v. Ingersoll Publications Company*, 621 A.2d 784, 789 (Del. Ch. 1992) (*citing Harff*, 324 A.2d at 222).
4. *See, e.g.*, Credit *Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation*, 1991 WL 277613, 17 Del. J. Corp. L. 1099 (Del. Ch. 1991); *In re Buckhead America Corp.*, 178 B.R. 956 (D. Del. 1994). *See also*, *Hechinger Investment Company of Delaware*, 274 B.R. 71, 89 (D. Del. 2002).
5. *Credit Lyonnais*, 1991 WL 277613, 17 Del. J. Corp. L. 1099 (Del. Ch. 1991).
6. *Id*. at *34, 1155. N. 55 in *Credit Lyonnais* provides an analysis of appropriate management by directors of an insolvent corporation, by inclusion of the interests of stockholders, creditors, employees, and other groups interested in the corporation.
7. *See Geyer*, 621 A.2d at 789 (citing *Credit Lyonnais*, 1991 WL 277613 n. 55).
8. *In re Healthco International, Inc.*, 208 B.R. 288, 302 (D. Mass. 1997) ("*Healthco II*").
9. *See Pereira v. Cogan*, 294 B.R. 449, 521 (S.D.N.Y. 2003) ("*Cogan II*").
10. *Id*. S*ee Hechinger Investment Company of Delaware*, 274 B.R. 71, 82 (D. Del. 2002) (citing *Healthco II* for the proposition that "unreasonably small capital" after a transaction is an appropriate test for the determination of fraudulent conveyance).
11. 11 U.S.C. § 101(32). *See, e.g.*, *Healthco II*, 208 B.R. at 301; *Geyer*, 621 A.2d at 789.
12. *See Healthco II*, 208 B.R. at 301; *Geyer*, 621 A.2d at 789; *see also* 11 U.S.C. § 303(h)(1), which applies the cash flow test in connection with involuntary bankruptcy cases.
13. U.C.C. 1-201(23).
14. *In re Trans World Airlines, Incorporated*, 134 F.3d 188, 195 (3rd Cir. 1998).
15. *Id*.
16. *Id*.
17. It may be anticipated that a similar analysis will apply for other types of entities, such as limited liability companies, although little case law has evolved determining what, if any, differences may arise from different corporate structures.
18. *In re Healthco International, Inc.*, 195 B.R. 971, 984 (Bankr. D. Mass. 1996) ("*Healthco I*") (applying Delaware law). *See Norlin Corp. v. Rooney*, 744 F.2d 255, 264 (2d Cir. 1984).
19. *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Norlin*, 744 F.2d at 264 (citing New York Business Corporation Law ("NYBCL") § 717, which requires that directors perform their duties in good faith and with "the degree of care which an ordinarily prudent person in a like position would use under similar circumstances." NYBCL § 717(a)).
20. *Graham v. Allis Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).
21. *Healthco II*, 208 B.R. at 305, citing Ernest L. Folk III, et al., Folk on Delaware General Corporation Law: A Commentary and Analysis § 141.2.1.
22. *See Aronson*, 473 A.2d at 812-13. *Pereira v. Cogan*, 2001 WL 243537 at *14 (S.D.N.Y. 2001) ("*Cogan I*"). *See also In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (holding that the lack of oversight of the contract with Michael Ovitz, which included a severance payment of $140,000,000 after one year of employment, constituted breach of the duty of care by directors).
23. See, e.g., Delaware General Business Law ("DGBL") § 102(b)(7), which permits a corporation to insert such an indemnification provision in the corporation's certificate of incorporation. See also, NYBCL § 722, authorizing the indemnification of corporate directors and officers for their reasonable acts performed in good faith for the benefit of the corporation.
24. *See infra* note 54.
25. *See Aronson*, 473 A.2d at 812-13. *Cogan I*, 2001 WL 243537 at *14. *See also In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (holding that the lack of oversight of the contract with Michael Ovitz, which included a severance payment of $140,000,000 after one year of employment, constituted breach of the duty of care by directors).
26. *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (N.Y. 1928) (citation omitted).
27. *Id*. at 464.
28. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 619 A.2d 103, 111 (Del. Ch. 1986) (citing *Weinberger v. UOP*, 457 A2d 701 (Del. 1983)).
29. *See Healthco II*, 208 B.R. at 302 (holding that an interested director is not protected by the business judgment rule absent approval of the transaction by a majority of disinterested directors); *Norlin*, 744 F.2d at 264 (holding that if self-dealing or bad faith is demonstrated, the burden shifts to the directors to prove that the transaction was fair and reasonable to the corporation).
30. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360-62 (Del. 1993).
31. *See* DGBL § 102(b)(7).
32. *See* DGBL § 102(b)(7)(i) and (ii), which require that directors act with loyalty and in good faith to the corporation.
33. *See Aronson*, 473 A2d at 812; *Spielgel v. Buntrock*, 571 A.2d 767, 774 (Del. 1990); *Graham*, 188 A.2d at 130.
34. *Aronson*, 473 A.2d at 812.
35. *Aronson*, 473 A.2d at 812-13. *See Graham*, 188 A.2d at 130.
36. These duties are more fully described in Sections III. A. and B., *supra*. *See Cogan II*, 294 B.R. at 519; *Cogan I*, 2001 WL 243537 at *8; *Healthco II*, 208 B.R. at 301; *Geyer* 621 A.2d at 789; *Credit Lyonnais* 1991 WL 277613 at *34.
37. *Healthco I*, 195 B.R. at 984.
38. *Healthco II*, 208 B.R. at 301.
39. *Cogan I*, 2001 WL 243537 at *13-14; *Cogan II*, 294 B.R. at 527-30 (holding that the directors violated their duties of care and loyalty during the insolvency period). For a minority view, *see Helm Financial v. MNVA Inc.*, 212 F.3d 1076, 1081 (9th Cir. 2000) (holding that under Minnesota law, the fiduciary duty of the directors and officers of an insolvent corporation to creditors does not extend beyond the prohibition against self-dealing or preferential treatment).
40. *Geyer*, 621 A.2d at 789 (*citing Harff*, 324 A.2d at 222).

41. *Healthco II*, 208 B.R. at 302. *See Cogan I*, 2001 WL 243537 at *8 (noting that "the fiduciary duty owed to creditors arises at a point short of actual insolvency, that is when the corporation is 'in the vicinity of insolvency'").

42. *Id*. at 298.

43. *Id*.

44. *Id.* at 298-99.

45. *Id*. at 307.

46. *Id*.

47. *Cogan II*, 294 B.R. 449.

48. *Citing In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996).

49. *Citing Canal Capital Corp. v. French*, 1992 WL 159009 at *4 (Del Ch. 1992).

50. *See Cede*, 634 A.2d at 361, 363.

51. *Cogan I*, 2001 WL 243537.

52. *Cogan II*, 294 B.R. at 509-13.

53. *See* Alec P. Ostrow, "*The Lessons of Pereira v. Cogan: Managers of Closely-Held Companies, En Garde!*" Bankruptcy Series, 2004 at 216.

54. *In re Ben Franklin Retail Stores, Inc., 2000,* WL 28266 at *8 (N.D. Ill. 2000); *Cogan I*, 2001 WL 243537 at *7-8.

55. *See*, *e.g.*, *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1057 (Del. Ch. 1984) ("It is well settled that a third party who knowingly participates in the breach of a fiduciary's duty becomes liable to the beneficiaries of the trust relationship"); *Healthco II*, 208 B.R. 208 at 309 ("Delaware recognizes a cause of action for aiding and abetting another in the other's breach of fiduciary duties").

56. *Id*. (*citing In re Santa Fe Pac. Corp. Stockholder Litigation*, 669 A.2d 59, 72 (Del. 1995)).

57. *See, e.g., In re Baltimore Emergency Services II, LLC*, 291 B.R. 382, 384 (Bankr. D. Md. 2003) (holding that a financial advisor's proposed indemnity provision would be disapproved as unreasonable because it provided for indemnities in the event of breach of the advisor's duties of care and loyalty). *See also, Healthco II*, at 309-10 (refusing to dismiss aiding and abetting claims against the eventual purchaser of the corporation and a major stockholder who had waged the proxy fight, because they assisted the breach of duties by the corporation's directors); *CMNY Capital, L.P v. Deloitte & Touche*, 821 F. Supp. 152 (S.D.N.Y. 1993) (refusing to dismiss claim against accountant for aider and abettor liability under § 10(b) of the Securities Exchange Act).

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Guardianship of Your Children

By Robert D. Bring

One of the more compelling reasons for parents to execute a Will, even if there is no substantial property to be disposed of, is that the Will may name a testamentary guardian of the minor child or children. Do not depend on "word of mouth" agreements. Although a harsh prospect to contemplate, if you and your spouse were to die simultaneously, and prior to the date when your last child has attained majority, no one would be better qualified to determine who will raise your children than you and your spouse.

If the life insurance money comes with the children, even the most distant relatives can become "loving" overnight and attempt through the Court to be named as guardian.

> *"Although a harsh prospect to contemplate, if you and your spouse were to die simultaneously, and prior to the date when your last child has attained majority, no one would be better qualified to determine who will raise your children than you and your spouse."*

The appointment of a guardian, made by a duly executed Will of either parent, will usually be effective, as to the naming of a guardian, providing that the other parent shall have died prior to the probate of such Will. However, only a married spouse, being the surviving parent, whether or not such parent is of full age, may, by his or her last Will, duly executed, determine who shall be the guardian of a legitimate minor child (born or unborn) during minority, or for any less time. As to an illegitimate child, the father may not appoint such child's testamentary guardian, although the Court may consider the father's wishes in making such appointment.

In addition, a father or mother may, during the lifetime of both of them, by a Will duly executed, and with the written consent of the other spouse, duly acknowledged, appoint the other spouse *and* a third party to be the guardians of the minor child or children. The consent of the consenting parent (other spouse) must be by sworn statement which must state that such parent is motivated solely by the welfare of the minor child or children; that the consenting parent has not received, and will not receive, any consideration for such consent; and that such consent may be revoked by such consenting parent at any time prior to the death of the other parent.

The guardianship of the person of the minor child or children, once having been issued, is not assignable; and a verbal or written contract by such guardian attempting to transfer the guardianship to another person is of no validity. Moreover, where it appears that the welfare of the infant child or children will best be promoted by removing such child or children from the custody of the appointed guardian, this power may be exercised by the Court, even though it may result in taking the child or children from their own parents or in placing such child or children in the custody of one parent to the exclusion of the other parent.

The guardian, whether appointed by Will of the surviving parent or by the Court, is a fiduciary in relation to the property of such infant; and shall take the custody and management of the personal estate of such infant and the profits of the infant's real estate, and may bring such actions in relation thereto as provided by Law. Such guardian is not a trustee in that the guardian does not acquire title to the infant's assets although the guardian is under a duty to litigate in order to protect and defend such assets against all persons.

The guardian may also maintain all proper actions for the wrongful taking or detention of the infant, and may recover damages in such actions for the benefit of his ward. By contrast, a guardian *ad litem* is a fiduciary whose scope is very limited in that his authority is confined to the one particular action, or proceeding, for which he is appointed; his two functions are to provide counsel for his ward and to see that his ward's rights are protected in the conduct of the litigation.

A guardian of the property of an infant is required, under New York Law, to file an annual accounting in the Surrogate's Court of the County of his appointment. The guardian is required to keep clear and accurate records and if he does not, the presumptions are all against him, obscurities and doubts being resolved adversely to him. The guardian also has the burden of showing that the account which he renders, and the expenditures which he claims to have made, are correct, just and necessary.

It must be emphasized that the *welfare* of the infant ward should control in the appointment of a guardian and that the Court, in exercising its sound discretion, is not bound, under all circumstances, to appoint the person named in the Will of the infant's parent as testamentary guardian, but may appoint another person as guardian, if the welfare of the child will thereby be benefited. In the situation where it is difficult or impossible to determine which of the parents died first, and both leave Wills appointing different persons as guardians, the Court will determine which of the appointments will best serve the welfare and needs of the minor child or children and appoint a guardian accordingly. However, in the absence of facts or circumstances disqualifying testamentary guardians, the statutory right of the married parent of a legitimate infant child to appoint a guardian, duly and lawfully exercised by the execution of his or her Will, which is later admitted to probate, will be respected and maintained by the Court. One Court has stated as follows:

> The policy of the Law authorizing fathers to appoint guardians for their children, the solid trust bequeathed by the decedent to his surviving friend, forbade a construction which would defeat such policy and render vain and ineffectual the hopes and a deliberate final choice of a father in last illness . . .

The Court commented further that a testamentary guardian does not receive the appointment for his own benefit, but for that of the minor.

In a divorce situation, it is customary in a Separation Agreement to provide for the custody of the minor children. Suppose, for example, custody of the two (minor) children, pursuant to the Separation Agreement, was granted to the father and thereafter, prior to both of the children having attained their majority, the father dies. In his Will, the father names his second wife (who never formally adopted the children) as the guardian of his children. Upon the probate proceeding of the father's Will, the former wife (the natural mother of the children) objects to the issuance of letters of guardianship to the second wife. It is the opinion of this writer that, although the Court would evaluate the entire situation to determine which of the two women would be more qualified and which one would be better for the welfare and needs of the minor children, the natural mother would prevail, in spite of the provisions of both the Separation Agreement and the Will of the deceased father.

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"Consent to Record" Provisions in ISDA Master Agreements

By Claude G. Szyfer, Sherri Venokur, Eileen Martinez

Derivatives transactions generally are entered into via telephonic communications and subsequently confirmed in writing. Reflecting this market practice, parties to an ISDA Master Agreement are "legally bound by the terms of each Transaction from the moment they agree to those terms (whether orally or otherwise)."[1] Furthermore, most ISDA Master Agreements[2] include a provision in the Schedule whereby the parties can consent to the recording of telephone conversations between their trading and marketing personnel. For example, the form of Schedule attached to the 2002 ISDA Master Agreement contains an optional "Recording of Conversations" provision, which the contracting parties can adopt, modify or eliminate.

Consent to record provisions assist parties to derivatives transactions in preserving their corporate relationships and avoiding the acrimony of legal disputes. Sound recordings provide a resource for counterparties to rely upon should any disagreement arise in connection with the recorded transaction. Resolving disagreements by referring to a taped recording rather than engaging in a bitter legal battle helps maintain long-lasting and profitable business relationships.

This article examines the components of a typical contractual provision relating to the recording of telephone conversations, some of the issues to consider in deciding whether to include a consent to record provision in a Master Agreement, and some of the issues to consider in drafting such a provision.

I. The ISDA Consent to Record Provision

Part 5(n) of the 2002 Master Agreement Form of Schedule provides that:

> Each party (i) consents to the recording of telephone conversations between the trading, marketing and other relevant personnel of the parties in connection with this Agreement or any potential Transaction, (ii) agrees to obtain any necessary consent of, and give any necessary notice of such recordings to, its relevant personnel and (iii) agrees, to the extent permitted by applicable law, that recordings may be submitted in evidence in any Proceedings.

In essence, this standard provision contains three separate agreements. First, the contracting parties consent to the recording of telephone conversations. Second, the parties agree to obtain the necessary consent and to provide the necessary notices of such recordings. Last, the parties agree that the sound recordings may be submitted in evidence to the extent permitted by applicable law. Although not included in the ISDA provision, frequently the contracting parties also agree to deliver a copy of any recordings to the other side upon request or in the event of a dispute.

Although market participants often view consent to record provisions such as those in Part 5(n) as innocuous boilerplate, the drafting choices that are made (or overlooked) can have important legal consequences. The following section takes a closer look at the agreements made in a consent to record provision and how some of these may influence the admissibility of sound recordings into evidence.

II. The Agreements

A. Consent to Record

Although it is common in this context for a party to record telephone conversations, it may be necessary to obtain the other party's consent in order to use the recording as evidence in a legal dispute. Moreover, in some circumstances a party could conceivably face major legal consequences for recording a conversation without obtaining the consent of the other party being recorded. For example, Title III of the Omnibus Crime Control and Safe Streets Act of 1968, as amended, gives individuals a private right of action for any improper taping of their conversations to which they did not consent.[3] Further, Title II provides for both civil and criminal penalties for anyone who intentionally (i) "intercepts, endeavors to intercept, or procures any other person to intercept or endeavor to intercept" any oral communications; (ii) uses an "electronic, mechanical, or other device" to intercept any oral communication; (iii) discloses or endeavors to disclose the contents of such intercepted communication to any other person; or (iv) uses or endeavors to use the contents of such intercepted communication.

Turning to state law, some states, such as New York, are "one-party consent" states, meaning that the consent of only one party to a conversation is necessary to lawfully record an in-person or telephonic communication. Other states, like California and Florida, are "two-party consent" states, which means that the consent of both parties to a conversation is required in order to lawfully record.[4] It is therefore particularly important that the parties to a derivatives master agreement include a consent to record provision in their Schedules if either party is located in a two-party consent state. When parties do not include a consent to record provision in their master agreement, a party located in a two-party consent state may claim that the recording should not be admitted in evidence because the conversation was not lawfully recorded. The risk of having the recording excluded from evidence becomes even greater if the legal proceeding is commenced in the two-party consent state. If, on the other hand, the parties include a consent to record provision, the contractual provision will qualify as the requisite consent, and the admissibility of the recording will not depend on whether a lawsuit is filed in a one-party consent state or a two-party consent state.

B. Obligation to Obtain Consent from Relevant Personnel

The second agreement set forth in Part 5(n) of the Master Agreement Form of Schedule, which provides that the parties agree to obtain any necessary consent of and give any necessary notice of such recordings to relevant personnel, places the onus on each contracting party to put its employees on notice that their conversations may be recorded. A party should not agree to such a contractual provision unless, through its personnel policies or otherwise, it is able to comply with these obligations. A party's failure to meet that obligation potentially may subject it to a civil suit by an employee located in a two-party consent state whose conversation was unlawfully recorded. That failure should not affect the admissibility of the recording as evidence in a case between the two parties.

C. Submission of Recordings in Evidence

The final agreement in the ISDA Consent to Record provision is that the parties may submit the recordings in evidence in any legal proceeding. This provision may actually encourage the parties to settle their disputes without litigation where the recording is definitive regarding the issue in dispute and both parties are aware that the recording would be used as evidence at trial.

It is important to note that this provision does not constitute a waiver of the contracting parties' rights to object to the admission of the recording on the basis of relevance, authenticity or quality of the taped conversation. Like the ISDA form, most consent to record provisions will state in pertinent part "each party agrees, *to the extent permitted by applicable law*, that recordings may be submitted in evidence in any proceedings."[5] Accordingly, a party is not waiving any objections it may have as to relevance, or even unfair prejudice, such as under Rule 403 of the Federal Rules of Evidence. Moreover, a party may still object on authenticity grounds, or on the ground that the tape does not contain the full discussion or that it has been edited.

