

Acredula®

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Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

CEOs and Boards Accountable for Ethics and Lawfulness of Companies

This issue of *Acredula*® reviews the first wave of legislation and regulations resulting from Enron. Congress and regulators are racing to judgment to hold CEOs accountable for the sins of their organizations.

Last April, the House of Representatives passed legislation directing the SEC to address CEO accountability. Before the SEC could respond, the Business Roundtable volunteered that companies should set the "tone at the top" with senior management for ethical behavior and legal compliance. In mid-June, the SEC proposed new rules expanding the current reporting requirements of traded companies, accelerating the required time to report, and requiring the CEO and CFO to certify the accuracy and completeness of the company's annual and quarterly reports. CEOs, CFOs and their boards should review their D&O coverage

Editor's Note

to ensure that senior management is not left to defend their organizations without adequate resources.

In this issue, you will also find a special supplement for distribution to board members that cautions against note-taking during meetings when there are formal minutes. Board members should make certain that formal minutes are used to document proceedings rather than hastily written notes, which can be used by a trial attorney to call into question competence and integrity by asking a witness to explain differences between his or someone else's notes and the minutes. This will become more important in our increasingly litigious post-Enron environment.



John P. Beavers
Partner,
Bricker & Eckler LLP

Bricker & Eckler LLP has been named to the 2002 *Corporate Board Member Magazine* list of **Best Corporate Law Firms in America**

Corporate Board Member, the only national magazine for the directors of publicly traded companies, released the results of its second annual survey of the best corporate law firms and lawyers in America. The results are available in the magazine's July/August 2002 issue. Bricker & Eckler LLP was chosen as one of the top five firms in the Columbus, Ohio market.

The Post-Enron Environment: The First Wave of Legislation and Regulations

John P. Beavers, Bricker & Eckler LLP

In our last issue of *Acredula*, we reviewed President Bush's ten-point plan on corporate governance issued on March 7, 2002, as well as Congressional reaction to the plan and Alan Greenspan's comments. Since then, we have seen the first wave of legislation from Congress and regulations from a number of organizations, including the SEC, the NYSE and Nasdaq, as well as a new statement of principles of corporate governance by the Business Roundtable (BRT).

CAARTA

In April 2002, the House of Representatives passed the Corporate and Auditing Accountability Responsibility and Transparency Act (CAARTA) by a vote of 334 to 90. CAARTA was sponsored by the House Financial Services Committee, chaired by Michael Oxley (R-Ohio). CAARTA names the SEC as the lead agency to address the Enron problem by requiring disclosure of insider trade before the next business date, greater disclosure of off-balance sheet transactions, more oversight and disclosure of business transactions outside the ordinary course of business or involving management, and more "plain" English explanations of accounting principles.

BRT Principles of Corporate Governance

On May 14, 2002, the BRT issued its new *Principles of Corporate Governance*, a compilation of previous statements from 1997, 1992, 1981 and 1978. The new *Principles* is an excellent primer on corporate governance for both boards and executives. (BRT's *Principles* is available at www.brt.org).

The BRT's new statement is based upon the following guiding principles:

- The chief duty of a public corporation's board of directors is to select a CEO and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
- It is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.
- It is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.
- It is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on generally accepted accounting principles. The board, its audit committee, and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.
- It is the responsibility of the independent accounting firm to ensure that it is independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with generally accepted auditing standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated with the board or the audit committee on these matters.
- The corporation has a responsibility to deal with its employees in a fair and equitable manner.

Elsewhere in its *Principles*, the BRT foreshadowed the wave of regulations about to come. The BRT states that companies should set “tone at the top” with senior management, especially the CEO, for ethical behavior and legal compliance. The BRT would have this include guaranteeing that systems of effective internal controls are in place to provide reasonable assurance, with periodic review and evaluation, as to the completeness and accuracy of the company’s books and records, accountability of assets, and compliance with legal requirements.

Proposed NYSE Corporate Governance Listing Requirements

On June 6, 2002, the NYSE Corporate Accountability and Listing Standards Committee issued a 140-page recommendation to the NYSE’s board of directors for adoption of comprehensive corporate governance requirements as part of the listing standards for companies whose securities are admitted for trading on the NYSE.

