Staying Ahead
of Corporate Governance Trends

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Whistle While You Work: Lessons Learned from Sarbanes-Oxley Whistleblower Cases

By Timothy E. Hoeffner and Sean W. Sloan

In the wake of the collapses of Enron and WorldCom, Congress overwhelmingly passed the Sarbanes-Oxley Act of 2002 ("SOX" or the "Act"). After the Enron and WorldCom situations surfaced, financial personnel who raised issues concerning the accuracy of these companies' financial statements were treated in the media as heroes. Because SOX was drafted in direct response to the Enron and WorldCom situations, certain provisions of the Act were created to protect individuals who come forward with information concerning a potential violation of the securities laws. These so-called "whistleblower" provisions set forth a detailed process for the resolution of employee whistleblower claims.

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As we approach the fourth anniversary of SOX, a significant number of cases have been decided, which permit us to draw certain conclusions concerning the steps that should and should not be taken by a company in handling a whistleblower claim.

This article summarizes the relevant provisions of SOX, a number of cases in which employers have received an unfavorable result from an administrative law judge ("ALJ") and the lessons learned from these determinations.

Whistleblower Protection

Section 806, the "whistleblower" provision of the Act, enacted in July 2002, states that no company may terminate or discriminate against an employee who provides information relating to a violation of the securities laws or mail, bank, or wire fraud statutes. Jurisdiction under the Act extends to: (1) companies with a class of securities registered under Section 12 of the Securities Exchange

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The Increasing Importance of Corporate Minutes

By Shiloh D. Theberge

This article summarizes the recent case law and investigations focusing on the contents of board and committee minutes to evaluate the conduct of board members. These cases fall into two broad areas: (i) compensation decisions and (ii) the defense of federal securities law claims. Examples of cases within both of these areas are discussed in this article. We will then summarize the lessons learned from these cases in an effort to provide guidance to board members, legal advisors and corporate secretaries on the preparation of minutes.

Compensation and Employment Decisions

Disney

In the recent Walt Disney derivative litigation [In re The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003)], plaintiffs challenged the compensation and severance paid to Disney's former President, Michael Ovitz. The Delaware Court of Chancery held that the plaintiff shareholders sufficiently stated a cause of action that Disney's Board of Directors and Compensation Committee failed to adequately investigate, oversee, and become informed about the details of the original employment agreement provided to Ovitz. [See id. at 278.] The Court also found that the directors should have, among other

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Act of 1934; (2) companies required to file reports under Section 15(d) of the Securities Act of 1933; (3) officers, employees, contractors, subcontractors, or agents of such companies, and (4) non-public subsidiaries of publicly traded companies where the parent company is a "mere instrumentality" of the parent company.

Protected employees are those who provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct that the employee *reasonably believes* to be violative of the above laws. For such conduct to be protected, the employee must relay the information to, or assist in an investigation with: (1) a federal regulatory or law enforcement agency, (2) any member of Congress or congressional committee, (3) a person with supervisory authority over the employee, or (4) a person working with the employer who has the authority to investigate, discover, or terminate misconduct. Additionally, whistleblower employees are protected from retaliatory conduct by the employer when he or she files, causes to be filed, testifies, participates in, or otherwise assists in a proceeding filed or about to be filed concerning an alleged violation of the above laws, regardless of the "reasonable belief" standard listed above.

In determining whether the employee's conduct was a contributing factor in the action taken, the Department of Labor and the opinions rendered look to the timing of the decision, along with the nature of the employer's action.

The Act does not protect all employee allegations of wrongdoing; rather, the employee must state *particular concerns* that reasonably identify the conduct that the employee believes to be unlawful. Furthermore, while the employee likely does not have to meet a materiality requirement as to the extent of the alleged violation, the employee must *reasonably believe* that the alleged conduct is unlawful. The reasonable belief standard is evaluated objectively and determined on the basis of a reasonable person with the complaining employee's experience and training.

An employer that is subject to an employee allegation of misconduct is prohibited from taking an adverse employment action against the complaining employee. Such an action is defined as one "constituting a significant change in employment status," such as hiring, firing, denial of promotion, reassignment with significantly disparate responsibilities, a significant change in benefits, or a change that leads to a hostile work environment for the employee.

Finally, causally, the whistleblower must prove that the protected conduct was, at the very least, a "contributing factor" in the employer's adverse employment action. In determining whether the employee's conduct was a contributing factor in the action taken, the Department of Labor ("DOL") and the opinions rendered look to the timing of the decision, along with the nature of the employer's action.

Penalties

The Act was drafted to allow for both criminal and civil sanctions against covered companies and individuals who retaliate against whistleblowers. With respect to criminal penalties, the Act allows for fines or imprisonment of up to 10 years for defendants who knowingly, and with intent to retaliate, take action harmful to any person for providing truthful information to a law enforcement officer relating to the commission or possible commission of any federal offense. Thus, while criminal penalties exist, they are limited only to instances where retaliation is taken against an employee who complains to a law enforcement agency, not a supervisor or the employer itself.

Generally, civil remedies in accordance with the Act are far-reaching. Essentially, aggrieved employees can recover all relief necessary to make him or her whole. For instance, prevailing employees may be reinstated with the same seniority of position in the company; recover back pay with interest, special damages (i.e., litigation costs, expert fees, and reasonable attorneys' fees), emotional distress damages (e.g., mental anguish, humiliation, damage to reputation), and lost stock options. Nonetheless, an employee has a duty to mitigate such damages to the extent possible.

Procedural Steps

Whistleblowers who believe they have been retaliated against must file a complaint with the Occupational Safety and Health Administration ("OSHA") (as delegated by the DOL) within 90 days of the alleged violation. The employee initially must present a *prima facie* case by showing, by a preponderance of the evidence, that he or she engaged in a protected activity, the employer was aware of the protected activity, the employee suffered an adverse employment action, and the protected activity was likely a contributing factor in the unfavorable action. The employer may then submit a substantive response within 20 days of being notified by OSHA. The employer may rebut the employee's *prima facie* case by showing, by clear and convincing evidence (a heightened standard), that it would have taken the same employment action even in the absence of the employee's protected conduct.

