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BNA INSIGHTS: Whistleblowing and Third-Party Service Providers
According to Gregory F. Parisi, Hogan Lovells, the new United States whistleblower program is global in scope and incentivizes a much wider array of individuals than merely corporate insiders to become watchguards of corporate compliance with federal securities laws. Companies should carefully select, engage, and manage third-party service providers in light of the new whistleblower rules as they are the most likely outside candidates to act on the financial incentives contemplated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. **Page 22**

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NOTICE

BNA WEBINAR: BNA is hosting a webinar, *Legal Ethics for Transactional Lawyers: Selected Current and Recurring Issues* on Wed., Jan. 19, at 1:00 - 2:30 p.m. ET. Information is available at http://www.bna.com/legal-ethics-transactional-w12884905984/.

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Shareholder Suits

Cincinnati Bell Inc. to Make Changes After Settling 2011 Say-on-Pay Lawsuit

Cincinnati Bell Inc.'s Dec. 20 approval of a settlement in a shareholders' lawsuit over pay increases will require the company to reaffirm its pay-for-performance practice and provide for annual discussion of its approach to executive compensation.

This event also could lead to similar shareholder suits and settlements against other companies with failed say-on-pay votes, according to corporate law attorney Dan Rakestraw of Connely & Braunstein LLP in San Francisco.

''Others of these lawsuits are out there, and I would expect more in the future,'' he told BNA Jan. 4. ''Boards may settle to avoid costly litigation, but it would be interesting to see what the award for attorneys fees will be.''

The lawsuit, filed in the Hamilton County Court of Common Pleas in Cincinnati, Ohio, came after shareholders of the telecommunications company voted down a say-on-pay advisory vote in May on pay raises for chief executive Jack Cassidy and other top officers.

The settlement, which is subject to a court hearing and final approval, was announced in a news release and Form 8-K filed with the Securities and Exchange Commission.

Stephen Quinlivan, a shareholder in the Minneapolis office of Leonard Street & Deinard, said the say-on-pay lawsuit that is settled for disclosure relief will become, to many, a shakedown for an attorney fee award, much like numerous cases filed to block an acquisition.

''Many of us in the corporate securities bar feel [these suits] are largely without merit,'' Quinlivan told BNA Jan. 4.

The drafters of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which requires companies to hold say-on-pay votes, went ''out of their way'' to state that the advisory votes do not present additional liability to companies or their boards, Quinlivan said.

Acquisition Led to Lower Income. The lawsuit came after Cincinnati Bell's net income fell 68 percent last year to $28.3 million, or 9 cents a share, from $89.6 million, or 37 cents a share, in the prior year as the company completed a $525 million acquisition of Texas-based data center CyrusOne.

The acquisition was strategically important to Bell, which is remaking itself into a leading provider of corporate data centers to serve a growing need for computer servers, storage gear and network connections, according to the company's Form 10-Q filed Nov. 4, 2011, with the Securities and Exchange Commission.

The CyrusOne acquisition has provided Cincinnati Bell with higher earnings and revenue, according to the 10-Q.

In its 10K filing, the company said the drop in its net income was ''a result of increased interest expense associated with the CyrusOne acquisition and debt refinancings, losses on extinguishment of debt and acquisition-related expenses.''

Hefty Pay Raises After CyrusOne Purchase. Bell's board of directors last year awarded pay increases to top executives that were influenced in part by the successful CyrusOne acquisition.

Cassidy's compensation increased 71 percent to $8.5 million. Gary J. Wojtaszek, then Bell's chief financial officer and now president of CyrusOne, saw his compensation increase 80 percent to $2.07 million; and Christopher J. Wilson, vice president and general counsel, saw his compensation increase 54 percent to $1.4 million.

Defending Against Such Claims. On Sept. 20, the U.S. District Court for the Southern District of Ohio refused Cincinnati Bells's motion to dismiss, finding that the plaintiff's allegations raised a plausible claims that multimillion dollar bonuses to top executives when company revenues were down violated the company's pay-for-performance policy and constituted abuse of discretion and bad faith (9 CARE 1145, 9/30/11).

The court said that the company's claim of protection under the business judgment rule was a matter to be determined with evidence, and it did not affect the plaintiffs' burden at the motion to dismiss stage.

Three days earlier, the Georgia Superior Court dismissed a derivative lawsuit filed against Beazer Homes USA following its failed say-on-pay vote (9 CARE 1251, 10/21/11). The court concluded that neither Delaware law nor the Dodd Frank Act supported the plaintiffs' assertion that the shareholders' judgment—as evidenced by the negative say-on-pay vote—sufficed to overcome the protections of the business judgment rule.

To date, issuers have taken the position that there is no basis for a claim in the say-on-pay suits, and they have used motions to dismiss as a low-cost way of determining or testing the merits of a case, Quinlivan said.

Despite the conflicting outcomes in Beazer and Cincinnati Bell, Quinlivan expects reliance on the motion to dismiss to continue.

Cincinnati Bell could have been motivated to settle because of peculiarities of Ohio state law or just to clear the slate in Ohio to concentrate efforts on defending the federal suit still pending, Quinlivan said.

''If you get a no vote, you have a significant number of investors and institutional investors who are not happy with your compensation program,'' he said, adding that it is a good practice for companies to talk with their investors, even when they receive positive say-on-pay votes, to find out if they have any specific concerns that can be addressed.

"To my knowledge, boards have not ignored negative shareholder votes," he said.

Company Agrees to Changes. Phillip R. Cox, Bell's chairman, said in a Dec. 20 news release that the proposed settlement "will clarify the company's executive compensation policies."

He said the agreement includes changes that "should better assist our shareholders' understanding of how these policies are applied."

Ed Korsinsky, the plaintiffs' lawyer, said in the news release that the settlement includes a binding agreement that the company's compensation decisions are consistent with its pay-for-performance philosophy.

Cincinnati Bell agreed to adopt a number of corporate-governance measures within 90 days of the settlement's effective date, which include:

- reaffirming its pay-for-performance executive compensation metrics approved by the company's shareholders to determine executive compensation;
- listing the discretionary factors that the company generally employs in determining executive compensation in the compensation discussion and analysis section of the proxy;
- reaffirming that there will be an annual shareholder say-on-pay advisory vote to address executive compensation as described in the discussion and analysis section; and
- rotating the directors on the compensation committee and maintaining a compensation committee composed of all fully independent directors.

By Che Odom

Cincinnati Bell's 8-K concerning the settlement is available at http://www.sec.gov/Archives/edgar/data/716133/000071613311000038/currentreport.htm.

Cincinnati Bell's most recent Form 10-Q is available at http://www.sec.gov/Archives/edgar/data/716133/000071613311000030/cbb-93011x10q.htm.

Director Nominations

Delaware Court Halts Annual Meeting Over Disputed Director Nominees

The Delaware Chancery Court Dec. 20 issued a temporary restraining order halting the annual meeting of ChinaCast Education Corp. to allow shareholders to consider further information on the plaintiff director's removal from management's slate of nominees for reelection and to review his competing nominees (*Sherwood v. Chan*, Del. Ch., C.A. No. 7106-VCP, 12/20/11).

In so ruling, Vice Chancellor Donald Parsons determined that holding the annual meeting on the originally scheduled date would not comport with the " 'scrupulous fairness' " required of corporate elections.

ChinaCast is a publicly traded Delaware corporation based in Hong Kong. The company is a leading post-secondary education and e-learning services provider in China.

Recommendation Withdrawn. The court said that the plaintiffs, Ned Sherwood and ZS EDU LP (collectively, Sherwood) moved for a temporary restraining order to enjoin ChinaCast Education Corp. from holding its annual meeting.

Sherwood currently is a director of ChinaCast, and until recently had been among the company's nominees for reelection to the board. In early December, the board publicly disclosed that it had removed from the company's slate and no longer recommended his reelection, the court wrote.

In this regard, the court noted that supplemental proxy materials issued specific reasons for the nominating committee's recommendation to remove Sherwood from the company's slate.

In connection with the allegations of insider trading, the court said that the proxy supplement also disclosed that the company reported Sherwood's trading activity to the SEC, but did not disclose further the status of any SEC investigation. In fact, the court said, Sherwood's personal counsel has sworn that he was informed by SEC attorneys that the SEC would not pursue insider trading allegations against Sherwood. However, the company's counsel was unable to confirm this, the court noted.

Meanwhile, the court also said that the proxy supplement does not disclose that Sherwood had criticized the board's handling of a buyback program, negotiations with a potential buyer, or any other corporate policy.

Colorable Claim. Sherwood asserted that the board breached its fiduciary duty of disclosure when communicating its reasons for removing him from the company slate. The court noted that the duty of disclosure is a specific application of corporate directors' fiduciary duties of care and loyalty, requiring directors to disclose fully and fairly all material information within the board's control when its seeks shareholder action.

The court said that from the record at this very early stage of the case, it can see "at least two ways" in which the proxy supplement may be materially misleading and, therefore, sufficient to find the existence of a colorable disclosure claim.

First, the court said, the plaintiffs alleged that the proxy supplement fails to disclose the true reason the board removed Sherwood from the company's slate-i.e., to silence an independent voice. Further, the company's disclosures "might cause a stockholder to question the character and ethics of Sherwood and, in that sense, to doubt his fitness to serve on the board," the court wrote.

The second way that the proxy supplement may be materially misleading relates to the accusations of insider trading, the court remarked. "Because the Proxy Supplement may be misleading, either as to the board's general motivations or specifically regarding any SEC investigation, Plaintiffs have demonstrated the existence of at least a colorable disclosure claim."

Sherwood asserted that the TRO is necessary to provide ChinaCast's shareholders sufficient time to consider corrective disclosures and Sherwood's completing slate of nominees.

For their part, the defendant directors and nominal defendant ChinaCast opposed the TRO motion on various grounds. While they denied that any disclosure violation occurred, the defendants primarily argued that the plaintiffs cannot show any irreparable harm sufficient to justify a TRO because the company's bylaws preclude Sherwood from initiating a proxy contest so soon before the annual meeting.

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Irreparable Harm. According to the defendants, because there can be no competing slate for shareholders to consider, there is no risk of a harmful, uninformed shareholder vote. Further, the court wrote, the defendants raised the defenses of laches and unclean hands, contending that the plaintiffs had ample opportunity to initiate their proxy contest earlier and that the company's delay in removing Sherwood from its slate of nominees resulted solely from a last resort, good faith, but ultimately unsuccessful attempt by all parties to resolve their differences amicably.

The court ultimately granted the TRO, finding that the plaintiffs have satisfied their burden to show irreparable harm. The TRO provides that the annual meeting will be enjoined until Jan. 10, 2012 and permits the plaintiffs to solicit proxies for their competing slate of directors at the annual meeting. In other provisions, the TRO requires the plaintiffs to post a bond of $250,000

Raymond J. DiCamillo, Kevin M. Gallagher, Susan M. Hannigan, Richards Layton & Finger, Wilmington, Del.; Adam H. Offenhartz, Brian M. Lutz, Mary Kay Dunning, Jonathan J. Li, Gibson, Dunn & Crutcher, New York, represented the plaintiffs.

Lewis H. Lazarus, Peter B. Ladig, Katherine J. Neikirk, Morris James, Wilmington, Del.; Eugene R. Licker, Laura Vasey, Loeb & Loeb, New York, represented the defendants.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8q2krr.

SEC Enforcement

Court Grants SEC's Emergency Stay Request In Light of Jan. 3 Deadline in Citigroup Case

The U.S. Court of Appeals in Manhattan late Dec. 27 agreed to the Securities and Exchange Commission's request to stay the case in the lower court and to expedite the appeal , which will be submitted to a motions panel of the court Jan. 17.