Accountability at the Top

The most significant change recommended by the NYSE is the concept of accountability at the top. If the NYSE recommendations are adopted, CEOs would be required to certify annually that:

- Their companies have established and complied with procedures for verifying the accuracy and completeness of information provided to investors;
- They have no reasonable cause to believe that the information provided to investors is not accurate and complete;
- They have reviewed with their boards those procedures and their company’s compliance with them; and
- They are not aware of any violations by their companies of the NYSE listing standards.

Commentators suggest that the recommended accountability at the top reflects investors’ desire for a zero tolerance policy for corporate improprieties for organizations of all sizes.

Additional NYSE Changes

Other changes summarized in the NYSE recommendations include:

1. Increasing the role and authority of independent directors.

- Independent directors must comprise a majority of a company’s board.
- Boards must convene regular executive sessions in which the non-management directors meet without management.
- Listed companies must have an audit committee, a nominating committee and a compensation committee, each comprised solely of independent directors.
- The chair of the audit committee must have accounting or financial management experience.
- Audit committees must have sole responsibility for hiring and firing the company’s independent auditors and for approving any significant non-audit work by the auditors.

2. Tightening the definition of “independent” director and adding new audit committee qualification requirements.

- For a director to be deemed “independent,” the board must affirmatively determine that the director has no material relationship with the listed company.
- In addition, there is a five-year “cooling-off” period for former employees of the listed company, or of its independent auditor; for former employees of any company whose compensation committee includes an officer of the listed company; and for immediate family members of the foregoing.
- Director’s fees must be the sole compensation an audit committee member receives from the listed company. Further, an audit committee member associated with a major shareholder (one owning 20% or more of the listed company’s equity) may not vote in audit committee proceedings.

3. Fostering a focus on good corporate governance.

- Listed companies must adopt corporate governance guidelines, as well as charters for their audit, compensation and nominating committees.
- Listed companies must adopt a code of business conduct and ethics.

4. Giving shareholders more opportunity to monitor and participate in the governance of their companies.

- Shareholders must be given the opportunity to vote on all equity-based compensation plans; brokers may only vote customer shares on proposals for such plans pursuant to customer instructions.
- Listed companies must publish codes of business conduct and ethics, and key committee charters. Waivers of such codes for directors or executive officers must be promptly disclosed.
- Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from the NYSE listing standards.

Nasdaq Changes

The attention to corporate governance is not limited to the NYSE. On May 24, 2002, Nasdaq's board of governors approved similar, but not as extensive, rule changes regarding the definition of "independence" of directors for purposes of audit committees. The board is considering expanding the "independence" requirement for purposes of compensation committees yet this summer. Nasdaq will also consider requiring a majority of the board to be composed of independent directors.

SEC Proposed Rule on CEO Certification

On June 17, 2002, the SEC proposed new rules that would require a company's CEO and CFO to certify that, to their knowledge, the information in the company's quarterly and annual reports is true and that the reports contain all information about the company that they believe is important to a reasonable investor. In addition, proposed new rules would require a company to maintain procedures to provide reasonable assurance that the company is able to collect, process, and disclose the information required in the company's quarterly and annual reports, as well as current reports on Form 8-K, and also to require periodic review and evaluation of these procedures. The intent of these rules is to make a company's CEO and CFO accountable to investors for the quality of disclosure and availability of information "to make informed investment and voting decisions and to ensure that capital is allocated efficiently to business enterprises."

Annual Certification

The proposed rules would require the CEO and CFO each to certify in the company's annual report that:

- He or she has read the report;

- The information in the report is true in all important respects as of the end of the period covered by the report, to his or her knowledge; and
- The report contains all information about the company that he or she is aware of and believes is important to a reasonable investor as of the end of the period covered by the report.

Management Disclosure Committee

The SEC recommends that companies create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The committee would report to senior management, including the principal executive officer and the principal financial officer, and would include:

- The principal accounting officer or controller;
- The general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel;
- The principal risk management officer;
- The chief investor relations officer (or an officer with equivalent responsibilities); and
- Other officers or employees, including individuals associated with the company's business units, as the company deems appropriate.