If the employee establishes a *prima facie* case, which the employer cannot rebut, OSHA begins an investigation into the matter. During this time, it may also temporarily reinstate the complaining employee. While in investigation, OSHA will submit preliminary findings, to which either party may object and request an Administrative Law Judge ("ALJ") hearing. If no objections occur, and 180 days follow, the employee may request *de novo* review in a federal district court. If the matter does go before the ALJ (the likely outcome), it follows through the administrative procedure before heading to the U.S. Court of Appeals for a final appeal.

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Cases Where the Employer Lost in Proceedings Before OSHA and the ALJ

Employers have been successful in whistleblower proceedings in the vast majority of cases that have been filed. To illustrate, in the first two years since the enactment of the statute, 226 of 268 cases were dismissed or withdrawn and 33 cases settled. Nonetheless, there have been a series of recent decisions in which the employer received an unfavorable decision from the ALJ. The following summarizes the leading decisions rendered against employers.

Welch v. Cardinal Bankshares, 2003-SOX-15 (ALJ Jan. 28, 2004). In 2003, the ALJ issued the first decision under the statute ruling against an employer, Cardinal Bankshares Corporation. David Welch, then CFO, alleged that Cardinal terminated him for refusing to sign allegedly fraudulent financial statements and for making reports of illegal insider trading and accounting irregularities. Cardinal, on the other hand, claimed that it terminated Welch for poor performance. Ultimately, the ALJ determined that Welch had established a *prima facie* case by a preponderance of the evidence, including, most importantly, a reasonable belief in his report. Additionally, the timing of the termination - six to seven weeks after the report of misconduct - provided significant evidence that his complaint was a contributing factor leading to his termination. The company attempted to rebut this by arguing poor performance; however, the ALJ concluded that Cardinal failed to meet its clear and convincing evidentiary burden because it lacked the proper documentation to demonstrate the dismissal of the employee for performance reasons. Among other things, the ALJ declined to accept the conclusions of the company's investigation of the individual's allegations, which investigation team included one of the individuals subject to the employee's allegations. Welch was awarded reinstatement (despite testimony that the company did not want him back) and monetary damages of over $170,000, including the cost of conducting a job search, health insurance premiums, cost of travel to subsequent employment, and substantial attorneys' fees and costs.

Windhauser v. Trane, 2005-SOX-00017 (OSHA Nov. 15, 2004) (ALJ Jun. 1, 2005). A more recent case that settled after judgment was commenced by an assistant controller of Trane Corporation, a division of American Standard Companies. The controller had been terminated after objecting and refusing to remove expenses from the company's financial books. The ALJ determined that certain company records indicated expenses were not properly recorded, and the small amount of time between his complaint and his termination provided "sufficient evidence" to establish the contributing factor requirement. He was awarded reinstatement, removal of disciplinary letters, and over $100,000 in back pay. When the company failed to reinstate the employee for five months after OSHA issued its order, the ALJ added another $70,000 in remuneration.

Bechtel v. Competitive Technologies, Inc., 2005-SOX-00033 (OSHA Feb. 2, 2005) (ALJ Oct. 5, 2005); 2005 WL 1138790 (D. Conn. May 13, 2005). Similarly, Competitive Technologies faced a significant judgment in 2005 when two of its Vice-Presidents were terminated shortly after raising concerns that agreements between the CEO and consultants should have been disclosed in SEC filings. A preliminary investigation showed that the company was unable to substantiate with documentary evidence its contention that it terminated the employees for poor performance or economic reasons. The ALJ initially awarded over $700,000 in damages, collectively, including lost stock options and emotional distress damages. One of the individuals later settled with the company, and, just recently, following a full hearing, the second individual's case was dismissed.

Kalkunte v. DVI Financial Services, Inc., 2004-SOX-00056 (ALJ July 18, 2005). An important decision was issued earlier this year when an ALJ awarded more than $170,000 in damages to a whistleblower who was retaliated against after she reported financial improprieties to the board of directors and made an affirmative effort to ensure that an investigation was proceeding into the allegations. This decision is important because the ALJ awarded those damages against AP Services, a private company that had contracted with DVI to serve as bankruptcy specialists and turn around consultants. The ALJ concluded that through AP's actions in taking on responsibilty for employment decisions, AP assumed *respondeat superior* liability to the whistleblower. That decision also centered on the fact that, while the company claimed the whistleblower knew she "brought little value to the company," no documentary evidence supported this contention. Moreover, she was terminated merely three weeks after her last complaint, which the ALJ concluded provided a sufficient temporal nexus to support a finding of retaliation. Finally, the company's argument that she was laid off as part of a work force reduction was deemed to be pretextual by the ALJ, because she was the only person laid off by the company at that time.

Kimble v. The Hertz Corporation, 2005-SOX-66 (OSHA Apr. 29, 2005). In 2005, a lead auto rental representative of Hertz Corporation was terminated after she complained that other rental represen-

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tatives and managers were selling insurance to customers whose contracts already included such insurance, in an effort to raise monthly bonuses. That employee was awarded reinstatement by OSHA, monetary damages of over $150,000 in back pay, compensatory damages, and attorneys' fees, and removal of disciplinary letters from her employee file. The case, however, later settled for an undisclosed amount.

Lessons Learned

The preceding decisions exhibit the vast remedial nature of the whistleblower protections contained within Sarbanes-Oxley. Indeed, as more individuals bring claims, over three hundred at last count, a larger body of law will emerge. As of now, however, these few decisions already prove that this statute maintains some teeth. Employers must be cognizant of the following lessons that can be gleaned from these adverse decisions.