The SEC Dec. 27 asked the U.S. Court of Appeals for the Second Circuit for an emergency stay of its case against Citigroup Global Markets Inc. in light of a Jan. 3 deadline by which the defendant must respond to the agency's complaint alleging misrepresentations over a $1 billion collateralized debt obligation (*SEC v. Citigroup Global Markets Inc.*, 2d Cir., No. 11-5227, 12/27/11).

The SEC Dec. 15 asked the Second Circuit to review the U.S. District Court for the Southern District of New York's rejection of its proposed $285 million settlement with Citigroup to resolve the charges (9 CARE 1436, 12/23/11).

In its Dec. 27 emergency motion, the SEC said that the district court, in rejecting the settlement and asking the parties to prepare for trial, also directed Citigroup to answer the SEC's complaint by Jan. 3 even though the defendant should have been given a longer time to respond pursuant to the Federal Rules of Civil Procedure.

Insufficient Facts. In late November, Judge Jed Rakoff concluded that he could not approve the proposed settlement because the parties had not provided enough facts for him to exercise his independent judgment (9 CARE 1368, 12/2/11). He faulted specifically the SEC's longstanding policy of allowing defendants—and in this case Citigroup—to neither admit nor deny the allegations in settling their charges.

"[A] proposed Consent Judgment that asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest," Rakoff said.

In its Dec. 27 motion, the SEC told the Second Circuit that without a stay, the parties could lose permanently the benefits of the proposed settlement.

Loss of Benefits. "If Citigroup files its answer, denying some or all of the allegations in the complaint, or if Citigroup moves to dismiss, challenging the complaint's legal sufficiency, it will disrupt a central negotiated provision of the consent judgment pursuant to which Citigroup agreed not to deny the allegations in the complaint," the SEC said. "If either event occurs, the parties will not be able to return to their initial bargaining positions should this Court ultimately reverse the district court."

The commission also said that investors will be harmed without a stay because it will have expended resources to litigate a case that ultimately may be "resolved by consent judgment if this Court reverses the district court's order."

The SEC asked the Second Circuit to stay the case pending appeal. Alternatively, the agency asked the court to stay the proceedings—including the Jan. 3 deadline—temporarily until it can rule on the stay motion. "The Commission believes that the Court must act by midday on January 3," it said.

The SEC, in conjunction with its stay motion, also asked the Second Circuit for an expedited review.

Citigroup Supports Stay. The SEC separately has asked the district court to stay the proceedings. Meanwhile, Citigroup does not oppose the SEC's stay request. Citigroup also has notified the district court that it intends to appeal its rejection of the proposed settlement.

In a Dec. 22 filing to the district court, Citigroup said the rejection of the proposed settlement "raises several legal and policy issues of fundamental importance," including whether defendants should be allowed to settle disputes with federal agencies without having to "adjudicate facts" or to admit them.

"Because of the profound and far-reaching importance of this issue and the other substantial issues implicated by this Court's Order, and the significant consequences to the Company and to shareholders of Citigroup Inc. of being required to litigate this matter while the Second Circuit considers the parties' appeals, CGMI respectfully submits that a stay pending appeal is appropriate here," it said.

The SEC is represented by senior counsel Jeffrey Berger. Citigroup is represented by Brad Karp, Paul, Weiss, Rifkind, Wharton & Garrison LLP, New York.

SEC Enforcement

Court in Citigroup Case Scolds SEC For 'Misleading' Statements to Obtain Stay

The U.S. District Court for the Southern District of New York, in a scathing Dec. 29 order, charged that the Securities and Exchange Commission made ''materially misleading'' statements to it and to the U.S. Court of Appeals for the Second Circuit in trying to obtain an emergency stay of its case against Citigroup Global Markets Inc. (*SEC v. Citigroup Global Markets Inc.*, S.D.N.Y., No. 1:11-cv-07387-JSR, 12/29/11).

Among other problems, the SEC failed to inform the appellate court that the district court's decision on a stay of the case was imminent, wrote Judge Jed Rakoff.

When the Second Circuit issued its temporary stay order—barely a minute ahead of the district court's denial of a stay—it did so ''without having received this Court's Memorandum Order and having before it only the materially misleading papers of the SEC,'' he said.

SEC Appeals. The SEC Dec. 15 asked the appellate court to review the district court's rejection of a proposed $285 million settlement to resolve allegations that Citigroup misrepresented its role in a $1 billion collateralized debt obligation that the firm structured and marketed in early 2007 (9 CARE 1436, 12/23/11).

One day later, the SEC Dec. 16 moved the district court for a stay of the case pending appeal.

Subsequently, the SEC—with Citigroup's consent—Dec. 27 filed an emergency motion with the Second Circuit requesting a stay of the lower court proceedings, saying the proposed settlement potentially was in jeopardy because of a Jan. 3 deadline by which Citigroup must respond to the commission's complaint.

Hours after the SEC filed the emergency motion, the Second Circuit Dec. 27 temporarily stayed the case until a panel considers the emergency motion Jan. 17 (*see related story in this issue*). On the same day, the district court issued an order concluding that a stay was not warranted because it was ''patently clear that the parties have no basis for an appeal.''

'Professional Obligation.' The district court, in its Dec. 29 order, also faulted the agency for not saying, in its district court filings, that Jan. 3 was a critical date. In addition, the SEC failed in its ''professional obligation to bring to the attention of the Court of Appeals the fact that the Supreme Court of the United States had previously ruled that the denial of the fruits of a settlement does not, without more, provide a basis for interlocutory appeal, let alone a stay,'' it said.

Moreover, after the SEC filed the emergency motion Dec. 27, it and Citigroup failed to inform the district court of its actions while on a joint conference with the court later in the afternoon to discuss the case, the court said.

The court said it issued its order to alert the appellate court to the events, and to prevent ''similar recurrences.''

''Specifically, the parties are hereby ordered to promptly notify this Court of any filings in the Court of Appeals by faxing copies of any such filings to this Court immediately after they are filed in the Court of Appeals,'' the court said. It also requested that its supplemental order be furnished to the Second Circuit panel that considers the SEC's emergency motion Jan. 17.

When contacted, SEC spokesman John Nester told BNA that the commission ''will respond as appropriate in the proceedings before the court of appeals.''

By Yin Wilczek

Executive Compensation

ISS 2012 Proxy Voting Policy Unveiled In White Paper on Pay-for-Performance

Institutional Shareholder Services Dec. 20 released a white paper in which the proxy advisory service explains the methodology it will use to identify companies that have demonstrated a disconnect between executive pay and company performance.

ISS will apply the new measurement in evaluating pay-for-performance as part of its 2012 proxy voting policy. According to ISS, a survey of institutional investors confirmed two factors as very important in evaluating a company's pay-for-performance alignment: pay relative to peers and pay increases that are disproportionate to company performance.

In response to investor concerns, ISS will use a quantitative approach that measures relative and absolute alignment of pay to performance over time, ISS said in the white paper, *Evaluating Pay for Performance Alignment: ISS' Quantitative and Qualitative Approach*. The relative evaluation looks at rankings of chief executive officer pay and performance relative to peers over three years, and the absolute evaluation looks at CEO pay trends relative to shareholder return trends over five years, ISS said.

ISS said the methodology will identify outlier companies that have demonstrated ''significant misalignment between CEO pay and company performance over time.'' The quantitative evaluation maintains ISS's longstanding approach to identifying problem companies, with the addition of new factors, ISS said. The new methodology is designed to measure alignment over multiple time horizons, using multiple measures, and provide more robust information about a company's pay-for-performance alignment, ISS said.

According to the white paper, an in-depth quantitative assessment will be done for all companies for which ''significant misalignment'' of pay-for-performance is identified through quantitative analysis.

Some or all of the steps ISS will take in the quantitative assessment include reviewing the company's time-based versus performance-based equity awards, as well as its peer group benchmarking practice; for cash payouts, ISS will review ''rigor of performance goals (if any) that generated the payouts.''

By Mary Hughes

The white paper is available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.

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SEC Rulemaking

SEC Adopts Rules for Accredited Investors, Mining Disclosures Mandated by Dodd-Frank

The Securities and Exchange Commission, in a bid to finalize some of its less controversial rulemakings before the end of the year, Dec. 21 adopted rules to redefine ''accredited investors'' who are eligible for unregistered securities offerings, and to require mine safety disclosures.

Both requirements are mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Accredited investors are eligible under the 1933 Securities Act to take part in certain private and limited offerings that are exempt from registration. Before the enactment of Dodd-Frank, individuals qualified as accredited if they had a net worth of at least $1 million, either alone or together with their spouse.

Dodd-Frank Section 413(a) redefined the term to exclude the value of an individual's primary residence in calculating the net worth. Although the change was effective on Dodd-Frank's operation, the provision also required the SEC to revise its '33 Act rules to conform to the new standard.

Follow-On Investments. The SEC added that under certain circumstances, those that qualified as accredited investors before the enactment of Dodd-Frank may be allowed to use that accreditation for certain ''follow-on investments.''

During an open meeting to consider whether to propose the amendments, Commissioners Troy Paredes and then-commissioner Kathleen Casey had raised concerns about the possibility of investors in existing private offerings being rendered ineligible under the new definition to participate in the transactions.

The amended net worth standard rules are effective 60 days after publication in the *Federal Register*, the SEC said. In 2014 and every four years after that, Dodd-Frank requires the SEC to review the definition to determine if further changes are warranted.

Mine Safety and Health. Meanwhile, Dodd-Frank Section 1503 required mining companies to include disclosures about mine safety and health in quarterly and annual reports filed with the SEC.

The requirements—the least controversial of the specialized disclosures mandated by the financial reform statute—already are effective without any action by the SEC. However, the agency's new rules—proposed in December 2010 (8 CARE 1347, 12/17/10)—lay out how companies must disclose the mine safety information required by Dodd-Frank.

The SEC's new rules require companies to provide mine-by-mine totals for certain matters, including:

- significant and substantial violations of health and safety standards cited by the Mine Safety and Health Administration under the 1977 Federal Mine Safety and Health Act;

- citations and orders for unwarrantable failures of the operator to comply with Section 104(b) of the Mine Act;

- flagrant violations under Section 110(b)(2) of the Mine Act; and

- the dollar value of proposed assessments from MSHA.

The SEC's new mine safety disclosure rules are effective 30 days after publication in the *Federal Register*.

The final accredited investor net worth rules are available at http://www.sec.gov/rules/final/2011/33-9287.pdf. The final mine safety disclosure rules are available at http://www.sec.gov/rules/final/2011/33-9286.pdf.

Mergers and Acquisitions

Delaware Court Allows Bad Faith Claim Over Call of Certain Outstanding Shares

The Delaware Chancery Court Dec. 9 refused to dismiss claims that the board of directors of environmental services concern Safety-Kleen Inc. acted in bad faith by deciding to exercise call rights as to certain of its shares held by a competitor at a price below market value (*Clean Harbors Inc. v. Safety-Kleen Inc.*, Del. Ch., Civil Action No. 6117-VCP, 12/9/11).

Assuming the allegations are true, the court wrote, this case involves an ''arguably clever move'' that left the plaintiff, a competitor, ''empty-handed and tricked out of the benefit of its bargain.''

Vice Chancellor Donald Parsons explained that in the fall of 2010, plaintiff Clean Harbors Inc., also an environmental services firm, became interested in acquiring Safety-Kleen. However, a proposed deal never got off the ground.

Options Held by Former Senior Employees. At the end of 2010, Frederick Florjancic Jr., a former senior employee of Safety-Kleen, approached Clean Harbors about the possibility of Clean Harbors acquiring shares of Safety-Kleen from him and other former senior employees who held stock options of the company.

Florjancic, along with T.R. Tunnell, Dennis McGill, Ed Genovese, Mike Williams, and Donald Budhu (collectively, the selling shareholders) cumulatively held options to acquire 1,700,840 shares of Safety-Kleen at exercise prices between $2.73 and $4.09. Most of the options were set to expire by the end of January 2011, but the selling shareholders did not have the requisite funds to exercise those options.

