FORUM

# Corporate Governance

CORPORATIONS TODAY ARE UNDER CONSTANT PRESSURE FROM THE MEDIA, THE PUBLIC, AND THE government to demonstrate that they have good corporate governance practices in place. The Securities and Exchange Commission is closely examining 10b5-1 trading plans of company executives. Boards of directors are increasingly involved in compliance issues. And the courts are beginning to make some decisions on stock options backdating cases. Another major issue for public companies is the enormous expense of complying with Sarbanes-Oxley.

Our panel of experts discuss these issues and provide some guidance on how to respond to these developments. They are Eric Klein and Bruce Vanyo of Katten Muchin Rosenman, Darryl Rains of Morrison & Foerster, and Jahan Raissi of Shartsis Friese. The forum was moderated by Editor Chuleenan Svetvilas.

**MODERATOR:** The SEC is turning attention to 10b5-1 trading plans. What is the effect of this increased scrutiny?

**KLEIN:** A 10b5-1 trading plan allows for stock to be sold on what we can call a preprogrammed basis, where a plan is established and the executive whose stock is to be sold doesn't have specific control over the timing of the stock sale. Instead it's done through a broker and with preestablished criteria.

What's put this onto the radar screen most recently is a study that came out of Stanford. Professor Alan Jagolinzer found that executive stock trades under the 10b5-1 plans actually performed better than executive trades that were not under the plans, and he noted a 6 percent performance increase. He looked at quite a large number of trades, a good number of companies, and that study has been cited by the SEC in various speeches.

It also doesn't help in the Qwest situation that [its former CEO Joseph] Nacchio, who was recently convicted, was found to have aggressively used 10b5-1 plans. The mechanism that's being used right now for the so-called abuse is the fact that executives have great flexibility to start up, amend, or terminate the plans and to have multiple plans, which could allow for market timing by executives.

**RAISSI:** The director of the enforcement division of the SEC gave a speech, and one of the themes was follow the money, which is what they are doing here. When 10b5-1 plans came into existence, the spirit was that if an executive puts a plan in place at a time when that person has no inside information and essentially puts their stock sales on automatic pilot, they are in a safe harbor for insider trading. What may have happened in some instances is that people have gamed the system a little bit to essentially cover ordinary trading, meaning making decisions about when to sell and when not to sell under the cloak of a 10b5-1 plan.

So what you have seen, anecdotally at least, are situations where people will implement a plan and have concentrated large-volume sales very quickly right before a stock goes down. In other instances, people adopt a plan, sell heavily and then terminate the plan, only to adopt another one some time thereafter. The concern is that they are selling when they want to sell, stopping the plan when they don't think it's a good time to sell, and using another plan to begin selling again. It's something that the SEC has made very clear they are going to take a look at. My guess would be they are going to find some problems in some cases but not that many.

**RAINS:** We shouldn't send the wrong message. 10b5-1 plans are the single best tool for reducing insider-trading risk. They are even better than the usual insider trading policy with window provisions. I'd hate for executives to avoid


## EXECUTIVE SUMMARY

Our panel of experts discuss executive stock trading plans, the Delaware Court of Chancery's ruling in a stock options backdating case, the impact of securities litigation on outside directors, and the Securities and Exchange Commission's and the Public Company Accounting Oversight Board's suggested revisions and interpretations to Section 404 of Sarbanes-Oxley.

10b5-1 plans because of the recent publicity and SEC activity. You shouldn't throw the baby out with the bath water.

**RAISSI**: These are definitely good plans. If I were an executive and I wanted to sell a large block of my company's stock, you better believe I would use one.

**VANYO**: The plans have been very beneficial and they've been very helpful in defending cases, as you can pretty much preclude sales that are made pursuant to 10b5-1 plans. The question is: what is the impact of the Stanford study? It's an odd study in that it finds that there seem to be trades that are unexplainable other than by gaming the system. I don't know how much data underlies it. The study also concludes that these trades are "not material." It's not clear in that context what it means. The SEC, of course, could conclude differently and find specific trades that would be material. I'm sure the SEC will be seeking all of the data the professor used, and we'll see what comes out of that.

When these plans first started, executives were very enthusiastic about them. They wanted to set something up to diversify their portfolios and not have everyone question them. But I've also seen people starting to game it and finding that when they thought the company was starting to head in the wrong direction, they would create these plans, and when the company started to pull out of that, they would abandon the plans. I've even seen situations where they would terminate one plan and change the price at which they were going to sell the stock and implement another plan, which is not really what the SEC intended by this.