For example, in New York, a sound recording usually is admissible in evidence if it is relevant and is established as genuine and unaltered.[6] As the New York Court of Appeals explained in *People v. Ely*,[7] "[t]he predicate for admission of tape recordings in evidence is clear and convincing proof that the tapes are genuine and that they have not been altered." In *Ely*, the Court of Appeals identified various alternatives to authenticate sound recordings of conversations:

- testimony of a party or witness to the conversation that the recording is complete and accurate and has not been altered;
- testimony of a party to the conversation together with proof by an expert witness that analysis of the recording did not reveal any alterations; or
- evidence concerning the making of the tape and identification of the speakers, together with testimony from all who have handled the tape as to its custody and unchanged condition (chain of custody).[8]

Where the recording contains only portions of a conversation or is substantially inaudible, it will not be admitted into evidence even if all the *Ely* requirements are satisfied. For example, if a recording is "so inaudible and indistinct that a jury must speculate as to its contents," it will be excluded from evidence, and the recording "should be at least sufficiently audible so that independent third parties can listen to it and produce a reasonable transcript."[9] Therefore, a provision allowing parties to submit recordings of conversations into evidence confers a more narrow right than may be immediately apparent. Rather, the plain meaning of the provision will be realized only if the parties can meet the standards set forth in the relevant case law. The consent to record provision does not guarantee that a sound recording will be admitted into evidence, but merely prevents the tape from being rendered inadmissible solely on the basis of its status as a sound recording.

D. Obligation to Deliver a Copy of the Recording

Many consent to record provisions also include the parties' agreement to deliver a copy of any recordings to the other side upon request or in the event of a dispute. This additional condition can become an issue in a situation where a contracting party requests a copy of a taped sound recording and is unable to obtain such a copy because it was destroyed pursuant to the recording party's internal document-retention policies. Under these circumstances, the party that destroyed the tape may face sanctions for what is known as "spoliation"[10] if a court decides that the failure to preserve the sound recording was done in either bad faith or negligently. It is critical to know the law of your jurisdiction as well as the law applicable to your counterparties.

In New York, a party seeking sanctions on the basis of the spoliation of evidence must establish that: (1) the party having control over the evidence had an obligation to preserve it at the time it was destroyed; (2) the destroyer of the records either negligently, intentionally or willfully destroyed evidence and (3) the destroyed evidence was relevant to the party's claim or defense.[11] In order to preserve relevant recordings and avoid court sanctions for the destruction of sound recordings, it is essential that contracting parties understand the terms of their own document retention policies when negotiating a Master Agreement. Where parties enter into long-term transactions, the importance of understanding one's document retention program is critical.

Generally, "[t]he obligation to preserve evidence arises when the party has notice that the evidence is relevant to litigation or when a party should have known that the evidence may be relevant to future litigation."[12] For in-house, as well as outside counsel, this obligation is especially important, as courts have held that: "Once on notice [that evidence is relevant], the obligation to preserve evidence runs first to counsel, who then has a duty to advise and explain to the client its obligations to retain pertinent documents that may be relevant to the litigation."[13] Thus, until a dispute arises or, based on conversations or correspondence between the parties, it appears that one is reasonably likely to arise, parties may continue to implement their standard document retention policies. When a dispute does arise, it is critical for in-house and/or outside counsel to get involved as early as possible, as any delay in implementing a potential "litigation hold" on the destruction of any sound recordings could be costly both in terms of a counterparty's litigation position and in terms of potential sanctions.

III. Ethical Questions for Lawyers

The recording or participation in the recording of conversations may have ethical implications for attorneys, even if they become involved at the request of a business person. For example, in New York, there are conflicting opinions as to the ethical propriety of lawyers taping conversations, both those with clients, as well as with third parties.[14] If parties have agreed to include a consent to record provision in their Schedules, then a strong argument could be made that any ethical issues are moot, as a lawyer could be considered "other relevant personnel." Similarly, if the attorney discloses at the inception that the conversation is being taped, a party would be hard pressed to demonstrate an ethical violation. Without such a consent to record provision, if an attorney is a participant to a telephone conversation that she or he knows is being recorded but that another party does not know is being taped, the attorney could run the risk of being sanctioned for ethical violations.

IV. Conclusion

A consent to record provision can serve a useful purpose in most circumstances. However, because there may be circumstances in which it is not in a party's best interest to include all four of the components that have been discussed in this article, it is critical to understand the obligations and legal consequences each component entails. A consent to record provision that is carefully tailored to the specific needs and goals of the parties can play an important role in assisting parties to derivative transactions to maintain their corporate relationships and to avoid bitter legal disputes.

Endnotes

1. ISDA Master Agreement Section 9(e)(ii) (emphasis added). In addition, under New York law, "qualified financial contracts" need not be in writing to be valid and enforceable. *See* NYGOL § 5-701(b)(1); § 5-701(b)(2) defines a "qualified financial contract" to include transactions generally thought to be derivatives transactions, with the exception of spot trades.
2. As used herein, the term "ISDA Master Agreement" will apply to both the 1992 and 2002 versions of the ISDA Master Agreement published by the International Swaps and Derivatives Association, Inc.
3. *See* 18 U.S.C. § 2511(1)(a)-(d). There is an exception for "business telephone" calls, where the monitoring of the calls and taping over an extension phone, which is provided to a subscriber, is done in the ordinary course of business. Although demonstration of standard industry practice usually is sufficient, given the differing policies of financial services firms, the question of whether monitoring and taping is done in the ordinary course of business may not be so easy to answer in the derivatives context.
4. Recall that a Maryland judge allowed the prosecution of criminal charges against Linda Tripp for secretly recording her conversations with Monica Lewinsky. Although the charges later were dropped, the case demonstrates the perils of recording conversations in two-party consent states.
5. Schedule to the 2002 ISDA Master Agreement part 5[(n)] (emphasis added).
6. *See People v. Bell*, 773 N.Y.S.2d 491, 495 (3rd Dept. 2004).
7. 68 N.Y.2d 520, 522 (1986).
8. *Ely*, 68 N.Y.2d at 528.
9. *People v. Carrasco*, 125 A.D.2d 695, 696 (2d Dept. 1986). *See also People v. Sacchietlla*, 31 A.D.2d (3d Dept. 1993).
10. Spoliation is the destruction or significant alteration of relevant evidence.
11. *Zubulake v. UBS Warburg LLC.*, No. 02 Civ. 1243, 2004 WL 1620866, at *6 (S.D.N.Y. July 20, 2004).
12. *Zubulake v. UBS Warburg LLC.*, 220 ER.D. 212, 216 (S.D.N.Y. 2003).
13. *Telecom International Am. Ltd. V. AT&T Corp.*, 189 ER.D. 76, 81 (S.D.N.Y. 1999).
14. In New York there is a split between bar associations as to whether it is ethical for a lawyer to herself tape or counsel a client to tape a conversation. The Association of the Bar of the City of New York has taken the position that it is unethical for a lawyer to surreptitiously record conversations with other lawyers or clients. Assoc. of the Bar of the City of New York, Committee on Attorney Ethics, Op. No. 80-95, at p.2 (maintaining the view that secret recordings with other lawyers or clients are improper). The New York County Lawyers Association, on the other hand, has concluded that it is in fact ethical for lawyers to secretly tape record third parties. New York County Lawyers' Assoc., Committee on Professional Ethics, Op. No. 696, at p.2 (June 21, 1993).

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Current SOX Issues

By Guy Lander

This article covers some of the Sarbanes-Oxley ("SOX") issues companies are currently addressing. It covers Section 404 internal controls, certifications and disclosure controls, how two companies in particular are handling the SOX issues, SEC enforcement issues, foreign private issuers, the role of the audit committee in this process, PCAOB inquiries, SEC reviews and Form 8-K disclosure controls.

I. Introduction

A. SOX is intended to enhance the reliability of financial statements in numerous ways.

Section 404

Section 404 requires management to assess and report on the effectiveness of internal controls and requires auditors to evaluate and attest to those controls. Auditing Standard ("AS") No. 2 provides the standards for the audit of management's assessment of the effectiveness of the company's internal control.

Section 404 compliance is the most expensive part of SOX. Expenses have been growing and are huge. Cost estimates for large companies have been $1 million in Section 404 costs for each $1 billion in revenues. The Financial Executives International Study found the average costs to be $3.1 million and 30,700 hours to comply. Much of that expense is revenue for public accounting firms whose audit fees are expected to increase 50% over last year.

Section 302 and 906 Certifications

Management certifications enhance the tone at the top by making senior management personally responsible through certifications of CEOs and CFOs. The SEC has begun to bring cases for failure to comply with certification requirements. CEOs and CFOs are taking the certifications very seriously.

Audit Committee

The audit committee has become a strengthened and important gatekeeper.

Increasing Punishment as a Deterrent

One estimate of the cost is $1 million in Section 404 costs for every billion dollars in revenue and 75% of that for the second year (which is probably high). As a result, the adequacy of internal controls now commands the attention of senior management.

B. Compare where we began to where we are now. The Senate Report accompanying SOX commented on the auditor attestation requirements as follows:

In requiring the registered public accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees.[1]

C. Questions have arisen whether too much regulation has been added. But the scandals keep coming (e.g., Fannie Mae). This results in regulators continuing to push on internal controls.

D. Canadian issuers and regulators watching the U.S. experience

Canadian securities regulators have deferred introducing their version of Section 404 pending at least in part understanding lessons learned by Canadian dually listed issuers who have gone through the preparatory phase for 404 compliance. A policy in draft form is expected in the next few months. Canadian issuers have been complying with a certification requirement comparable to that in Sections 302 and 906 although it is still in the form of a bare certificate. The requirement to certify CEO/CFO responsibility for internal controls has been deferred until the Canadian version of the 404 report is introduced.

II. Overview of Section 404 Internal Controls: SEC Regulations and PCAOB Standards

A. Introduction

Reporting and attestation on internal controls is one of the most far-reaching changes in management's and auditors' responsibilities for financial reporting. Since the adoption of the Foreign Corrupt Practices Act in 1977, public companies have been required to have effective controls. What is new is "simply" the obligation of management to assess and report on internal controls and auditors to evaluate and attest to management's report on them. The discipline of having to report is intended to expose weaknesses in the controls.

The objectives of Section 404 are to protect investors and improve the reliability of financial reporting, but what is it that investors now get that is new? First, a strengthened process, i.e., an integrated audit of financial statements and internal controls. However, the audit and internal controls only provide "reasonable assurance," not absolute certainty. Nevertheless, financial frauds should be less frequent and detected earlier.

Second, investors should get either clean audit reports on internal controls on the process for preparing reliable financials, or disclosure about audit adjustments if a material weakness is identified. AS No. 2 requires auditors when they identify a material weakness to add a paragraph disclosing meaningful information about the material weakness.

B. Integrated Standard

Under AS No. 2, auditors conduct two audits:

(1) an audit of financial statements and

(2) an audit of internal controls, which entails two opinions:

- (a) whether the auditors agree with management's assessment of the internal controls, and
- (b) whether the internal controls are effective.

The integrated audit results in two separate opinions:

- (a) an opinion on whether the financial statements present fairly the company's financial condition and results, and
- (b) an opinion on management's assessment of the effectiveness of the company's internal controls over financial reporting.

The two opinions are intertwined. The internal control audit requires the standard audit of financial statements, but the reverse is not true. You can have an audit of financial statements without an audit of internal controls, for example, in the public offering context.

In the past, in the financial statement audit, the auditor obtained assurances from internal controls or substantive testing, or both. The auditor did not have to test internal controls. Under AS No. 2, the auditor must perform substantive testing for every item.

The auditor must obtain reasonable assurances that no material weakness exists as of the date of the report.

The materiality standard for financial reporting and for information on internal controls is the same.

The audit covers the company's controls over the preparation of its financial statements and notes. For foreign private issuers, the audit covers the primary financial statements and U.S. GAAP reconciliations.

C. Small Business Concern

AS No. 2 has latitude for auditors to treat small companies differently than large companies.

D. Management's Report

(a) Management's report must state:

- (1) Management is responsible for establishing and maintaining adequate internal control;
- (2) The framework used in the evaluation;
- (3) Management's assessment of the effectiveness of the company's internal control as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. Management must disclose any material weakness in the internal control over financial reporting it identified. Management may not conclude that the internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting; and
- (4) That the auditors have issued an attestation report on management's assessment.

Consequently, an auditor must evaluate the following matters:

(1) Whether management has properly stated its responsibility for establishing and maintaining adequate internal control;

(2) Whether the framework used by management for the evaluation is suitable (e.g., the COSO framework);

(3) Whether management's assessment of the effectiveness of internal control over financial reporting is free of material misstatement;

(4) Whether management has expressed its assessment in an acceptable form. Specifically, management must state whether the company's internal control over financial reporting is effective. Management cannot give a negative assurance (e.g., "nothing has come to our attention . . .") and cannot qualify its statement; and

(5) Whether any material weaknesses have been properly disclosed, including material weaknesses corrected during the reporting period.

E. The Review Process

(1) Auditor Evaluates Management's Assessment of Internal Controls

Management's process requires documentation, evaluation and testing of controls. Most companies that are accelerated filers are well into the documentation and testing parts of the process. The auditor's first step is to understand the internal controls and plan the audit.

(2) Auditor Must Understand the Design and Operation of the Internal Controls

The auditor must look at management's assessment and interview management and other company personnel.

(a) Auditors "walk through" the controls and must identify, beginning to end, the major classes of transactions that are part of each significant process, e.g., sales, from initial recording in the books to ultimate inclusion in the financials.

(b) Auditors evaluate the effectiveness of the audit committee as part of understanding the control environment. An ineffective audit committee would be a material weakness.

(3) Actual Testing and Evaluating the Operating Effectiveness of Controls

This is the heart of the assessment. Some rotation of testing is permitted. However, the financial statement audit and the internal control audit must stand on their own each year.

Whether the auditor can rely on the work of the internal audit staff depends on the particular controls. Some things must be done by the auditor, e.g., the walk through because of the principal evidence test, i.e., the auditor must have sufficient evidence to form its own opinion.

The auditor can rely on the work of the internal audit staff of the client without duplicating that work if the auditor has a reasonable basis for doing so based on the competency and objectivity of the internal audit staff. Consequently, some of the work of the internal audit staff should be tested.

Generally, having a good internal audit function that auditors can rely on could decrease the cost of a Section 404 audit of internal controls.

(4) Forming an Opinion on Effectiveness: Identifying and Evaluating Any Deficiencies

What happens if the auditor finds more deficiencies than expected? The goal should be remediation.

Newly remediated controls must be tested by management and auditors to make sure they are working, and sufficient time should be allotted for this.

Each deficiency must be accumulated and evaluated to determine whether alone or in the aggregate there is a material weakness, which would depend on the effect in financial reporting. Any compensating controls must also be taken into account.

If there are material weaknesses, auditors must describe what they are and should be consistent with management (or else a disagreement may ensue but not one that would trigger disclosure under Section 304 of Regulation SK unless the situation results in a change of auditor). The existence of a material weakness requires either:

(a) an unfavorable report; or

(b) management identifying the material weakness in its report and the auditors issuing a report agreeing with management. If management fails to do its assessment, then the auditor would have to disclose this and not render any opinion. Additionally, if management fails to do its assessment, that is a violation of Section 404.

If management has identified a weakness that it discloses in its report, then the auditor need not disclose it (because it agrees with management's assessment).

Understanding the process is based on understanding some fundamental terms:

(a) Internal Control Deficiency

A deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

(b) Significant Deficiency

A control deficiency is a significant deficiency if it results in more than a remote likelihood that a misstatement in the financials, that is more than inconsequential in amount, will not be prevented or detected. "More than" a remote likelihood is one that is reasonably possible or probable. "More than inconsequential" is one that is "more than inconsequential" but less than "material." If informed persons have to think about it, then it is "more than inconsequential."

(c) Material Weakness

A material weakness is a significant deficiency that, alone or with others, results in more than a remote likelihood that a material misstatement in the financials will not be prevented or detected.

F. Disclosure: Internal and External

Internally, auditors should report to management in writing all deficiencies uncovered. The auditors must also report to the audit committee in writing all significant deficiencies.

Externally, a material weakness is disclosed in management's report in the company's annual report. Changes in internal control during the most recent quarter that have materially affected or are reasonably likely to materially affect internal control are disclosed quarterly in Form 10-Q (or Form 10-K for the fourth quarter). Nonreliance on previously issued financials due to error is disclosed in Form 8-K. However, there are no SEC penalties for an adverse opinion on internal controls.

G. Reporting on the Results of the Audit of Internal Controls

As discussed above, the auditor renders one internal control report with two opinions:

(1) on management's assessment, and

(2) whether internal controls are effective.

H. Other Comments

(1) Collaboration Between Management and Auditors

Discussions between management and the auditors have become very constricted because of independence concerns. What level of collaboration or discussion is possible between management and the auditor?

At least one member of the PCAOB has stated that the PCAOB did not intend to limit open conversation between the company and its auditors. As a matter of fact, PCAOB FAQ No. 7 is intended to indicate that management can give auditors draft financial statements and if they are subject to revisions, tell the auditors that.

The SEC's view is that the auditor may provide limited assistance (FAQ Q17), but the auditor is external, and it is management's responsibility to make the basic decisions. Management (or its staff) must be sufficiently knowledgeable to make its own informed decisions. The auditor is not part of the company's control system. The SEC wants to maintain discussions without putting the auditor in the position of making decisions for management, i.e., management must be sufficiently informed.

(2) Earnings Releases

Now, public companies oftentimes get private comfort from their auditors that they will not come up with material adjustments or material weaknesses, so the company may release its earnings. But the Section 404 audit could hold up the earnings release. The financial statement closing process is important, and internal controls over that process could delay the release. Earnings releases won't go out until accounts are closed and controls operated on them.

Consequently, management must speak to the auditor to make sure the auditor's schedule is realistic and that it understands the company's need for informing the marketplace. Additionally, management should be careful not to violate Regulation FD if the company is late in its earnings release. For example, if a shareholder calls the CEO to ask what is going on and the CEO says, "Well, the SEC Section 404 audit is late," this may be a material statement requiring immediate disclosure under Regulation FD depending on the circumstances.

(3) M&A: Recently Acquired Businesses

The SEC has granted a one-year pass on the assessment of a recently acquired business. Management may omit an assessment of an acquired business's internal control from its assessment of internal control for up to one year (but not more than one annual report of management on internal control).

