COZEN O'CONNOR

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BUSINESS LAW OBSERVER

NEWS ON CONTEMPORARY ISSUES

MESSAGE FROM THE CHAIR

TO THE FRIENDS OF COZEN O'CONNOR:

This Summer issue of the *Business Law Observer* focuses on important changes contained in cases and regulatory actions affecting both public and private companies. The highlights of this Observer include:

- A recent Delaware Supreme Court decision provides guidance with respect to the duties that directors of insolvent companies and companies in the zone of insolvency owe to creditors and shareholders. This updates a report from a previous issue of the *Observer*;
- Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 has been eased by the SEC for smaller public companies, in an effort to reduce the costs of such compliance while maintaining meaningful disclosure;
- The SEC has amended Rule 144 and Rule 145 to make it easier to dispose of securities acquired in a private placement; and
- The USA PATRIOT Act requires the provision of additional information to banks when opening escrow as well as other accounts.

We hope you find this issue helpful, and we welcome your inquiries.

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FIDUCIARY DUTIES TO CREDITORS

Each member of a board of directors owes a fiduciary duty to the company on whose board he or she sits and to the stockholders of that company. In evaluating these fiduciary duties, courts adhere to the business judgment rule, a judicially created presumption in favor of directors that, in making any decision, a director acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company. Directors of a solvent company generally owe no fiduciary obligation to any person or entity beyond the company and the stockholders of that company; that is, they do not owe any fiduciary duty to the company's creditors. The presumption is that creditors can protect themselves through the contractual agreements that govern their relationship with the company, as well as the law of fraudulent conveyance, general commercial law and federal bankruptcy law. Directors of a solvent company should be primarily focused on generating cash flow in excess of the amount required to pay the creditors in order to provide a return to the company's stockholders, who provided the equity capital and agreed to bear the residual risk associated with the operation of the enterprise.

"Courts have granted creditors the right to bring derivative claims for breach of fiduciary duty against directors of insolvent companies."

However, when a company has become insolvent, the playing field changes. In an insolvency situation, the company's directors owe fiduciary duties to the company's creditors. The directors continue to have the responsibility to attempt to maximize the value of the entity. But the insolvency necessarily affects the constituency upon whose behalf the directors are pursuing that end. Insolvency places the creditors in the position normally occupied by the stockholders, namely that of residual risk bearers. It may be more appropriate in those circumstances for the directors to undertake a course of action that preserves the value of the enterprise in a situation where the continuation of the enterprise, as a going concern, would be value destroying. Courts have granted creditors the right to bring derivative claims for breach of fiduciary duty against directors of insolvent companies; in essence, recognizing this fiduciary duty. Creditors of an insolvent company have the same incentive to pursue valid derivative claims on their behalf that stockholders have when the company is solvent.

Over the years, there has been growing concern over a situation where the company is still solvent but is operating in the vicinity of insolvency. Operating in this manner is referred to as operating in the "zone of insolvency." In this circumstance, directors were unsure whether they had the responsibility to temper the risks taken on behalf of the stockholders in order to take into account the interests of creditors. That is, directors would be exercising their fiduciary duties if they, in good faith, pursued a less risky business strategy because they feared that a more risky strategy might render the company unable to meet its legal obligations to creditors. In the proper exercise of their fiduciary duties, directors of a company that is solvent but operating in the zone of insolvency have to consider that the appropriate course to follow for the company may diverge from the choice that the stockholders, the creditors, or any other single group interested in the company would have. The directors are forced to preserve and, if possible, maximize the company's value to best satisfy legitimate claims of all constituents and not simply to pursue the course of action that stockholders might deem to be in their best interests. Moreover, it is often difficult to determine when a company is in the zone of insolvency, as there is no set standard test that courts would apply. As a result, it is difficult for directors to determine whether a court will find the enterprise to be in the zone of insolvency.