- **Carefully Evaluate and Document Employment Decisions.** The Act is not intended to protect incompetent employees or individuals who engage in wrongful conduct. However, the burden of proof placed on the employer is higher under the Act, requiring the employer to demonstrate by "clear and convincing" evidence that a legitimate basis exists for actions taken against a whistleblower. Particular attention should be paid to decisions made soon after an individual raises an issue that is potentially subject to protection. Therefore, a company must maintain proper documentation to be in a position to demonstrate that legitimate reasons exist for the action taken against an employee.

- **Take Credible Allegations Seriously.** Should an employee raise a credible issue that could be the subject of a whistleblower claim under the Act, that issue should be taken seriously. To that end, a credible inquiry should be conducted to test the merits of the concern raised by the employee. It is also important that the review be performed by an individual whose conduct is not at issue. If the issue brings into question the acts of senior management or members of the legal department, consideration should be given to engaging outside counsel. Establishing a credible structure may also deter whistleblowers from reporting to outside agencies, and, therefore, such concerns can be remedied without the damaging costs of a government inquiry and potential harm to the company's credibility in the market.

Should an employee raise a credible issue, that issue should be taken seriously.

- **Beware of Pretext.** After a potential whistleblower surfaces, it is important to ensure that the decision given for a change in the employment circumstances of the whistleblower is not being manufactured by the individual's supervisor. Thus, it is important to consider the individual's performance over an extended period of time. If the superviser claims that a dramatic change in performance has occurred, it is important to test the validity of the assertion (e.g., has the individual recently received promotions or performance bonuses) and to document the legitimate reasons for the change in circumstances. Otherwise, the employee will use the change in performance evaluations as evidence that the employer has created a "pretext" for a retaliatory employment decision.

- **Educate Your Employees.** It is important to take the opportunity to educate your employees about the law. Many of the provisions of the Act may be counterintuitive to certain employees. For example, an individual may feel that an employee's concerns are unfounded, but the statute provides for liability if the individual has a reasonable (but even incorrect) belief that misconduct has occurred. An educated employee feels much more comfortable consulting with individuals within the company prior to taking action that could become the subject of litigation, and is less likely to make decisions in haste that could be subsequently second-guessed by an ALJ.

- **Challenge Claims Lacking Merit.** The purpose of SOX was not to compensate employees terminated for good reason, and the record demonstrates that most cases favor the employer. If a company permits employees to settle meritless claims, it will commonly lead to a string of additional claims by disgruntled employees. It is therefore important to defend non-meritorious claims. However, in order to defend against the non-meritorious claims, it is critical to have a credible process in place that will withstand scrutiny by an ALJ. ■

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things, evaluated a "non-fault" termination provision that was later added to Ovitz's employment agreement, which provision resulted in a payout of more than $140,000,000 to Ovitz after only one year of employment. [Id. at 289.]

The Court reviewed the minutes of Disney's Compensation Committee and Board of Directors meetings, which had been provided to plaintiff's counsel pursuant to a books and records demand. [See Del. Code Ann. Tit. 8 § 220.] In upholding the claim, the Court placed emphasis on the following: (i) that the proposal to the Compensation Committee did not include detailed information as to the provisions of Ovitz's employment; (ii) that the Committee got "sidetracked" by the issue of a fee paid to one of the members of the Board for securing Ovitz's employment; and (iii) that the Committee did not retain a compensation expert to provide industry comparisons to the Board. [Walt Disney, 825 A.2d at 280.] The Court further stated that "[t]he minutes of the meeting were fifteen pages long, but only a page and a half covered Ovitz's possible employment," and the Board appointed Ovitz without asking "any questions about the details of [his] salary, stock options, or possible termination." [Id. at 281.]

The existence of a clear record of the board's activities has become an increasingly critical element in establishing a corporations decision-making process.

The Court's post-trial decision repeated the emphasis on board meeting minutes. In the decision, the Court entered judgment in favor of the directors on all counts. [In re The Walt Disney Co. Derivative Litig., No. 15452, 2005 WL 2056651, at *52 (Del. Ch. Aug. 9, 2005)]. When deciding whether certain members of the compensation committee breached their duties of care and good faith, however, the Court stated that "[i]t would have been extremely helpful . . . if the minutes had indicated in any fashion that the discussion relating to the OEA [the Ovitz Employment Agreement] was longer and more substantial than the discussion relating to the myriad of other issues brought before the compensation committee that morning." [Id. at *45 n.539.]

Cogan

The Pereira v. Cogan [294 B.R. 449 (S.D.N.Y. 2003)] case was similar to Disney, except that the decision followed a trial on the merits. The Court upheld various claims by a Chapter 7 trustee against a former chief executive officer, officers, and directors of the corporation. The Court held, among other things, that the director defendants were liable for the payment of excessive compensation that was provided to the chief executive officer, Marshall Cogan, and that the approval of that compensation was a breach of the directors' fiduciary duties.

Based upon a review of the minutes of the board meeting, the Court found that when the Board ratified Cogan's unilaterally increased compensation in 1992, the directors appeared to be entirely unaware of the amount of such compensation. [Id. at 475.] In particular, the Court stated that there was "no evidence regarding any discussions of Cogan's compensation, nor any evidence that the Board members were aware of Cogan's compensation." [Id. at 475.] Also, when the Board later retroactively ratified Cogan's compensation for 1998 to 1994, "there [was] no agreement on what level of compensation the Compensation Committee or the Board believed they were ratifying." [Id. at 477.]

Grasso Compensation

One of the most publicized disputes regarding director compensation was addressed in a lengthy report prepared by legal counsel for the New York Stock Exchange ("NYSE"). The report is the result of a detailed internal investigation into the compensation of Richard Grasso ("Grasso") during his tenure as the Chairman and Chief Executive Officer of the NYSE, which found that Grasso received up to $156.7 million in excessive compensation and benefits. [Report to the New York Stock Exchange on Investigation Relating to the Compensation of Richard A. Grasso, Dec. 15, 2003, at 2.]