(4) Outsourcing to Third Party Service Providers

If a company outsources functions that affect the initiation, authorization, recording, processing or reporting of transactions in the financial statements (e.g., payroll), management must still assess the controls over the outsourced operations. Management may rely on a Type 2 SAS 70 report[2] performed by the third party's auditors even if the auditors for both companies were the same or if the reports are as of a different year end.[3]

(5) Accounting Firm Letters

Accounting firms have been examining where their clients are in relation to the annual report (Form 10-K) filing dates. This is not an assessment of effectiveness. Rather, it is an evaluation of how far along the client is in the process, so that the accountants will have enough time to do their work.

III. Certifications and Disclosure Controls

A. Section 302 Certification

Section 302 certifications cannot be altered. There may be issues in the filing, but disclosure in the report should enable the officers to give the certification. For now, certifications can exclude certain language for internal controls.

B. Section 906 Certification

The certifications do not apply to Forms 8-K, 6-K and 11-K. The Department of Justice (not the SEC) administers the Section 906 certification. Nevertheless, the SEC views the 906 certification as part of its filings. Qualifications or the absence of Section 906 certification would raise questions for the SEC and could be referred to the Department of Justice.

C. Provisions in Certifications that Are Currently Effective

Disclosure controls and procedures must be established and evaluated, i.e., a description of management's evaluation and what is concluded must be provided in each annual report. The SEC is making companies that discuss their controls and procedures meet their objectives.

(1) Disclosure of Material Weakness in Internal Controls

The SEC may raise questions about the effectiveness of disclosure controls when there is a material weakness in internal controls. Disclosure controls subsume a large portion of internal controls. Therefore, when a material weakness exists, it raises questions about how management can conclude that the disclosure controls are effective. The SEC wants the conclusion to be a clear statement, i.e., the disclosure controls are effective or not and a clear explanation of how management concluded they are effective if there are issues. The disclosure should provide who, what, when, where, why, how and what management is doing about it.

In the comment process, the SEC is trying to understand how management concluded that disclosure controls are effective in light of a significant deficiency in internal controls. There are different possibilities as to how management can get comfortable with its conclusion. The disclosure control may be something that does not relate to financial reporting, e.g., the means of disclosing related party transactions.

If there is a problem, the SEC will ask for a copy of the disclosure controls and procedures and they will check to see if what is written is done. Disclosure controls and procedures must therefore fit what the company is really doing.

(2) Disclosure Where Restatement of Financials

If a company has a restatement for a prior period due to an identified material weakness, management's report for the restated period would have to be modified or corrected. Issuers should meet their obligations under Rule 12b-20 of the Exchange Act and disclose in an amendment to the original report that the controls were not effective. The lawyer should coordinate with the accountants so that the disclosures are consistent with the footnotes in the restated financials.

IV. What Two Companies Are Actually Doing

A. Disclosure Committee

Pfizer: Pfizer established a disclosure committee with a formal charter with a mandate to review it annually. The members of the committee include a cross section of senior management: principal accounting officers, general counsel, chief investment relations officer, various key department heads, chief risk officer, internal auditors and external reporting controllers. The committee is chaired by the controller.

The committee reviews all periodic filings, other information filed with the SEC and press releases with financial information and certain other material information. The committee has authority to investigate any matter relating to disclosure reporting. It has full access to independent auditors and all books and records. The committee may retain counsel, auditors and other advisors, at company expense.

The committee meets three times a quarter: before each earnings release, before finalizing each periodic filing (Forms 10-Q and 10-K) and at the signing of the CEO and CFO certifications under Sections 302 and 906.

The disclosure committee runs formal meetings with an agenda. One agenda item is how the process worked that quarter. At signing, each member of the committee verbally confirms that he did what he was supposed to. The CEO asks if he or she has been told everything, and everyone is very forthcoming.

Intel: The disclosure committee consists of the director of finance, external reporting controllers, corporate affairs and legal. The committee reports directly to the CEO and CFO.

About one to two weeks before the Form 10-Q or 10-K is filed, the CEO, CFO, financial reporting people and attorneys for certifications review the financials and draft Form 10-Q or 10-K. The review of the Form 10-Q or 10-K includes a review of financial areas and new disclosures.

There is then a controls review and identification of any significant changes. Each significant area completes a template and discusses with the corporate controller policies and procedures, reconciliations, verification procedures, management review and related controls, and any gap is identified. The results are summarized and reported in a certification meeting. Each operating segment provides changes in its business, and there is no threshold for dialogue and assessment.

Any issues that would cause disclosure are reviewed, and the certifications are prepared for signature.

B. Sub-Certifications

Sub-certifications are not a defense to an SEC problem but a firm culture issue for getting and keeping processes in shape. They are something to consider, but one size does not fit all.

Pfizer: Pfizer obtains sub-certifications from senior business leaders to support CEO and CFO certification. Pfizer does not go lower. The CEO and CFO ask if all sub-certifications are received, and once they are handed over, they sign their certificates.

Generally, the draft document does not change as a result of this process, except for updating, e.g., for litigation but not, generally, because new disclosures surfaced. Everyone confirms that she did her job.

Intel: Does not use backup sub-certifications because they do not want to have senior management in a difficult position when assessing materiality.

C. Section 404 Implementation

Pfizer: Pfizer's whole program implementation group works to roll out the implementation. Above that, a steering committee receives reports on what the group is dealing with, and that committee reports to the senior executives (the GC and CFO).

The process is as follows:

1. Setting the scope of work;
2. Developing the project plan;
3. Working on the IT plan;
4. Developing guidelines and tools;
5. Planning documentation and distributing that to business units;
6. Road shows for each operating business to educate them and facilitate their participation in the readiness assessment;
7. End of internal documentation; and
8. Complete testing. The external auditor then comes in, remediation is done, and fine-tuning the certification process takes place.

Intel: Intel's Section 404 methodology is as follows:

1. Scope (financial statement areas, significant accounts and significant processes);
2. documentation (process documentation, risk assessments, key controls: manual applications and general IT controls);
3. monitoring and testing;
4. external audit testing;
5. management assertion; and
6. external auditor attestation.

Intel's initial efforts went into documentation and verifiability. Once a deficiency threshold is triggered, there is a compulsory review at executive level for its disposition.

V. Enforcement

The announcement of a restatement invariably results in an informal enforcement inquiry by the SEC. Therefore, attorneys may need to coordinate the corporate finance comment process with the SEC's enforcement division.

There were over 300 restatements last year for public companies. Increasingly, restatements are a fact of life. Once the process begins, management has to go through it and has to live by the results. No one should destroy documents, and when forensic accountants come in, they will go through everything.

Under the Federal Sentencing Guidelines an effective compliance and ethics program is one factor the Department of Justice considers in deciding whether to pursue a company and what punishment to seek.

VI. Foreign Private Issuers Enter the System Later

Section 404 applies to foreign private issuers in their annual reports for their first fiscal year ending on or after April 15, 2005. For calendar year issuers, this means the annual report for 2005 due in early 2006.

In response to the cost and other burdens of SOX, some foreign private issuers have left the U.S. capital markets. However, there are mechanical difficulties in counting U.S. shareholders to permit withdrawal from the U.S. reporting system. Also, some foreign private issuers are taking advantage of the information supplying exemption from Exchange Act obligations provided by Rule 12g3-2(b) under the Exchange Act. However, if Canadian or European regulators install something like Section 404, these companies will be back at square one.

VII. Role of the Audit Committee

The role of the audit committee is a mixed question of federal and state law: for example, the effect of SOX on the fiduciary duty of directors to be informed. However, now audit committee members are more informed than ever.

A. How do Auditing Firms Rate the Audit Committee

The auditor has to investigate the audit committee. Audit committees are meeting much more frequently, doing self-assessments, meeting Section 404 and stock exchange obligations and handling other topics such as tax services. They are also very interested in continuing education, with the external auditor probably involved in the process.

The auditor should attend meetings and observe the audit committee activity and determine whether the audit committee is effective.

B. The Audit Committee Rating the Auditor

The auditor must pass all deficiencies to the audit committee. What is communicated between management and the auditor concerning remediation of a material weakness is probably passed on to the audit committee as well.

Generally, the audit committee is heavily involved in the Section 404 process. The auditor meets with the audit committee. The audit committee can meet in executive session with management, the external or internal auditor or in any combination they choose.

VIII. PCAOB Inquiries

PCAOB inspectors have asked to speak to chairs of various audit committees. This arose out of the 2003 inspection of the Big 4 firms. The PCAOB staff looked at 16 engagements and asked to interview the audit committee chair on those engagements to get the audit committee chair's perspective of the auditor's performance. Generally, these inquires were done by telephone. The inspectors have discussed critical accounting principles, internal control issues and what the audit committee expected of the auditor.

The PCAOB was trying to evaluate the auditor, not the audit committee.

The information the PCAOB obtains is available to the SEC, but the SEC does want to facilitate open communications. An attorney could prepare the audit committee for the conversation.

To date the PCAOB has not called any foreign private issuers.

The PCAOB inspection reports have public and nonpublic parts. The nonpublic part goes to the SEC, state examiners, stock exchanges and the firm itself. One thing the audit committee might do is ask for a copy of the PCAOB report, including the nonpublic part. The auditor should remove any information about another client.

Many IPO engagements are getting reviewed by the PCAOB.

If the PCAOB finds something that would affect an issuer's financial statements, the PCAOB would discuss it with the auditor, but, the auditing firm would probably bring that to the audit committee's attention quickly.

IX. SEC Reviews

The SEC is upgrading the quality of Exchange Act reports and its investigative efforts. Every public company's filings will be reviewed every three years. The SEC is targeting large companies but will cover smaller ones as well. It is also moving to selective reviews based on a "risk profile." It is also conducting limited scope reviews intended to assess the quality of disclosure usually followed by a review targeting various disclosure areas. Overall, the SEC is trying to "touch" as many companies' filings as possible.

X. Disclosure Controls for Form 8-K

Disclosure controls should also cover current reports on Form 8-K, which have been expanded to cover 22 items. Many companies have set up a Form 8-K sub-committee of the disclosure committee. Sizeable companies have redundancies, i.e., they have two people backing each other up.

The Form 8-K committees evaluate whether a reportable event has occurred. The company should make sure that every member of the disclosure committee is aware of the Form 8-K rules, who the primary reporting officer is and his or her backup for each Form 8-K item. The people in the best position to know whether a reportable event occurred are the people who should alert members of the Form 8-K committee of a reportable event.

The disclosure committee should review the Form 8-K procedures annually.

Generally, whether an event is material is the concern. An initial review threshold can be a first step to assess materiality, i.e., a quantitative rule of thumb such as a percentage of revenues. However, qualitative factors (such as SAB No. 99 factors) must be considered and could result in small items becoming material. Management could have its risk committees feed into the Form 8-K committee with their comments. Additionally, transactions could be tied to authority levels, so they could go through two people or the proper committees before being authorized, which would avoid triggering Form 8- K reports prematurely.

XI. Conclusion

Don't underestimate the investment required for Section 404 internal control. It is a very big undertaking that must be continually evaluated. Procedures are very important. This includes the process of certifying under Sections 302 and 906, the disclosure committee, disclosure controls and internal controls.

The audit committee is not only part of the team but a decision maker in the process.

The outside auditor can't design or implement the internal control systems, but it should be involved in the process. While management must be responsible for the process, its auditor's views are very important, and the company is best off if it brings its auditors into the process early.

Endnotes

1. From Report of the Committee on Banking, Housing and Urban Affairs of the United States Senate to Accompany S.2673 at 31 (July 3, 2002).
2. This report is a service auditor's report on a service organization's description of controls as to whether the controls were suitably designed to achieve specified control objectives, whether they had been placed in operation as of a specific date and whether the controls that were tested were operating with sufficient effectiveness to provide reasonable assurance that the related control objectives were achieved during the specified period.
3. But management may not rely on a Type 2 SAS 70 report if it engaged the company's auditors to also prepare the report on the third party service providers. Additionally, a company may not limit the scope of its assessment of internal control over financial reporting even if management has outsourced a significant process to a service organization and the service organization is unwilling to provide a Type 2 SAS 70 report or access to assess the controls in place at the service organization.

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Life in the Post-SOX World: The Sarbanes-Oxley Act of 2002—What Corporate Directors and Executives Need to Know

By Winston & Strawn LLP

The Sarbanes-Oxley Act of 2002, enacted on July 20, 2002, effected sweeping changes in the responsibilities and potential liabilities of officers and directors of public companies, including foreign private issuers, and the corporate reporting obligations of these companies. The effects of these changes have become evident in the 2½ years since passage as the Securities and Exchange Commission, Public Company Accounting Oversight Board, stock exchange and other self-regulatory organizations, public company accounting firms and corporate America have responded to the statutory requirements and initiatives. Additionally, actions of the SEC, self-regulatory bodies, state attorneys general, and private investor litigants that were initiated during the same time period have heightened the visibility and personal responsibility of executives and directors.

This briefing provides an overview of developments after the enactment of the Sarbanes-Oxley Act, covering those areas of the Act and related developments of greatest interest to executives and directors.

Personal Responsibility

A theme throughout the Act is the emphasis on the personal responsibility, and potential personal liability, of officers of public companies. Corporate personnel from the most senior officers and directors to middle-level managers face civil and criminal penalties for their actions or inactions, and for disclosure failures. Indeed, in certain instances corporate officers and managers currently are facing significant penalties for participation in preparing incomplete or misleading disclosure or in the misstatement of financial information, and for their roles in assisting a customer or supplier to misstate financial information. As a result, team training and team knowledge become critical to senior officers and directors as they fulfill their responsibilities.

Certifications—One major change introduced by the Act is the requirement that chief executive officers and chief financial officers of public companies make personal certifications under Section 302 and 906 of the Act in each annual report on Form 10-K, 20-F or 40-F, and each quarterly report on Form 10-Q, and amendments to them.

Under Section 302 each of these officers must certify in each such report that:

- he/she has reviewed the report;
- based on the officer's knowledge, the report is materially accurate and the financial statements and other financial information are fairly presented;
- he/she is responsible for establishing and maintaining the company's "disclosure controls and procedures" and "internal control over financial reporting" (these terms are discussed below);
- the disclosure controls and procedures are designed to ensure that material information relating to the company is made known to him/her, and he/she has evaluated the effectiveness of these controls and procedures and presented his/her conclusions as to the effectiveness of such controls to the independent auditors and the audit committee; and
- he/she has disclosed to the company's independent auditors and to the audit committee all "significant deficiencies" in the design or operation of internal control, has identified for the independent auditors any material weakness in internal control and has disclosed in the SEC report whether there were changes in internal control that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

The certification of disclosure controls and procedures relates to all information disclosed in the report, not just financial information. The certification as to financial information covers not only the company's financial statements (including footnote disclosure) but also selected financial data, MD&A disclosure and all other financial information disclosed in the report.

The "fairly presents" standard with respect to the financial information certification imposes a standard of overall material accuracy and completeness that is broader than GAAP requirements. This standard encompasses activities such as the (i) selection of appropriate accounting policies and proper application of those policies, (ii) disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and (iii) the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.

The other set of personal certifications required to be provided by chief executive officers and chief financial officers is mandated by Section 906 of the White-Collar Crime Penalty Enhancements portion of the Act. The chief executive and financial officers of each public company must state that the periodic report "fully complies" (no materiality qualifier) with the applicable requirements for that report and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. A "knowing" violation of this certification requirement subjects an executive to criminal penalties up to $1 million in fines and imprisonment up to 10 years, or both. For willful violations the stake increases to $5 million and 20 years.

Forfeiture of Certain Bonuses and Profits—Chief executive officers and chief financial officers of public companies will be required to disgorge bonuses and other incentive or equity-based compensation received, and trading profits realized, in the 12 months following issuance of financial statements that are subsequently restated due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws. Given the language of the Act, it is unclear what level of officer misconduct is required for those provisions to apply. These provisions of the Act have not been tested, although disgorgement has been frequently imposed by the SEC in negotiated settlements.

Pension Fund Blackout Periods—Directors and executive officers of public companies may not purchase or sell any of their company's equity securities during any "blackout period" if the director or officer acquired the equity security in connection with his or her service or employment as a director or executive officer. A blackout period is any period of more than three consecutive business days during which the ability of 50 percent or more of the participants or beneficiaries under all individual account plans (e.g., 401(k) plans) maintained by the company to purchase or sell or otherwise acquire or transfer an interest in any equity security of the company is temporarily suspended by the company or a fiduciary of the plan. Blackout periods do not include regularly scheduled periods incorporated into the individual account plan and timely disclosed to employees before they become participants. Profits realized from trades that violate this provision will be recoverable by the company, irrespective of the intent of the parties to the transaction. Companies are required to timely notify directors and officers and the SEC of impending blackout periods.

Prohibition of Personal Loans—The Act prohibits personal loans by a public company to any "director or executive officer (or equivalent thereof)." This prohibition covers extending or maintaining credit or arranging for the extension of credit. Loans in place on July 30, 2002, were grandfathered but may not be modified or renewed. The prohibition is written in sweeping language, broad enough to include loans such as relocation loans.

Accelerated Reporting of "Insider" Stock Transactions—The Act significantly accelerated deadlines for the reporting of changes in equity ownership (including through security-based swap transactions) by directors, officers and 10 percent stockholders. Reports on Form 4 with respect to such change must be filed (i.e., received by the SEC) before the end of the second business day following the day on which the transaction has been executed. The applicable date of "execution" is the trade date, not the settlement date and, in the case of options, is the option exercise date. For transactions executed pursuant to Rule 10b5-1(c) of the Exchange Act in which the reporting person does not select the execution date or "discretionary transactions," the transaction date is deemed to be the date on which the reporting person is notified of the trade, so long as such notification is no later than the third business day following the execution date.

The filing dates for Form 3 and Form 5 remain the same. Option grants and restricted stock and other awards are now reportable on Form 4 on the accelerated basis.

Forms 3, 4, and 5 must be filed electronically (via EDGAR), and any public company that maintains a corporate website must post the filings on its website, in each case not later than the end of the business day following the SEC filing.

Disclosure Controls and Procedures and Internal Control Over Financial Reporting—Management and Board Roles

Under rules promulgated by the SEC, all reporting companies that file reports, including foreign private issuers, must establish and maintain an overall system of "disclosure controls and procedures." This is a newly defined term and is broader than the traditional internal controls that relate to financial reporting and control of assets. These disclosure controls and procedures should be designed to ensure timely collection and evaluation of information either required to be disclosed or that may be relevant to assess the need to disclose developments and risks. Issuers should be able to show that they are able to timely record, process and report the financial and other information required to be included in their periodic and current reports and definitive proxy materials and that this information is communicated to management in a manner that allows timely decisions regarding required disclosures.