SEC Proposed Rule on Expanded 8-K Disclosure

On June 18, 2002, the SEC proposed expanding disclosure required by Form 8-K reports for companies subject to the period reporting requirements of the Securities Exchange Act of 1934. This is the most significant change since 1933 in disclosure requirements applicable to the U.S. markets.

One proposed change would accelerate the Form 8-K filing deadline by requiring companies to file Form 8-K within two business days after the occurrence of a triggering event rather than the current five business days and 15-calendar day deadlines.

Other changes would add the following as triggering events requiring disclosure in a Form 8-K:

- Entry into a material agreement not made in the ordinary course of business;

- Termination of a material agreement not made in the ordinary course of business;
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues;
- Creation of a direct or contingent financial obligation that is material to the company;
- Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation;
- Exit activities including material write-offs and restructuring charges;
- Any material impairment;
- A change in a rating agency decision, issuance of a credit watch, or change in a company outlook;
- Movement of the company's securities from one exchange or quotation system to another, delisting of the company's securities from an exchange or quotation system, or a notice that a company does not comply with a listing standard;
- Conclusion or notice that security holders no longer should rely on the company's previously issued financial statements or a related audit report;
- Any material limitation, restriction, or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement, and stock ownership plans;
- Unregistered sales of equity securities by the company;
- Material modifications to rights of holders of the company's securities;
- Departure of a director for any reason including a disagreement or removal for cause, the appointment or departure of a principal officer, and the election of new directors; and
- Material amendment to a company's articles of incorporation or bylaws.

SEC Proposal to Create a Public Accountancy Board

On June 20, 2002, the SEC proposed creating an independent

board not under the control of the accounting profession to provide oversight of accounting firms, individual accountants, public companies and their management. Outside auditors would be required to be members of a public accountancy board in order for financial statements audited by such auditors to qualify for inclusion in SEC registration statements and reports. As proposed, a public accountancy board would be a nine-member board, no fewer than six of whom would be independent public members, and no more than three of whom would be representatives of the public accounting profession.

A public accountancy board would perform quality control reviews of audit procedures and practices, at least annually for large firms and at least triennially for all other firms. Such reviews will be designed to ensure that audit firms have quality control policies and procedures regarding, among other things:

- Independence, integrity, and objectivity of audits;
- Personnel management;
- Acceptance and continuation of audit clients;
- Audit performance;
- Audit methodology; and
- Consultation and resolution of differences of professional opinion during audits.

In addition, the board would require quality control reviews to address, among other things:

- Rotation of audit personnel;
- Independent partner reviews of audits;
- Consulting services;
- Reporting termination of auditor engagements to the Commission;
- Assisting in audits by foreign associated firms;
- Reporting litigation alleging violations of the securities laws; and
- Partners and employees of auditors joining clients.

Focus Beyond Audit Committees

The focus of new legislation and regulations is not limited to

oversight of financial reporting and the audit process by audit committees, it also extends to oversight of compensation and

compensation plans by the compensation committee and to nomination of directors and, at least, the CEO by nominating committees. Both NYSE and Nasdaq are considering requiring stockholder approval of all equity compensation plans in which any officer or director can participate.

Additionally, Senator John Edwards (D-North Carolina) believes "it is time to scrutinize the role of lawyers as well." In a letter to SEC Chairman Harvey Pitt, Edwards urged the SEC to force corporate attorneys to report any misconduct to a company's board of

directors, saying that "When corporate managers are engaged in damaging illegal conduct, the lawyers who represent the corporation can sometimes stop that conduct simply by reporting it to the corporate board of directors."

More Competence, Not More Rules

In March 2002, Alan Greenspan commented that "Rules cannot substitute for character." BRT's new *Principles*, the NYSE's recommendations and Nasdaq's rule changes are an attempt to raise the ethical and competency bar on boards and executives to pre-empt the need for Congress to impose additional statutory liability on directors or reduce the availability of protection through D&O liability insurance and state-law indemnification provisions.

Choosing independent directors based upon the competencies that they can bring to the company, educating them as to the functions and responsibilities of a director, and allowing them to exercise their independent judgment is more likely than remedial legislation to prevent future problems comparable to those perceived in Enron. Remedial legislation adding to potential board and executive liability will only result in decreasing the availability of qualified competent directors and officers.