In addition to criticizing Grasso, the report examined and criticized the actions of the NYSE Compensation Committee. The report concluded that "Grasso's excessive compensation and benefits were the product of multiple flaws in the compensation and benefits process employed by the NYSE." [Id. at 3.] After extensively considering the content of several compensation committee and board meetings, based upon a review of the minutes of such meetings, the report concluded that the Committee: (i) failed to "examine and consider the level of Grasso's [supplemental executive retirement plan] benefits accumulating when making its compensation decisions"; (ii) used an "inappropriate comparator group for benchmarking Grasso's compensation levels"; and (iii) employed consultants who "did not have the appropriate level of involvement in, or input regarding, the compensation and benefits process." [Id. at 3-4.]

Securities Litigation Decisions

Enron

In the Newby v. Enron Corp. [258 F. Supp.2d 576 (S.D. Tex. 2003)] class action litigation, the class plaintiff alleged that the outside directors of Enron engaged in fraud because they failed to disclose, and recklessly approved, "the fraudulent transactions, conflicts of interest, and deceptive accounting practices [that] were at the center of the fraud." [Id. at 611.] The Court granted the outside director defendants' motion to dismiss with regard to these fraud claims arising under § 10(b) and § 20A of the federal securities laws. [Id. at 638-39.]

The Court utilized the Board and committee meeting minutes to demonstrate that the outside directors were unaware of the alleged fraudulent acts that were taking place and being approved, noting that the "references in the [board and committee meeting] minutes . . . are merely brief allusions or lists of topics . . . but no particular facts or details about the presentation or discussion indicate that . . . their resolutions as members of the board or committees were intended to further fraud." [Id. at 627-28.] The Court also used these minutes to hold that the outside directors acted "in reasonable reliance on opinions of legal and accounting experts [such as Arthur Andersen] whose opinions they had no reason to question," and that "[e]ven a strong inference of negligence, which requires a much lower showing than severe recklessness, is negated by reliance on outside auditors' accounting." [Id. at 617-20.] Together, these conclusions helped to support the Court's dismissal of the fraud claims against the outside directors.

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Arnlund

In contrast to the Enron decision, the opinion in Arnlund v. Smith [210 F. Supp.2d 755 (E.D. Va. 2002)] demonstrates that meeting minutes that are inconsistent with public disclosures can subject directors to potential liability. In Arnlund, investors alleged that the directors of Heilig-Meyers Company (the "Company") committed federal securities fraud by making certain misrepresentations and omitting certain information regarding the financial condition of the Company in the May 30, 2000 annual report. [Id. at 762.] The Court held that Plaintiffs sufficiently pled facts supporting the allegation that the statements regarding the financial condition of the Company were made by the director Defendants, who either knew that they were false, had no reasonable grounds for the belief that the statements were true, or knew facts that undermined grounds for that belief that they were true. [Id. at 765.]

Upon a review of the allegations, the Court noted that "Plaintiffs do more than rely on a change in the Company's position to infer fraud; they set out in painstaking detail when Defendants were made aware of material information, based on the Company's own meeting minutes." [Id.] Thus, the Court held that the complaint sufficiently stated a claim under Section 10(b) and Rule 10b-5 of the federal securities laws, and denied Defendants' motion to dismiss.

Minutes should by no means set forth a transcript of the statements made during board of directors or committee meetings.

Guidelines: What to Include in the Minutes

Minutes should by no means set forth a transcript of the statements made during board of directors or committee meetings. Indeed, by the Oxford English Dictionary's definition, minutes constitute "a summarized record of the points discussed at a meeting." However, recent litigation described in this article demonstrates the importance of minutes that clearly set forth the decisions made by a board of directors or board committee, and the basis for those decisions. While each board and board committee should have significant latitude in the amount of detail to include in the minutes of its meetings, these cases demonstrate the need to consider the following five guidelines in preparing minutes:

1) The minutes should clearly identify the decisions made by the board or board committee, either through a resolution or statement within the document.

2) The minutes should set forth the identity of experts, such as accountants, attorneys, or compensation consultants, who provided advice to the board of directors, and a summary of the advice provided to the board.

3) The minutes should refer to handouts or other materials that were distributed to directors or committee members, stating whether such documents were distributed in advance of the meeting, and copies of the documents should be filed with the minutes in the corporate records books by the corporate secretary.

4) The minutes do not need to include a recitation of all questions asked or answers given by persons attending the board meeting. Instead, it should be sufficient to note that, following discussion of the matter, the board took action.

5) The minutes should be consistent with the company's public statements.

If these five guidelines are followed, the potential liability of directors can be reduced. ■

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New Rules for Audit Committees and Auditors

By Steven G. Blum, Timothy E. Hoeffner, and Jennifer B. Bonniwell

The relationship of the audit committee to its independent auditor has never been more important – or more challenging to maintain. Outside directors for the first time are paying money out of their ownpockets to settle class action litigation and external auditors face stiff civil and criminal penalties for failing to sound alarm bells when their clients engage in misconduct. Auditors and audit committees therefore must begin to play by a new set of rules.

Some say the new era of corporate governance sets up appropriate checks and balances. Section 301 of the Sarbanes-Oxley Act ("SOX") made it clear that the audit committee, and not management, is responsible for overseeing a company's relationship with the outside auditor, specifically the "appointment, compensation and oversight" of the auditor. At the same time, the Public Company Accounting Oversight Board ("PCAOB") has clearly articulated that the auditor is expected to monitor the effectiveness of the audit committee.

Others argue that the post-SOX regulatory structure impedes communication between the audit committee and the auditor. Why should the outside auditors, as trusted advisers, not be permitted to provide consulting services to the company? Adding to the changes, audit committees now must deal with entirely new auditor attitudes. Why have these attitudes changed? More importantly, what should an audit committee member do when managing this auditor relationship?