In *North America Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 2007 Del. LEXIS 227 (Del. May 18, 2007), the Delaware Supreme Court clarified Delaware law by holding that creditors have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the directors of a company, regardless of whether such company is operating in the zone of insolvency or is already insolvent.

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The Supreme Court reasoned that the benefit of adding another layer of protection for creditors through direct breach of fiduciary duty claims appears minimal and would be significantly outweighed by the costs to economic efficiency. A company operating in the zone of insolvency is one in most need of leadership and the ability to negotiate with its creditors. Such goals would be undermined by director liability from direct claims of creditors.

The need for providing directors with definitive guidance compelled the Delaware Supreme Court to make the following key rulings:

- Creditors of an insolvent company have standing to maintain derivative actions against directors on behalf of the company for breaches of fiduciary duties.
- Creditors of a company that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the company's directors.

The court explained that when a solvent company is navigating in the zone of insolvency, the focus of directors should not change. That is, directors must continue to discharge their fiduciary duties to the company and its stockholders by exercising their business judgment in the best interests of the company for the benefit of its stockholders. Allowing direct claims by creditors would create uncertainty for directors because the duty to creditors would conflict with their duties to maximize the value of the company for the benefit of those having a direct interest in the company.

The decision provides comfort to directors as there had been suggestions and dicta from prior opinions indicating that creditors might have a right to maintain direct actions against directors for breaches of fiduciary duties, whether in the zone of insolvency or insolvent.

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SEC ISSUES GUIDANCE FOR COMPLIANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002

In May 2007, the Securities and Exchange Commission (the SEC) approved interpretive guidance for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404). Consistent with its previous pronouncements, the SEC outlined a top-down, principles-based framework to help public companies (particularly those with less than $75 million in market capitalization) to balance their internal control over financial reporting while reducing compliance costs and expenses.

SOX 404 requires each annual report of a public company to include a report by management on the company's internal control over financial reporting. This report must contain, among other things, a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company, a statement identifying the framework used by management to evaluate the effectiveness of internal control, management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year, and a statement that its auditor has issued an attestation report on management's assessment.

SOX 404 does not take into account for revenue base, headcount, or other variables, which has resulted in ongoing compliance challenges to smaller companies. Following the SOX-mandated corporate governance, auditing and disclosure changes, smaller companies have been facing steadily increasing compliance costs, which take the form of higher legal and audit expenses and accounting and finance personnel training costs, among others, all to comply with internal control standards as mandated under SOX 404.[1] SOX 404 proponents have forcefully argued that the compliance requirement fulfills its intent to strengthen investor confidence in the integrity of public company reporting mechanisms, which would minimize (if not completely prevent) future corporate cataclysms of Enron and similar proportions. Smaller companies, on the other hand, almost in unison, have complained that, although SOX 404 may have well been appropriate for larger companies with substantially greater resources at their disposal, its breadth and scope does not fit the realities of a smaller public company in today's global economy. Smaller companies generally do not retain full-time financial controllers; they tend to maintain less documentation and controls which, in turn, makes it more difficult for management and auditors to review the controls and attest to their quality; their management teams tend to have a much wider scope of functions, control and responsibilities that at times results in override of financial controls. SOX 404's "one size fits all" compliance approach puts smaller companies at a competitive disadvantage because it causes them to divert their scarce resources that otherwise would be directed to new product development or research and development, to establish and monitor internal control, the efficacy of which is difficult, if not impossible, to assess.

The May 2007 release represented yet another attempt by the SEC to bring clarity and certainty to this debate. "Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of SOX 404 is to provide meaningful disclosure to investors about the effectiveness of a company's internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources," said SEC Chairman Christopher Cox. "With the Commission's new interpretive guidance for management on the evaluation and assessment of its internal controls over financial reporting, companies of all sizes will be able to scale and tailor their evaluation procedures according to the facts and circumstances. And investors will benefit from reduced compliance costs."