Although the new rules provide no particular procedures that an issuer is required to implement in connection with its review and evaluation of disclosure controls and procedures, the SEC expects that each public company will develop a process that is consistent with its business and internal management and supervisory practices. To this end, it is noteworthy that the SEC recommends that a public company create a committee of its officials with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. Such a committee would report to senior management (including the CEO and CFO) and might possibly include the principal accounting officer (or the controller), the general counsel, the principal risk management officer, the chief investor relations officer and persons associated with the company's business units. It would be the responsibility of the committee to consider the materiality of information, determine disclosure obligations on a timely basis, and report to senior management.

"Internal control over financial reporting" is a process designed by, or under the supervision of, the company's principal executive and principal financial officers and effected by the company's board of directors, management (including the issuer's internal auditor) and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. This concept and requirements imposed by Section 404 of the Act, SEC regulations issued under Section 404, and rules of the Public Company Accounting Oversight Board (described below) have added major expense to the audit of financial statements and related attestation as to internal control.

There is a substantial overlap between a company's internal control over financial reporting and its disclosure controls and procedures. For example, both include those components that provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in accordance with generally accepted accounting principles. However, in designing disclosure controls and procedures, management can make judgments about the processes on which it will rely to meet the applicable requirements. As a result, the company's disclosure controls and procedures will not contain all components of the internal controls that are designed to assure accurate recording of transactions and disposition of assets or the safe-guarding of assets (e.g., dual signature requirements on checks).

Management must make an annual evaluation of the effectiveness of internal control and disclose its conclusions. In making a determination as to the effectiveness of the internal control, management must base its evaluation using a suitable, recognized control framework. The SEC and PCAOB point to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) "Internal Control Integrated Framework" as a framework that meets the criteria, and recognize certain foreign frameworks as well.

The COSO framework notes that the composition of a company's board and audit committee, and how the directors fulfill their responsibilities related to the financial process, are key aspects of the company's control environment. An important element of the internal control process is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key filings with regulatory agencies. A significant part of the annual review of a company's internal control over financial reporting is the required attestation by the company's auditors with respect to the internal control. Because the company's auditor must provide this attestation, it may not participate in the design of the evaluation process. The Public Company Accounting Oversight Board has established detailed procedures governing the evaluation process underlying the attestation, which process requires the dedication of substantial and expensive resources at the auditor and the company. One important element in the process is the evaluation of the audit committee activities in the financial reporting process.

Broad Structure

The New York Stock Exchange (NYSE), Nasdaq National Market and American Stock Exchange have established substantially consistent SEC-approved corporate governance listing standards that effect significant changes in the structure of public company boards. For example, the NYSE standards require each listed company (with very limited exceptions) to:

- Maintain a board comprised of a majority of independent directors;
- Schedule regular executive sessions in which non-management directors meet without management participation;
- Maintain a nominating/corporate governance committee that is composed entirely of independent directors and that is governed by a written charter meeting certain requirements;
- Maintain a compensation committee that is composed entirely of independent directors and that is governed by a written charter meeting certain requirements;
- Maintain an audit committee that has at least three members, is composed entirely of independent directors, and is governed by a written charter meeting certain requirements;
- Adopt and disclose certain corporate governance guidelines;
- Adopt and disclose a code of business conduct and ethics that must include specified topics and

promptly disclose any waivers of the code for directors or executive officers;

- Disclose significant differences in corporate governance practices, if the listed company is a foreign private issuer;
- Provide an annual chief executive officer certification regarding violations by the company of NYSE corporate governance listing standards and prompt notice of material non-compliance with the NYSE corporate governance standards.

Independence standards require (1) that the board of directors affirmatively determine that an independent director has no material relationship with the listed company, either directly or as a partner, shareholder or officer of a company that has a relationship with the listed company, and (2) that the definition of "relationship" includes those which members of a director's immediate family have. The standards contain very specific elements and require an assessment of all relevant facts and circumstances.

Audit Committee and Auditor Roles

Audit Committee—The New York Stock Exchange, The American Stock Exchange and NASDAQ National Market require that each listed company have an audit committee composed entirely of independent directors, one of whom is an "audit committee financial expert." The factors to be considered in determining whether an individual is an audit committee financial expert include education and experience generally in accounting and auditing matters, experience in preparing or auditing financial statements of generally comparable public companies, and experience with the application of accounting principles in connection with accounting for estimates, accruals and reserves. All public companies (not just listed companies) must disclose in their SEC filings whether their audit committees have at least one member who is a financial expert or explain the reasons for not having such a member.

The audit committee, rather than the board of directors, is responsible for the appointment, compensation and oversight of the auditor. This includes resolution of disagreements between management and the auditor. The audit committee must have the authority to engage independent counsel and other advisers whose fees will be paid by the company. The auditor must issue a report to the audit committee that discusses all critical accounting policies and practices to be used, all alternative GAAP treatments of financial information that have been discussed with management, the ramifications of the use of such alternatives and the treatment preferred by the auditor. All other material written communications between the company and the auditor, such as any management letters and any schedule of unadjusted differences, must be submitted to the audit committee. The report to the audit committee must also include the auditor's report on the company's system of internal controls as discussed above.

Whistleblowers—Audit committees are to establish procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. The Act provides protection for "whistleblowers" by making it a criminal offense to retaliate against any person, including interference with that person's lawful employment or livelihood, for providing truthful information to a law enforcement officer relating to the commission or possible commission of any U.S. Federal offense, not just those covered by U.S. securities law.

Non-Audit Services—The following non-audit services may not be performed by the registered accounting firm performing the company's audit:

- bookkeeping and similar services related to the accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contributions-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management or human resources functions;
- broker, dealer, investment adviser or investment banking services; and
- legal services and expert services unrelated to the audit.

All other non-audit services (broadly defined as anything other than those provided in connection with an audit or review of the financial statements), specifically including tax services, must be approved in advance by the audit committee. The preapproval authority may be delegated by the audit committee to one or more of its members.

Public Company Accounting Oversight Board

The five-member Public Company Accounting Oversight Board is charged with establishing and enforcing auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports. The PCAOB is further charged with performing such other duties as the PCAOB or the SEC determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, accounting firms conducting public company audits. PCAOB actions are subject to SEC review, and no rules of the PCAOB may become effective without prior approval of the SEC. The PCAOB and its staff are funded by mandatory fees collected from public companies based on their market capitalization. Registered public accounting firms are subject to inspection by the PCAOB, annually in the case of firms that audit more than 100 public company accounts and every three years for others.

Changing Responsibilities of Attorneys

The Sarbanes-Oxley Act and regulations issued by the SEC have created what may be a new set of reporting obligations on attorneys, both inside and outside counsel, who are "appearing and practicing" before the SEC in the representation of public companies. Any such attorney who identifies what he/she believes to be evidence of a material violation of a federal securities law or a breach of fiduciary duty is required to report such evidence "up the ladder" to his/her superior. The SEC's rules establish procedural steps for review and evaluation, ultimately by the company's general counsel, but if the reporting attorney is not satisfied with the evaluation response, he/she may be required to pursue the reporting to the audit committee or another committee composed entirely of independent directors. In addition, according to the SEC's rules, in limited circumstances to prevent a material violation that is likely to cause substantial financial injury to the company or its investors, the attorney may reveal confidential information to the SEC without the client's consent and in so doing not violate state ethical requirements. Although these reports are likely to be infrequent, the adoption of the rules is an example of the initiatives under the Act and by the SEC to impose standards of conduct on professionals who have been identified as gatekeepers. Over time this may lead to a reassessment of basic principles of attorney-client communications.

Additional Disclosure Requirements Pursuant to Sarbanes-Oxley and SEC and Stock Exchange Initiatives

Accuracy of Financial Reports—The Act mandates that each report filed with the SEC that contains financial statements must reflect all material correcting adjustments identified by the registered public accounting firm in accordance with GAAP and applicable SEC rules and regulations. This provision seems to leave no room for disagreement between management and the accounting firm auditing or reviewing the report.

Off-Balance Sheet Transactions—Each Form 10-K, 20-F or 40-F and Form 10-Q must disclose all material off-balance sheet transactions, arrangements and obligations and other relationships with unconsolidated entities that may have a material current or future effect on the company's financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

Pro Forma Figures—Pro forma financial information (e.g., EBIT and EBITDA) included in any periodic or other report filed with the SEC (this requirement applies as well to reports filed on Form 6-K and Form 8-K) or any other public disclosure, including press releases, must be presented in a manner that is not misleading and that reconciles such information with the company's financial condition and results of operations under GAAP. If information is provided orally, the reconciliation must be provided on the public company's website.

Code of Ethics—Each public company must adopt a code of ethics applicable to its principal financial and accounting officers. Changes or waivers of an adopted code of ethics must be disclosed immediately in a Form 8-K or posted on the company's website.

Real Time Disclosures—Public companies must file current reports on Form 8-K, in most cases within four days following the event, reporting the occurrence of an expanded list of events.

Mandatory SEC Review—The SEC must review the periodic reports (including financial statements) filed by each exchange-listed or NASDAQ company at least every three years. Among the factors that may lead to more frequent reviews are material restatements of financial results and stock price volatility, as well as the size of the public company's market capitalization.

Conclusion

The provisions of the Sarbanes-Oxley Act and related initiatives by regulatory and self-regulatory bodies are broad and far-reaching and continue to spawn headlines and litigation. There can be no mistaking the basic intent of Congress and the SEC to get to the bottom of the scandals that have rocked corporate America and to punish wrongdoers, and to minimize abuses going forward. The Act gives the SEC greater authority and, equally important, more resources. A number of new securities law violations have been created and new and/or enhanced penalties for existing and new violations have been established. The SEC has pursued substantially higher penalties and disgorgement sanctions against individuals. Criminal penalties have been added or increased, including a crime of securities fraud with a maximum penalty of 25 years' imprisonment. Enhanced penalties for attempts to commit criminal fraud, mail and wire fraud, Employee Retirement Income Security Act related fraud and other offenses have also been enacted. No one should count on any significant reversal of the momentum evidenced by the passage of the Act.

Copies of this Sarbanes-Oxley Act briefing are available on the Winston & Strawn website at http://www.winston.com. In addition, Winston & Strawn has prepared client briefings on many of the topics discussed in this briefing which contains additional information and which are available on our website.

Doing Business With Governments in New York State: Status Quo or Changes in Store for 2005?

By William C. Snyder

Introduction

The Procurement Stewardship Act, originally enacted in 1995 with a five-year sunset provision, and reauthorized in 2000 for an additional five years, will be a focus of attention this spring as a significant portion of it approaches a June 2005 expiration date. This Act is of critical importance for attorneys who counsel clients selling products to New York State and local governments. Coupled with the Act and its sunset is a 2003 executive order by Governor George Pataki regulating lobbying activities in the procurement process. This article provides business lawyers with a historical overview of the laws governing the procurement process in New York prior to and under the Procurement Stewardship Act of 1995. It also discusses the role and responsibilities of the New York State Procurement Council.

One portion of the Act, entitled *Preferred Sources*, was amended in 2002 to remove its sunset provision. That 2002 amendment did not affect the heart of the Act, entitled *Purchasing Services and Commodities* and now codified at section 163 of the State Finance Law, and it will expire on June 20, 2005, unless the legislature acts before then. Section 163 has been described in legislative history as "the main statutory backbone of public contracting."[1] It sets forth the infrastructure governing public procurement, including the methods and processes required for purchasing and contracting commodities, services and technologies. It defines and establishes such key concepts as competitive bidding, best value, responsible offeror, and centralized contracts, among many others.

The legislature's choices in the face of this expiration date will impact every state agency and virtually everyone who does business with New York. Affected will be literally billions of dollars of commerce with the state, comprised of tens of thousands of contracts.

The legislature could simply extend the sunset provision of the Procurement Stewardship Act, as it did in 2000. Or, after reviewing the experience of the past ten years under the Act, it might determine that the Act is beneficial and remove the sunset provision, thereby making the Act good law until repealed. The legislature could take this occasion to reenact the law with any of a series of changes which have been proposed by various lawmakers and groups around the state. One important area in which debate is likely will be whether to codify the regulation of lobbying for state contracts, a measure that would have far-reaching implications for those who do business with state and local governments.

Should the legislature fail to act for some reason, there will be a void in statutory procurement law. If Section 163 expires, the old law that it replaced will not become effective again. Various state agencies, such as the State Procurement Council, the Office of General Services, and the Office of the State Comptroller, may attempt to fill that void with administrative regulations and guidelines. Indeed, the State Procurement Council attempted to do just that in 2000 in anticipation of sunset that year.[2] Without the force of law behind them, however, these stop-gap measures may face court challenge. Moreover, there is no mechanism to ensure that various agencies do not adopt conflicting practices.

The Procurement Stewardship Act was intended to direct state agencies to "[p]rovide for the wise and prudent use of public money in the best interest of the taxpayers," to "[g]uard against favoritism, improvidence, extravagance, fraud and corruption," and to "[f]acilitate the efficient and timely acquisition of commodities and services of the highest quality at the lowest practicable cost."[3] While there is no official legislative history of the Act from 1995, the changes the legislature intended to make can be seen by comparison to prior law.

State Procurement Law Prior to the Procurement Stewardship Act

The former procurement law, originally promulgated in 1940 and amended 14 times between its inception and its repeal in 1995, was primarily concerned with the procurement of what it called "articles," which are generally referred to today as "commodities."[4] Accordingly, the processes set forth in the original law were geared toward a bidding process for commodities.[5] Essentially, under the old law the lowest bid was required to be awarded the contract, barring any failure to comply with the specifications set forth in the bid solicitation.[6] Specifically, the law stated: "Contracts . . . shall be let to the lowest responsible bidder . . . taking into consideration the reliability of the bidder, the qualities of the articles proposed to be supplied, their conformity with the specifications, the purposes for which required and the terms of delivery."[7] If more than one bidder met these minimum requirements, only the lowest bidder received the contract.

New York's highest court, the Court of Appeals, examined the old statute, listed those same five criteria quoted above, and concluded: "Manifestly, [the Office of General Services] may not add others."[8] The Court held: "In our opinion, the successful bidder must be the lowest responsible bidder, based on the five criteria expressed in the statute. It is not merely that State contracts shall be let as will best promote public interest."[9] But, why not? If a contract with company X will best promote the public interest, why must the State sign a contract with Y? Is there a public interest in attributes other than price that could render a higher-priced contract to be more in the public interest? If so, what are those attributes? This is one of the quandaries the Procurement Stewardship Act addressed in 1995.

Another deficiency of the old law was that one whole area of contracting fell completely outside its structure. There was an exception recognized in the courts for the procurement of services requiring scientific knowledge or professional skills which completely excluded them from the statutory requirement of competitive bidding.[10] The Court of Appeals has held that old "[s]ection 174 of the State Finance Law does not apply because the subject matter of the contract falls within the long-standing exceptions to the competitive-bidding requirements of State law in that it calls for services whose proper performance requires scientific knowledge or professional skills."[11] Not only was it important that services were outside the scope of the old statute, but the definition of "service" used by the courts included the use of virtually any technology. Thus, this exception was producing a large and growing body of law and practice with no legislative or statutory guidance. For example, the purchases of computer hardware, alarm systems, communication networks and many more items based on recent technology were all deemed to be purchases of "services" rather than "articles," the term used in the statute.

Although this "services" exception allowed the circumvention of many pragmatic problems the law would have otherwise presented, the overall result of this practice was that the procurement of technology and services was removed from the care of the protections provided in the statute for more than 50 years. As observers from the Office of General Services noted:

> Under these circumstances the law was no longer adequate or responsive to the scope of public procurements. It did not cover services, creating an imbalance and inconsistency in the procurement system where those acquisitions were conducted on an ad hoc basis by state agencies not necessarily adhering to a predicate set of competitive bidding practices.[12]

The Promulgation of the Procurement Stewardship Act of 1995

In 1995, the state legislature swept away the old system with the simple statement: "Article 11 of the state finance law is repealed and a new article 11 is added."[13] The new law, entitled the Procurement Stewardship Act, is considerably longer than its predecessor, adding whole new procurement concepts and establishing specific procedures for implementing them.

The Procurement Stewardship Act divided contracting for commodities from contracting for services. The new Act stated that "Commodities contracts shall be awarded on the basis of the lowest price to a responsive and responsible offeror."[14] Price remains the primary criterion for purposes of procuring commodities.[15] Services, however, were given their own subsection of the new statute with its own procedures, including: "Service contracts shall be awarded on the basis of best value to a responsive and responsible offerer."[16] This added concept of "best value" is defined by the statute as: "the basis for awarding contracts for services to the offeror which optimizes quality, cost and efficiency, among responsive and responsible offerors."[17] Under this approach, price alone is not the only criterion. An agency, or the Office of General Services in the case of a centralized contract, may put forth criteria that include qualitative measures for determining which contract best serves the relevant agency's needs and public interest.[18] Also, Section 160 of the Act incorporates case law, stating that "technology shall be deemed a service."[19] All of the Act's use of the "best value" concept is contained in provisions that sunset this year.

Centralized Contracts

Another concept that debuted in Section 163 is "centralized contract," defined as "any contract for the purchase of commodities or services, established or approved by the commissioner of general services as meeting a state's requirements."[20]

The concept of centralized contracting is perhaps the single most important provision in enhancing the efficiency of the procurement process.[21] Centralized contracts allow for the Office of General Services to make purchases of commodities and services in bulk to satisfy the needs of a number of agencies. These contracts lower administrative costs and purchase prices. Administrative costs are lowered because the needs of a number of agencies may be met through one contract. By doing so, the costs associated with soliciting bids and processing bid proposals in awarding contracts are minimized by eliminating the need for multiple agencies to repeat the same processes in procuring the same products through multiple contracts. Purchase price can be reduced, because in most instances the marginal cost of additional units in bulk contracts are discounted.