In the view of many experts, the relationship between corporations and their auditors has suffered in this first year after implementation of Section 404 of SOX. According to PricewaterhouseCoopers senior partner

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Sovereign Bank Fight Leads to Important Changes to Pennsylvania's Business Corporation Laws

By Shiloh D. Theberge

On February 10, 2006, Pennsylvania Governor Edward G. Rendell signed into law a bill that will impact many, if not most, Pennsylvania corporations. The bill revises the Pennsylvania Business Corporation Law ("PBCL") statutes relating to the removal of directors and the definition of a "controlling person" for determining "control transactions." The bill was enacted by the Pennsylvania legislature in less than 48 hours. The legislation is in response to a now settled proxy contest between Sovereign Bancorp, Inc. ("Sovereign") and an eight percent shareholder, Relational Investors LLC ("Relational"). Sovereign, headquartered in Reading, Pennsylvania, is the state's second largest employer.

Relational, with a history of shareholder activism, opposed Sovereign's sale of a 19.8% stake in the company to Banco Santander Central Hispano ("Santander") for $2.4 billion. The sale will occur without a shareholder vote because it includes less than 20% of Sovereign's stock – a mark set by the New York Stock Exchange. Relational threatened to remove Sovereign's board of directors, including CEO Jay Sidhu, despite the seats not being up for election.

Relational argued Sovereign's governing documents allow for removal of directors without cause, even in the case of a classified board of directors. Sovereign disputed this statement and filed a federal lawsuit in the Southern District of New York seeking a declaration that, under the company's governing documents, classified directors may only be removed for cause. Sovereign claimed that its prior SEC filings stating otherwise were in error. The new legislation provides that removal of directors without cause may only occur where the company has "provided in the Articles by a specific and unambiguous statement that directors may be removed from office without assigning any cause."

Sovereign hoped this legislation would strengthen its argument that under its governing documents directors could not be removed without cause. In the New York federal case, however, Relational argued that the new legislation's application to the lawsuit would amount to "improper retroactive application," while Sovereign responded by saying the legislation's application to "Relational's current attempt to remove the directors without cause is a proper application of a prospective amendment." Relational Investors LLC v. Sovereign Bancorp, Inc., No. 05 CIV.10394, 2006 WL 496963, at *5 (S.D.N.Y. Mar. 2, 2006). The Court ruled that shareholders of Sovereign may remove its directors without cause, holding that the new legislation "alters the previously established understanding between Sovereign and its shareholders as to removal of directors, and therefore amounts to improper retroactive application of a prospective statute." Id. The Court noted that shareholders of Sovereign, at the time they became shareholders, expected that a director could be removed without cause based on Sovereign's governing documents. Id. at *6.

Relational also claimed that the sale is a "control transaction" under Pennsylvania law, which would trigger a provision requiring that Sovereign purchase stock from objecting shareholders at "fair value." This provision essentially provides shareholders with dissenter's rights. Relational claimed the sale exceeds 20% of stock because the 8% management-owned stock also being sold should be included in the control calculation given management's affiliation with Santander. The new legislation provides that "shares acquired directly from the corporation in a transaction exempt from the registration requirements of the Securities Act of 1933" are not included when determining whether a person is a "controlling person" – i.e., holds 20% of the company's stock – for purposes of the control-share acquisition statute. Thus, Sovereign's management-owned stock would be excluded from the calculation and the control-share acquisition statute would not be triggered. In response to this portion of the legislation, Relational dropped the part of its federal lawsuit relating to the "control" issue.

Also, on March 2, 2006, Relational filed suit against the state of Pennsylvania, legislative officers and Governor Rendell in Pennsylvania Commonwealth Court, asking that the legislation be voided. The suit claims the legislation was unconstitutional, and was enacted as part of a "secretive process designed to avoid fair disclosure and deliberation." In a press release, Relational stated that the legislation was passed to keep Sovereign's directors from being held accountable by the shareholders.

The two parties settled their disputes on March 22, 2006. Sovereign agreed to add two new directors to its board, all litigation is to be dropped, and the sale of Sovereign stock to Santander will be unopposed. Still, these new statutes raise significant issues concerning shareholder rights of Pennsylvania corporations. Indeed, in his letter to the legislature, Governor Rendell noted that he has "great hope for the potential positive impact . . . for one of Pennsylvania's key employers," however he is concerned the bill will possibly "require a review of and possibly changes in the bylaws, or articles of incorporation, or both, of literally thousands of corporations across the Commonwealth" in addition to "unnecessarily contentious actions by corporate board members and shareholders" in response to the change in the "controlling person" definition. Governor Rendell has suggested that the legislature narrow the bill, perhaps so that it applies only to bank holding companies. ■

Court Applies Entire Fairness to Merger Where Directors Received $376 Million Premium

By Candice Toll Aaron

In re Tele-Communications, Inc. S'holders Litig., C.A. No. 16470 (Del. Ch. Dec. 21, 2005) (Chandler, C.)

The former directors of Tele-Communications, Inc. ("TCI"), individual defendants in this action, moved for summary judgment on plaintiffs' claims alleging breach of fiduciary duty and disclosure violations resulting from the merger of TCI and AT&T (the "Merger"). In the Merger, TCI's class B shareholders received a $376 million premium over the class A shareholders and the majority of TCI's directors held most of the class B shares.

Because TCI's directors stood to benefit disproportionately from the Merger and a majority of them were interested in the transaction, the Court applied the entire fairness standard to plaintiffs' claims. The burden of showing a transaction is entirely fair rests with defendants unless they can show that the directors who considered the transaction were truly independent, fully informed, and had the freedom to negotiate at arm's length or that the transaction was ratified by informed shareholders. Here, the Court could not find at the summary judgment stage of the case that the special committee who considered the Merger was disinterested due to the "suspiciously contingent nature" of the compensation promised to the members of the committee and the fact that one of the two special committee members held a significant number of class B shares. Nor was there evidence sufficient to show that the Merger was ratified by TCI's disinterested stockholders because, as the Court noted, it is not clear that material facts regarding the planned contingent compensation of the special committee and its purported "careful consideration" of the Merger were disclosed to TCI's shareholders adequately, if at all.