The interpretative guidance is designed to make it less costly for public companies to implement the SOX internal control requirements and to reduce uncertainty about what constitutes a reasonable approach to management's evaluation. It specifically focuses on risk and materiality by using a risk-based approach and centering on two broad principles:

I. Management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner.

II. Management's evaluation of evidence about the operation of its controls should be based on its assessment of risk.

Management may be able to use more efficient approaches to gathering evidence, such as self-assessments in low-risk areas and performing more extensive testing in high-risk areas. Conrad Hewitt, the SEC's Chief Accountant, expressed the staff's position that smaller public companies should make reasonable judgments in their assessments that reflect each company's individual facts and circumstances. Interestingly enough, the staff declined to include illustrative examples in the final guidance so as to avoid setting "bright line" evaluation approaches, i.e., the guidance was intended to be more a principle and less of a rule. The guidance is not mandatory, and the SEC has indicated that many companies will be able to continue using their existing procedures if they choose, assuming those procedures are otherwise in accordance with Section 404 and related rules.

Notably, however, the SEC did not extend the deadline for smaller companies to comply with SOX 404 beyond the December 31, 2007, deadline. The staff assured SEC commissioners that the new guidance provides scalable and flexible ways for smaller companies to meet the current deadline. Under the extension presently in effect, non-accelerated filers were required to provide a management assessment of the effectiveness of internal control over financial reporting for the first fiscal year ending on or after December 15, 2007, and such filers will need to have an audit of internal control over financial reporting for the first fiscal year ending on or after December 15, 2008.

In addition to the foregoing, the SEC also:

- approved rule amendments providing that a company that performs an evaluation of internal control in accordance with the interpretive guidance satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15;
- amended its rules to define the term "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis"; and
- amended Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the

effectiveness of internal control over financial reporting by the auditor in its attestation report.

Here are a few suggested practical steps that smaller public companies should be considering:

- Educate your finance, accounting and executive teams, and assign compliance responsibilities throughout various teams;
- Communicate with your auditors and legal advisors, hire additional ones if needed, and ask for their feedback at each critical step of the compliance process;
- Document compliance processes early, thoroughly and consistently; and
- Review, revise and modify your current controls and procedures to ensure that they are properly matched against your current and future business needs.

1. Studies have shown that the actual SOX 404 compliance costs are far in excess of the original SEC estimate of $91,000 per company.

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DEADLINE APPROACHES FOR AMENDING DEFERRED COMPENSATION ARRANGEMENTS UNDER SECTION 409A

On April 10, 2007, the Internal Revenue Service (the IRS) and the Treasury Department issued final regulations regarding the taxation of non-qualified deferred compensation under Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Code Section 409A provides that amounts deferred under non-qualified plans and arrangements may be subject to current taxation and penalties if certain requirements are not satisfied.

Although good faith compliance with the regulations is currently required, the IRS has granted extensions for compliance with the requirement that the terms of non-qualified deferred compensation plans and programs be amended to document compliance with the regulations ("Documentary Compliance"). Documentary compliance is now required to be in place by December 31, 2008, and the IRS has stated that there will be no further extensions. Additionally, the IRS has explicitly stated that, regardless of a plan's operational compliance, failure to bring a non-qualified deferred compensation plan into documentary compliance will be considered a violation of Code Section 409A (triggering current taxation and penalties).

Basically, the 409A regulations require a plan to specify the amount to be paid, the date or event when deferred compensation will be paid and the form of payment. The regulations generally prohibit a further deferral or an acceleration of the time of payment. Events such as separation from service, death, disability, a change in control of the service provider or unforeseeable emergency, as defined in the regulations, are all permissible payment events. In addition, certain key employees of public companies may be required to wait six months before being paid any amount of deferred compensation following their separation from service. Linking payments under a deferred compensation plan to payments under a qualified plan is no longer permitted.