Emergency Contracts

Another critical part of Section 163 now facing sunset is authorization for emergency contracts. The Act states that "procurements made to meet emergencies arising from unforeseen causes, may be made without a formal competitive process."[22] Under such circumstances, "the bases for a determination to purchase from a single or sole source, or the nature of the emergency giving rise to the procurement" must be documented for review by the state comptroller.[23] Emergencies are defined by the statute as "an urgent and unexpected requirement where health and public safety or the conservation of public resources is at risk."[24] "Emergency contracts have been used for crucial acquisitions to support disaster relief efforts arising from the September 11, 2001 terrorist attacks, to acquire insecticides to combat encephalitis threats, and to obtain generators to support farmers in the 1998 ice storm."[25]

The Procurement Process

The Procurement Stewardship Act establishes standardized procedures to be used for various types of procurements, but allows for state agencies to exercise discretion in making decisions concerning their needs and the best way to procure the goods and services needed to suit those needs. First, a state agency engages in a complete needs assessment. The agency must then determine if those needs may be met by contracting with a preferred source.[26] If so, the contract is awarded to a preferred source, such as the Department of Correctional Services, qualified charitable agencies for the blind, and others. If a preferred source cannot meet the needs of the particular agency, it must be determined whether those needs may be met by way of a centralized contract.[27] If no centralized contract could meet those needs, then the agency must look to the competitive bidding process.[28]

This competitive bidding process is more complex under the new law. Under the Procurement Stewardship Act, in order to determine the proper procedure to be undertaken for a procurement, the procuring agency must first ask: can the needs be met by a competitive bid? If so, the next inquiry involves whether price is to be the sole criterion.[29] If price is to be the sole criterion, then bid solicitations are to be published by way of invitations for bids, including the specifications, and then an award will be granted on the basis of price alone.[30] If price is not the sole criterion, then solicitations are to be by way of requests for proposals that include specifications as well as those factors to be weighed in addition to price.[31]

If the competitive bidding process does meet the needs at issue, the agency is left with three options. In the event that an item is not common to the marketplace, and only made available from a limited number of suppliers, the agency may choose among those suppliers a single source without resort to a bidding process by providing a substantial basis for doing so.[32] An example of such a substantial basis may be prior experiences with a contractor, or a certain service that only one contractor provides in addition to the service or technology sought to be purchased.[33] In the event that only one contractor can meet the agency's needs, or the needs may only be met by a sole source, the agency may choose that source without engaging in the bidding process. If this route is chosen, the agency must publish in the procurement record: "(1) the unique nature of the requirement; (2) the basis upon which it was determined that there is only one known vendor able to meet the need . . . ; and (3) the basis upon which the agency determined the cost to be reasonable . . ."[34] Should the technology or service simply be unavailable, the agency may choose to enter into a strategic partnership with an existing contractor to develop new technology or services to meet those needs.[35]

Assurances of fairness and responsibility in the process instituted under the Procurement Stewardship Act place some of the burden on the state and some of the burden on the contractors. State agencies are required to document the procurement process.[36] In the event that contracts are procured through the competitive bid process, the agency soliciting bids must create specifications that are publicized for all bidders to see.[37] In addition, vendors participating in the development of bid specifications are precluded from partaking in the competitive bids. It is then the responsibility of the bidders to offer bids conforming to the specifications set forth. Thus, if a contract is awarded to a bidder not meeting requirements, there is a record that may be challenged in the judicial system.

The State Procurement Council

The Procurement Stewardship Act establishes a State Procurement Council to oversee the procurement process.[38] Although the Procurement Council is in a section of the law that does not sunset this year, it is important to understand the Council's function because of its role in evaluating and recommending any changes that might be considered during the debate over the sunset of the Procurement Stewardship Act. Also, the Council will be an important player in any *de facto* procurement regime that might arise if the legislature takes no action before the Act sunsets.

The statute provides that the Council "shall continuously strive to improve the state's procurement process."[39] No such body existed under the former statute, which restricted the ability to expeditiously adapt the procurement process to the dynamic needs of various state agencies.

The Council is comprised of nineteen members, and is headed by the Commissioner of the Office of General Services (OGS).[40] The remaining members of the council include the State Comptroller, the Director of the Budget, the Commissioner of Economic Development, seven members who are the heads of large and small state agencies, and eight at large members to be appointed by holders of various legislative offices.[41]

Section 161 of the State Finance Law sets forth the tasks "the council shall" undertake, including maintaining guidelines specifically for purchases of commodities and specifically for "procurement of services and technology."[42] More generally, the Council shall: "Establish and, from time to time, amend guidelines concerning state procurement and provide for the appropriate distribution and dissemination of such guidelines."[43] This includes setting forth guidelines for the formation of centralized contracts that allow the commissioner of OGS to procure commodities or services in bulk for a number of state agencies in a single contract.[44] However, to avoid limiting the flexibility in procurement accorded the individual agencies, the State Procurement Council is also required to set forth guidelines for purchases by individual agencies.

The procurement guidelines serve to summarize the various approaches to procurement permitted under the Procurement Stewardship Act. Through this summary the various approaches undertaken and methods employed can be identified and compared for any state agency conducting procurement to learn the most successful approaches to procurement used by others. By distributing these guidelines among the agencies, an opportunity is provided for agencies to learn from one another's successes and mistakes. The Council also makes the guidelines available to the public through a site on the World Wide Web. The Council's guidelines for both government agencies and for businesses are available at <http://www.ogs.state.ny.us/procurecounc/default.asp>.

The Council is also tasked to "[c]onsult with and advise the commissioner on strategic technology investments that will . . . promote electronic commerce including . . . payment to vendors."[45] Electronic commerce might enhance competition while reducing administrative cost and expediting the process. Electronic commerce is not otherwise specifically established in the Procurement Stewardship Act, but this provision of the Act tasking the State Procurement Council to pursue electronic commerce demonstrates that the Act approaches procurement law as one that must change and modernize with the development of emerging technologies.

Similarly, and importantly for any upcoming legislative debate over procurement law, the Act requires the Council to recommend necessary legislative changes "which would simplify, accelerate or otherwise improve the state's procurement process"[46] and report biennially to the governor, the legislature and the director of the budget the significant findings of the Council, including "recommendations of the Council concerning the state's procurement practices."[47]

Recommendation of the State Procurement Council

On November 17, 2004, the State Procurement Council passed a resolution entitled: "Removal of June 30, 2005 Sunset Provision." It states: "The State Procurement Council acknowledges the critical need for and value to the state of the statutory authority and dictates of § 163, *Purchasing Services and Commodities*, and formally endorses making this permanent and removing the June 30, 2005 sunset provision." The resolution contains no recommendation for other amendments to the law.

Procurement Lobbying

In 2003, Governor Pataki issued Executive Order Number 127 in order to increase "the disclosure requirements regarding persons and organizations contacting State government about procurement and real estate transactions, and [to make] that information available to the public."[48] The order directs that:

> Every covered agency and authority shall ensure that bid or proposal documents for procurement contracts include the name, address, telephone number, place of principal employment and occupation of every person or organization retained, employed or designated by or on behalf of the contractor to attempt to influence the procurement process and whether such person or organization has a financial interest in the procurement.

It also provides: "Every covered agency and authority shall ensure that any contracts that reasonably appear to be an attempt to influence the procurement process by persons and organizations other than those identified in bid or proposal documents or supplemental bid or proposal documents shall be recorded by the agency." The results must be public: "Every covered agency and authority shall, for each procurement contract, maintain a written record of all persons and organizations identified. . . . Such record shall be open to inspection by the public."

In addition to these disclosures or "transparency" requirements, Executive Order 127 requires that: "Prior to making an award of a procurement contract, each covered agency or authority shall make a determination of responsibility of the proposed awardee." This echoes the requirement of the Procurement Stewardship Act that contracts be awarded "to a responsive and responsible offerer."

"The Governor is not the only leader to call for restrictions or an outright ban on procurement lobbying."

One limitation of Executive Order 127 is that a governor's executive order cannot control independently elected officials such as the State Comptroller or State Attorney General, both of whom have responsibilities before any contract is let. This limitation could be cured through legislation.

It is reasonable to expect that some lawmakers may consider a sunset-induced review of the Procurement Stewardship Act as an opportunity to statutorily enact the practices established in Executive Order 127 and, perhaps, to extend them. Indeed, in his January 5, 2005, State of the State address, the Governor stated:

> Let's begin with seven major goals. Number One: Let's reform our state's lobbying laws. Last year, I signed an Executive Order requiring all State agencies and authorities to publicly disclose information on procurement lobbying for the first time ever. This year, let's work together to enact legislation imposing a smart and effective ban on procurement lobbying.[49]

Executive Order 127 puts the burden for acting to maintain the list of contacts on each individual agency. It does not provide for a centralized record or database to be kept statewide. Thus, it requires companies doing business with multiple state agencies to duplicate disclosures. Similarly, it requires someone such as a watchdog group seeking to find all procurement contacts by a specific company to canvass each and every state agency's records.

Another limitation of E.O. 127 is that it may encourage meaningless, over-inclusive disclosure. In order to avoid the consequences of failing to disclose "every person . . . retained, employed or designated . . . to attempt to influence the procurement process," some firms may disclose the "name, address, telephone number, place of principal employment and occupation" of every person employed in their marketing or lobbying operations, including receptionists and file clerks.

The Governor is not the only leader to call for restrictions or an outright ban on procurement lobbying. For example, on November 29, 2004, Attorney General Eliot Spitzer stated: "Instead of proposing merely to register lobbyists seeking to influence the award of government contracts, the Lobbying Commission should join me in calling for a complete ban on procurement 'lobbying' and should limit communications to written submissions and responses to agency requests for information."[50]

One approach to regulation of procurement lobbying is to amend the New York State Lobbying Act[51] so that its registration and disclosure provisions apply to procurements. This could be accomplished simply by amending the Lobbying Act's definitions. Currently, Section 3 of the Lobbying Act defines "lobbying" as

> any attempt to influence the passage or defeat of any legislation by either house of the legislature or the approval or disapproval of any legislation by the governor, or the adoption or rejection of any rule or regulation having the force and effect of law or the outcome of any rate making proceeding by a state agency.[52]

In 2004, the Senate passed a bill supported by the governor which would have amended that definition to include "any attempt to influence the award, denial, approval or disapproval of any contract or other agreement for the purchase of goods or services by a state agency."[53]

An outright ban on procurement lobbying could also be effected by amending Article 11 of the State Finance Law to proscribe all contacts between offerors and state procurement officers that are not contained in the procurement record. This approach would not limit contacts, but would result in public disclosure of all such contacts.

Conclusion

Business lawyers will need to be alert in 2005 for changes in the procedures required to do business with the state of New York. It is too early to know if the changes will be as small as the extension of a statutory expiration date or as large as the revocation of the heart of New York's procurement law. Given the sunset of Section 163, even legislative inaction would result in changes of which businesses and their lawyers must be aware.[54]

Endnotes

1. 2002 Sess. Laws of N.Y. Legis. Memo Ch. 95 (McKinney's).
2. Interview with Anne G. Phillips, Esq., Associate Counsel, New York State Office of General Services, in Albany, NY (Nov. 3, 2004).
3. 1995 Sess. Laws of N.Y. Ch. 83, § 32.
4. *Compare* N.Y. State Fin. Law § 172 *et seq*. (1994) (repealed 1995).
5. *See* State Fin. Law § 172 *et seq*. (1994) (repealed 1995).
6. *Id.*
7. State Fin. Law § 174 (1994) (repealed 2000).
8. *Am. Inst. For Imp. Steel, Inc. v. Office of General Serv.*, 47 A.D.2d 118, 119 (3d Dep't 1975).
9. *Id.* at 120.
10. *See Burroughs Corp. v. N.Y. State Higher Education Services Corp.*, 91 A.D.2d 1078 (3d Dep't 1983).
11. *Id*. at 1079.
12. Robert J. Fleury and Anne G. Phillips, New York State Procurement Law: Public, Contracts and Competitive Bidding.
13. 1995 Sess. State Fin. Law § 163(3)(a)(ii)(2000).
14. N.Y. State Fin. Law § 163(3)(a)(ii)(2000).
15. *Id.* at § 163(3).
16. *Id*. at § 163(4)(d).
17. *Id.* § 163(1)(j).
18. *Id.* § 163(4); *see also* Fleury & Phillips, *supra* note 12, at 221-223.
19. State Fin. Law § 160(7)(2000).
20. State Fin. Law § 160(1).
21. *See generally*, Fleury & Phillips, *supra* note 12, at 221-223.
22. State Fin. Law § 163(10)(b)(2000).
23. *Id.*
24. State Fin. Law § 163(1)(b).
25. Fleury & Phillips, *supra* note 12, at 223.
26. State Fin. Law § 162 (2000) (providing that the preferred sources are those produced by the Department of Corrections, qualified not for profit organizations of the blind and others inflicted with disabilities, and the mentally ill, and qualified veterans' organizations).
27. State Fin. Law § 163(3)(a)(i).
28. *Id.*
29. Fleury & Phillips, *supra* note 12, at 285 Appendix C.
30. *Id.*
31. *Id.*
32. *Id.*; *see also* State Fin. Law § 163(1)(h) (2000).
33. *Id.*; *see also* State Fin. Law § 163(9) (2000).
34. New York State Procurement Council; *Procurement Guidelines* at IV-11 (rev. March 2001).
35. State Fin. Law § 163(3)(c) (2002).
36. State Fin. Law § 163(9)(g).
37. State Fin. Law § 163(9).
38. State Fin. Law § 161 (2000).
39. State Fin. Law § 161(1)(a).
40. State Fin. Law § 161(1)(a) (2000).
41. *Id.*
42. State Fin. Law § 162(2).
43. State Fin. Law § 161(2)(c).
44. *Id.*
45. State Fin. Law § 161(2)(g) (2000).
46. State Fin. Law § 162(2)(e).
47. State Fin. Law § 161(2)(k).
48. Providing for Additional State Procurement Disclosure, Executive Order 127 (2003), *available at* <http://www.ogs.state.ny.us/legal/exeorder127/overview.asp>.
49. Governor George Pataki, *State of the State Address* (Jan. 5, 2005).
50. Comments Submitted by Eliot Spitzer at p. 4, Public Forum on Amending the Lobbying Act in Albany, NY (Nov. 29, 2004).
51. N.Y. Legislative Law, Article 1-A, Lobbying Act (1999).
52. Legislative Law Section 1, 1-C (1999).
53. N.Y. S.B. 7628 (June 19, 2004).
54. The author wishes to acknowledge the able assistance of Albany Law School student Andrew L. Poplinger in researching New York procurement law.

William C. Snyder is the Post-Graduate Fellow for Government Law and Policy at Albany Law School's Government Law Center. The Center hosted a symposium on April 1, 2005, entitled "Evaluating New York Procurement Law as the Sun Sets: An Analysis of the Experience of the Past Ten Years." Ultimately, the issue for examination during the symposium was whether the Procurement Stewardship Act should be reauthorized and, if so, for how long and with what modifications. Sessions during the symposium included: The Model Procurement Act and Procurement Laws in Other States: How New York Compares; Procurement Lobbying Disclosure and Other Ethical Considerations; E-Commerce and Other Innovative Procurement Strategies; A View From the Business Community; Facing the Sunset: Issues in Reauthorization; and National Perspectives on Procurement.

SEC Proposes Dramatic Reforms to the Public Offering Process

By Valerie Ford Jacob, Stuart H. Gelfond and Michael A. Levitt

Overview

The SEC has proposed a wide-ranging package of rules which will have a significant impact on the U.S. public offering process. The SEC proposals, which revisit many of the same topics covered by the SEC's "Aircraft Carrier" in 1998, would broaden the amount of communications permissible before and during an offering, liberalize the rules governing shelf registration statements, eliminate the need to physically deliver final prospectuses in most cases, clarify and in some cases increase the liability for material misstatements in prospectuses, and require additional disclosures in periodic reports. The SEC proposals weigh in at close to 400 pages and reconsider many aspects of the securities offering process against a backdrop of the "integral role that technology plays in timely informing the markets and investors about important corporate information and developments."

Almost all of the SEC's proposals are deregulatory in nature and allow issuers, underwriters and other offering participants to take actions that are currently prohibited, particularly in the areas of written offering communications and prospectus delivery requirements. A new category of well-known seasoned issuers would particularly benefit from flexible automatic shelf registration procedures—without having to worry about potential staff review—and relaxed communication rules in the period prior to filing a registration statement. On the other hand, several of the proposals regarding securities law liability could increase the liability of issuers, underwriters and other offering participants compared to current law and at the very least would codify the SEC's current views regarding the proper level of liability. Final comments were due to the SEC on January 31, 2005, and it is generally believed that the SEC will adopt some version of the proposed rules, although the rules may be variously modified in response to the public comments.

Communications Proposals

Communications before, during and after a securities offering are currently severely restricted by section 5 of the Securities Act and the SEC's gunjumping interpretations. The SEC's proposed rules would significantly clarify which communications are permitted and allow greater communication prior to and during a public offering.

- ***Pre-Filing Period***. Before a registration statement is filed, Section 5(c) of the Securities Act prohibits all oral and written offers. The term "offer" includes any attempt or offer to dispose of a security for value, but the SEC also interprets the term broadly to include "the publication of information and publicity efforts made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or its securities."

  The SEC proposals would clarify that during this period: (1) regularly released factual information may be issued by reporting issuers and nonreporting issuers, (2) regularly released forward-looking information may be issued by reporting issuers, (3) any statement by any issuer made more than 30 days prior to filing a registration statement is not a prohibited offer so long as it does not refer to a securities offering, and (4) well-known seasoned issuers can make any oral or written statement within the 30 days prior to filing a registration statement (but written statements would need to be filed with the SEC).

- ***Pre-Effective Period***. After a registration statement is filed but before it is declared effective, under current SEC rules oral offers are permitted, but written offers (including offers made in writing, by e-mail, over the Internet, by radio or on television) can only be made pursuant to a statutory prospectus that meets the requirements of section 10 of the Securities Act. The only written materials that can be used during this period are preliminary prospectuses filed with the SEC and Rule 134 notices that contain limited information about the offering.

  The SEC proposals would: (1) clarify that during this period regularly released factual information may be issued by reporting issuers and nonreporting issuers, (2) clarify that during this period regularly released forward-looking information may be issued by reporting issuers, (3) broaden the categories of information that may be disclosed under Rule 134, and (4) permit the use of "free writing prospectuses" (generally any writing other than a statutory prospectus), subject to satisfaction of various requirements.

- ***Post-Effective Period***. After a registration statement is declared effective, under current SEC rules written offers can only be made with a statutory prospectus. However, under Section 2(a)(10) of the Securities Act, additional written offering materials may also be used if a final prospectus that meets the requirements of Section 10(a) of the Securities Act (a standard final prospectus) is sent or given prior to or with those additional materials.

  The SEC proposals would: (1) clarify that during this period regularly released factual information may be issued by reporting issuers and nonreporting issuers, (2) clarify that during this period regularly released forward-looking information may be issued by reporting issuers, and (3) broaden the use of "free writing prospectuses" which are not accompanied or preceded by a statutory prospectus.