The entire fairness standard requires that, assuming the defendants are unable to shift the burden to plaintiffs, defendants show (i) the process leading to the consummation of the transaction was unflawed and (ii) that a fair price was paid. Here, the Court held, defendants could not show a lack of process flaws that would likely lead to an unfair result because (i) the special committee did not have a clear mandate and did not understand its mandate, (ii) the interests of the directors on the committee were not ideally aligned with the interests of the (minority) class A shareholders, (iii) the special committee chose legal and financial advisors who were already advising the company and a financial advisor being compensated on a contingent basis, and (iv) there was evidence indicating that the special committee lacked complete information in making its decision to recommend the Merger to the board. Nor could defendants show that a fair price was paid in the Merger because the board and special committee were not advised, and did not consider, whether the relative impact of a preference to one class of stock was fair to the other, disadvantaged class of stock and only considered the fairness of the exchange ratios to each class respectively.

Thus, the Court concluded, a trial was required on the fair price and process issues as well as certain of the disclosure claims. The Court has not yet scheduled the trial. ■

Court Reinforces That Board Decisions Will Not Be Judged in Hindsight

By Candice Toll Aaron

Stone, et al. v. Ritter, et al., C.A. No. 1570-N (Del. Ch. Jan. 26, 2006) (Chandler, C.)

Defendants moved to dismiss plaintiffs' derivative action on behalf of AmSouth Bancorporation ("AmSouth" or the "Company") which alleged that fifteen defendants – all current or former AmSouth directors — breached their fiduciary duties by failing to institute sufficient internal controls to guard against violations of the Bank Secrecy Act and anti-money laundering regulations which led to a federal investigation of the Company and $50 million fine. In support of their motion, defendants argued that plaintiffs failed to satisfy the demand requirements of Court of Chancery Rule 23.1, which provides that in order to proceed with a derivative claim plaintiffs must plead with particularity the reasons why pre-suit demand would have been futile. In response to defendants' motion, plaintiffs argued that the board was not disinterested and independent because the defendants face a substantial likelihood of liability for their failure to implement adequate internal controls and that demand is excused because AmSouth's directors made no business judgment with regard to internal controls, but instead "consciously and intentionally disregarded their responsibilities" after the scheme that triggered the federal investigation came to light. In particular, citing the Court's recent Disney decision, plaintiffs asserted that defendants adopted "in effect, a 'we don't care about the risks' attitude concerning a material corporate decision."

The Court noted that "this case is not about a board's failure to carefully consider a material corporate decision that was presented to the board, [but rather]... a case where information was not reaching the board because of ineffective internal controls."

The Court disagreed with plaintiffs' assertions and, noting the paucity of well-pled, non-conclusory allegations in plaintiffs' complaint, dismissed it. In so doing, the Court noted that "this case is not about a board's failure to carefully consider a material corporate decision that was presented to the board, [but rather] . . . a case where information was not reaching the board because of ineffective internal controls." The Court explained that "with the benefit of hindsight, it is beyond question" that the Company's internal controls were inadequate and that this inadequacy resulted in a "huge fine," but "[t]he fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible." ■

Court Reconfirms Shareholders as "Ultimate Holders of Power" of Corporation

By Candice Toll Aaron

Unisuper Ltd., et al v. News Corp., C.A. No. 1699-N (Del. Ch. Dec. 20, 2005) (Chandler, C.)

This action was brought pursuant to a dispute between defendant News Corporation ("News Corp." or the "Company") and plaintiffs, certain institutional shareholders, in connection with a plan of reorganization in which the Company, then an Australian corporation, was to be re-reincorporated as a Delaware corporation, which action required shareholder approval. Australian corporate governance firms expressed concern over the reincorporation's impact on shareholder rights and other corporate governance issues, including the specific concern that after the reincorporation, under Delaware law, the Company's board of directors would be able to institute a poison pill without shareholder approval, while under Australian law, shareholder approval is required. On October 6, 2004, News Corp., rather than amending the proposed Delaware certificate of incorporation, announced that its board had adopted a board policy (the "Policy") that, among other things, any shareholder rights plan adopted by the Company following reincorporation would have a one year sunset clause unless shareholder approval is obtained for an extension. The Company's shareholders and option-holders, including plaintiffs, shortly thereafter voted to approve the reorganization, allegedly in reliance on the Policy. A few weeks later, the board adopted a poison pill and stated that, going forward, it might or might not implement the Policy and, one year later, the board extended the poison pill without a shareholder vote. Plaintiffs, a group of Australian investors, filed their complaint asserting claims for breach of contract, promissory estoppel, fraud, negligent misrepresentation, and breach of fiduciary duty against the Company's directors on October 7, 2005. Defendants moved to dismiss all of plaintiffs' claims.

The Court denied defendants' motion as to plaintiffs' claims for breach of contract and promissory estoppel, ultimately concluding that plaintiffs alleged (i) the existence of an agreement, (ii) that the board intentionally breached, (iii) for which valuable consideration (i.e., plaintiffs' vote in favor of the reorganization) was exchanged. In so holding, the Court explained that while a board policy enacted by resolution is normally revocable at will, where a board enters into a contract to adopt and keep in place a policy that others justifiably rely on to their detriment, that contract will be enforceable regardless of whether such resolutions are typically revocable at will by the board. Addressing defendants' assertion that the Policy was invalid as a matter of law because it prevented the board from exercising its fiduciary duties, the Court explained that because the contract made by the board here gives power to shareholders rather than takes it away, it is not invalid, as the power of a board of directors is that of an agent who acts on behalf of a principal, the shareholders, who are "the ultimate holders of power under Delaware law." Finally, the Court explained that fiduciary duties exist not to limit the power of shareholders but "in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation." Thus, they cannot be used to "silence shareholders and prevent them from specifying what the corporate contract is to say" and, as in this instance, "[o]nce the corporate contract is made explicit on a particular issue, the directors must act in accordance with the amended corporate contract."