So we will see changes come out of this and [Linda] Thomsen has declared that there will be a study. You may see a bunch of investigations that come out of it if the data is there in the Stanford study. You are going to have to do it like the options backdating, some sort of a statistical basis. If the data is there, we may see a rash of SEC activity.

**MODERATOR**: So for companies that are interested in setting up 10b5-1 plans now, what advice do you have about how their plans should be written up?

**RAISSI**: Some basics to think about are to adopt the plan during the company's open window when it's okay to trade the securities. The plan shouldn't begin its sale cycle until a minimum of 30 or more days after the plan is adopted. The sales themselves shouldn't be front-loaded or concentrated in a short period of time, but rather spaced out over a reasonable period of time. And if someone is going to terminate a plan, and there's nothing wrong or illegal about terminating a plan, even if you have inside information, do not then restart another plan shortly thereafter.

I don't think it's hard to design a plan that is going to effectively protect somebody. It is something executives need to think about, and maybe companies need to think about setting guidelines for their executives. One of the odd questions that's come up in this area is that there's the possibility that announcements from the company could be timed to coincide with 10b5-1 sales. So you may have a 10b5-1 plan that's entirely mechanical. The trading is out of the executive's hands, but the ability to time announcements from the company is within executives' purview, and so they could time positive announcements right before their scheduled sales. I'm not sure how a company deals with that, and I'm not sure it's a real problem either, but it is one of the things that the SEC has raised as a possible abuse.

**RAINS**: Obviously, modifying or terminating a plan is the riskiest thing to do. One way to deal with that is just to have a shorter duration plan, 12 months to 18 months, which reduces the temptation to terminate or modify it. You also can put some instead of all of your stock in it. That way if you make a separate investment decision or you have tuition or taxes or something to do, you can deal with that without modifying your plan. You need to pay close attention to what triggers you are going to use for selling. The safest one is to sell a small number of shares every quarter.

**MODERATOR**: The same number of shares?

**RAINS**: Absolutely. That way you are insensitive to price. If you want to play the market a little bit, you can also use price triggers. You can set a trigger to sell 10,000 shares at $20. If the stock hits $25, you have a trigger to sell another 10,000

## FORUM PARTICIPANTS

**ERIC KLEIN** is a partner in Katten Muchin Rosenman's corporate group and co-leads their West Coast venture capital, private equity, and M&A law practice, assisting clients with public/private securities offerings, acquisitions, venture capital, private-equity financing, and strategic partnering. He represents both emerging growth and Fortune 500 companies in industries that include technology, health care, life sciences, and consumer goods. He holds Martindale-Hubbell's highest-quality "AV" rating and was recently recognized as a Securities/Corporate Finance Southern California Super Lawyer by *Southern California Super Lawyers Magazine* and *L.A. Magazine*.
eric.klein@kattenlaw.com

**BRUCE G. VANYO** is national cochair of the Securities Litigation Practice at Katten Muchin Rosenman. He has practiced securities litigation for 33 years and defended more than 250 major securities cases. He has represented clients from such diverse industries as high tech, life sciences, airlines, motion pictures, banking, and insurance, including Krispy Kreme Doughnuts, Dell Computer, Boeing Company, Fluor Corp., Amdocs Limited, and Genentech. He was named to the *National Law Journal*'s 2006 list of the 100 Most Influential Lawyers in America.
bruce.vanyo@kattenlaw.com

**DARRYL P. RAINS** currently serves as cochair of Morrison & Foerster's Securities Litigation Group. Over the past 25 years, he has represented numerous companies, officers, and directors in various securities cases, including class actions, derivative actions, SEC enforcement proceedings, and internal investigations. He also represents financial institutions in individual actions brought by investors and portfolio companies. Mr. Rains has successfully tried cases in federal and state court and before the National Association of Securities Dealers, the New York Stock Exchange, and the American Arbitration Association.
drains@mofo.com

**JAHAN P. RAISSI** is a partner in the San Francisco office of Shartsis Friese and cochair of the firm's Securities Enforcement Defense Group. Prior to joining the firm, he was an enforcement attorney with the SEC's Division of Enforcement in Washington, D.C. Mr. Raissi represents public companies, officers, directors, auditors, and securities industry professionals in securities litigation, SEC enforcement actions, investigations by self-regulatory organizations such as the NASD and NYSE, and internal investigations.
jraissi@sflaw.com

shares. You put that in the plan at the beginning.