> *"If a violation of Code Section 409A is discovered, the compensation becomes retroactively taxable to the date on which it originally vested."*

The regulations provide exceptions to the rules described above. For example, the regulations allow subsequent deferrals of deferred compensation if the individual receiving the

compensation agrees to forego receipt for at least five years and makes the election at least one year before the payments would otherwise have been paid. The regulations also permit acceleration of benefits in the event the plan and all similar deferred compensation plans of the employer are terminated. The pre-409A practice of permitting an acceleration of benefits if the recipient was willing to accept a 10% "haircut" of the amount paid is prohibited.

Non-compliance with the regulations carries with it the potential for substantial tax penalties, which are borne by the individual who earns the compensation (i.e., the employee). If a violation of Code Section 409A is discovered, the compensation becomes retroactively taxable to the date on which it originally vested. In addition to being required to restate his or her taxes for that year, the employee will owe interest and penalties from that date, as well as a 20% excise tax. States may also apply parallel penalties. It is possible, in some cases, for the amount of taxes owed to be greater than the compensation paid.

As noted above, these penalties are borne by the employee. However, because the compensation will generally be subject to payroll taxes, the employer also runs the risk of underpayment of taxes on the retroactively taxable compensation, as well as failure to comply with reporting and withholding requirements.

Non-qualified deferred compensation is very broadly defined by the regulations. (Certain amounts are grandfathered and not subject to Section 409A if earned and vested as of December 31, 2004.) With certain exceptions, any form of compensation which is earned, or vested in one year, but actually paid in a subsequent year, may be subject to the rules. In addition to traditional deferred compensation plans, this can impact employment contracts, severance agreements, bonus plans, change in control agreements and even certain compensation arrangements with contractors. In general, stock options with an exercise price equal to the underlying stock's fair market value on the date of grant will generally be exempt from the rules. However, in certain circumstances, equity programs can become subject to Code Section 409A.

The first step employers must undertake to ensure compliance is to identify those plans or programs that may require review and amendment for compliance with the regulations. As noted above, a wide variety of compensation arrangements, including individual employment contracts, may fall under the Section 409A rules. It is vitally important that employers identify these programs as soon as possible to ensure that programs are compliant by December 31, 2008. Sufficient time should be allotted for coordination with executives, especially for bi-lateral arrangements, as well as the employer's compensation committee and board or other governing body.

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COMPLYING WITH THE USA PATRIOT ACT IN ESTABLISHING ESCROW ACCOUNTS

It has become more onerous for customers to open new bank accounts, including escrow accounts, since 2003, when regulations became effective which implement portions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (the Act).

The Act, which became law on October 26, 2001, contains strong measures to prevent, detect and prosecute terrorist financing and money laundering. Section 326 of the Act calls for the enactment of regulations requiring financial institutions to implement reasonable procedures to (1) verify the identity of any person opening an account; (2) maintain records of the information used to verify the person's identity; and (3) determine whether the person appears on any list of known or suspected terrorists or terrorist organizations. Effective as of October 1, 2003, the Department of Treasury, together with the federal banking agencies, issued a regulation under Section 326 of the Act, codified at 31 C.F.R. 103.121 (the CIP Rule), which requires that banks and certain financial institutions implement a written Customer Identification Program (the CIP) establishing risk-based procedures for verifying the identity of each customer to the

extent reasonable and practicable. Pursuant to the CIP Rule, the procedures set forth in the CIP must enable a bank to form a reasonable belief that it knows the true identity of each of its customers. These procedures must be based on the bank's assessment of the relevant risks, including those presented by the various types of accounts maintained by the bank, the various methods of opening accounts provided by the bank, the various types of identifying information available, and the bank's size, location and customer base.

Under the CIP Rule, a customer is generally a person that opens a new account, and an escrow account is generally an account established for the deposit of funds that are to be paid or returned to a specified party depending on the fulfillment of escrow conditions. According to the Department of Treasury, (1) for purposes of an escrow account for which a third party serves as escrow agent, such third party escrow agent will constitute the bank's customer, and (2) for purposes of an escrow account for which a bank serves as escrow agent, the individual or entity who or which opens the account will constitute the bank's customer.