On January 20, 2006, the Court entered an order certifying an interlocutory appeal of its decision and the appeal now is pending in the Delaware Supreme Court. ■

New Rules for Audit Comm.... (cont. from pg. 6)

Garrett L. Stauffer, "It's driven bad behavior. It's prevented good communications, and it has the impact of going backwards when you think about the quality of financial reporting."

A large part of the problem is caused by the external auditors' increased (and valid) concerns about maintaining independence. Civil and criminal prosecutions of Arthur Andersen for its work with Enron and WorldCom, and KPMG for its work related to tax shelters have put increased scrutiny on the relationship between auditors, management, and audit committees.

Regulators put further pressure on auditors to conform to both the PCAOB and SEC rules. Last spring, PCAOB Chairman William McDonough gave external auditors a reason to feel threatened. He said, "They know full well that if they do something wrong, especially if it involved moral turpitude, we will beat the hell out of them."

In addition to outside constraints, auditors are reassessing their business models to make the business of auditing more profitable. Not surprisingly, this is resulting in higher audit fees.

According to corporate and securities law expert Jim Verdonik, in fiscal year 2004, companies spent $35 billion trying to comply with the new congressional auditing regulations. Further, audit bills rose about 40 percent in 2004 (to a total of $533 million) for 23 of the 30 companies that are used to compute the Dow Jones Industrial Average. According to an article by veteran financial writer Stephen Taub, the increase in audit fees is nearly double the percentage increase in audit fees paid by the same companies in 2003, the first year that SOX took effect.

As business booms, auditors constrained by staffing shortages may choose to jettison certain clients in favor of more profitable ones. External auditing firms that see the quantity of work exceeding their capacity are creating a waterfall effect, in which smaller firms have acquired the overflow from busier, larger firms. This can be a costly disruption for a company.

Firms also are becoming more selective in the clients they accept. This is another attempt to lower the risk that the outside auditor will be taken to task for a company's dishonest financial reporting. The profession's quality control standards have long required CPA firms to implement procedures to "provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized." A firm's compliance with auditing, quality control, and ethics standards used to be a self-regulated process through peer reviews. These reviews provided constructive criticism for improvement but did not typically result in restrictive sanctions.

The creation of the PCAOB changed the inspection process and raised the stakes. The PCAOB regulates auditors through firm registration, professional standard setting, audit inspections, and enforcement of its standards. There is little history, however, to assess the size of PCAOB's regulatory stick. The first year for PCAOB inspections was 2003, and early reports suggest the inspection process focused on rooting out audit deficiency trends among registered firms – the low-hanging fruit.

Information to gauge the PCAOB's enforcement process is scant. There has only been one enforcement proceeding, which was finalized in May 2005. This proceeding, however, resulted in the PCAOB revoking the firm's registration, which prohibits the firm from auditing public companies, and censuring two of the individual auditors at the firm.

This means that audit firms must thoroughly and continuously assess their legal, regulatory, and client profitability exposure on a client-by-client basis. As a result, more auditors are resigning (or more clients are being fired), requiring companies to find new audit firms.

Likewise, a corporation's audit committee must reconsider its own needs from the audit relationship under the new rules. It is not surprising that a corporation's relationship with its auditor may appear healthy and constructive when financial reporting functions are running smoothly. The evolution of a company, however, may lead to uncertainties in the financial reporting process even in well-run organizations. Changes in accounting standards and the business environment can lead to new issues that did not previously affect the company and its auditing relationship.

The biggest impact of this new financial reporting climate may be on an audit committee's consultations with its outside auditor. New rules and increased scrutiny mean that independent accountants will be reluctant to render accounting advice. While this flies in the face of our expectations, auditors who give accounting advice to management or the audit committee may appear to lack objectivity or face allegations that they are auditing their own work.

The new rules also prohibit an external audit firm from stepping into management's shoes and making accounting decisions. This would result in the auditor reporting to the audit committee on behalf of management. For example, if a company begins selling a new product containing a software component, this could trigger a series of complicated accounting guidelines. Revenue might have to be recognized differently for the software component than the rest of the product. In this example, management typically would ask the auditors whether the revenue recognition guidelines apply to its new product and then ask them to help develop the new guidelines.

These days, however, auditors are reluctant to provide such accounting advice and risk appearing too close to management. The auditor instead might offer to review management's recommendation. If management contends the new product does not need new accounting, then the auditor's contrary opinion could add cost and complexity to the company's financial reporting function.

If this disagreement cannot be resolved, the auditor could flag a control deficiency in the company's financial reporting process. The audit committee is now caught between management and the auditors over an issue the company would have been happy to defer to the auditor's judgment in the first place.

While the auditor may be correct, the auditor also may be erring on the side of being too conservative in choice of accounting treatments or, simply having an attack of enlightened self-interest. After all, it is easier to defend a more conservative position with regulators and any others who may second guess auditors with the benefit of hindsight.

As an audit committee member, you are responsible for ensuring that the accounting is correct, but you may not want the most conservative answer. Unfortunately, by the time this issue arises, it is too late to call an audit expert to assess and mediate the differing views of management and the outside auditors because this may open up the company to allegations of opinion shopping.

Regardless of who instigates the change, companies engaging a new auditor have become more common. With that change can come considerable challenges and public companies can expect an uphill battle. With the dwindling number of firms qualified to perform public company audits and more stringent client-acceptance policies, high-risk clients have fewer options. Some companies are considered such a high risk that the only option for an audit committee seeking a respectable audit firm is to clean house and hire a new management team.

Even if the new firm accepts the engagement, the selection of a new audit firm can create significant issues. Due to the higher level of auditor scrutiny and the subjective nature of GAAP' s application, it is not uncommon for current and former auditors to disagree over appropriate accounting treatment for the same transaction. For example, if a company's new auditor discovers an accounting problem with previous financial statements, the new auditor may push the company to restate previously released financial statements. Meanwhile, the predecessor firm will likely defend the original accounting. In such a case, the company and its audit committee are now in a bind. They cannot issue comparative financial statements without the consent of both audit firms.