**VANYO:** Companies will need to solve the problem of when they allow people to implement the plans. They might consider having a certain time set every year, perhaps after the close of the year when everybody is issuing annual filings and everybody is well informed. If you want to do a plan, you have to create it at the same time every year for everyone in the company. A limited window will be a month or even shorter because that's the key: what you know when you are setting up the plan. Once you set that up, there's no issue about material nonpublic information and I think you are okay. You might want to do the same thing for termination: name the window [during] which you can terminate a plan.

**RAINS:** If the company doesn't step up and do it, individuals can have their own annual plans. Every January an executive should sit down with his financial planner and create an annual 10b5-1 plan. If you get on a pattern like that and you have a witness, like a financial planner, and a financial plan in writing telling you to do it every year, you are creating this record that shows you are not gaming the system. You are on a regular pattern.

**MODERATOR:** The Delaware Court of Chancery, which has a reputation of being business-friendly, issued a decision in February that allowed the options backdating case *Ryan v. Gifford* to go forward. In that case, the compensation committee of Maxim Integrated Products granted stock options to John Gifford, the company's CEO at that time. What are the implications of that decision?

**VANYO:** The *Maxim* case is not good news for the 160 or so companies that are implicated in backdating options and defendants in derivative suits. The decision says that it's a breach of fiduciary duty to violate the shareholder-approved plan. That's not a tough decision to reach. It was an expected result. What was uncertain was exactly how the court would find that [result]. Going forward, I can see backdating taking place purely by accident and in very rare circumstances. In the current cases, it's going to make it more difficult to defend the case, and it will be harder to get them terminated at any sort of early stage. It will also make it more difficult for a special litigation committee to get the case terminated.

**RAINS:** Certainly it will be more difficult to get these cases dismissed in Delaware, but that hasn't been our experience in California. In the cases that have been decided after *Maxim* in the last three months in the Northern District of California, in every case I'm involved in and every case I'm aware of, the judge has recognized that *Maxim* is out there but concluded it's different on its facts. These courts are still dismissing complaints for failure to plead demand futility. Now, that's a data sample of only three or four cases. But so far no one out here has followed *Ryan* in concluding that demand would be futile. Perhaps one consequence will be that cases will be filed in Delaware instead of California. Other than that, it's too soon to say that *Maxim* is going to change the courts' perspectives about what has to be pleaded to make one of these cases good enough to go forward.

**RAISSI:** Other courts have applied the traditional barriers to derivative cases in options cases. It's not so much the legal technicalities, but the tenor you get from the *Maxim* case is one of permissiveness. The court was finding a way to allow the case to navigate the various prohibitions and survive at the pleadings stage, and that permissive tenor was probably the most important thing about the decision.

It seems to signal an open sign in Delaware for these cases, whereas in other jurisdictions we really haven't seen judges accommodating these cases any differently than ordinary derivative cases.

**KLEIN:** You have an indication as to the roadmap that potentially is being set up for Delaware. But we have to keep in mind that these are early stage decisions. These are not final decisions, findings of liability in cases, but rather in cases on early motions. There will be opportunities for further commentary to be made on these issues, or for the Delaware Supreme Court potentially to step into the situation and speak.

*Maxim* does very much countertrend against where Delaware has gone providing pretty broad protection to directors. At the same time, it seems that to some extent, this is a continuation of the

Delaware court's stated concern in the *Disney* [Michael Eisner] case as to excessive executive compensation and at what point compensation becomes a burden, if you will, and takes value away from the shareholders, which directly breaches the fiduciary duties of directors to the shareholder to assure the greatest value for the shareholder. So if we look at this in the context of the prior rulings on executive compensation, it does make sense. If we look at this as a broader commentary on the business judgment rule or as a change in the direction of Delaware law, I don't believe that that's an accurate viewpoint at this point.

**RAINS**: The focus in *Ryan* is on compensation committee members, and that is the battleground right now. What the courts in California have correctly recognized is that a company can admit it has measurement date problems with its options without concluding that fraud occurred. It could be innocent process errors or negligent processes or bad paperwork. There are all sorts of explanations short of fraud that can require you to do a restatement.