Violations of Section 5 of the Securities Act and the SEC's gunjumping rules and interpretations can have severe consequences for an issuer and related offering participants. The SEC may in some cases delay an offering, require additional disclosures to be added to the prospectus, or bring an enforcement action against the violator. In addition, under Section 12(a)(1) of the Securities Act, any purchaser of securities issued in violation of Section 5 of the Securities Act can bring an action against the company and require the company to repurchase the securities at the price at which they were sold. The new rules provide bright line answers to issues raised in this area and will make compliance with Section 5 before an offering more certain for most companies.

Regularly Released Factual Information

While the SEC has long taken the position that companies are permitted to issue ordinary course press releases if an offering is contemplated or ongoing, there has been concern that release of positive information might be deemed by the SEC to be conditioning the market for an offering. Although companies may want to release material information to the public or may believe that the securities laws require the release of such information, because of concern that the SEC might delay an offering, some companies may elect not to release information or may narrow the type of information released.

In order to address this problem, the SEC's proposal provides that regularly released factual information issued by or on behalf of a "reporting issuer" would be permitted at any time, would not be deemed an "offer" under Section 5(c) and would not be deemed a prospectus under Section 2(a)(10). Specifically, proposed Rule 168 would provide a gunjumping safe harbor for regularly released factual information subject to the following conditions:

- the issuer is required to file reports pursuant to Section 13 or 15(d) of the Exchange Act and is not a registered investment company or a business development company;
- the information includes (i) factual information about the issuer or some aspect of its business, (ii) advertisements of, or other information about, the issuer's products or services, (iii) factual information about business or financial developments with respect to the issuer, (iv) dividend notices and/or (v) factual information in any Exchange Act report filed by the issuer;
- the information is issued "by or on behalf of" the issuer (information is released by or on behalf of an issuer if the issuer or an agent or representative of the issuer authorizes and approves the communication before its use);
- the information may not include information about the registered offering or information released as part of the offering activities in the registered offering;
- the issuer has previously released or disseminated information of this type in the ordinary course of its business (although there is no particular length of time requirement); and
- the information is released or disseminated in the ordinary course of business and the timing, manner and form in which the information is released is materially consistent with similar past disclosures.

A similar new rule would also allow "non-reporting issuers" to regularly release factual business information. However, in the case of non-reporting issuers, the information must be released or disseminated to persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the issuer's securities, by the issuer's employees or agents who regularly and historically have provided such information to such person.

The new safe harbor provides an exemption only from Section 5 of the Securities Act. Factual business information would continue to be subject to the provisions of Regulation FD (prohibiting selective disclosure of material information), Regulation G (governing use of non-GAAP measures in any context), Item 10 of Regulation S-K (governing use of non-GAAP measures in SEC filings) and Item 2.02 of Form 8-K (covering disclosure of earnings information for a completed fiscal period).

Regularly Released Forward-Looking Information

As with the release of factual information, companies have long been concerned that the release of earnings guidance or expectations information at the time of a potential offering could be viewed by the SEC as conditioning the market for the offering. Not only might the SEC delay an offering, but the SEC might also require the projections information to be included in the registration statement, a result that is anathema to companies, their directors and underwriters.

In order to address this concern, the SEC's proposal provides that regularly released forward-looking information issued by or on behalf of a reporting issuer would be permitted at any time, would not be deemed an "offer" under Section 5(c) and would not be deemed a prospectus under Section 2(a)(10). The release of such information would not constitute an offer of a security which is the subject of an offering pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective.

Specifically, proposed Rule 168 would provide a gunjumping safe harbor for ***regularly released*** forward-looking information subject to the following conditions:

- the issuer is required to file reports pursuant to Section 13 or 15(d) of the Exchange Act and is not a registered investment company or a business development company;
- the information includes (i) projections of the issuer's revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items (including, for example, earnings expectations and guidance information), (ii) statements about management's plans and objectives for future operations, (iii) statements about the issuer's future economic performance, including statements of the type contemplated by MD&A and/or (iv) assumptions underlying or relating to any of the foregoing;[1]
- the information may not include information about the registered offering or information released as part of the offering activities in the registered offering;
- the issuer has previously released or disseminated information of this type in the ordinary course of its business (although there is no particular length of time requirement); and
- the information is released or disseminated in the ordinary course of business and the timing, manner and form in which the information is released is materially consistent with similar past disclosures.[2]

Communications More than 30 Days Prior to Filing a Registration Statement

While it has long been clear that "offers" are not permitted prior to filing a registration statement, there has not been a clear rule as to when such restricted period commences. In order to address this uncertainty, the SEC's proposal provides that any communication made by or on behalf of an issuer more than 30 days before the date of the filing of the registration statement will not be prohibited by the gunjumping rules and will not be deemed an offer under Section 5(c) of the Securities Act. In order to satisfy the safe harbor, the communication cannot reference a securities offering, and the issuer is required to take reasonable steps within its control to prevent further distribution or publication of the communication during the 30 days immediately preceding the date of filing the registration statement. Statements made in reliance on the 30-day exemption would still be subject to Regulation FD, as well as the antifraud provisions of the securities laws.

Pre-Filing Communications by Well-Known Seasoned Issuers

The SEC proposals would further loosen the gunjumping prohibitions with respect to a category of large issuers called "well-known seasoned issuers."[3] Like other issuers, these well-known seasoned issuers would benefit from the safe harbors for regularly-released factual information and regularly-released forward-looking information, as well as the safe harbor for communications made more than 30 days prior to filing a registration statement. However, the SEC also proposed an exemption from the gunjumping prohibition for all pre-filing communications by these issuers within the 30 days prior to filing a registration statement, subject to satisfaction of various conditions.

Definition of "Well-Known Seasoned Issuer"

As proposed, a "well-known seasoned issuer" is any company that meets all of the following criteria:

- it is eligible for primary offerings under Forms S-3 or F-3 because (1) it is offering securities for cash for its own account and has a public float held by non-affiliates of at least $75 million, or (2) it is offering investment grade nonconvertible securities for cash, or (3) it is eligible to make automatic shelf offerings (discussed below);
- it either (1) has outstanding common equity held by nonaffiliates with a market value of U.S. $700 million or more,[4] or (2) has issued during the last three years at least U.S. $1 billion of debt securities in registered offerings and will register only debt securities[5];

- it is required to file reports pursuant to sections 13 or 15(d) of the Exchange Act and has been required to file reports pursuant to those sections for at least the last 12 calendar months;
- it has filed "in a timely manner" all materials required to be filed during the 12 calendar months and any portion of a month immediately preceding the date of determination, other than certain reports required to be filed on Form 8-K;
- it is not an "ineligible issuer"[6] or an asset backed issuer.

For purposes of testing whether or not a company is a well-known seasoned issuer, an issuer would measure its public float and the amount of debt securities issued on the last business day of its most recently completed second quarter prior to the date of filing its Form 10-K or Form 20-F.

Oral or Written Offers Made by Well-Known Seasoned Issuers Within 30 Days of Filing a Registration Statement

The SEC has proposed a new rule that would exempt all pre-filing communications by well-known seasoned issuers from the prohibition in section 5(c) of the Securities Act on offers before a registration statement has been filed. This exemption, contained in proposed Rule 163, is subject to satisfaction of the following criteria:

- The exemption only applies to offers "by or on behalf of" the issuer.
- Every written communication made pursuant to this exemption must be filed with the SEC "promptly" upon the filing of the registration statement or amendment covering the securities that are being offered in reliance on the exemption.
- Any written offer made in reliance on this exemption must contain a specified legend which advises potential investors to read the prospectus before making their investment.
- Any written offer made in reliance on this exemption will be deemed a "prospectus" under section 2(a)(10) of the Securities Act and a "free writing prospectus" relating to a public offering of securities to be covered by the registration statement to be filed. The SEC's proposing release states that "all oral communications and prospectuses would be subject to liability under Section 12(a)(2). The offers would also be subject to liability under other provisions relating to offers, including Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act."

Expansion of the Rule 134 Safe Harbor for Limited Releases of Information After a Registration Statement Is Filed

Rule 134 is a limited communications safe harbor which issuers may use after a registration statement is filed. The safe harbor generally provides that a communication may include only specified categories of information, such as the name of the issuer, the title of the security, a brief indication of the general type of business of the issuer, the price of the security, the names of the managing underwriters, and any statement required by state law. Any communication which satisfies these criteria is not deemed to be a "prospectus" and thus can be distributed after a registration statement is filed.

The SEC's proposal would generally broaden the categories of information that may be included in releases issued under Rule 134. The additional information would include:

- the segments in which the company conducts business;
- the address, phone number and email address of the issuer's principal offices and contact for investors, the issuer's country of organization and the geographic areas in which it conducts business;
- in the case of a fixed income security, not just the yield or probable yield range, but also the final maturity and interest rate provisions, the probable final maturity or interest rate provisions, and the yield of securities with comparable maturities and security ratings (but not a detailed term sheet);
- not just "the names of managing underwriters," but also the names of underwriters participating in the offering of the securities and their additional roles, if any, within the underwriting syndicate;
- not just "the approximate date upon which the proposed sale to the public will begin," but also the anticipated schedule for the offering and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them);
- a description of the procedures by which the underwriters will conduct the offering and the procedures for transactions in connection with the offering with an underwriter or participating dealer;

- any rating "reasonably expected to be assigned" (the current rule allows actual ratings only);
- the names of selling security holders (if included in the prospectus filed at the time of the communication);
- the names of securities exchanges where any class of the issuer's securities are, or will be, listed;
- the ticker symbols, or proposed ticker symbols, of the issuer's securities; and
- information disclosed in order to correct inaccuracies previously contained in a communication made pursuant to Rule 134.

Free Writing Prospectuses Used after Filing a Registration Statement

Under current rules, after a registration statement is filed but before it becomes effective, in general the only writing related to an offering that may be distributed is a prospectus that complies with section 10 of the Securities Act. Further, after a registration statement becomes effective, written offers other than a statutory prospectus may be made only if prior to or at the same time as the written offer a final prospectus meeting the requirements of section 10(a) of the Securities Act is sent or given. The SEC proposes to significantly relax these restrictions. As proposed, after a registration statement is filed, all issuers and other offering participants would be permitted to distribute "free writing prospectuses" (generally any writing other than a statutory prospectus) so long as various conditions are satisfied.

Definition of "Free Writing Prospectus"

A "free writing prospectus" would be defined as any "written communication" that constitutes an offer to sell or a solicitation of an offer to buy the securities relating to a registered offering that is used after the registration statement in respect of the offering is filed (or, in the case of a well-known seasoned issuer, whether or not such registration statement is filed).

The SEC proposal would define the term "written communication" broadly to include all methods of communication, including electronic communications, but not oral communications. Therefore, a "written communication" would include any communication that is "written, printed, broadcast or a graphic communication." "Graphic communication" includes "all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet Web sites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilations." In particular, electronic postings on web sites, including electronic road shows, would be deemed written communications subject to the free writing prospectus rules. The definition of written communications would not cover oral communications, such as live phone calls. The SEC's proposing release clarifies that "written communications" would not include individual telephone voice mail messages but would include broadly disseminated "blast" voice mail messages.

A communication would be a free writing prospectus only where it constituted an "offer" of securities. Whether a communication is an offer must be determined based on the particular facts and circumstances. Communications that would not be considered offers or prospectuses, such as Rule 134 notices, Rule 135 notices, regularly released factual business information, regularly released forward-looking information, and research reports falling within the safe harbors, would not be free writing prospectuses.

Conditions to the Use of a "Free Writing Prospectus"

A free writing prospectus could be used by an issuer or any other offering participant in connection with a registered offering of securities after the filing of the registration statement if the writing satisfied the following requirements.

- ***Nonreporting and Unseasoned Issuers: Accompanying Statutory Prospectus.*** For issuers that are not required to file reports pursuant to sections 13 or 15(d) of the Exchange Act, or that do not satisfy the requirements of Form S-3 or F-3 for a primary offering of securities, including voluntary filers,[7] in general a free writing prospectus can be distributed only if it is accompanied or preceded by a statutory prospectus. Importantly, this can be accomplished by an electronic hyperlink.

  (1) The free writing prospectus must be accompanied or preceded by the most recent prospectus that satisfies the requirements of section 10 of the Securities Act, including a price range where required (e.g., an IPO preliminary prospectus without a price range would not satisfy the requirements of section 10), if the free writing prospectus was prepared by or on behalf of an issuer or any other person participating in the offer or sale of the securities, or if consideration has been or will be given by the issuer or an offering participant for the publication or broadcast (in any format) of any free writing prospectus (including any published article, publication or advertisement).

(2) Once the required statutory prospectus is sent or given to an investor, additional free writing prospectuses could be provided without having to send or give an additional statutory prospectus, unless there were material changes in the most recent statutory prospectus from the provided prospectus.[8]

The result of this framework is that, for nonreporting issuers and unseasoned issuers, in general a free writing prospectus can be used only if it is preceded or accompanied by the most recent statutory prospectus that satisfies the requirements of section 10 of the Securities Act (generally a red herring or a final prospectus), which can be accomplished by electronic hyperlink. The SEC's proposing release indicates that the "precede or accompany" requirement would apply to (i) a direct written communication by an issuer or offering participant, (ii) an interview in print or broadcast given or prepared by an issuer, its officers, directors or representatives or an offering participant, or the publication or broadcast (in any format) of any free writing prospectus for which consideration was or would be given by the issuer or an offering participant, or for which section 17(b) of the Securities Act required disclosure of a payment made or consideration given by an issuer or other offering participant, (iii) a press release disseminated by an issuer or offering participant and rebroadcast by the media, or (iv) a paid advertisement, in any format, by the issuer or offering participant.

- ***Well-Known Seasoned Issuers and Seasoned Issuers: Statutory Prospectus Must be on File***. If at the time of the filing of the registration statement the issuer is a well-known seasoned issuer or an issuer eligible to use Form S-3 or Form F-3 to register securities to be offered and sold by or on its behalf, on behalf of its subsidiary, or on behalf of a person of which it is the subsidiary, then the issuer or any person participating in the offering may use a free writing prospectus if the issuer previously filed as part of its registration statement a statutory prospectus covering the securities that satisfies the requirements of section 10 of the Securities Act.

- ***Filing Requirement***. Issuers would be required to file with the SEC any free writing prospectus that they prepare. In particular, the issuer would need to file with the SEC: (1) any "issuer free writing prospectus" (a free writing prospectus prepared by or on behalf of the issuer) used by any person, (2) any free writing prospectus of any person used by the issuer, (3) any "issuer information" ("material information about the issuer or its securities that has been provided by or on behalf of the issuer") that is contained in a free writing prospectus prepared by any other person (but not information prepared by a person other than the issuer on the basis of that issuer information), and (4) any free writing prospectus prepared by any person that contains only a description of the final terms of the issuer's securities.[9]

  In general, there is no condition that underwriters and participating dealers file the free writing prospectuses that they prepare. The SEC's proposing release states that "[t]his would include information prepared by underwriters and others on the basis of, but not containing, issuer information. Examples of this information would include information prepared by underwriters that could be, but would not be limited to, information that is proprietary to an underwriter."[10] However, as an exception to this general rule, any person other than the issuer participating in the offer and sale of the securities must file any free writing prospectus that is distributed by such person in a manner reasonably designed to lead to its ***broad unrestricted dissemination***, unless it was previously filed. "For example, the filing condition would apply where (1) an underwriter included a free writing prospectus on an unrestricted web site or hyperlinked from an unrestricted web site to information that would be a free writing prospectus or if a dealer or other offering participant released or gave a copy of its free writing prospectus to a newspaper or other media; or (2) an underwriter or other offering participant sent out a press release regarding the issuer or the offering that would be a free writing prospectus."[11] On the other hand, a web site with access restricted to customers or a subset of customers would not require filing, nor would an e-mail by an underwriter to its customers, regardless of the number of customers. Free writing prospectuses sent directly to customers of an offering participant, without regard to number, would not be broadly disseminated and thus would not need to be filed.

- ***Information***. The free writing prospectus can take any form and need not meet the informational requirements otherwise applicable to prospectuses. It can contain information that is beyond the information contained in the statutory prospectus. There are no line item disclosure requirements, other than the legend. However, the information in a free writing prospectus cannot be inconsistent with information contained in the company's other public filings.

- ***Legend Requirement***. Any free writing prospectus used in reliance on this exemption must contain a specified legend advising investors to read the prospectus before making an investment.

A free writing prospectus would not be part of a registration statement subject to liability under section 11 of the Securities Act, unless the issuer elected to make it part of the registration statement. Regardless of whether the free writing prospectus is filed, any person using it would be subject to liability for prospectuses under sections 12(a)(2) and 17(a) of the Securities Act and liability under the other anti-fraud provisions of the securities laws, including section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Electronic Road Shows

An electronic roadshow would be considered a written communication, a prospectus, and a free writing prospectus. As such, electronic roadshows in any registered offering would be permitted only if they satisfied the conditions applicable to free writing prospectuses. For example, electronic road shows involving a non-reporting or unseasoned issuer, including a voluntary filer, would be subject to the condition that the issuer's statutory prospectus accompany or precede the electronic road show; as such, the electronic road show would need to include a hyperlink to the issuer's filed statutory prospectus. Electronic road shows also would have to satisfy the legend requirement. In addition, issuer involvement or participation in the road show would make it an "issuer free writing prospectus," which is subject to filing with the SEC.

However, pursuant to proposed Rule 433(d)(6), the electronic roadshow (and its script) would not need to be filed with the SEC if (1) the issuer of the securities makes at least one version of a "bona fide electronic road show"[12] readily available electronically to any person, including any potential investor in the securities (and if there is more than one version of an electronic roadshow, the version available without restriction is made available no later than the other versions) and (2) the issuer files any issuer information ("material information about the issuer or its securities that has been provided by or on behalf of the issuer") that is contained in the electronic road show, unless such information is included or incorporated by reference in a prospectus or free writing prospectus previously filed that relates to the offering.[13]

The free writing prospectus rules do not apply to oral communications made at live road shows.

Free Writing Prospectuses Published or Distributed by the Media

Any written communication about an issuer or its securities that is published by unaffiliated persons in the media, for which an issuer or any person participating in the offering or any person acting on their behalf provided information, will be considered a free writing prospectus prepared by or on behalf of the issuer or a person participating in the offering. Therefore, in accordance with proposed Rule 433(f), the media publication would need to comply with all of the requirements otherwise applicable to free writing prospectuses.

However, the filing, legend, information, and accompanying prospectus requirements will not apply if (1) no payment is made or consideration given by or on behalf of the issuer or any person participating in the offering for the written communication, and (2) the issuer or any other person participating in the offering files the written communication with the SEC with the required legend within one business day after the publication or dissemination of the writing.