"…in order to ensure compliance, banks look to confirm…the identities of each of the signatories to the relevant escrow agreement."

In the context of mergers and acquisitions which involve the establishment of escrow accounts, a bank generally serves as the escrow agent and the individual or entity who or which opens the account generally constitutes the bank's customer. Although a bank is generally not required to look through trust, escrow or similar accounts to verify the identities of all of the beneficiaries thereof, the CIP Rule provides that, based on the bank's risk assessment of a new account opened by a customer that is not an individual, the bank may need to obtain information about the individuals who will exercise control over such account, including signatories, in order to verify the customer's identity.

Thus, although not explicitly required by the CIP Rule or any other rule or regulation, in order to further ensure compliance with the CIP Rule, banks look to confirm not only the customer's identity, but also the identities of each of the signatories to the relevant escrow agreement. To do so, banks will generally require that each of the signatories to an escrow agreement complete and submit to the bank a due diligence questionnaire and IRS Form W-9/W-8. In addition, signatories who are individuals will generally be required to submit a copy of his or her driver's license, passport or government-issued identification card, and signatories that are entities will generally be required to submit one of the following certified documents: (1) a certificate or articles of incorporation/formation; (2) a corporate governance document, such as bylaws, a partnership agreement, an operating agreement or limited liability company agreement, or a trust agreement; (3) a government-issued business license; or (4) a recently-issued certificate of good standing.

Even before the enactment of the CIP Rule, the concept of appointing a shareholder or seller representative was often used for ease of administration of escrow accounts and escrow funds in the context of merger transactions and stock sales involving a significant number of selling equity holders. A shareholder or seller representative is a person who represents the rights and interests of, signs the escrow agreement on behalf of, and administers the distribution of escrow funds to the other shareholders or sellers who are entitled to receive funds out of an escrow account upon the satisfaction of certain conditions. In light of the enactment of the CIP Rule, the use of a shareholder or seller representative is even more regularly used and recommended in order to streamline the process of setting up escrow accounts and allow the parties to focus on the more important goal of closing the deal.

In sum, parties who intend to establish an escrow account in connection with a merger or acquisition transaction should keep in mind the obligations of the bank or financial institution which will serve as escrow agent to comply with the CIP Rule, and should allow enough time prior to the desired closing date to obtain, complete and submit the personal information and documentation requested by the bank for purposes of verifying such parties' identities in compliance with the CIP Rule.

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SEC ADOPTS AMENDMENTS TO RULES 144 AND 145

On November 15, 2007, the SEC adopted significant amendments to Rules 144 and 145[1] in order to increase the liquidity of privately sold securities and decrease the cost of capital for all issuers without compromising investor protection. The amendments have significant implications for PIPES because they have the potential of obviating registration in a number of circumstances and reducing the need for penalties associated with a failure to register.

The amendments, which became effective on February 15, 2008, have:

- shortened the holding period for restricted securities;
- eliminated resale conditions for non-affiliates;
- amended the manner of sale requirements applicable to resales by affiliates;
- eliminated the conditions on the resale of debt securities by affiliates;
- increased the thresholds that trigger the Form 144 filing requirement for affiliates;
- codified certain SEC staff interpretations; and
- eliminated the underwriter presumption in Rule 145.

RULE 144 AMENDMENTS

Holding Periods

Rule 144 previously imposed a one-year holding period on securities acquired from the issuer or an affiliate of the issuer. The amendments shorten the length of the holding period to a minimum of six months for securities of issuers that have been subject to the reporting requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934 for at least 90 days before the Rule 144 sale.[2]

Non-Affiliate Resale Conditions

The resale of restricted securities by a non-affiliate is no longer subject to the conditions of Rule 144 once the applicable holding period has been met (i.e., six months for reporting issuers and one year for non-reporting issuers), except that, with regard to the resale of reporting issuer securities, the current public information requirement in Rule 144(c) applies for an additional six months after the six-month holding period is met.