Similarly, California courts are also appreciating that even if fraud occurred, it may have been by someone other than compensation committee members. For purposes of trying to get a case dismissed for demand futility, it's the current directors who matter. So even current compensation members may be qualified to consider a shareholder demand.

**KLEIN**: In *Maxim*, the court is very much focused on the fact that the stock option plan was adopted by the stockholders. The plan stated that grants would not be made below fair market value and the public disclosure was made and was relied upon by the marketplace, by the stockholders. It seems almost as though the chancellors are suggesting that the directors forgot to look at the plan and paraphrasing the directors' actions as, "We did say were going to issue only at fair market value, and yet here we are issuing at a price that, because it's backdated, is less than current fair market value."

You could take the perspective that the court is essentially slapping the directors on the hand for failing to fulfill their duty of care —not just the duty of loyalty—for getting proper advice and going through the process and remembering that essentially they made a contract with the stockholders as to at what prices options would be granted. If the plan had been amended and the plan had allowed for backdating to occur, I would suggest the result here in *Maxim* would have been much different.

**RAINS**: One good part of *Ryan* is the reaffirmation of the standing requirement under Delaware law. Basically Delaware law has always said that a plaintiff must have held the company's stock at all times when wrongdoing allegedly occurred. A plaintiff must also hold the stock at the time the action is filed. Stock option backdating cases typically reach back to 1997 or earlier. There aren't very many shareholders who bought in 1997 and still hold their shares today. We may see that a lot of these cases will evaporate because the plaintiff actually doesn't have standing to bring some or all of the claims.

**MODERATOR**: What is the impact of securities litigation on outside directors?

**RAISSI**: It was recently reported that outside directors had to go out of their own pocket to the tune of $41 million to settle a securities class action case, which was more than the outside directors had to pay in *Enron* and *WorldCom* combined. That's a frightening prospect for an outside director. Although cases where directors personally pay are rare, people are asking, "What is the benefit that outweighs the potential risk of being a director?"

**RAINS**: The costs often outweigh the benefits. Even if the risk of having to pay your own money to settle litigation is only one percent, that's not the only risk a director faces. The risk may be 20 percent that an audit committee member will have to devote maybe 300, 400 hours this year to an internal investigation, followed up by depositions about his work, Why would a director want to do that? Few people think: "Yes, I'd like to spend a good part of my time with lawyers investigating my officers or my fellow directors." It's not attractive.

**RAISSI**: It's hard to see the upside compared to the risk, and unfortunately, it's scaring away a lot of really good people from public companies.

**RAINS**: As a result, directors will have to get paid a lot more. The continuing trend is that directors are no longer seen as business counselors who bring expertise and experience to complement the CEO. Instead, directors are seen as compliance officers who have experience in accounting or legal matters and are expert at dealing with compliance problems, whistleblowers, and investigations.

**RAISSI**: It does pose a challenge for companies and executives in populating a board that's exactly right. There is a bent toward compliance these days, and the challenge is for boards to be structured in the way that you have people with the technical expertise, perhaps former auditors, accountants, attorneys on the board, and you also have a cadre of business executives and business professionals that can bring the business perspective to bear. The danger here is that we lose perspective. There's an underlying business here that needs to grow and prosper, instead of only focusing on compliance matters.

**KLEIN**: If you think about the supply pool for directors who are qualified to serve on audit committees, that pool is relatively thin if you look at the number of public companies out there. So by its nature, you will find that the larger companies will have qualified people, but that the smaller public companies find it much more difficult to get people to serve, especially because the perception is that the smaller companies do not have the infrastructure because of the daunting cost to ensure compliance. Therefore you have a vicious cycle where you are not going to be able to attract the necessarily better qualified people because they are worried about the lack of infrastructure, and it keeps circling around.

**VANYO**: If you talk to the headhunters who search for and supply the directors for the public corporations, they will tell you that there has not been a lack of interest in being a member of a board of directors. There hasn't been a fallout because a lot of people like the privilege and stature of being on a public company board. Also, if you get stock options, even if they are not backdated, it's not a

$40,000 or $80,000 a year job. It could be a multi-million-dollar job over the course of time.

But the one complaint you hear from the board members today is that too much time and cost is being devoted to corporate governance, to Sarbanes-Oxley, all these controls, and not enough time to running the business and making it profitable and making strategic decisions.