Therefore, the selling shareholders sought to negotiate a deal with Clean Harbors that would provide them with the funds needed to exercise their options before they expired so that they could salvage some value from them.

Although Clean Harbors initially was uninterested in the proposal, the parties eventually entered into an agreement by which Clean Harbors would purchase the shares for $7.50 per share. The deal was structured so that the selling shareholders first would exercise the options and receive the shares from Safety-Kleen. Clean Harbors would then pay the exercise price, withholding taxes, and a small premium for each share. The selling shareholders then would have Safety-Kleen transfer the shares to Clean Harbors.

Because the transaction would give Clean Harbors an equity interest in Safety-Kleen, Clean Harbor's counsel notified Safety-Kleen's counsel of the transaction and asked if Safety-Kleen had any objections to it. Safety-

Kleen responded that it did not object. The transaction was consummated on Dec. 23, 2010.

Same Day Exercise of Call Rights. With the exception of Florjancic, who retained 300,000 of his 806,850 shares, the other selling shareholders sold to Clean Harbors all the shares they received from exercising their options.

Later that same day, Safety-Kleen sent written notice to Clean Harbors that it was exercising its call rights on the shares pursuant to the option agreement under which the shares were issued. The option agreement provided that Safety-Kleen could call the shares purchased under the selling shareholders' options for fair market value on the date upon which the right is exercised. Fair market value is defined as the fair market value of a share as determined by a board-appointed committee in its good faith discretion.

Safety-Kleen thus called all of the shares acquired by Clean Harbors in the deal for $7.50 per share, the same price Clean Harbors had paid for the shares just hours before.

Central Dispute. Clean Harbors filed this action against Safety-Kleen in January 2011. ''The central dispute in this action involves whether Safety-Kleen [exhibited] bad faith by deciding to call the Shares at $7.50 per share on December 23, 2010, the same day that Clean Harbors purchased them from the Selling Shareholders at that price,'' the court wrote.

It refused to dismiss the case, declaring that Clean Harbors's complaint alleges facts that conceivably could support a conclusion that $7.50 was not the fair market value of the shares and that Safety-Kleen's board acted in bad faith by calling the shares at that price.

In so ruling, the court said that it agreed with Clean Harbors that, to allege a breach of a contractual duty to act in good faith, a complaint need only allege facts related to the alleged act taken in bad faith and a plausible motivation for it. This is a minimal standard, the court remarked, the purpose of which is to give the defendant notice of the claim being made against it.

Applying this pleading standard, the court found that Clean Harbors sufficiently pleaded ''bad faith.'' The complaint alleged that Safety-Kleen failed to act in good faith in determining the fair market value of the shares. Moreover, the court wrote, Clean Harbors alleged a sufficient improper motivation, claiming that Safety-Kleen desired to benefit the remaining Safety-Kleen shareholders, which conceivably could include Safety-Kleen's directors, at Clean Harbors's expense.

In addition, the court continued, the complaint suggested that Safety-Kleen intentionally sought to deprive its competitor, Clean Harbors, of the benefit it bargained for. Meanwhile, the court said that it would not dismiss at this stage Safe Harbors's claim for breach of the implied covenant of good faith and fair dealing.

Christopher M. Winter, Duane Morris, Wilmington, Del.; Gary S. Matsko, Davis, Malm & D'Agostine, Boston, represented Clean Harbors.

Daniel K. Hogan, Wade W. Scott, Hogan Firm, Wilmington, Del.; William T. Reid, IV, P. Jason Collins, Joshua J. Bruckerhoff, Reid Collins & Tsai, Austin, Texas; represented Safety-Kleen.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8q2kmd.

Corporate Governance

Delaware High Court Affirms Contents Of Hurd Letter in HP Suit Not Confidential

Former Hewlett-Packard Co. chairman Mark Hurd did not show good cause for keeping confidential the contents of a letter from the lawyer for a woman he allegedly subjected to sexual harassment, the Delaware Supreme Court affirmed Dec. 28 (*Hurd v. Espinoza*, Del., 167, 2011, 12/28/11).

The chancery court ''acted well within its discretion in holding that the . . . letter (as redacted) should be unsealed,'' Justice Carolyn Berger held.

Controversy Led to Resignation. Hurd resigned as HP chairman in 2010 after the HP board allegedly discovered that he had falsified expense reports over a two-year period in connection with outings with former reality television contestant Jodie Fisher, an HP contractor (8 CARE 920, 8/27/10). At the time, practitioners told BNA that HP's situation highlights the importance of business judgment in corporate America, and the difficulties that boards and management face when forced to make decisions in the spotlight.

Meanwhile, prior to his resignation, Hurd received a letter from Gloria Allred, Fisher's California attorney, detailing claims against him and HP based on his alleged inappropriate relationship with Fisher.

In this case, a shareholder sought to inspect the company's books and records in connection with an investigation into the circumstances of Hurd's resignation. Opposing the move, Hurd, who was allowed to intervene in the case, contended that the letter contained personal and confidential information. In March 2011, the chancery court disagreed (9 CARE 349, 3/25/11).

Affirming, the state high court said the chancery court ''has found good cause to seal documents containing trade secrets, nonpublic financial information, and third-party confidential material. Information that is only 'mildly embarrassing' will not be protected from disclosure.''

Embarrassing Detail. ''The Allred letter does not contain any nonpublic financial information, trade secrets, or other proprietary information,'' the court continued. It also said several factors support the lower court's conclusion that the letter does not contain confidential third-party data. First, it said, the letter—although marked personal and confidential—was sent to Hurd in his capacity as HP CEO at the company's address.

Second, the letter stated that Fisher's claims were against Hurd and HP; and third, ''the substance of Fisher's claims was widely reported in virtually every media. Finally, although the letter goes into embarrassing detail about Hurd's behavior, it does not describe any intimate conversations or conduct,'' the supreme court said.

Lawyers. Hurd's case was argued by Rolin P. Bissell, Young Conaway Stargatt & Taylor LLP, Wilmington, Del. Blake A. Bennett, Cooch & Taylor PA, Wilmington, Del., argued for plaintiff Ernest Espinoza.

HP was represented by Steven M. Schatz, Wilson Sonsini Goodrich & Rosati PC, Palo Alto, Calif.

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FCPA

SEC, DOJ Announce $95 Million Settlement In Bribery Actions Against Hungarian Telecom

Magyar Telekom, Hungary's largest telecommunications provider, and majority owner Deutsche Telekom agreed to pay over $95 million to settle charges that they bribed government and political party officials in Macedonia and Montenegro, the Department of Justice and Securities and Exchange Commission announced Dec. 29 (*United States v. Magyar Telekom,* E.D. Va., No. 1:11-cr-00597-CMH, 12/29/11; *SEC v. Straub,* S.D.N.Y., 11 Civ. 9645, 12/29/11; *SEC v. Magyar Telekom Plc,* S.D.N.Y., 11 Civ. 9646, 12/29/11).

The DOJ filed its charges under the Foreign Corrupt Practices Act against Magyar and Deutsche Telekom, Magyar's majority owner, in the U.S. District Court for the Eastern District of Virginia. In a release, prosecutors said that the companies agreed to pay nearly $64 million in combined criminal penalties as part of a non-prosecution agreement.

Separately, the SEC said that Magyar agreed to settle FCPA charges against it in the U.S. District Court for the Southern District of New York by paying more than $31.2 million in disgorgement and prejudgment interest.

Deutshe Telekom also settled SEC charges of books and records and internal control violations under the FCPA, the commission announced. At the time of the alleged violations, the SEC's complaint said, the companies' securities were traded through American Depository Receipts listed on the New York Stock Exchange and registered with the commission under 1934 Securities Exchange Act Section 12(b).

Meanwhile, SEC charges are pending in the Southern District of New York against three former Magyar executives whom the commission accused of orchestrating, executing, and approving the bribery scheme. They are Elek Straub, former chairman and chief executive officer, and Andras Balogh and Tamas Morvai, two former senior executives in the company's strategy department.

The agency said it is seeking disgorgement, penalties, and permanent injunctions against them.

Regulatory Benefits Sought. The DOJ and SEC said the case involved a scheme in the winter and spring of 2005 to bribe government and political party officials in Macedonia and Montenegro in order to stifle Magyar's competition and gain other regulatory benefits for the company.

In the case of Macedonia, the alleged bribery scheme was in response to new laws and regulations designed to liberalize the country's telecommunications market—a development that Magyar deemed detrimental to MakTel, its Macedonian subsidiary. In the wake of this new legislation, Magyar allegedly entered into a secret agreement entitled the ''Protocol of Cooperation'' with senior Macedonian government officials to delay or preclude the issuance of a new license to a new competitor and mitigate other adverse effects.

To win their support, prosecutors said, Magyar paid 4.875 million euros (about $6.31 million) to a third-party intermediary under a series of sham contracts with the intention that the intermediary forward the money to the government officials. The sham contracts were recorded as legitimate on MakTel's books and records, which were consolidated into Magyar's financials, prosecutors added.

Magyar also promised a Macedonian political party the opportunity to designate the beneficiary of a business venture in exchange for the party's support, the SEC said.

Favorable Acquisition Terms. In Montenegro, the SEC charged, Magyar used intermediaries to pay bribes to government officials in return for their support of its acquisition of the state-owned telecommunications company on terms favorable to Magyar. These included payments to at least two Montenegrin government officials involved in the acquisition and to a family member of a top Montenegrin government official.

Two of the contracts were backdated and concealed the true counterparties, and no legitimate services were provided under the contracts, the DOJ added.

Vigorous Defense Promised. Attorneys for two of the former senior officials vehemently defended their clients. Michael Koenig, Greenberg Traurig LLP, Albany, New York, representing Morvai, told BNA, ''There is a vast difference between allegations and actual evidence. Simply because the SEC says it does not make it so. Tamas and I look forward to aggressively defending him against the allegations, and that's all they are, in this complaint.''

William R. Sullivan Jr., Pillsbury Winthrop Shaw Pittman LLP, Washington, who is representing Balogh, said in an e-mail to BNA that the allegations against his client ''have been investigated and pursued for more than half a decade by officials in Hungary, Macedonia, Germany, and the United States, as well as by private law firms engaged by the Company, and no one has ever uncovered evidence of bribery of any government officials for the simple reason that none ever occurred.

We look forward to vigorously defending against the meritless charges made today against Mr. Balogh and to vindicating his well-earned and unblemished reputation.''

Carl Rauh, Hogan Lovells LLP, Washington, an attorney for Staub, did not reply to a request for comment.

Peter Clark and Michael Horowitz, Cadwalader, Wickersham & Taft LLP, Washington, represented Magyar. Deutsche Telekom was represented by Mary Jo White and Jonathan Tuttle, Debevoise & Plimpton LLP, Washington.

Robert I. Dodge, Washington, will lead the SEC's litigation efforts.

BY JOE LUSTIG

The SEC's complaints can be seen at http://www.sec.gov/litigation/complaints/2011/comp-pr2011-279-ex.pdf and http://www.sec.gov/litigation/complaints/2011/comp-pr2011-279-co.pdf. The DOJ's release is available at http://www.justice.gov/opa/pr/2011/December/11-crm-1714.html.

Executive Compensation

NYC Pension Funds Propose Stiffer Clawbacks on 'Street' Pay

The New York City Pension Funds have submitted shareholder proposals to Wall Street giants JPMorgan, Goldman Sachs, and Morgan Stanley seeking tougher clawback policies on executive pay, New York City Comptroller John C. Liu announced Dec. 21.

The proposals aim to prevent the ''perverse incentives and bad practices'' that contributed to the financial collapse of 2008, Liu said.

''No one should profit or be rewarded with bonuses when engaged in improper or unethical behavior,'' Liu said. ''These tougher clawback provisions will not only recover money that shouldn't have been paid in the first place, but also set the tone for a stronger standard of conduct for company executives as well as their bosses,'' the official contended.