Affiliate Resale Conditions

Resales of restricted securities by an affiliate continue to be subject to the conditions of Rule 144. However, as amended, Rule 144(f) permits the resale of securities through riskless principal transactions in which trades are executed at the same price and the transaction is permitted to be reported as riskless under the rules of a self-regulatory organization.

The amendments also added a new provision to the definition of brokers' transactions found in Rule 144(g), permitting a broker to insert bid and ask quotations for a security in an alternative trading system, provided the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last 12 business days.

Resale of Debt Securities by Affiliates

The amendments completely eliminated the manner of sale requirements for resales of debt securities held by affiliates and added a definition of debt securities to paragraph (a) of Rule 144.

The amendments also changed the volume limitations applicable to debt securities. Rule 144(e) now provides that the amount of debt securities sold by an affiliate in a three-month period may not exceed 10% of a tranche (or class when the securities are non-participatory preferred stock).

Form 144 Filing Triggers

The dollar and share thresholds in Rule 144(h) were increased so that now a Form 144 must be filed if the security holder's intended sale exceeds either 5,000 shares or $50,000 within a three-month period.

Summary of Resale Conditions under Rule 144

See chart on following page.

CODIFICATION OF STAFF INTERPRETATIONS

The SEC adopted the following interpretive positions issued by the staff of the Division of Corporation Finance:

1. Securities acquired under Section 4(6) of the Securities Act are restricted securities for purposes of Rule 144.
2. Holders may tack the Rule 144 holding period in connection with transactions made solely to form a holding company, provided certain conditions are satisfied.
3. Securities acquired from an issuer solely in exchange for securities of the same issuer will be deemed to have

Summary of Resale Conditions under Rule 144		
	AFFILIATE	**NON-AFFILIATE[3]**
Restricted Securities of Reporting Issuer	**After six-month holding period** Resale permitted subject to following conditions: • current public information, • volume limitations, • manner of sale requirements for equity securities, and • filing of Form 144.	**After six-month holding period** Resale permitted subject only to current public information condition. **After one-year holding period** Resale permitted unconditionally.
Restricted Securities of Non-Reporting Issuer	**After one-year holding period** Resale permitted subject to following conditions: • current public information, • volume limitations, • manner of sale requirements for equity securities, and • filing of Form 144.	**After one-year holding period** Resale permitted unconditionally.

been acquired at the same time as the securities surrendered for conversion or exchange.

4. Upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired, except that if the options or warrants were not purchased for cash or property, the newly acquired securities will be deemed acquired at the time the options or warrants are exercised.
5. When calculating the volume limitation condition under Rule 144(e), a pledgee does not need to aggregate a sale of securities with sales by other pledgees of the same securities from the same pledgor, as long as there is no concerted action by the pledgees and the pledgees are not the same "person" under Rule 144(a)(2).
6. Resales of securities initially issued either by a reporting or non-reporting shell company or by an issuer that has been at any time previously a reporting or non-reporting shell company will be permitted under Rule 144, provided certain conditions are met, such as reporting and timing requirements. This amendment effectively revokes the staff's position in the Worm/Wulff letters that unregistered securities of a public shell company can *never* be resold.[4]

RULE 145

Prior to the adoption of the amendments, Rule 145(c) created a presumption that persons, other than issuers or affiliates, who are parties to exchanges of securities in connection with a reclassification of securities, mergers or consolidations, or transfers of assets that are subject to shareholder vote, were underwriters. The amendments eliminated this presumption, except with regard to transactions involving a shell company (other than a business combination related shell company).

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1. *See* SEC Release No. 33-8869.
2. Restricted securities of non-reporting issuers will continue to be subject to a one-year holding requirement.
3. If a security holder is not an affiliate at the time of the proposed resale, but has been an affiliate at any time during the three months prior to the proposed resale, the security holder is not considered a non-affiliate.
4. *See NASD Regulation, Inc.* (available January 21, 2000).

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