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Taking Notes During Meetings Can Harm CEOs and Boards

The official record of a meeting is its minutes. Accordingly, many organizations prohibit note taking by participants or follow an established policy of collecting and destroying all notes at the end of the meeting, including notes taken by the person serving as secretary for purpose of preparing the minutes.

Although the laws of most jurisdictions recognize a meeting's minutes as the official record of that proceeding, these jurisdictions do not equate "official" with "exclusive." Therefore, if there is other evidence of what occurred, such as a participant's notes, the courts will allow those notes to be used to impeach either the competence of the minute-maker, the integrity of the

minutes, the memory of the note taker or, even worse, the integrity or competence of the other participants. An experienced prosecutor or trial attorney can effectively call into question competence, integrity, or memory by asking a witness to explain differences between his or someone else's notes and the minutes or the witness's memory.

To make minutes not only the official, but also the exclusive record of a proceeding, participants who take notes should, as a routine practice, destroy those notes after satisfying themselves

that the minutes accurately reflect the proceedings. A good practice is for the chair or presiding officer, secretary, or legal counsel to collect all written material, including notes, at the conclusion of the meeting and destroy those materials as soon as the minutes of that meeting have been approved. This has been accepted by courts in most jurisdictions.

Establishing a policy regarding note taking can help ensure that all notes are properly destroyed and that the meeting's minutes are the official and exclusive record of that proceeding. Following is an example of such a policy:

1. Approved minutes of any meeting of the Board or of any committee of the Board shall be the official and exclusive record of that meeting. For this purpose:
 - (a) The practice will be for the chair or presiding officer of the Board and each committee of the Board to designate the Secretary or another person to prepare minutes of each meeting of the Board or that committee except for meetings called in executive session.
 - (b) Except for materials collected and retained by legal counsel pursuant to paragraph 1(d), the person designated to prepare minutes of any meeting will collect at the end of each meeting, for which minutes will be prepared, all written materials prepared or distributed in connection with the meeting, including any notes taken by any person present regarding the meeting or any subject matter thereof, and destroy all such materials after the minutes of the meeting are approved. This includes any notes taken by the person designated to prepare the minutes of that meeting.
 - (c) In considering approval of minutes of any meeting of the Board or any committee, any member of the Board or that committee may review any written materials prepared or distributed in connection with that meeting, including any notes taken by that member, before those minutes are approved; however, all materials collected for destruction shall be destroyed pursuant to paragraph 1(b) immediately after approval of the minutes of the meeting at which those materials were collected.
 - (d) Notwithstanding paragraph 1(b), material regarding matters discussed with or in the presence of legal counsel for the Board or committee or for the Corporation and any attorney-client privileged material may be collected and retained by such legal counsel.
- (2) Minutes approved by the Board or any committee of any of its proceedings shall be evidenced by the signature of the chair or other presiding officer or the secretary or other person that prepared the minutes, which approval shall be conclusively evidenced by such signature, and

To make minutes not only the official, but also the exclusive record of a proceeding, participants who take notes should, as a routine practice, destroy those notes after satisfying themselves that the minutes accurately reflect the proceedings.

any person may act in reliance upon such signature reasonably believed by that person to be genuine and assume that such minutes are authentic and approved.

- (3) All approved minutes shall be kept as part of the Corporation's books and records pursuant to applicable law.

Paragraph 1(d) of this provision recognizes the importance of legal counsel in protecting the confidentiality of materials, especially attorney-client privileged materials. Materials distributed or prepared in connection with discussions with legal counsel or about their legal rights or obligations are protected by the attorney-client privilege, especially if they are retained by legal counsel.

Discouraging note taking or collecting and destroying notes does not relieve board or committee members of their responsibilities for ensuring that the minutes of their proceedings are sufficient. A board or committee should approve minutes only after they have taken steps to ensure the sufficiency of the minutes. At a minimum, this should include reviewing minutes of each meeting and, if necessary, refreshing their recollection by asking to review any notes collected at the end of the meeting. Only after such steps are taken and the minutes are approved should any notes be destroyed.