The firms each have clawback policies that allow them to recoup incentive pay from employees who act improperly. The proposals submitted by the pension funds call on the compensation committees of the respective corporate boards to strengthen those compensation clawback policies.

First, they would increase executives' accountability. Current Goldman Sachs and JPMorgan clawback policies hold executives responsible only for ''material'' losses, Liu said, thus creating unrealistically high legal and financial standards for clawback actions.

The proposal requests that the word ''material'' be stricken from the two firms' clawback policies in order to lower this barrier. Morgan Stanley's existing clawback policy does not include the ''material'' standard.

Next, the comptroller said, the proposal seeks to hold supervisors responsible for misconduct by subordinates.

Finally, the proposal asks that the three firms' clawback policies be amended to require disclosure of any decision by their boards on whether or not to recoup executive compensation. Currently, Liu said, they do not have to make clawback decisions public.

Shareholder Suits

Court Confirms $54M Award to Investors On Colo. Claims Against Citi Global Markets

The U.S. District Court for the District of Colorado Dec. 21 confirmed an arbitration award totaling over $54 million to investors asserting claims under Colorado law over Citigroup Global Markets Inc.'s alleged misrepresentations as to the risks of investment products sold to them (*Hosier v. Citigroup Global Markets Inc.*, D. Colo., Civil Action No. 11-cv-00971-CMA-CBS, 12/21/11).

Judge Christine M. Arguello was not persuaded by CGMI's defense, which she noted ''relied largely on the fact that the Petitioners had signed Subscription Agreements 'in which they specifically represented and warranted that they had read and understood the written risk disclosures-including the warning that they could lose all of the principal they were investing.' ''

CGMI argued at the arbitration hearing—and again here—that the petitioners's claims were barred as a matter of law because of these risk disclosure statements.

Risks Allegedly Misrepresented. In June 2009, the court said, petitioners Gerald D. Hosier, Brush Creek Capital LLC, and Jerry Murdock Jr., filed an arbitration statement of claim with the Financial Industry Regulatory Authority seeking to recover losses from investments they made with CGMI.

The petitioners asserted various causes of action, including Colorado claims of breach of fiduciary duty, breach of contract, and constructive fraud. The claims related to the sale of investment products that were created or sponsored by CGMI and sold to the petitioners through CGMI's investment advisers.

The petitioners asserted that CGMI marketed the products to high net worth individuals as a higher yielding alternative to municipal bond portfolios with little, if any, additional risk.

Argument 'Wholly Unpersuasive.' After a hearing, the court said, the FINRA arbitration panel issued an award to petitioners. The panel awarded Hosier compensatory damages of $21,683,679, Brush Creek compensatory damages of $8,472,212, and Murdock compensatory damages of $3,903,057. The panel also awarded the petitioners punitive damages in the amount of $17 million and attorneys' fees of $3 million.

Granting the petitioners' motion to confirm the award, the court emphasized that ''[m]aximum deference is owed to the arbitrators because the parties have contracted to use binding arbitration rather than litigation as a means to resolve their disputes.''

Turning to CGMI's arguments to vacate, the court first determined that the panel did not manifestly disregard the law. In this connection, CGMI argued that because the petitioners signed subscription agreements, they were charged with constructive knowledge of the risks disclosed therein and could not have justifiability relied on any contrary oral representations made in connection with their purchases.

CGMI asserted that the panel acted in manifest disregard of the law when it ignored *Zobrist v. Coal-X Inc.*, 708 F. 2d 1511 (10th Cir. 1983).

The court rejoined that *Zobrist* is a Tenth Circuit case interpreting federal law, specifically Section 10(b) of the Securities Exchange Act of 1934, while the claims pleaded and tried before the arbitration panel were Colorado state law claims.

Thus, the court said, *Zobrist* is not directly on point and the panel cannot be said to have deliberately ignored governing law.

The court also found that the panel did not exceed its authority by awarding punitive damages to the petitioners, and that the panel did not exceed its authority in awarding attorneys' fees to the petitioners.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8pxs7r.

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Officer Liability

$49.5 M Order Concludes SEC Case Against Plastics Exec Who Lied in Filings

The Securities and Exchange Commission announced Dec. 22 that a plastics industry executive who allegedly lied in SEC filings regarding his ownership of Musicland Stores Corp. stock, along with a trust he controlled, were ordered Dec. 20 by the U.S. District Court for the District of New Jersey to pay a total of $49.5 million in disgorgement plus prejudgment interest and civil penalties (*SEC v. Teo,* D. N.J., Civil Action No. 2:04-cv-01815 (SDW) (MCA), 12/20/11).

Earlier this year, a jury found defendant Alfred S. Teo liable for fraud and disclosure violations under Sections 10(b) and 13(d) of the 1934 Securities Exchange Act. It also found M.A.A.A. Trust, a trust Teo established for his children, liable for disclosure violations.

At the time, the SEC said it would ask Judge Susan Wigenton, who presided over Teo's trial, for an injunction, disgorgement, prejudgment interest, and civil penalties.

Teo was charged by the SEC in 2004 with filing false and misleading Forms 13D forms and failing to make other required filings from 1998 to 2001. By doing so, Teo and the trust materially misrepresented their ownership of Musicland stock, the SEC charged.

Ownership Misrepresented. In a release announcing the final judgment, George S. Canellos, director of the SEC's New York Regional Office, said, ''Teo lied in his public filings for his personal gain and fraudulently circumvented core disclosure requirements designed to protect investors in public companies.''

''The court's decision sends a strong message that our regulatory framework depends on truthful disclosure, and intentional violations will be appropriately sanctioned.'' According to the SEC, the evidence at trial showed that Teo lied in filings with the agency about how many shares he controlled in order to avoid triggering Musicland's ''poison pill'' shareholders rights plan.

It said Teo ''understood that triggering the poison pill would have significantly diluted his stock and caused massive losses to him. Teo deceptively purchased millions of Musicland shares well above the poison pill threshold, which he eventually sold to receive illicit profits.''

The court ordered Teo and the trust to pay $17,422,054.13 in disgorgement plus $14,649,034.89 in prejudgment interest, and penalties of $17,422,054.13, the SEC recapped. It also barred the defendants from future disclosure violations. The agency added that in addition to that $49,493,143.15 final judgment, in 2010, Teo paid $996,782.68 in disgorgement and prejudgment interest for insider trading violations. In a related criminal case, he also paid a $1 million fine and was sentenced to serve 30 months in prison.

''The court previously enjoined Teo from further violations of the antifraud provisions and barred him from serving as an officer and director of a public company,'' the SEC said.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8ptrdl.

Jurisdiction and Procedure

N.Y. High Court Rules Investors May Sue LLC Promoters For Breach of Fiduciary Duty

Investors in seven limited liability companies may sue the LLC promoters for alleged breaches of fiduciary duty that occurred before the entities were formed, the New York Court of Appeals ruled Dec. 20 (*Roni LLC v. Arfa,* N.Y., No. 228, 12/20/11).

The ruling paves the way for the investors to continue with their claim that the promoters had fiduciary obligations toward them based on the confidence the investors reposed in the promoters and the latter's superior skills and knowledge compared to theirs.

Traditional Claim for Breach. In June 2010, the New York Supreme Court, Appellate Division, held that the investors' allegations did not state a traditional claim for breach of fiduciary duty based on a business or personal relationship of trust and confidence, superior expertise and knowledge.

The court nonetheless upheld the denial of the defendants' dismissal motion based on the defendants' ''status as the organizers of the business venture.'' In September 2010, the Appellate Division granted the defendants' motion for leave to appeal to the Court of Appeals, which issued the subject ruling.

David Katz, Schlam, Stone & Dolan LLP, New York, who represented the investors, noted that the court deemed their pleadings adequate to demonstrate a fiduciary relationship. However, he acknowledged, the ''court went out of its way to avoid endorsing the Appellate Division's ruling that someone who files the articles of organization for a New York LLC and solicits individuals to invest in the LLC is automatically a fiduciary to anyone he or she solicits based solely on his or her status as a 'promoter' of the LLC.''

For his part, John Van Der Tuin, Balber Pickard Maldonado & Van Der Tuin PC, New York, who represented defendant Roni LLC, conceded that the ruling confirms ''that the corporate form of the proposed investment—whether shares in a corporation or interests in an LLC or partnership—should not affect the fiduciary duties of the promoters to the prospective investors. Those who argue that limited liability company structures allow a lower standard are wrong.''

Investment Property. The LLCs purchased residential buildings in the Bronx and Harlem for renovation and resale. The promoters organized the LLCs, located and managed the properties, and solicited the investors.

The investors sued the LLC promoters for an accounting, waste, breach of fiduciary duty, and actual and constructive fraud. They argued that the promoters, before the LLCs were formed, deliberately concealed from the investors the fact that property sellers and mortgage brokers involved in the deal paid them commissions of up to 15 percent of the purchase prices of the properties, and that these commissions inflated the purchase prices by millions of dollars.

In its ruling, the New York Court of Appeals noted that ascertaining the existence of a fiduciary relationship ''inevitably requires a fact-specific inquiry.''

In this case, it related, the investors asserted that the promoters planned the business venture, organized the LLCs, solicited their involvement, and controlled the invested funds. Accordingly, the investors reasoned, the promoters owed them a fiduciary duty to act in their benefit regarding the investments.

The court agreed with the investors that the promoters of an LLC ''are in the best position to disclose material facts to investors and can reveal those facts more efficiently than individual investors, who would otherwise incur expense investigating what the promoters already know.''

According to the investors, who were Israeli, the promoters represented that they had ''particular experience and expertise'' in the New York real estate market. Moreover, they argued, the promoters played upon the investors' cultural identities and friendship in soliciting their investments.

Accepting as true the sum total of these allegations on the motion to dismiss, the high court held the complaint adequately pleaded a fiduciary relationship.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8pskhv.

SEC Enforcement

Court Directs SEC to Provide More Facts Before Approving Settlement

In another judicial move scrutinizing the Securities and Exchange Commission's settlement practices, the U.S. District Court for the Eastern District of Wisconsin Dec. 20 directed the agency to provide a ''factual predicate'' for its proposed agreement with Koss Corp. and its chief executive officer Michael Koss before signing off on the accord over faulty internal controls at the entity (*SEC v. Koss Corp.*, E.D. Wis., 11-991, 12/20/11).

''The Court requests that the SEC provide a written factual predicate for why it believes the Court should find that the proposed final judgments are fair, reasonable, adequate, and in the public interest,'' Judge Rudolph Randa wrote in a letter to the agency, citing Judge Jed Rakoff's recent ruling in *SEC v. Citigroup Global Markets Inc.* (9 CARE 1372, 12/2/11).

In that case, the U.S. District Court for the Southern District of New York declined to approve a proposed settlement between the SEC and Citigroup because the parties had not provided enough facts for the court to exercise its independent judgment—a move currently being challenged by the SEC (9 CARE 1436, 12/23/11) (*see related stories in this issue*).

Settlement Announced. In October, the SEC announced that Koss and his firm settled charges over their failure to maintain adequate financial reporting controls that allegedly perpetrated a financial fraud scheme by two employees.

The SEC said the defendants had agreed to be barred from future securities violations but neither admitted or denied wrongdoing. According to the proposed final judgment, Koss also agreed to pay back the company roughly $450,000.

Concerns Raised. Randa questioned the ''adequacy of the SEC's proposed final judgment provision regarding disgorgement'' by Koss.

''[W]ithout any factual predicate for how those disgorgement terms were determined and what more, if anything, could have been subject to disgorgement, the Court cannot assess their fairness and the extent to which they serve the purpose of disgorgement which is to deprive the violator of unjust enrichment and thereby further the deterrence objectives of the securities laws,'' Randa wrote.