In another example, a company fires its auditor before the start of its year-end audit because the auditor could not begin fieldwork in a timely fashion. Now, the new auditor disagrees with the prior firm's revenue recognition approach and recommends new accounting that requires specific documentation about past revenue transactions. However, the documentation is not available to the company because this more cumbersome and costly process was not necessary under the old accounting rules. Without the needed information, the company cannot switch to the new accounting rules. This leaves the company in a disastrous limbo without its previous auditor and unable to stay with its new auditor.

In either example, a submission to the SEC's Office of the Chief Accountant ("OCA") may be the only way to break the deadlock. Based on our experience in these situations, the OCA tends to agree with the current auditor. This places the timely completion of the company's financial statements in serious jeopardy. The former auditor typically will not agree to the change in the prior financial statements since it could be viewed as an admission that the auditor made a mistake, potentially exposing the auditor to malpractice accusations. Without the former auditor's consent, the company cannot include the former auditor's opinion in the current filings. Ultimately, the company's best option may be to allow the current firm to audit restated prior years' financial statements, leading to significant costs, additional audit fees and delays in the current filing.

The best way to minimize the pain associated with the new world of audit committees and audit relationships is to take the initiative. To avoid some of the problems described above, an audit committee should consider the following suggestions:

Recognize that the approach to fulfilling audit committee responsibilities has changed. As with virtually all challenging issues, the first step is acknowledgment. The worst thing audit committee members can do is to bury their heads in the sand and continue operating with a business-as-usual attitude.

Assess and monitor the tone at the top. Almost all corporate scandals have at least one thing in common: One or more senior executives took a cavalier attitude toward accounting practices and financial reporting. A senior management team that tends to adopt aggressive accounting positions or downplay the importance of good internal controls generally sets the company up for a conflict with the auditors, or worse, with regulators. Audit committees can correct this by monitoring and addressing the tone set by management.

Exercise a reasonable level of skepticism. Just as generally accepted auditing standards require that auditors exercise professional skepticism, so too should audit committee members. Certainly, the roles of auditors and audit committees are different and require various levels of attention, but both have the common goal of providing some assurance that management's financial statements are materially correct.

Much of this assurance rests on the presumption that management's positions are subject to challenge by the external auditors and, by extension, the audit committee. If an audit committee simply accepts information coming from management as the truth, this assurance is diminished. In addition, Section 301 requires each member of the audit committee to be independent. A good audit committee will look at information provided by the company's management and the external auditors with an unbiased attitude and make an independent assessment when resolving disputes or otherwise performing its oversight function.

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Pay appropriate attention to internal control issues identified during SOX testing. While the process of documenting and testing internal controls has proven to be painful and expensive for most public companies, its output can be very valuable and can lead to a smooth relationship with auditors. Virtually every company that participated in this exercise identified internal control weaknesses that were previously unidentified – some more critical than others.

Do not allow the effort and expense to identify control deficiencies be expended in vain, and do not fail to remedy control issues raised by the auditors. The real benefit will be realized when corrective actions are taken to improve internal controls.

Good documentation is king. The root cause of many regulatory actions and civil proceedings against corporations is inadequate, nonexistent or destroyed documentation that support an accounting treatment. Many actions could have been avoided if better real-time documentation existed to explain a position on certain accounting issues. Put a process in place to ensure significant accounting policies are well documented and reviewed.

Maintain open and frequent dialog with auditors. As with any relationship, good communication between audit committees and auditors is critical. Open conversations facilitate timely financial reporting and help address issues before they spin out of control.

Although an auditor's independence may be challenged when it develops the company's accounting policies, the audit committee should be able to engage auditors in a constructive dialogue about any financial reporting approaches being considered by the company. In addition, the committee should spend time understanding where the auditors feel the most risk exists in your company. Then you will know where to focus more of your time in minimizing risk.

Ensure adequate staffing in accounting and internal audit departments. An accounting staff that is adequate in number and comprised of competent people is more critical today than ever. Many companies historically placed a lower priority on staffing the accounting and related departments than other groups more linked to revenue growth (sales and marketing). Be on the lookout for red flags indicating an overburdened accounting and internal audit department. For example, when company accountants consistently work late nights and weekends to complete their work, it may indicate an overburdened staff.

The internal control assessments mandated by SOX forced many companies to beef up accounting staff, but some view this as a temporary situation. Given the public and private costs of regulatory action, companies must recognize that adequate accounting and internal audit departments are critical to not only long-term profit but also responsible financial controls.

Retain an independent source of accounting expertise before major problems arise. Having a qualified accounting expert who is unencumbered with auditor independence issues can be of significant value. An outside expert is available as needed to provide technical accounting advice, facilitate communication, and resolve issues between the company and its auditors or regulators, and act as an external sounding board for the audit committee. Such an expert should be someone that the company's auditors are familiar with and respect, and should possess expertise in the accounting, auditing, and regulatory environments. ■

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For more information, please contact Saul Ewing's Corporate Governance Group:

Practice Group Co-Chairs:
Kathleen A. Chagnon
410.332.8851
kchagnon@saul.com

Spencer W. Franck Jr.
610.251.5082
sfranck@saul.com

Timothy E. Hoeffner
215.972.7711
thoeffner@saul.com

Contributing authors in this issue:

Candice Toll Aaron
302.421.6875
caaron@saul.com

Jennifer B. Bonniwell
215.972.8388
jbonniwell@saul.com

Timothy E. Hoeffner
215.972.7711
thoeffner@saul.com

Sean W. Sloan
215.972.8383
ssloan@saul.com

Shiloh D. Theberge
215.972.8382
stheberge@saul.com

Steven G. Blum
610.992.1600
steven.blum@fticonsulting.com

Publisher: Saul Ewing LLP, a Delaware LLP

Editors:
Candice Toll Aaron
302.421.6875
caaron@saul.com

Timothy E. Hoeffner
215.972.7711
thoeffner@saul.com