Therefore, if an issuer or offering participant prepared, paid or gave consideration for a published article, broadcast or advertisement, the issuer would have to satisfy the conditions on the use of a free writing prospectus at the time of publication or broadcast. For example, in the case of a non-reporting issuer, a statutory prospectus would have to precede or accompany the communication. As a result, in offerings by non-reporting and unseasoned issuers, issuers and offering participants would not be able to publish or broadcast written advertisements, infomercials or broadcast spots about the issuer, its securities or the offering that included information beyond that permitted by Rule 134. In contrast, for seasoned issuers, the most recent statutory prospectus would need to be on file with the SEC, and the issuer or offering participant would need to file the free writing prospectus with the SEC not later than the date of first use.

However, where the free writing prospectus is prepared by unaffiliated persons in the media and not paid for by the issuer or offering participants, the statutory prospectus would not need to precede or accompany the media communication. Therefore, an interview or other media publication or broadcast where an issuer or offering participant participates (but does not prepare or pay for the event) could be a free writing prospectus but would not require prior or simultaneous delivery of the statutory prospectus. Any such free writing prospectus would still be subject to filing by the issuer or offering participant involved within one business day after first publication or first broadcast. The media would have no filing or other obligations under these provisions. In this scenario, the SEC stated in its proposing release that "if a chief executive of a non-reporting issuer gave an interview to a financial news magazine without payment to the magazine for the article, the publication of the article after the filing of the registration statement would be a free writing prospectus of the issuer that would have to be filed by the issuer after publication. In that case, there would be no requirement that a statutory prospectus precede or accompany the article at the time of publication."

Shelf Registration

Overview of the Current Shelf Registration Procedures

Shelf registration is currently governed by Rule 415. This rule provides that securities may be registered for an offering to be made on a continuous or delayed basis in the future in one of eleven categories of offerings. The shelf category most used covers securities to be registered on Form S-3 or F-3 which are to be offered and sold on a continuous or delayed basis by or on behalf of the company, a subsidiary of the company or a person of which the company is a subsidiary (shelf category X). Other categories of shelf offerings include, among others (1) securities to be offered or sold solely by or on behalf of a person other than the company, a subsidiary of the company or a person of which the company is a subsidiary (shelf category I), (2) securities the offering of which will be commenced promptly, will be made on a continuous basis and may continue for a period in excess of 30 days from the date of initial effectiveness (shelf category IX), (3) securities to be offered and sold pursuant to a DRIP plan or an employee benefit plan, (4) securities to be issued upon the exercise of options, warrants or rights, (5) securities to be issued upon conversion of other outstanding securities, (6) securities to be pledged as collateral, and (7) securities which are to be issued in connection with business combination transactions (shelf category VIII).

Modifications to Shelf Procedures

The SEC proposals would generally make the shelf registration process less burdensome for all issuers. Principal changes to Rule 415 would include the following:

- **Two Year Period**. Under current shelf rules, securities registered in shelf categories VIII (business combination transactions), IX (continuous offerings for more than 30 days after effectiveness), and X (standard Form S-3 primary issuances) may only be registered in an amount which is reasonably expected to be offered and sold within two years from the initial effective date of the registration statement. As proposed, the two year limitation would no longer apply to shelf offerings in category X and would only apply to shelf offerings in categories VIII and IX which are not registered on Form S-3 or Form F-3.
- **Three Year Period**. As proposed, securities registered in shelf categories I (secondary shelves) and X (standard Form S-3 primary issuances) on Forms S-3 or F-3 could be offered and sold for a period of three years after the initial effective date of the registration statement. There would be no limit on the amount that could be registered.
- **At the Market Offerings**. The SEC proposals would eliminate the current limitations on "at the market" offerings of equity securities by or on behalf of a company. An "at the market offering" is an offering of securities into an existing trading market for outstanding shares of the same class at other than a fixed price on or through the facilities of a national securities exchange or to or through a market maker. Under current rules, securities sold in an at the market offering: (1) must be issued on a Form S-3 or F-3, (2) if voting securities, must not exceed 10% of the aggregate market value of the company's outstanding voting stock held by non-affiliates, and (3) must be sold through underwriters who are named in the prospectus.
- **Immediate Shelf Takedowns**. Under current SEC policy, issuers that file shelf registration statements for a continuous or delayed offering on Forms S-3 or F-3 are not permitted to make an immediate takedown off the shelf after it is declared effective unless the takedown is disclosed in the shelf registration statement. The SEC proposals would reverse this policy and allow immediate primary offerings on Form S-3 or Form F-3 following effectiveness.

Information in Base Prospectuses and Prospectus Supplements

Under current practice, a shelf registration statement at the time of effectiveness may contain a base prospectus which omits information about the particular offering and the particular plan of distribution. When particular offerings are made using the base prospectus, a prospectus supplement containing this additional information may be distributed to investors and filed with the SEC.

- **Information That is Unknown or Unavailable to the Issuer**. In general, as proposed, the base prospectus for offerings in shelf categories VIII (business combination transactions) and X (standard Form S-3 primary offerings) "may omit information that is unknown or not reasonably available to the issuer pursuant to Rule 409." This is intended to be consistent with current practice.

- **Identity of Selling Shareholders**. Under current SEC policy, new or previously unidentified selling shareholders can be added to resale registration statements only pursuant to a post-effective amendment, with limited exceptions. This can impose potential delay on a transaction because the SEC may choose to review the post-effective amendment. The SEC proposes to address this concern by allowing certain issuers to add the names of selling shareholders, and all information about them required by Item 507 of Regulation S-K, after effectiveness of the registration statement either in post-effective amendments or in prospectus supplements (which would be deemed part of the registration statement for liability purposes).

  Specifically, a base prospectus filed as part of a shelf registration statement for offerings pursuant to shelf category I (secondary shelves) by an issuer eligible to use Form S-3 or Form F-3 for primary offerings (satisfying the $75 million public float requirement) could omit the identities of selling shareholders and amounts of securities to be registered on their behalf if: (1) the offering in which the selling shareholders acquired the securities being registered was completed, (2) the securities were issued and outstanding prior to the original date of filing the registration statement covering the resale of the securities, and (3) the registration statement identifies any known selling security holders and refers to any unnamed selling security holders in a generic manner by identifying the transaction in which the securities were acquired. Following effectiveness, the registrant would need to file a prospectus, a prospectus supplement or a post-effective amendment to add the names of previously unidentified selling shareholders and the amounts of securities they intend to sell.

- **Methods of Including Omitted Information**. Information omitted from a base prospectus pursuant to the provisions above may be included in the prospectus by a post-effective amendment, a prospectus filed pursuant to Rule 424 or, if the form permits, by incorporating the information by reference to a periodic or current report filed with the SEC.

- **Incorporation by Reference of Information into Forms S-3 and F-3**. The SEC's proposals would amend Form S-3 and Form F-3 to allow any information required in the base prospectus pursuant to Items 3 through 11 of Form S-3 and Form F-3 to be incorporated by reference through documents filed pursuant to Exchange Act reports. This includes risk factors, ratio of earnings to fixed charges, use of proceeds, determination of offering price, dilution, selling security holders, plan of distribution, description of securities, interests of named experts and counsel, and material changes. Therefore, all of this information could be included in Exchange Act reports or in the prospectus or a prospectus supplement.

- **Material Changes to the Plan of Distribution**. As proposed, material changes in the plan of distribution in Forms S-3 and F-3, which currently are required to be included in post-effective amendments, could be included by incorporated Exchange Act reports or prospectus supplements.

Automatic Shelf Registration for Well-Known Seasoned Issuers

The SEC has also adopted a new form of "automatic shelf registration" which would make the shelf registration process more flexible for well-known seasoned issuers. As proposed, eligible well-known seasoned issuers could register unspecified amounts of different specified types of securities on automatically effective Form S-3 or Form F-3 registration statements. Eligible issuers could add additional classes of securities or eligible majority-owned subsidiaries as additional registrants after the registration statement is effective. Issuers could pay filing fees in advance or on a pay-as-you-go basis at the time of each takedown in an amount calculated for that takedown. The proposals would also allow more information to be omitted from the base prospectus than would be allowed for other issuers.

- **Initial Issuer Eligibility**. Any company can utilize automatic shelf registration if, immediately prior to the filing of the registration statement, it is a well-known seasoned issuer. In addition, the issuer must satisfy the registrant requirements of Form S-3 or Form F-3 and one of the first four transactional requirements of Form S-3 or Form F-3. The automatic shelf registration statement can cover any offering pursuant to Rule 415, other than business combinations and mortgage-related securities. The SEC's proposing release states that the issuer must reassess its eligibility for use of the automatic shelf registration statement at the time of each updated prospectus required by section 10(a)(3). This update usually occurs upon the filing of the issuer's Form 10-K or Form 20-F for the prior fiscal year.

- **Securities Covered**. Generally the registration statement can cover securities of the company, securities of majority owned subsidiaries and securities owned by selling security holders.

(1) **Company Securities**. The registration statement can cover securities of the issuer to be offered pursuant to Rule 415, Rule 430A and Rule 430B.

(2) **Majority-Owned Subsidiary Securities**. The registration statement can cover securities of majority-owned subsidiaries to be offered pursuant to Rule 415 and 430B if the parent registrant is a well-known seasoned issuer and the subsidiary securities fall into one of five specified categories.

(3) **Selling Security Holder Securities**. The registration statement can cover securities of any person other than the issuer. The registration statement and the prospectus are not required to separately identify the securities to be sold by selling security holders until the filing of a prospectus supplement, post-effective amendment to the registration statement, or periodic or current report under the Exchange Act identifying the selling security holders and the amount of securities to be sold by each of them.

- **Registration of Securities Offered**. The issuer can register an unspecified amount of securities to be offered, without indicating whether the securities would be sold in primary offerings or secondary offerings on behalf of selling security holders. Well-known seasoned issuers who satisfy the definition only because they have issued over $1 billion of debt securities could only register non-convertible obligations. The calculation of registration fee table in the initial filing would not need to include a dollar amount or specific number of securities, but would specify each class of security registered.
- **Automatic Effectiveness**. The automatic shelf registration statement would become effective automatically, without staff review. Any post-effective amendment, including a post-effective amendment to register additional classes of securities, would become effective automatically. Also, a post-effective amendment filed to add a new issuer and its securities that satisfies the requirements of Form S-3 or F-3, including signatures, and which contains a prospectus satisfying the requirements of Rule 430B, would become effective automatically. An automatic registration statement and any post-effective amendment thereto is deemed filed on the proper registration form until the SEC notifies the issuer of its objection to use of the form.
- **Adding Additional Securities of the Issuer**. Well-known seasoned issuers could add additional classes of securities to the automatic shelf registration statement by filing a post-effective amendment which would become effective automatically. The information required by Item 202 of Regulation S-K (containing a description of the securities) must be contained either in the post-effective amendment, a Form 10-K, Form 20-F, Form 10-Q, Form 8-K or Form 6-K that is incorporated by reference into the registration statement or in a prospectus filed pursuant to Rule 424 deemed to be part of and included in the registration statement.
- **Adding Subsidiaries as New Registrants**. An automatic shelf registration statement could be amended by post-effective amendment to add a majority-owned subsidiary as a new registrant.
- **Pay-As-You-Go Registration Fees**. The initial registration fee at the time of initial filing is *de minimis* and will be credited against any fee subsequently due. In the initial filing the "Calculation of Registration Fee" table should identify the classes of securities being registered and the initial filing fee and state that it registers an unspecified amount of securities of each identified class of securities, but it does not need to include the number of shares of securities or the maximum aggregate offering price of any securities. The registration fees may then be paid on a pay-as-you-go basis, and the registration fee may be calculated on the basis of the aggregate offering price of the securities to be offered in a particular offering.
- **Information That May Be Omitted From the Base Prospectus**. A base prospectus filed as part of an automatic shelf registration statement for all shelf offerings could omit not just "information that is unknown or not reasonably available to the issuer" (which all issuers could omit pursuant to proposed Rule 430B) but also information as to whether the offering is a primary offering or an offering on behalf of persons other than the issuer, the plan of distribution for the securities, and the identification of other issuers unless known.

  In addition, a base prospectus filed as part of an automatic shelf registration statement for offerings pursuant to shelf category I (secondary shelves) by an issuer eligible to use Form S-3 or Form F-3 for primary offerings may omit the identities of selling shareholders and amounts of securities to be registered on their behalf, without having to satisfy any conditions.

- **Including Omitted Information in an Automatic Shelf Registration Statement**. Information could be added to any shelf registration statement (whether or not an automatic shelf registration) on Form S-3 or F-3 pursuant to a post-effective amendment, a periodic or current report incorporated by reference into the registration statement, or a prospectus supplement which would be deemed to be part of the registration statement pursuant to Rule 430B. Any information required to be in the prospectus pursuant to Item 3 through Item 11 of Form S-3 and Form F-3 could be included in this manner, including the public offering price, a detailed description of the securities, the identity of underwriters and selling security holders, and the plan of distribution for the securities. The only exception to this approach is that the addition of new types of securities, or new eligible issuers, including guarantors, and the securities they intend to issue, must be accomplished by post-effective amendment.

- **Duration of the Registration Statement**. Issuers would be required to file new automatic shelf registration statements every three years. Issuers would be prohibited from issuing securities off an automatic shelf registration statement that is more than three years old. However, as long as eligibility for automatic shelf registration is maintained, the new registration statement would be effective immediately and would carry forward the securities registered and any fee paid on the old registration statement. Therefore, an issuer's securities offerings under the registration statement would not be interrupted.

Prospectus Delivery

The SEC proposals would eliminate in many cases the need for issuers, underwriters and dealers to physically deliver a final prospectus if a statutory prospectus is filed with the SEC on EDGAR.

Access Equals Delivery (Proposed Rule 172(b))

Section 5(b)(2) of the Securities Act states that it is unlawful to deliver a security unless it is accompanied or preceded by a section 10(a) prospectus. This provision effectively requires every purchaser of securities in a registered offering to physically receive a final prospectus. The SEC proposes to allow issuers and other offering participants to satisfy this "delivery" requirement without physical delivery if a statutory prospectus is filed with the SEC on EDGAR. Specifically, physical delivery would not be required to satisfy section 5(b)(2) if:

(1) the registration statement relating to the offering is effective and is not the subject of any pending proceeding or examination by the SEC,

(2) neither the issuer, nor an underwriter or participating dealer is the subject of a pending proceeding under the Securities Act in connection with the offering, and

(3) the issuer has filed with the SEC a prospectus with respect to the offering that satisfies the requirements of section 10(a), other than omitting price-related information under Rule 430A, or for offerings relying on Rule 430B or Rule 430C, the issuer has filed or will file such a prospectus within the time required under Rule 424.

Confirmations and Notices of Allocations (Proposed Rule 172(a))

Section 5(b)(1) of the Securities Act currently prohibits the delivery of written confirmations and notices of allocation after effectiveness of a registration statement unless they are accompanied or preceded by a section 10(a) prospectus.[14]

The SEC proposes to allow confirmations and notices of allocation to be delivered even if not accompanied or preceded by a prospectus, subject to certain conditions. In particular, after the effective date of a registration statement, written confirmations of sales of securities in a registered offering could be distributed if the confirmation contained information limited to that called for in Rule 10b-10 of the Exchange Act and other information customarily included in written confirmations of sales. Similarly, notices of allocation of securities sold or to be sold in a registered offering could be distributed if the notice identifies the security and is otherwise limited to information regarding pricing, allocation, and settlement and information incidental thereto. For example, broker-dealers could send e-mail notices after effectiveness to inform investors in a public offering of their allocations.

The SEC's proposal would allow distribution of confirmations and notices of allocation, as described above, subject to the following conditions: (1) the registration statement relating to the offering is effective and is not the subject of any pending proceeding or examination by the SEC; (2) neither the issuer, nor an underwriter or participating dealer is the subject of a pending proceeding under the Securities Act in connection with the offering; and (3) the issuer has filed with the SEC a prospectus with respect to the offering that satisfies the requirements of section 10(a), other than omitting price-related information under Rule 430A, or for offerings relying on Rule 430B or Rule 430C, the issuer has filed or will file such a prospectus within the time required under Rule 424.

Notice of Registration (Proposed Rule 173)

As a corollary to the access equals delivery rules, the SEC is also proposing a new rule which would require underwriters participating in an offering to provide purchasers with a notice stating that the sale was made pursuant to a registered offering. The SEC proposal includes the following elements:

- The requirement would apply to any underwriter or broker or dealer participating in an offering pursuant to a registration statement.
- The requirement would apply in a transaction that represents (1) a sale by the issuer or an underwriter, or (2) a sale where a final prospectus meeting the requirements of section 10(a) is not exempt pursuant to section 4(3) of the Securities Act and Rule 174 from a requirement to be delivered.
- Within two business days following the completion of the sale, the underwriter, broker or dealer would have to provide to each purchaser from it either (1) a copy of the final prospectus, or (2) a notice to the effect that the sale was made pursuant to a registration statement or in a transaction in which a final prospectus would have been required to be delivered in the absence of Rule 172.
- If the sale was made by the issuer and was not effected by an underwriter, broker or dealer, the responsibility to send a prospectus or the notice is the issuer's.
- Compliance with Rule 173 is not a requirement for compliance with Rule 172.
- A purchaser may request from the person responsible for sending a notice a copy of the final prospectus if one has not been sent.
- After the effective date of a registration statement, Rule 173 notices are exempt from section 5(b)(1) of the Securities Act.

Aftermarket Prospectus Delivery (Rule 174)

Dealers are currently required to deliver final prospectuses in secondary market transactions for specified periods of time after a registration statement becomes effective. Rule 174 specifies that (1) no prospectus delivery is required by dealers for reporting issuers, (2) final prospectuses must be delivered for 25 days with respect to non-reporting issuers that will be listed on a national securities exchange or quoted on NASDAQ, and (3) final prospectuses must be delivered for 90 days after effectiveness or after funds are released from the escrow or trust account in connection with offerings of securities of non-reporting companies that will not be so listed or quoted as well as offerings by blank check companies.

The SEC proposes to eliminate any dealer requirement to physically deliver a final prospectus pursuant to Rule 174 if a statutory prospectus has been posted on EDGAR and Rule 172 is otherwise complied with.

Liability

The SEC's proposed rules, if adopted, may impact or clarify liability in three principal ways under the federal securities laws.