The court also said portions of the proposed injunctive relief ''lack provisions for implementation,'' including a time frame, ''mechanism'' for implementation, and a provision for reporting or auditing of the ''agreed changes.'' ''If enforcement became necessary, the terms of such a vague injunction would make it difficult for the Court,'' Randa said. He directed the agency to respond by Jan. 24.

The full text of the SEC's complaint is available at http://op.bna.com/car.nsf/r?Open=tchi-8psks4.

In Brief

Minority Shareholder Not Allowed to Sue Derivatively

A minority shareholder in a Spanish corporation cannot bring a Delaware derivative suit against the corporation, because the shareholder did not comply with Spain's presuit demand requirements, the Delaware Supreme Court affirmed Dec. 28 (*Sagarra Inversiones S.L. v. Cementos Portland Valderrivas S.A.*, Del., No. 425, 2011, 12/28/11).

The high court, in an en banc ruling authored by Justice Jack B. Jacobs, ruled that Spanish law governed the minority shareholder's standing to sue to rescind a corporate acquisition, because the only company in which it owned shares was incorporated in Spain.

Under Spanish law, the court emphasized, the minority shareholder must ask the parent company's board to convene a shareholders' meeting to decide whether the company should sue its own board. Since Sagarra did not do so, its Delaware derivative claims must be dismissed.

Sagarra Inversiones S.L., a Spanish corporation, is a 26 percent minority shareholder of Uniland, also a Spanish corporation. Cementos Portland Valderrivas (CPV), another Spanish corporation, was the controlling shareholder of Giant Cement Holdings, the corporation Uniland acquired through Uniland Acquisition Corp., a vehicle created specifically to acquire Giant. Thus, as the supreme court recapped, within this hierarchy UAC was a third-tier subsidiary of Uniland. The Delaware Supreme Court held that Sagarra's standing to sue derivatively on behalf of UAC must necessarily derive from its ownership of shares in Uniland, because Uniland is the only corporation in which Sagarra owns shares.

Citing the internal affairs doctrine, the court concluded that the presuit demand requirements in this case are set by Spain, where Uniland is incorporated. The presuit demand requirement is quintessentially an ''internal affair'' that falls within the scope of that doctrine, the high court stressed. The court declined Sagarra's invitation to set aside the internal affairs doctrine in this case because of Delaware's strong interest in preventing its corporations from being used for abusive purposes.

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The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8q827w.

SEC Targets Executives for Life Settlement Fraud

The Securities and Exchange Commission Jan. 3 charged a financial services firm and three of its senior executives in the U.S. District Court for the Western District of Texas with having a role in a fraudulent disclosure and accounting scheme involving life settlements (*SEC v. Life Partners Holdings Inc.,* W.D. Texas, No. __, 1/3/12).

In a statement that day, the agency identified the defendants as Life Partners Holdings Inc.; chairman and chief executive officer Brian Pardo; president and general counsel Scott Peden; and chief financial officer David Martin. Allegedly, the defendants misled shareholders by failing to disclose a significant risk to Life Partners' business—that the company was ''systematically and materially underestimating'' the crucial life expectancy estimates it used to price transactions.

The individual defendants were involved in disclosure violations and improper accounting that the firm used to overvalue assets held on its books and to ''create the appearance of a steady stream of earnings from brokering life settlement transactions,'' the SEC said.

As explained by the SEC, life settlements involve the purchase and sale of fractional interests of life insurance policies in the secondary market. In such transactions, life insurance policy owners sell their policies to investors in exchange for a lump-sum payment. Among other considerations, the dollar amount offered by the investor takes into account the insured's life expectancy.

The complaint can be seen at http://www.sec.gov/litigation/complaints/2012/comp-pr2012-2.pdf.

Maine Supreme Court Vacates Shareholder's Award

The Maine Supreme Judicial Court Dec. 29 vacated a $1.5 million judgment in a shareholder's derivative action, finding that the shareholder lacked standing to file the action because he participated or acquiesced in the division or sale of the corporation's assets (*Voisine v. Berube,* Me., Aro-11-196, 12/29/11).

In an en banc ruling authored by Judge Donald G. Alexander, the court held that because the shareholder, Gary Voisine, participated in the sale and division of assets of the firewood supply company in which he was a vice president, he lacked standing to bring a derivative action on the company's behalf.

The court determined that Voisine lacked standing to file derivatively on Valley's behalf because he participated in the division of assets, and received the benefits of that distribution. Moreover, he created a corporation to sell firewood formerly sold by Valley that, he acknowledged in testimony, was intended to replace Valley, which had terminated its firewood business. Thus, the high court concluded, he was not entitled to an award of damages as a matter of law.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8q6tsx.

Aon to Pay $14.5M to SEC to Settle FCPA Charges

Leading insurance broker Aon Corp. agreed to pay $14.5 million to settle Securities and Exchange Commission charges that it bribed foreign officials to obtain or retain business, the commission announced Dec. 20 (*SEC v. Aon Corp.*, D.D.C., No. 1:11-cv-02256, 12/20/11).

Aon, without admitting or denying the allegations, also agreed to entry of a judgment barring it from further securities violations. The settlement is subject to approval by the U.S. District Court for the District of Columbia, the SEC said in a release. In a same-day announcement, the Department of Justice said Aon agreed to pay $1.764 million in a non-prosecution agreement to settle related criminal charges.

The SEC's complaint alleged that Aon and its subsidiaries, in violation of the Foreign Corrupt Practices Act, made over $3.6 million in improper payments to government officials and others in various countries—including Costa Rica, Egypt, Vietnam, and Indonesia—between 1983 and 2007. According to the agency, Aon made more than $11.4 million in profits from the alleged bribes. As part of the non-prosecution agreement, Aon admitted that its U.K. subsidiary's books and records did not accurately reflect the purposes of the payments. It also admitted that its internal accounting controls were inadequate to ensure FCPA compliance. The agreement further requires Aon to adhere to rigorous compliance, bookkeeping, and internal controls standards, and to fully cooperate with DOJ.

DOJ said it agreed to enter into the non-prosecution agreement because of the company's ''extraordinary cooperation'' with it and the SEC; ''timely and complete'' disclosures of the alleged violations; ''early and extensive'' remedial efforts; and payment of a £5.25 million fine to the U.K. Financial Services Authority. ''These factors also led to a substantially reduced monetary penalty,'' it said.

The SEC's release is available at http://www.sec.gov/litigation/litreleases/2011/lr22203.htm. DOJ's release is available at http://www.justice.gov/opa/pr/2011/December/11-crm-1678.html.

Casey Seeks Probe of Chinese Firms Trading in U.S.

Sen. Robert Casey Jr. (D-Pa.) Dec. 15 asked the Securities and Exchange Commission to investigate how Chinese solar panel firms ''gain access'' to U.S. capital markets, citing concern for investor protection.

''Chinese companies are using offshore holding companies to circumvent American legal barriers and gain access to our domestic capital markets,'' Casey wrote in a letter to SEC Chairman Mary Schapiro. ''[O]nce these investments have been made, investors have limited shareholder protections and non-existent recourse against fraud.'' In particular, Casey pointed to ''shell companies'' recently set up by Chinese solar panel firms in the Cayman Islands to sell shares on U.S. exchanges. Investors poured money into these companies, Casey said, but the shares eventually took a hit as the Chinese government began to subsidize the solar industry and drive global prices down.

''Investors have no recourse to confront these situations,'' the senator said, noting the opacity of accounting practices for China-based companies. SEC spokesman John Nester told BNA in an e-mail, ''We share the Senator's interest in this area, and have already taken several significant investor protection steps in the past two years to address it.''

Judgment Against Grupo Mexico Increased

One of the largest awards in the history of the Delaware Court of Chancery has gotten bigger.

In a Dec. 20 revised opinion, Chancellor Leo E. Strine Jr. recalculated the damages against Grupo Mexico SAB, increasing the judgment's principal amount to $1.347 billion from $1.263 billion plus interest (*In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, Del. Ch. Ct., Civil Action No. 961-CS, 10/14/11, rev. 12/20/11).

The original opinion in this derivative suit, which involved the purchase of a mining operation, came in October (9 CARE 1235, 10/21/11). Southern Copper of Lima, Peru, formerly known as Southern Peru Copper Corp., purchased 99 percent of the shares in Minera Mexico, a company owned by Grupo Mexico, in April 2005 for $3.75 billion.

Afterward, Southern Copper shareholders sued on behalf of the company claiming it overpaid because its board relied on a skewed analysis that raised Minera's worth and lowered its own, according to court documents. The court ruled that the price was unfair, and ordered Grupo Mexico to compensate Southern Copper in shares needed to cover the award, which equals this difference between what Grupo Mexico was paid and what it probably would have been paid in a good-faith bargain.

On Dec. 19, the court awarded the plaintiffs' attorneys a $285 million fee for the case. The fee will go to two law firms, Kessler, Topaz, Meltzer & Check LLP of Radnor, Penn., and Prickett, Jones & Elliott of Wilmington, Del. The attorneys' fees must be paid in cash by Southern Copper, while Grupo Mexico may pay the $1.347 billion award by returning a sufficient number of shares to Southern Copper, the court said.

The revised opinion is available at http://op.bna.com/car.nsf/r?Open=codm-8pzmvz.

Court Ends Case Against Galleon Cooperator

The U.S. District Court for the Southern District of New York Dec. 23 agreed to terminate, at the Securities and Exchange Commission's request, the agency's case against David Plate—a Schottenfeld Group LLC trader who was implicated in the alleged insider trading scheme at Galleon Management LP—without imposing a monetary fine (*SEC v. Galleon Management LP*, S.D.N.Y., No. 1:09-cv-8811-JSR, 12/23/11).

In June, Plate settled the SEC's charges over his role in the massive insider trading at Galleon, now defunct, by agreeing to pay more than $53,000 comprising disgorgement in the amount of $43,876.37, plus prejudgment interest of $9,415.54 (9 CARE 1296, 11/4/11). At the time, the court said it would determine at a later date whether to impose civil penalties against Plate. In its Dec. 23 order, the court said it would terminate the case against Plate without a fine, citing a Dec. 19 letter from the SEC.

The SEC said in the letter that when it reached a settlement with Plate, the parties agreed to defer the decision of whether a civil fine should be imposed so that Plate's cooperation with the commission and the Department of Justice ''could be taken into consideration in the determination whether and to what extent civil penalties were appropriate.''

Since that time, the SEC said, Plate has continued to cooperate with the commission.

2d Cir. Okays Appeal by BNYM in $8.5M Settlement

The U.S. Court of Appeals for the Second Circuit Dec. 27 granted Bank of New York Mellon Corp. and other petitioners leave to appeal a district court order denying BNYM's request to remand an $8.5 billion settlement agreement to a state court (*BlackRock Financial Management Inc. v. Walnut Place LLC*, 2d Cir., No. 11-4554-mv, 12/27/11; *Bank of New York Mellon v. Segregated Account of Ambac Assurance Corp.*, 2d Cir., No. 11-4571-mv, 12/27/11).

In an order by Judges Peter W. Hall, Debra Ann Livingston, and Gerard E. Lynch, the appeals court consolidated two cases and granted Bank of America's motion to file amicus briefs in support of the petitions for leave to appeal. The controversy stems from BoA's agreement in June to pay BNYM $8.5 million to settle possible claims of fiduciary duty and other alleged violations committed by Countrywide Financial Corp. in connection with millions of mortgages held by 530 trusts.

BNYM is the trustee of the trusts holding the mortgages, which Countrywide, now owned by BoA, sold through a third party to BNYM to hold in trusts. Securities based on the underlying value of the mortgages were then sold to investors.

In October, Judge William H. Pauley ruled that an intervener in the case, Walnut Place LLC, appropriately removed the case from state court to federal court under the Class Action Fairness Act.

The full text of the opinion is available at http://op.bna.com/car.nsf/r?Open=tchi-8pys7f.