**KLEIN:** When you are looking as a director at the part of the company that requires an internal investigation, that's one thing and likely won't scare a director candidate away. But when you are looking at the possibility of seeing your own name all over the media as a significant target, with the Delaware Court of Chancery questioning the business judgment of the directors and saying that the directors acted in bad faith or intentionally, that's a much more uncomfortable situation to deal with.

**MODERATOR:** Companies have been complaining about the cost of complying with Sarbanes-Oxley (SOX). What do you think about the SEC and Public Company Accounting Oversight Board's [PCAOB] suggested revisions and interpretations to Section 404 of SOX?

**KLEIN:** The cost of compliance with 404 has far exceeded what anyone forecast at the time it was implemented and proposed. The SEC has proposed some guidance to try to make the compliance process a little bit more efficient and cost effective. First, there's a delay provision so newly public companies don't have to comply with the 404 rules until their second annual report. But they do have to put into the filings that they are not including the necessary reports and certifications of internal controls. Secondly, the compliance deadline for nonaccelerated filers has been extended to the end of this year, so management reports are now required for all annual reports that cover fiscal years ending December 15, 2007 or thereafter.

My partner, Herb Wander, was the cochair for the SEC Advisory Committee on Smaller Public Companies, which was the task force put together by the SEC to come up with recommendations on how to modify and appropriately reduce the adverse effect of Sarbanes-Oxley on the smaller public companies. These changes adopt some of the concepts put forth by the advisory committee's report.

One of the main concepts is scalability. For companies that are less complex from an audit perspective and from a internal controls perspective, the auditors would be encouraged to use more professional judgment and not have to go through each and every absolute step to the maximum extent possible, essentially encouraging the auditors to avoid the checklist mentality of protecting themselves by checking every single box not once, but three times, which is in large part where we've seen much of the transfer of wealth from the corporation to the accounting firms.

**VANYO:** How is the SEC defining what a small company is?

**KLEIN:** It does not at this point. The change to 404 does not relate to the size of the company. It merely states that there is the opportunity for auditors to scale and to use professional judgment in how they apply the standards of 404 to the companies. You may have a very large company that may somehow be seen as less complex than other companies of similar size. Size doesn't matter in this type of situation.

**VANYO:** The PCAOB was created with oversight over the auditors, and they were very stern coming into this—not allowing any kind of mistakes. You had a combination of a statute that had a checklist approach saying you have to go through all of these things even if they don't apply, and you had an organization created that was making sure you were checking all those boxes and giving you no latitude. This approach has been a big part of what's caused these things to be not just expensive and time consuming but also producing unnecessarily burdensome reports.

**RAISSI:** Section 404 fell heavily on all companies, but especially on smaller public companies, because there was one size fits all mentality. The Ciscos and Apples of the world started out as small public companies, and it doesn't make sense if we are deterring such companies from going public or imposing an undue burden on management.

The proposals from the SEC and PCAOB certainly attempt to address those issues. We'll see out in the field how much auditors actually back off of this area. There's nothing but potential risk for them in doing so, which leads me to believe that not a lot is going to change in the near term.

**VANYO:** A couple of things need to happen. One is that PCAOB has to make it clear by its actions and not just words that it's fully supportive of this, and it's not going to be punitive with auditors for doing this. The other is that companies need to use this now as a weapon in their discussions with auditors when they go through this procedure. They should keep pointing them to the revisions and saying, "You are supposed to be using your judgment, let me see you use your judgment and let me see you use your judgment intelligently."

**RAISSI:** To the PCAOB's credit, they did specifically call out a few procedures that had been required in this area, but which will no longer be required. So those would certainly be areas that companies could specifically point to and say, " We don't need to do those tests anymore," and they did allow auditors much more latitude in relying on work performed on the ordinary audit to serve double duty for 404 purposes, which should streamline some of this.

**RAINS:** I'm not very optimistic. We've all recognized that there's a huge disconnect between the perceived problem and the solution that's been implemented. The problem was financial fraud at companies like Enron and WorldCom, and the solution was to have a bunch of accountants and regulators write up a bunch of procedures to follow. They came up with solutions that really are not well correlated to the problem.

When I deal with companies and I find out what they are doing for 404 compliance, I scratch my head and say, "I don't understand how what you are doing reduces the risk of financial fraud." Most of what they are doing is checking boxes. The idea that those same regulators are now talking about streamlining their own regulations is moderately encouraging. But they are not asking: "Are we focusing on high-risk fraud areas or are we just creating checklists for people?"

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