Information Delivered After the Time of Sale for Purposes of Section 12(a)(2) and Section 17(a)(2) Liability

Sections 12(a)(2) and 17(a)(2) of the Securities Act impose liability for materially misleading disclosures in connection with the sale of securities in an offering. Under section 12(a)(2), sellers have liability to purchasers for offers or sales made by means of a prospectus or oral communication that contains an untrue statement of material fact or omits to state a material fact that would make the statements made, based on the circumstances under which they were made, not misleading. Similarly, section 17(a)(2) makes it unlawful for any person in the offer and sale of a security to obtain money or property by means of any untrue statement of a material fact or any failure to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The Securities Act registration regime allows companies to send information to investors after investors have made their investment decision. For example, in shelf offerings, issuers can file a final prospectus supplement two business days after a takedown from a shelf registration statement. The SEC, in proposing Rule 159, is taking the position that the liability standards of sections 12(a)(2) and 17(a)(2) should apply only to information which an investor has received at the time the investor makes his or her investment decision, i.e., when an investor has entered into a contract of sale and is thus committed to the transaction.[15]

The SEC's interpretation would be codified in new Rule 159. This rule would provide that:

> [f]or purposes of section 12(a)(2) [and section 17(a)(2)] of the Act only, and without affecting any other rights a

> purchaser may have, for purposes of determining whether a prospectus or oral statement included an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading at the time of sale (including, without limitation, a contract of sale), any information conveyed to the purchaser only after such time of sale (including such contract of sale) will not be taken into account.

Thus, evaluation of information at or prior to the time of sale would not take into account any modifications, corrections or additions that are made available after the time of sale, including information contained in any final prospectus, prospectus or Exchange Act filing that is only filed or delivered after the time of sale.[16]

Issuer as Seller Under Section 12(a)(2)

Section 12(a)(2) imposes liability on "sellers" of securities in offerings. In *Pinter v. Dahl,* 486 U.S. 622 (1988), in interpreting "sellers" under section 12(a)(1), the Supreme Court held that statutory liability is not limited to those persons who simply pass title to the securities but may extend to any person who actively solicited the securities transaction to further its own financial motives. Courts have typically applied *Pinter* to claims brought under section 12(a)(2).

Because the issuer does not have title to its securities when shares are issued in a firm commitment underwriting, under current law, section 12(a)(2) liability can be imposed on an issuer only when it solicited the securities transaction at issue. Following *Pinter,* courts have generally rejected section 12(a)(2) claims against issuers in offerings consummated under firm commitment underwriting arrangements. The courts have usually concluded that allegations that the issuer's conduct consisted of the type of conduct one would expect of an issuer, i.e., preparation of a registration statement or prospectus or presentation at a roadshow[17] does not rise to the level of active solicitation to make the issuer subject to section 12(a)(2) liability as a seller.

The SEC's proposed Rule 159A, if enacted and enforced by the courts, would fundamentally change the scope of liability for issuers under Section 12(a)(2). Under the proposed rule, regardless of the underwriting method used, any communications by or on behalf of the issuer (whether in a registration statement, free writing prospectus or otherwise) would result in seller status for the issuer even if those communications are of the type typically undertaken by an issuer in the offering process—and which, under current law, would not be sufficient to confer seller status on the issuer under section 12. That is, under the proposed rule, in any primary offering, an issuer would be considered a seller when any of the following communications are made "by or on behalf of the issuer":

- an issuer's registration statement relating to the offering and any preliminary prospectus and prospectus supplement filed pursuant to Rule 424;
- any "free writing prospectus" prepared by or on behalf of the issuer;
- information about the issuer or its securities provided by or on behalf of the issuer and included in any other free writing prospectus; and
- any other communication made by or on behalf of the issuer.[18]

Section 11 Liability for Prospectus Supplements

Currently, only information included in a base prospectus or in an Exchange Act periodic report that is incorporated by reference into a base prospectus is deemed to be included in a shelf registration statement. Prospectus supplements have generally been thought not to be part of the registration statement or subject to section 11 liability. Proposed Rule 430B would clarify that prospectus supplements and information in them would be deemed to be part of and included in a registration statement filed pursuant to shelf category X (primary shelf offerings on Form S-3). Proposed Rule 430C would include similar provisions for shelf categories I (secondary shelves) and IX (continuous offerings). The information in the prospectus supplement, by virtue of being included in the registration statement, would become subject to section 11 liability. The earlier of the date such prospectus supplement is first used or the date and time of the first contract of sale of securities to which such prospectus supplement relates would be deemed, for section 11 liability purposes, to be a new effective date of the registration statement relating to the securities to which the subsequent prospectus supplement relates.[19]

The new effective date of the registration statement would only be relevant for liability purposes. The new effective date would not be considered the filing of a new registration statement for purposes of form eligibility; such determination would continue to be made at the time of the section 10(a)(3) update to the registration statement. The new effective date would not, by itself, require the filing of additional consents of experts, and would not constitute an updating of the registration statement for purposes of section 10(a)(3) of the Securities Act.

Prospectus supplements filed with the SEC other than in connection with a shelf takedown, pursuant to Rule 424(b)(3) (covering information which constitutes a substantive change from or addition to the information in the last form of prospectus filed with the SEC), would be deemed part of and included in a registration statement as of the date it is first used after effectiveness.

Other Changes to the Registration Process

Expanded Use of Incorporation by Reference in Forms S-1 and F-1

The SEC proposes to allow certain issuers filing on Forms S-1 and F-1 to incorporate by reference a large portion of the information required in the form. The documents incorporated by reference would not need to be delivered to investors with the prospectus. As proposed, an issuer would need to satisfy the following requirements in order to incorporate by reference on Forms S-1 and F-1:

- The issuer must be required to file reports and must have filed all reports and other materials required to be filed by sections 13(a), 14 or 15(d) of the Exchange Act during the prior 12 months.
- The issuer must have filed an annual report under section 13(a) or 15(d) of the Exchange Act for its most recently completed fiscal year.
- The issuer cannot be an ineligible issuer.
- The issuer must make its periodic and current reports readily available and accessible on a web site maintained by or for the issuer and containing information about the issuer.

A qualifying issuer could incorporate by reference all of the information required by Items 3 through 11 of Form S-1 and Item 4 of Form F-1.[20] Issuers electing to use this provision would need to include the following additional information in their Form S-1 or Form F-1:

- The issuer must disclose any and all material changes in the company's affairs which have occurred since the end of the latest fiscal year for which audited financial statements were included in the latest Form 10-K and which have not been described in a Form 10-Q, Form 8-K or Form 6-K filed with the SEC.
- The issuer must specifically incorporate by reference into the prospectus its latest annual report on Form 10-K, 20-F or 40-F and all other reports previously filed pursuant to section 13(a) or 15(d) of the Exchange Act or proxy or information statements filed pursuant to section 14 of the Exchange Act since the end of the fiscal year covered by the annual report. The issuer may only incorporate previously filed documents; forward incorporation is not permitted.
- The issuer must state: (1) that it will provide to each person to whom a prospectus is delivered a copy of all of the documents incorporated by reference but not delivered with the prospectus, (2) that it will provide these reports or documents upon written or oral request, (3) that it will provide these documents at no cost to the requester, (4) the name, address, telephone number, and e-mail address, if any, to which the request for these documents must be made, and (5) the issuer's web site address, including the URL where the reports and other documents may be accessed. If the issuer sends any information that is incorporated by reference, it must also send any exhibits that are incorporated by reference in that information.
- The issuer must identify the reports and other information that it files with the SEC and state that the public may read and copy its SEC filings at the SEC's public reference room.

Risk Factor Disclosure

The SEC proposes to require risk factor disclosure in the Form 10-K and Form 10. As proposed, issuers would need to describe under the caption "Risk Factors" the risk factors described in Item 503(c) of Regulation S-K that are applicable to the company, including the most significant factors with respect to the company's business, operations, industry, or financial position that may have a negative impact on the company's future financial performance. The risk factor discussion must be in plain English. In addition, issuers would be required to disclose in their Form 10-Q any material changes from previously disclosed risk factors contained in the company's Form 10-K.

Disclosure of Unresolved Staff Comments

The SEC proposes to require disclosure of unresolved staff comments in Form 10-Ks and Form 20-Fs filed by accelerated filers (essentially Form S-3 filers who have filed at least one annual report). As proposed, if the issuer is an accelerated filer and has received written comments from the SEC staff regarding its periodic filings under the Exchange Act at least 180 days before the end of the fiscal year to which the annual report relates, and such comments remain unresolved, the issuer must disclose the substance of any such unresolved comments that the issuer believes are material.

The disclosure may include the position of the issuer with respect to any such comment.

Disclosure of Status as Voluntary Filer under the Exchange Act

Voluntary filers are issuers that are not "required" to file reports with the SEC but which do so voluntarily. Most voluntary filers are issuers who completed a registered offering of debt securities under the Securities Act, have no equity securities registered under section 12 of the Exchange Act, and continue to file Exchange Act reports even after their reporting obligation under section 15(d) has been suspended. Section 15(d) suspends automatically its application to any issuer that, on the first day of the issuer's fiscal year, has fewer than 300 holders of record of the class of securities that created the section 15(d) obligation. The SEC proposes to include a check box on the cover of Form 10-K, Form 20-F, and Form 10-KSB in which the issuer would indicate whether or not it is required to file reports pursuant to section 13 or 15(d) of the Exchange Act.

Endnotes

1. An issuer's communications of forward-looking information made in reliance on the proposed gunjumping safe harbor would still have to satisfy the conditions of Section 27A of the Securities Act (a safe harbor from liability for the substance of forward looking statements) if the issuer wished to rely on the statutory safe harbor for the content of the information.
2. The SEC's proposing release states with respect to the proposed safe harbors for factual information and forward-looking information that "[w]hile the proposal does not establish any minimum time period to satisfy the regularly released element, the safe harbor would require the issuer to have a track record of releasing the particular type of information. Issuers should consider the frequency and regularity with which they have released the same type of information. For example, an issuer's release of new types of financial information or projections just before or during a registered offering would likely prevent a conclusion that the issuer regularly released that type of forward-looking information in the ordinary course of its business. As another example, if an issuer has consistently released certain forward-looking information on a quarterly basis through ordinary course press releases, it could not satisfy the condition if it instituted a stepped-up media campaign just before or during an offering to release that type of forward-looking information on a different basis or with different timing."
3. The SEC calculates that well-known seasoned issuers represent approximately 30% of listed issuers but accounted for 87% of the total debt raised in registered offerings over the past seven years and also account for about 95% of U.S. equity market capitalization.
4. Based on data compiled by the SEC, issuers with market capitalizations of over $700 million which conducted offerings between 1997 and 2003 had on average 10 sell-side analysts following them prior to the offering, institutional investor ownership of approximately 56% and average daily trading volume of $25 million, and accounted for 78% of all equity securities issued and 97% of all debt securities issued.
5. Based on data compiled by the SEC, issuers of debt that meet the $1 billion threshold account for 23% of issuers that issued public debt from 1997 through 2003 but 72% of all debt issued during the same period. All of their debt was rated investment grade, and 84% of their debt offerings were rated A or higher by a rating agency.
6. Many of the SEC's proposed rules and exemptions would not be available to an "ineligible issuer." As proposed, an ineligible issuer cannot be characterized as a well-known seasoned issuer, cannot use free writing prospectuses, cannot use the safe harbor for communications more than 30 days before filing a registration statement, cannot use the automatic shelf registration procedure, and cannot incorporate by reference into its Form S-1 or Form F-1. An "ineligible issuer" includes, among other things: (1) any issuer that is required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act that has not filed all required materials, including any certifications (the proposal says "filed," not "timely filed"); (2) an issuer which has an audit opinion in which the auditor expressed substantial doubt about the issuer's ability to continue as a going concern; or (3) an issuer which has filed for bankruptcy or insolvency during the past three years, unless subsequent to such event the company filed an annual report with audited financial statements.
7. Footnote 426 of the SEC's proposing release states that "an issuer that is voluntarily filing Exchange Act reports, but is not required to do so, would be an unseasoned issuer for purposes of the communications and procedural proposals."
8. The SEC expects that if there were material changes in a preliminary prospectus, or preliminary prospectus supplement, the issuer and offering participants would generally recirculate the revised preliminary prospectus or supplement to potential investors.
9. Oral communications would not be subject to any filing conditions, but would still be subject to Section 12(a)(2) liability and the anti-fraud provisions of the securities laws.
10. The SEC proposing release also states that "[t]he ability of offering participants to use free writing prospectuses in connection with offerings would impart a greater ability to provide information to investors about securities before they make investment decisions. For example, issuers and underwriters would be able to provide proprietary analytical material that is specifically tailored to address the particular asset allocation considerations of different investors."
11. The SEC's proposing release also states that "[a]n underwriter, dealer, or other offering participant would be considered to have made such a distribution of a free writing prospectus if the dissemination was made by or on its behalf. As with an issuer free writing prospectus, 'by or on behalf of' an underwriter, dealer or other offering participant would mean that the particular underwriter, dealer, or other offering participant, its agent or representative authorized and approved the use of the free writing prospectus before its dissemination. Thus, an issuer, underwriter, dealer, or other offering participant could not indirectly disseminate information through the press or otherwise without complying with the conditions of proposed Rule 433. In that case, the materials provided to the press would be a free writing prospectus of the underwriter, dealer, or other offering participant. . . . Where an issuer distributed a free writing prospectus prepared by an underwriter, dealer or other offering participant, that free writing prospectus would be an issuer free writing prospectus for purposes of the filing condition."
12. A "bona fide electronic road show" is defined as "a version of a road show that contains a presentation by some officers of an issuer or other person in an issuer's management and, if an

issuer is using or conducting more than one road show transmitted or made available by means of graphic communication, includes discussion of the same general areas of information regarding the issuer, its management, and the securities being offered as such other issuer road show or shows for the same offering." The SEC's proposing release states that, to be bona fide, the version (1) need not address all of the same subjects or provide the same information as the other versions of an electronic road show and (2) need not provide an opportunity for questions and answers or other interaction, even if other versions of the electronic road show do provide such opportunities.

13. The SEC's proposal does not require that road shows be made available to unrestricted audiences, but encourages issuers to allow unrestricted access to the electronic roadshow (by allowing issuers to not file the electronic roadshow as long as there is unrestricted access to a bona fide electronic road show).

14. Section 5(b)(1) provides that it is unlawful to transmit any "prospectus" unless it meets the requirements of Section 10 of the Securities Act. The term "prospectus" is defined in Section 2(a)(10) as any communication which offers any security for sale or confirms the sale of any security. Therefore, a confirmation or notice of allocation would be deemed to be a "prospectus." However, the definition of "prospectus" states that a communication sent or given after the effective date of the registration statement is not a prospectus if it is accompanied or preceded by a Section 10(a) prospectus. Therefore, a confirmation or notice of allocation could be sent after effectiveness only if accompanied or preceded by a Section 10(a) prospectus.

15. Both Sections 12(a)(2) and 17(a)(2) focus on a seller's liability at the time of sale. The term "sale" under the Securities Act includes any contract of sale. The SEC states that the date of a sale is the date when the investment decision is made, not the date that a confirmation is sent or received or the date when payment is made. Further, the Uniform Commercial Code does not require that a securities contract be in writing. Therefore, the time of contract of sale can be the time the purchaser either enters into the contract (including by virtue of acceptance by the seller of an offer to purchase) or completes the sale, whichever comes first.

16. Although the SEC's interpretation focuses on the time the investor makes its investment decision, the SEC's proposing release emphasizes that the proposed rule is not intended to affect any of an investor's other rights. Section 12(a)(2) would still apply to oral communications and prospectuses (including final prospectuses) at other times. Section 17(a)(2) would similarly apply to statements at other times. In addition, both Securities Act Section 12(a)(2) and Section 17(a) assess liability for offers as well as for sales. Also, the SEC interpretation is not intended to affect the information requirements for registration statements or final prospectuses and prospectus supplements; the final prospectus must still contain information necessary to satisfy a line item requirement or Rule 408 of the Securities Act and to meet the requirements of Section 10(a) of the Securities Act, and issuers must still include required disclosures in their registration statements either directly or through incorporation by reference.

17. *See, e.g.*, *Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003) (the issuer and its directors and officers are not liable under Section 12(a)(2) to purchasers in a firm commitment underwriting where they did not actively solicit the plaintiffs to purchase their shares); *Lone Star Investment Club v. Schlotzsky's Inc.*, 238 F.3d 363, 369-70 (5th Cir. 2001) (issuers generally cannot be held liable under Section 12(a)(2) when securities are sold through a firm commitment underwriting, but plaintiffs should be permitted to try to show that the issuer's role exceeded normal bounds and that the issuer became the vendor's agent); *In re Nationsmart Corp. Sec. Lit.*, 130 F.3d 309, 319 (8th Cir. 1997) (allegations that the corporation offered, sold, and solicited sales of shares, by means of a prospectus, were sufficient to support the claim that the corporation was a "seller" under Securities Act Section 12(a)(2)); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1215 (1st Cir. 1996) (there is no issuer liability under Section 12(a)(2), absent active solicitation by the issuer).

18. The SEC's proposing release states that "[a] communication by an underwriter or dealer participating in an offering would not be on behalf of the issuer solely by virtue of that participation. However, depending on the facts and circumstances, a communication by an underwriter or dealer could be a communication on behalf of an issuer to the extent it contained issuer information."

19. The SEC's proposing release states that "[c]urrently, there can be a mismatch among offering participants in the time that liability is assessed. For example, in an offering from a shelf registration statement, an issuer could have its liability assessed as of the date of the registration statement's original effectiveness or the most recent updating required under Securities Act Section 10(a)(3), while the liability of an underwriter would be assessed at the later time when it became an underwriter. Thus, for example, underwriters in takedowns occurring after initial effectiveness or the Section 10(a)(3) update would be subject to liability under Section 11 for an issuer's Exchange Act reports incorporated by reference into the prospectus included in the registration statement after the Section 10(a)(3) update. . . .We believe the proposals also would eliminate the unwarranted, disparate treatment of underwriters and issuers and others subject to liability under Section 11. Today, new effective dates of shelf registration statements occur annually at the time of the Section 10(a)(3) updates, when takedowns occur periodically throughout the year. Our proposals generally would not change the date at which disclosure is evaluated under Section 11 for underwriters but generally would move the effective date for the issuer and others subject to liability under Section 11 to the same date, or approximately the same date, as for underwriters for takedowns off shelf registration statements."

20. This includes summary information, risk factors, ratio of earnings to fixed charges, use of proceeds, determination of offering price, dilution, selling shareholders, plan of distribution, description of securities, interests of named experts, and information with respect to the company (including business, litigation, properties, market price and dividends on common stock, financial statements, selected financial information, supplementary financial information, MD&A, changes in accountants, market risk disclosures, directors and officers, executive compensation, security ownership and related party transactions).

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