Accounting

Auditor Oversight

Auditors, Corporations Express Opposition To PCAOB Proposal for Audit Firm Rotation

The audit community and many large corporations appear solidly opposed to a Public Company Accounting Oversight Board proposal requiring public companies to change their audit firms periodically in an effort to heighten auditor independence and professional skepticism.

As a Nov. 18 letter to the PCAOB from Ernst & Young LLP of New York explains it, mandatory rotation would ''not only give rise to substantial costs and disruptions, but also would, we believe, impair audit quality, undermine sound corporate governance, and detract from the ability to maintain a robust accounting profession.''

Similarly, a Dec. 2, 2011, letter to the board from U.S. Steel Corp. of Pittsburgh said that mandatory rotation would result in ''increased costs and inefficiencies and reduced audit quality with little, if any, added benefits.''

Those letters are among 602 received by the PCAOB as of Jan. 3 on its concept release requesting feedback on its proposal for mandatory audit-firm rotation, and seeking suggestions for alternative approaches.

The deadline for comment letters was Dec. 14, but some letters have continued to trickle in.

Investors Support Rotation. While auditors, audit-committee members, and corporations expressed almost universal opposition to the idea of mandatory rotation, many in the investment community considered the proposal ''sound.''

''Without any doubt, this would change the mindset and behavior of public accounting firms and provide for a much greater level of independence,'' Paul F. Kurgan, president of the investment consulting firm FYI Consultants LLC of Potomac, Md., said in a Dec. 14 letter.

''In addition to adopting the mandatory rotation after a 10-year period, I strongly believe that accounting firms should be prohibited from [providing] all other services to an audit client, not just those prohibited by the Sarbanes-Oxley Act [of 2002],'' he added.

On Dec. 13, Professors Ralph S. Polimeni and Jacqueline A. Burke of Hofstra University submitted to the board an article they wrote for *The Journal of Portfolio Management*, in which they proposed a two-pronged solution to the problem of insufficient auditor independence. Mandatory rotation was part of their solution.

''An accounting firm would be permitted to audit an organization for a maximum of five consecutive years with the process being monitored by the PCAOB,'' they wrote. ''The accounting firm must wait an additional five years after its last audit of an organization before being permitted to perform ay additional work for that organization.''

The second prong provides tenure protection for auditors.

''An organization being audited would not be permitted to fire an accounting firm without due cause, such as violation of the contract agreement, gross negligence, and so forth. An organization would be required to petition the PCAOB for dismissal proceedings,'' they wrote.

Hundreds of Auditing Failures. The concept release, which was approved Aug. 16 by the board for public comment, highlighted the concerns many investors have over the decades-long relationships that some audit firms have had with some public companies (9 CARE 1001, 8/19/11). It said that term limits could be a way of improving the reliability of audits and auditor skepticism of management's numbers.

Over the last nine years, board inspectors have discovered hundreds of cases of auditing failures, and a lack of auditor objectivity, independence, and skepticism may have been a contributing cause in some of those cases, according to concept release. Workloads, changes in audit rules, and fluctuations in markets are among other possible causes, it said.

Deloitte LLP of New York, which was cited by the PCAOB for failures committed by its subsidiary Deloitte & Touche LLP of New York (9 CARE 1248, 10/21/11), wrote in a Dec. 8 letter to the board that it undertook a ''broad, fact-based assessment of the public company disclosure system'' to develop suggestions for improving protections for the investing public.

Deloitte said it determined that mandatory rotation would not bring about increases in audit quality sought by the PCAOB.

''Research studies show that restatements and frauds are less likely to occur with longer auditor tenure,'' Deloitte's letter said.

Alternatives Recommended. Deloitte pointed to several areas in which it said ''building upon current best practices'' would enhance the protections of SOX. They include:

- require early and direct guidance from the audit committee in fee negotiations to reinforce the representation of shareholder interests;

- provide that prior to the earnings release the audit firm has sufficient opportunity to review and discuss significant accounting and auditing judgments with the audit committee;

- increase the sharing of findings and remediation efforts relating to internal and PCAOB inspections;

- define an expanded scope for the audit committee report on its auditor oversight and move the report from the proxy statement to the Form 10-K.

Other audit firms also expressed support for strengthening the role of independent audit committees as a means to further promote audit quality and auditor skepticism.

Ernst & Young, as well as other audit firms, also supported a process by which the PCAOB could recommend rotation of an audit firm in instances in which ''it has been demonstrated, through the PCAOB's enforcement process against a firm, that professional skepticism or objectivity was significantly lacking in the firm's audit of a particular issuer.''

The board will convene a public roundtable meeting to discuss the concept release in March.

The board might then draft a proposed rule or decide to take no action. Any rule approved by the board must gain further approval of the Securities and Exchange Commission before it can be enforced.

By Che Odom

The concept release is available at http://pcaobus.org/Rules/Rulemaking/Docket037/Release_2011-006.pdf.

The comment letters are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx.

Accounting Guidance

Significant Application Guidance Needed After U.S. Adopts IFRS, KPMG Partners Say

Enough differences will exist between Financial Accounting Standards Board rules and International Accounting Standards Board standards—after their convergence—that significant application guidance from FASB will be needed for U.S. firms to use international financial reporting standards, KPMG accounting and auditing partners said Dec. 20.

The partners, conducting a KMPG IFRS Institute webcast on the outlook for convergence and IFRS adoption, also said it is unclear whether the standards convergence-IFRS endorsement phase-in approach, which apparently is being followed by the Securities and Exchange Commission, or a single-date adoption deadline of IFRS would prove to be the most cost effective implementation.

The IFRS webcast analyzed the Nov. 16 SEC staff working papers on IFRS-U.S. GAAP comparison and on IFRS in practice. The webcast examined those papers against the backdrop of recent IFRS pronouncements by FASB Chairman Leslie Seidman and IASB Chairman Hans Hoogervorst.

As Differences Narrow, Guidance Still Needed. Mark Bielstein, KPMG Audit Partner and Accounting Group Head, told the webcast that FASB comments at the AICPA conference indicated that it is ''a reasonable observation'' that more application and industry-specific guidance will be needed from the standards-setters after IFRS is incorporated into GAAP. That guidance will be needed ''even though the differences become less as U.S. GAAP comes closer to IFRS,'' Bielstein said

Also based on those FASB and IASB comments at the AICPA, ''it is likely that we will move toward a convergence-endorsement approach, based on the recent discussions,'' Bielstein said.

The SEC staff at the 2010 AICPA conference outlined a ''condorsement'' approach, in which FASB and IASB would converge their standards as much as possible, and then FASB would endorse the adoption of remaining IFRS standards as they became further developed. The Financial Accounting Foundation, FASB's parent, in a comment letter to the SEC backed that idea. However, Seidman emphasized at the AICPA conference that FASB would endorse only those IFRS that represented clear improvements over U.S. standards, and only if they could be implemented and audited at reasonable cost.

KPMG Audit Partner and U.S. IFRS Professional Practice Leader Paul Munter described how the boards' experience in trying to converge financial instruments rules into a common standard shows why discrepancies and differences could persist despite their best effort at complete convergence.

''I think that the boards acknowledge that when they get out of sync—and one board is working on one phase of the project and another board is working on another phase of the project—it is extremely difficult to come back and get lined up,'' Munter said. ''When they have been working hand-in-hand throughout, like they have been on the revenue project, they have a much greater likelihood of getting to a converged solution. I think the financial instruments project is kind of a case study in how not to go about a convergence undertaking.''

Most Cost Effective Approach? On whether a date-certain adoption of IFRS or a more phased-in approach under a conversion/endorsement approach is more cost effective, Munter noted that the SEC is required to conduct a cost-benefit analysis in adopting its regulations and to choose the less costly adoption method. However, ''it is always challenging to do that,'' he said.

''I think the [SEC] staff was initially thinking that going the convergence endorsement route might be a way of mitigating some of the costs by kind of spreading them out a bit,'' Munter said. ''But I think that there are some larger companies who might find it easier to manage if [the SEC] were to pick a date, drive towards that and do it all at once. I think the answer to that depends on where your perspective is, what your resource capability is, and what your access to technical people are. I think it's really difficult to answer that in a once-size-fits-all kind of fashion.''

By Steven Marcy

Accounting Standards

Uncertainty Over Standards Convergence, Audit Role Clouds Outlook for 2012

The accounting profession enters into 2012 with greater uncertainty than at the outset of other recent years.

The assumption of U.S. adoption of international financial reporting standards under renewed doubt, a possible major reshaping of the auditor's role, and the stalled drive toward convergence of U.S. and international accounting standards have all muddied the 2012 outlook, practitioners and accounting academics told BNA over the last month.

Uncertainty over U.S. adoption of IFRS and the standards-convergence efforts of the Financial Accounting Standards Board and International Accounting Standards Board officially escalated in December.

Securities and Exchange Commission Chief Accountant James Kroeker told an American Institute of Certified Public Accountants that the staff will need a few

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more months before it can produce a report on which the SEC can base a decision whether to allow IFRS use by domestic U.S. companies. FASB Chairman Leslie Seidman and IASB Chairman Hans Hoogervorst that the convergence effort had concluded a ''side-by-side'' convergence model of identically worded standards was no longer viable, practically or politically.

But those officially-expressed doubts also confirmed what had been emerging for some time, practitioners noted.

''I think the [FASB-IASB] standards won't ever by be completely congruent—and where IFRS has been adopted in many countries, they haven't been too perfectly adopted, either,'' said Jack Ciesielski, founder of R.G. Associates. ''I don't think we're going to be the exception'' of not reaching converged standards, he said. ''Continuing differences will probably be in the area of specialized industry standards.''

One-World Accounting Standards Now Dead. Despite the diminution of the effort to converge their standards, FASB and IASB will not disengage from it completely, a source in the accounting academic community told BNA, responding on the condition of anonymity.

''Those who report the demise of convergence efforts seem to be assigning relatively little significance to the remaining active and inactive projects that are still listed on the IASB's and FASB's websites,'' the source said. ''In addition to the oft-mentioned ongoing and active projects to converge and improve the accounting for revenue recognition, leases, insurance and financial instruments (the last of these contains several subprojects each with its own vexatious issues), the boards have committed to resolve income tax accounting, financial statement presentation and the accounting for instruments with characteristics of equity.

The academic source, along with others, said the profession continues to face issues of complexity, and the attempt of the boards to converge their financial instruments standards added to that complexity.

''As of the end of 2011, the single area where the IASB and FASB appear to be most divergent is the accounting for financial instruments,'' the source said. Part of the FASB-IASB convergence problem rests with fear of incurring the wrath of the accounting community if they do not allow it to weigh in on every nuance of the standards-setting process, according to the source.

FASB, IASB Preoccupied With Process. ''Increasingly, the IASB and FASB seem to be preoccupied with process, including but not limited to interminable outreach and consultation with constituents,'' the source said. ''The result seems to be a form of standard-setting gridlock. Although input from constituents is a desirable component of standard-setting, the decisions to re-expose the proposals on leases and revenue recognition illustrate how it is possible to have too much of a good thing.''

''We are locked in cycle of ever more complex standards, followed by ever more creative abuses of those standards, which, in turn are followed by even more complex standards,'' said David Cairns, an IFRS applications consultant, from the United Kingdom. ''Among other things, this means that standard setters and their constituencies are constantly having to revisit the same topics. As one standard setter put it: the topics stay the same, only the people change.''

The attempt to force companies, especially financial institutions, to bring variable interest entities and other special vehicles back onto their balance sheets through consolidations rules is a case in point, Cairns said.

''The current [consolidations] standards have worked perfectly well for millions of straightforward parent-subsidiary relationships around the world. However, the standards—both international and U.S.—have not worked well in the face of structures created with the sole purpose of avoiding consolidation and so hiding the true financial position and performance of groups around the world.''

G20 Must Step Up. ''The result is more complex standards designed to deal with these abuses,'' Cairns continued. ''The IASB has recently issued the third and most complex version of its consolidations standard with the primary aim of dealing with relationships designed to avoid consolidation. This new standard will not change the accounting for millions of straightforward parent-subsidiary relationships around the world but every company that reports under IFRS is having to battle with the complex new terminology and disclosure requirements. At the same time, there are undoubtedly those accountants, lawyers and bankers who are creating new structures that will create the next wave of abuses by continuing to hide the true financial position and performance of groups around the world.''

The only way out of ''this cycle of evermore complex standards, followed by evermore creative abuses of those standards'' is for the G20 nations to insist vigorously that international regulators and standards setters adopt the reforms it suggested for preventing another financial crisis by backing ''their words by pushing their national constituencies, not only to implement the revised standards, but to do so in a way that breaks the standard setting-abuse-standard setting cycle,'' Cairns said.

Major Revisions to Auditor's Role, Practice? The Public Company Accounting Oversight Board holds the key for other major changes to the profession that will likely gather force in 2012—its consideration of an expanded role for auditors that gives investors more information about the evaluations auditors conduct in examining a client's financial reports (9 CARE 333, 3/18/11) and a possible required rotation by companies of their auditors every few years to ensure auditor independence (9 CARE 1001, 8/19/11).

Besides continued deliberations over the accounting standards, Arnold Hanish, Eli Lilly and Company, said the possible imposition of auditor rotation looms as the biggest possible change for the profession.

''The implication of auditor rotation, if it comes to pass, will be significant on all parties,'' Harnish said. ''It would interrupt a whole host of nonaudit services currently performed by the other Big Four [accounting firms] for large multinational companies. None of the firms today would be truly independent. If they decide to go the path of an auditor's discussion and analayis [to give investors more insight into auditing decisions], it will be a huge issue as to the interpretation of financial statements.''

Eugene Imhoff, a University of Michigan accounting professor, rated auditor independence, ''and the related integrity of the U.S. financial reporting system and its impact on the capital markets'' as among the biggest challenges for standards setters and regulators for 2012.

Imhoff wants the SEC and stock exchanges to promulgate rules requiring corporate boards to be more knowledgeable of financial reporting issues and independent of company management.

Auditors ''need more help from independent directors in order to force corporate managers to comply with the spirit of [generally accepted accounting principles] in a transparent way in their financial statements,'' Imhoff said. ''These issues underpin nearly all corporate scandals and failures, yet we have failed to take sufficient steps to meaningfully improve corporate governance in the U.S.''

''When corporate boards in the U.S. bring executive compensation contracts in line with those of the rest of the world, doing away with agreements for managers and themselves that are high probability lottery tickets in a lottery that can be manipulated by managers, then we will have effective governance,'' Imhoff continued. ''You can not effectively address auditor independence without addressing the governance problems created by uninformed and/or management appointed and aligned corporate boards.''

By Steven Marcy

Accounting Standards

FASB's Trustees Champion New Era For Financial Reporting Standards

NORWALK, Conn.—The Financial Accounting Foundation, the trustee organization for the Financial Accounting Standards Board and the Governmental Accounting Standards Board, has emerged to actively champion what appears to be a new era for financial reporting.

Two key issues expected to significantly change the accounting landscape have been earmarked for resolution in 2012: whether, when or how will the Securities and Exchange Commission adopt international financial reporting standards (IFRS) for U.S. public companies; and whether to establish a U.S. private company standards-setter to develop private company accounting standards, including how it would function.

'Robust Financial Reporting.' FAF President and Chief Executive Officer Terri Polley told BNA Dec. 28 both were key historic issues within the context of U.S. financial reporting. ''The most important thing that the Trustees want to ensure is that the U.S. investor has appropriately robust financial reporting on which to make capital allocation decisions,'' she said.

In a formal letter to the SEC Nov. 15 the FAF said it agreed with the regulator's ''condorsement'' staff paper on the possible path toward IFRS but contingent on certain key enhancements being made, including that the FASB would actively participate in the standard-setting activities of the International Accounting Standards Board.

In weighing its recommendations, the overriding factor for the Trustees was how to best structure standard-setting to ensure the needs of U.S. investors are met,'' said Polley. The SEC's chief accountant James Kroeker in December said its staff would need ''a measure of a few additional months time to produce a final report,'' on the role of IFRS in the U.S.

Private Company Reporting. Unlike decisions on IFRS however, private company GAAP lands squarely in the FAF's domain. It's an old debate spanning almost 40 years but moved to closer scrutiny over the past two years with a ''blue ribbon panel'' review, followed by the panel's recommendations January 2011.

As a result, the FAF Oct. 4 issued a proposal aimed at establishing a Private Company Standards Improvement Council (PCSIC) to determine whether exceptions or modifications to U.S. generally accepted accounting principles (GAAP) are warranted for private company financial reporting. The deadline for public comment on the FAF proposal ends Jan. 14.

Heavily Opposed by AICPA. The proposal has been heavily opposed by the American Institute of Certified Public Accountants because it allows for FASB's veto authority to be maintained over any standard setting decisions the new group would make. The AICPA has launched a counter campaign stating that it wants a solution inside FAF and is hopeful the response from members will cause FAF to alter the FASB veto provision that is proposed.

On Oct. 18, the AICPA said its governing council approved a resolution that could include creating a separate standard-setting body to develop private company GAAP should the FAF move ahead with its proposal. That debate is expected to heighten in 2012.

Polley told BNA that the FAF proposal is very much identical to the blue ribbon panel recommendations with the exception of the authoritative status of the new group. ''The Trustees felt it was important to retain the FASB as the sole U.S. standard setter, which is very consistent with the movement of standard setting over the last 10 to 12 years,'' she said.

Fundamental to the Trustees is that there should be one standard-setter, said Polley. ''The AICPA has come out publicly saying that this body should have its own authority independent of the FASB and I think that the FAF needs to work through the comments and work through the process,'' she said.

Decision Expected by March. The FAF has also scheduled roundtables Jan. 18, in Atlanta; Jan. 26, in Dallas; Feb. 7, in Palo Alto; and March 1, in Boston, to hold further discussions on the topic. The Trustees would begin to review feedback on the proposal starting with their first meeting of the year, which is mid-February, with the possibility of coming to a decision whether or not to establish the PCSIC by the end of March or the beginning of April, Polley said.

If the decision is to move forward with creating this new council, the Trustees would soon thereafter begin an implementation program. ''I would think that by the second half of the year we would be able to see this group formed,'' she said.

Relevance of GAAP, Blue Ribbon Panel. Accounting practitioners have for some time stated that U.S. GAAP lacks relevance for private companies, and is too costly and complex.

Currently, in the U.S., private companies have three choices for financial reporting purposes:

- U.S. generally accepted accounting principles;
- Full IFRS as issued by IASB; and

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■ IFRS for small-and-medium sized entities (SMEs).

Private companies also have other comprehensive basis of accounting such as income tax basis, which some banks and other users will accept for small and mid-sized companies.

In December 2009 to address private company concerns, the AICPA, the FAF and the National Association of State Boards of Accountancy, established a blue ribbon panel to comprehensively evaluate private company issues. Following its review process the panel made two recommendations: that differences in existing and future GAAP were warranted; and, an independent board should set those differences.

AICPA's Vigorous Objections. The AICPA has said FAF's proposal falls short of the recommendations of the blue ribbon panel, because of the allowance that FASB would maintain veto power over the PCSIC.

''Some may read FAF's plan and think the planned council is a new and viable solution to the systemic problems in the current standard-setting process. But a careful analysis shows that is not the case,'' said AICPA's President and CEO Melancon in an online appeal. ''The proposed process, with FASB veto power at its core, is what we have today,'' he said.

Melancon maintains moreover, that previous similar attempts have not worked and pointed to the Private Company Financial Reporting Committee (PCFRC), as an example of a joint effort of the AICPA and the FASB, which did not get its major recommendations approved by the FASB.

''I'm referring to FASB Interpretation No. 48 ,Topic 740-10-05 and FASB Interpretation No. 46R, Topic 810-10-05. Yes, the FASB has improved its responsiveness to private company issues lately, after the Panel started its work, but given the history and other pressures on the FASB, we cannot trust that this will be the case in the long run. We need a solution that will last,'' Melancon stated.

He urged constituents to write into the FAF stating: ''FAF will pay close attention to the comment letters it receives from private company constituents: preparers, auditors, lenders, investors, regulators and others.''

Constituents' Comments. At the Dec. 8 Financial Accounting Advisory Council meeting, Polley said the Trustees received about 4,500 comment letters, of which about 4,400 appear to be ''form'' letters. Asked by a FASAC member what the 4,400 people were asking for, Polley said they have said: ''accept the blue ribbon panel recommendations, which is to create a separate authoritative standard setting board.''

Discussions by members at the meeting indicated that the letters were instigated by the AICPA and at least one FASAC member cautioned ''that it was fundamentally a position that is being espoused by a specific group that is trying to get the idea across through 4,400 people.''

Polley Dec. 28 told BNA that the FAF and the AICPA both have the same goal in mind, ''which is to ensure that financial statements of private companies present relevant and useful information for users of those statements.''

''I think that in terms of the AICPA and the FAF—we talk with them often and while there are differences in views, I think the Trustees have to let the comment and outreach process work,'' said Polley.

''We're close to the end of the comment period, I think there's going to be lots of good input. Frankly this is one of the reasons why due process works. You can't possibly think of all the best solutions yourself. We get very good input through the comment process,'' she said.

By Denise Lugo

BNA Insights

WHISTLEBLOWERS

A World of Whistleblowers: What Companies Should Know About Dealing With Third Parties Going Forward

BY GREGORY F. PARISI

The new United States whistleblower program is global in scope and provides incentives to a broad array of individuals. The new rules incentivize a much wider array of individuals than merely corporate insiders to become watchguards of corporate compliance with federal securities laws–including customers, stockholders and academics, market watchers and citizen activists, and third-party service providers. Of these groups, individuals working for third-party service providers are the most likely outside candidates to act on the financial incentives contemplated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. They often have access to and work with sensitive corporate information.

The new whistleblower program is causing many companies to take a close look at, and in some cases revise, their internal policies, procedures, communications, and culture in connection with reporting and compliance. In doing so, companies should not ignore the implications of the whistleblower program with respect to third-party service providers. Because any report by a whistleblower, however frivolous, can result in substantial costs and distractions, companies should select, engage, and manage third-party service providers in light of the new whistleblower rules.

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This article provides a brief summary of the new federal whistleblower program[1] as it relates to third-party service providers, and discusses some of the particular implications and actions companies should consider going forward.

I. The New Whistleblower Program

Section 922 of the Dodd-Frank Act added new Section 21F to the 1934 Securities and Exchange Act, directing the SEC to pay awards of between 10 percent and 30 percent of the amount recovered to individuals who voluntarily provide the SEC with original information about a possible violation of the federal securities laws leading to an enforcement action resulting in monetary sanctions exceeding $1 million. The SEC's final rules implementing Section 21F became effective on Aug. 12, 2011.

According to the SEC staff's recently released Annual Report on the Dodd-Frank Whistleblower Program for Fiscal Year 2011, the SEC received 334 whistleblower tips in the first seven weeks of the new whistleblower program.[2] The tips cited by the SEC covered a broad range of alleged infractions, including, among others, market manipulation, offering fraud, insider trading, non-compliant corporate and financial disclosure, and FCPA violations.

A. Global Scope

Under the new rules, eligibility for an award as a whistleblower is not limited by geography. Published data and other evidence demonstrates that individuals

[1] For simplicity, descriptions of the program in this article are based on the Securities and Exchange Commission's rules rather than those of the Commodity Futures Trading Commission. The CFTC rules are generally similar to the SEC's, though some differences exist.

[2] The final SEC rules implementing the program became effective on Aug. 12, 2011 and the report included data through Sept. 30, 2011, the end of the SEC's fiscal 2011. The 334 tips cited excludes tips from individuals who did not wish or were not eligible to be considered for awards under the whistleblower program.

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the world over have been made aware of the substantial financial rewards available under the program. A surprising 32 of the 334 tips cited in the SEC's Annual Report on the whistleblower program originated from countries other than the United States. A recently published article in Australia's biggest-selling newspaper proffered that the ''new U.S. whistleblower rules could see Australian workers turn sleuths in the hope of discovering corporate wrongdoings and reaping millions of dollars in rewards.'' [3]

Many global citizens will not be in a position to credibly offer the SEC the sort of information that would qualify them for a reward, and some individuals who would otherwise be in position to obtain or use such information are not permitted to do so under the rules. However, despite these limitations, the magnitude of potential rewards and the breadth of participant eligibility have clearly made the program newsworthy around the world. With nearly 10 percent of the tips provided under the program in its first seven weeks coming from abroad, companies should not ignore the implications of the new whistleblower program when dealing with entities or individuals outside the United States.

B. Broad ''Whistleblower'' Eligibility

The SEC did not provide data in its Annual Report on the whistleblower program regarding the number of tips that originated from within the allegedly noncompliant companies as compared to the number of tips that originated from external sources. Likewise, the SEC declined to provide information regarding the role or expertise of any particular categories of tipsters. Unlike the global reach of the program then, we have no hard data as to the extent to which employees of third-party service providers have attempted to participate in the whistleblower program. However, we can be sure from the rules themselves that the incentives are in place, with some important limitations, for individuals working for third-party service providers to participate in the whistleblower program.

Under the new rules, ''whistleblower'' is broadly defined, with eligibility for an award limited only by requirements that a whistleblower must:

- voluntarily provide the SEC ''original information'' relating to a possible violation of the securities laws;
- be an individual and not an entity, though a whistleblower may act jointly with others; and
- comply with certain procedures related to the submission of information to the SEC.[4]

There is no requirement that a whistleblower be an employee of the company that is possibly violating the securities laws. The definition of ''whistleblower'' therefore opens the door for individuals working for third-party service providers to qualify as whistleblowers. However, the requirement that whistleblowers provide ''original information,'' together with the definition of that term and the related terms ''independent knowledge'' and ''independent analysis'' serve to limit the scope of individuals that may qualify as whistleblowers. In particular, certain potential whistleblowers are excluded from eligibility based on the type of work they perform and the nature of the information that comes into their possession.

The rules generally exclude from whistleblower eligibility attorneys acting on behalf of a company and, more broadly, other individuals who obtain information subject to attorney-client privilege. Specifically, the rules exclude from consideration as ''original information'' any information obtained by an attorney or other employee of a firm in connection with the legal representation of a client where the attorney or employee seeks to use the information to make a whistleblower claim for their own benefit. The rules further exclude from consideration as ''original information'' any information obtained ''through a communication that was subject to the attorney-client privilege'' without regard to who is attempting to use such information or for whose benefit a whistleblower claim is being made. Both of these restrictions are subject to certain exceptions, however, most notably where disclosure is necessary to prevent the company from committing a material violation of the law that is likely to cause substantial injury to the financial interest or property of the company or its investors.[5]

The rules also generally exclude from whistleblower eligibility individuals acting as auditors, compliance personnel, and investigators of possible violations of law. Specifically, the rules exclude from consideration as ''original information'' any information obtained by (1) employees of, or other persons associated with, public accounting firms to the extent such information is obtained in the performance of audit services required by the securities laws; (2) employees or other associates of a firm retained to perform compliance or internal audit functions for an entity; and (3) employees or other associates of a firm retained to conduct an inquiry or investigation into possible violations of law. However, these exclusions do not apply where the individual reasonably believes (a) that disclosure of the information to the SEC is necessary to prevent a company from engaging in conduct likely to cause significant injury to the financial interest or property of the company or investors or (b) that the entity is engaging in conduct that will impede an investigation of possible wrongdoing. The exclusions also do not apply where at least 120 days have elapsed since the individual provided the information to the company's audit committee or chief legal or compliance officer, or to the individual's supervisor.[6]

Under the rules, performers of legal and audit services generally have been eliminated from whistleblower eligibility, likely to avoid interfering with such activities and the open avenues of communication between companies and their attorneys and financial auditors. Similarly, the rules restrict compliance and investigative service providers from whistleblower eligibility, as any chilling effect on communication or trust with such personnel would be counterproductive to the larger goals of the whistleblower program. Individuals performing other functions and working with other types of third-parties are eligible for rewards under the program.

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[3] ''US Law Offers Huge Potential Rewards to Aussie Whistleblowers,'' by Susannah Moran, The Australian, Nov. 7, 2011.

[4] Rule 21F-2, 17 C.F.R. § 240.21F-2.

[5] Rule 21F-4(b)(4), 17 C.F.R. § 240.21F-4(b)(4).

[6] Id.

C. Use of Publicly Available Information

Importantly, the rules permit information that is obtained solely through examination and evaluation of publicly available information to qualify as ''original information'' as long as the resulting information is not generally available to the public.[7] As a result, individuals working for a third-party service provider could qualify as whistleblowers based both on confidential information obtained from a company directly or on information obtained as a result of analysis performed, individually or collectively, on publicly available information. This is important in that it means that individuals working for third-party service providers who do not have access to non-public information can still be successful whistleblowers.

D. No Impeding Communications

Significantly, the rules also prohibit companies from taking actions to impede individuals from communicating with the SEC regarding possible securities law violations, including by enforcing or threatening to enforce a confidentiality agreement.[8] As a result, confidentiality agreements or provisions and other contractual obligations cannot be utilized or relied on to prevent individuals at third parties from acting as whistleblowers.

II. Third-party Whistleblowers

A. What Third Parties?

Potential candidates for whistleblowing activity may work for a variety of third-party service providers. Some may merely handle confidential company information in the course of performing other, often technical services, such as individuals who work for financial printers, proxy solicitors, and third-party monitors of reporting hotlines.

Employees of non-financial auditors, appraisers, and evaluators are also potential whistleblower candidates. These firms and individuals are typically engaged for their expertise in a particular subject matter specific to the company in question. These service providers could include, for example, environmental audit firms, loan portfolio evaluators, FCPA auditors, and asset valuation experts. Of course, as described above, providers of legal, financial audit, and compliance services generally would not qualify.

Employees of third parties that are hired to help a company evaluate a particular transaction such as an acquisition may also be whistleblower candidates. Examples include many of the same specialized appraisers and evaluators discussed above, as well as forensic accountants and other parties (other than attorneys) that might assist with due diligence efforts. These individuals could be whistleblowers with respect to either the company on which they are performing diligence (i.e., the seller or target) or the acquiror assuming the acquisition closes and the transaction is structured in a manner under which the acquiror inherits any compliance issues of the target.

[7] Rule 21F-4(b), 17 C.F.R. § 240.21F-4(b).

[8] Rule 21F-17(a), 17 C.F.R. § 240.21F-17(a).

B. How Are Third-party Whistleblowers Different from Internal Employees?

Individuals who work for the types of firms described above are different in some important ways from internal employees who may be potential whistleblowers. For better or worse, individuals employed by a third-party service provider typically will not have the same level of familiarity and experience with the company as internal employees. Service providers may therefore be less loyal to the company or its executives, which could in turn lead to a greater likelihood of making a bad faith whistleblower report or bypassing internal reporting procedures with respect to a good faith report in the hope of receiving a reward. Employees of third-party service providers are also less likely than internal employees to be familiar with the company's policies and procedures for internal reporting, the preferred formal and informal channels of communication at the company, and the company's overall culture or emphasis with respect to compliance.

III. What Should Companies Be Doing?

No company wants to face an SEC inquiry or investigation into allegations of non-compliance with the securities laws, even where it is certain it will be ultimately exonerated. Given the new incentives for whistleblowers to report potential violations and the broad group of individuals eligible to be awarded, companies should take certain steps, in addition to compliance with the securities laws, to minimize the risk of such allegations and to increase the likelihood that reports are brought to the company's attention first. In particular, companies should consider the following:

- Make third-party service providers aware of your internal reporting system and compliance culture and your preference that any issues be brought first to the attention of internal employees (such as a chief compliance officer) in accordance with company policy. Much has already been said and written regarding actions companies should consider in light of the new whistleblower program in general–steps such as reinforcing an emphasis on ethics from the top levels of the company on down, updating and stressing internal reporting policies and systems, empowering a senior level compliance officer, and creating a culture where internal reporting is rewarded and valued and those who make such reports are protected. These steps can make a difference with respect to third-party service providers as well as internal employees, provided that the policies, procedures, and culture are communicated effectively to third parties.

- Where appropriate, have outside counsel engage third parties in connection with legal representation. Although this may not be an option in all circumstances, where work is being performed in connection with a legal representation, companies will benefit from having their counsel engage and manage third-party service providers because information shared with or obtained from the third parties may be protected by the attorney-client privilege. Such information would not qualify as eligible for an award under the whistleblower program.

- Make clear where third-party service providers are being engaged for compliance or internal audit functions. Like information that is subject to the attorney-client privilege, information obtained or produced for purposes of such compliance or audit work will not easily qualify as eligible for a reward. Discussions with third-party management, as well as more formal steps such as contractual recitals, acknowledgements, and representations can be useful in managing the incentives perceived by third-party service provider employees and the procedures they are inclined to follow.

- Where possible, include the existence and quality of internal reporting policies among the criteria used for selecting third-party vendors. Third-party vendors with effective internal policies that require employees to first report complaints and compliance issues related to customers internally (and then, where appropriate, to the customer) are preferable to those that have no policy or a weak policy. While no such policy can entirely eliminate the incentives of the whistleblower program or negate the potential for frivolous claims, engaging third parties that have strong policies or are willing to put such policies in place can certainly help.

IV. Conclusion

In light of the substantial potential rewards under the new United States whistleblower program and the broad scope of eligibility, companies that are smartly examining their compliance culture, policies, and procedures should also focus on how they select, engage, and manage third-party service providers.

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THIS WEEK'S ISSUE

Listed below are the headlines and page numbers of articles in this issue followed by Web sites providing related information.

Auditors, Corporations Express Opposition To PCAOB Proposal for Audit Firm Rotation (p. 17)
The concept release is available at http://pcaobus.org/Rules/Rulemaking/Docket037/Release_2011-006.pdf. The comment letters are available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx.

ISS 2012 Proxy Voting Policy Unveiled In White Paper on Pay-for-Performance (p. 8)
The white paper is available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.

SEC Adopts Rules for Accredited Investors, Mining Disclosures Mandated by Dodd-Frank (p. 9)
The final accredited investor net worth rules are available at http://www.sec.gov/rules/final/2011/33-9287.pdf. The final mine safety disclosure rules are available at http://www.sec.gov/rules/final/2011/33-9286.pdf.

INTERNET SOURCES

Listed below are Web sites consulted by the editors of BNA's Corporate Accountability Report and Web sites for official government information.

ABA Task Force on Attorney-Client Privilege
http://www.abanet.org/buslaw/attorneyclient

American Institute of Certified Public Accountants
http://www.aicpa.org

Committee of Sponsoring Organizations of the Treadway Commission
http://www.coso.org/

Council of Institutional Investors
http://www.cii.org

Delaware State Courts
http://courts.delaware.gov/

Financial Accounting Standards Board
http://www.fasb.org

Financial Executives International
http://www.fei.org

Institute of Internal Auditors
http://www.theiia.org/

International Accounting Standards Board
http://www.iasb.org

Nasdaq Stock Market
http://www.nasdaq.com

National Association of Corporate Directors
http://www.nacdonline.org

National Investor Relations Institute
http://www.niri.org

New York Stock Exchange
http://www.nyse.com

Public Company Accounting Oversight Board
http://www.pcaobus.org

Securities and Exchange Commission
http://www.sec.gov

U.S. Code
http://uscode.house.gov/

White House
http://www.whitehouse.gov/

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