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MARCH 2018

RESTATEMENTS AND LATE PERIODIC REPORTS

Energy Series

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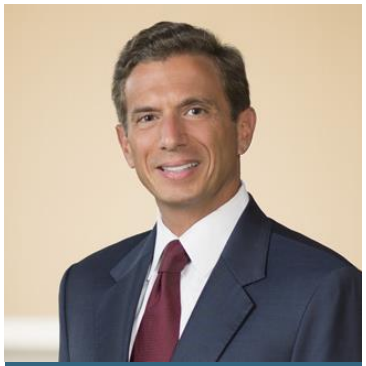
Representations and Warranties Insurance in Energy M&A: An Old Product Gets a New Look

Wednesday, April 11, 2018

Speakers: Caroline Blitzer Phillips (V&E); Sarah Mitchell (V&E); Craig Schioppo (Marsh USA Inc.)

TODAY'S PANEL



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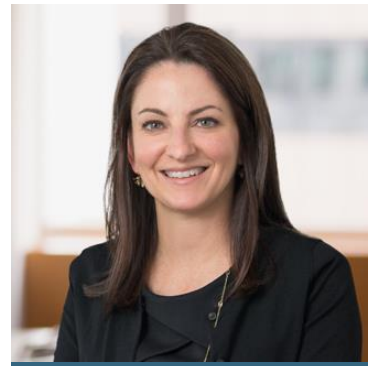

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TOPICS

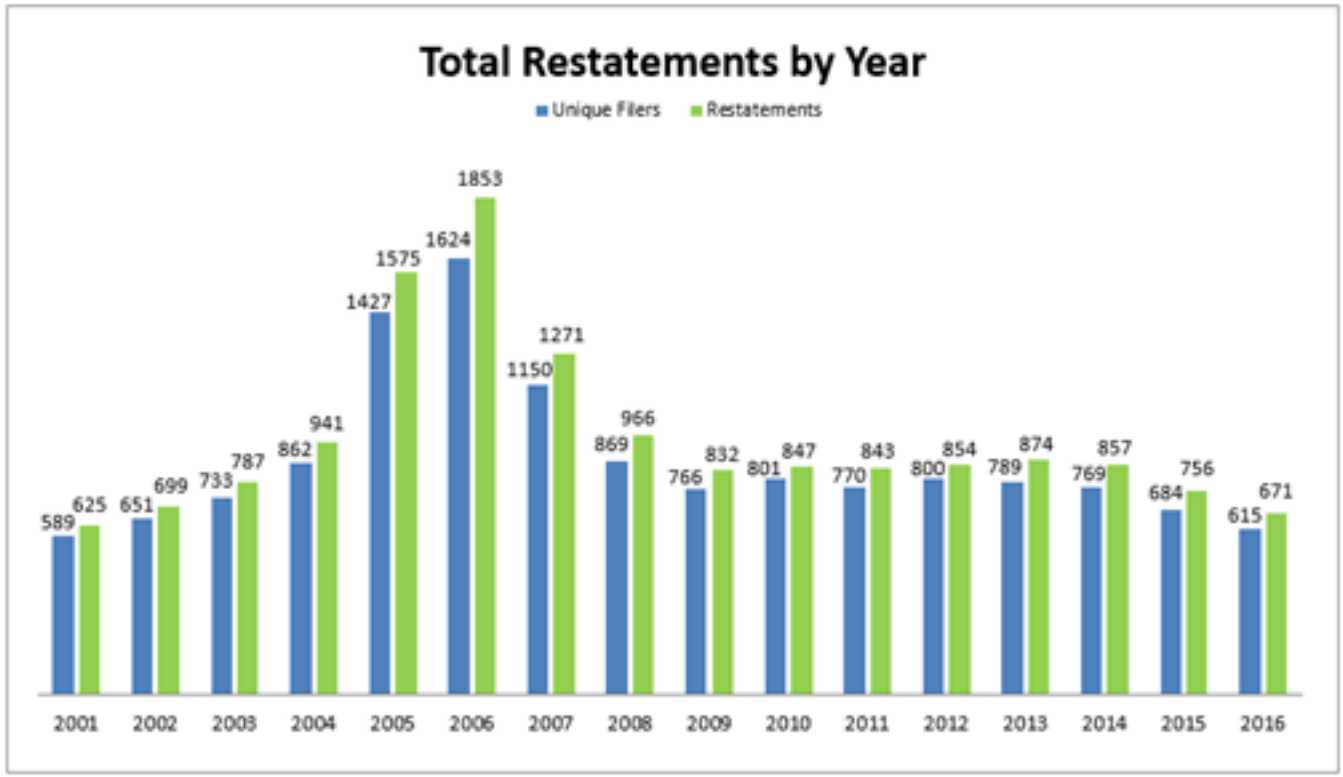
FINANCIAL RESTATEMENTS DATA

- In 2016, we saw an all-time low in the number of restatements filed
  - 6.8% (or just 671) of the 9,831 reporting companies disclosed that they would need to reissue or revise their financial filings
  - A decline of 11% from 2015
- Lowest number of restatements in 15 years
- Tighter regulation and a decline in the number of U.S. listed companies are believed to be the two key drivers behind the decline
- 51 accelerated filers disclosed restatements in 2016 – the smallest number in 7 years

Most restatements occur in March, April and November, when auditors begin or complete their year-end audit work

Source: Tatyana Shumsky, "Financial Restatements Hit Six-Year Low," *Wall Street Journal* (June 7, 2017)

RESTATEMENTS TREND



Source: Audit Analytics, *2016 Financial Restatements Review* (June 12, 2017)

COMMON CAUSES OF RESTATEMENTS

- Errors made in the calculation of specific types of taxes and credits
- Changes in valuation allowances
- Improper classification of current and non-current deferred tax assets
- Errors in the calculation of the tax effects of stock-based compensation
- Errors in purchase accounting adjustments and goodwill impairment calculations
- Incorrect revenue recognition

Significant changes in tax laws and in revenue recognition standards effective in 2018 may increase the risk of accounting errors and reissuance restatements in the next few years.
Audited revision restatements will be required for many companies filing new registration statements after their first 2018 10-Q.

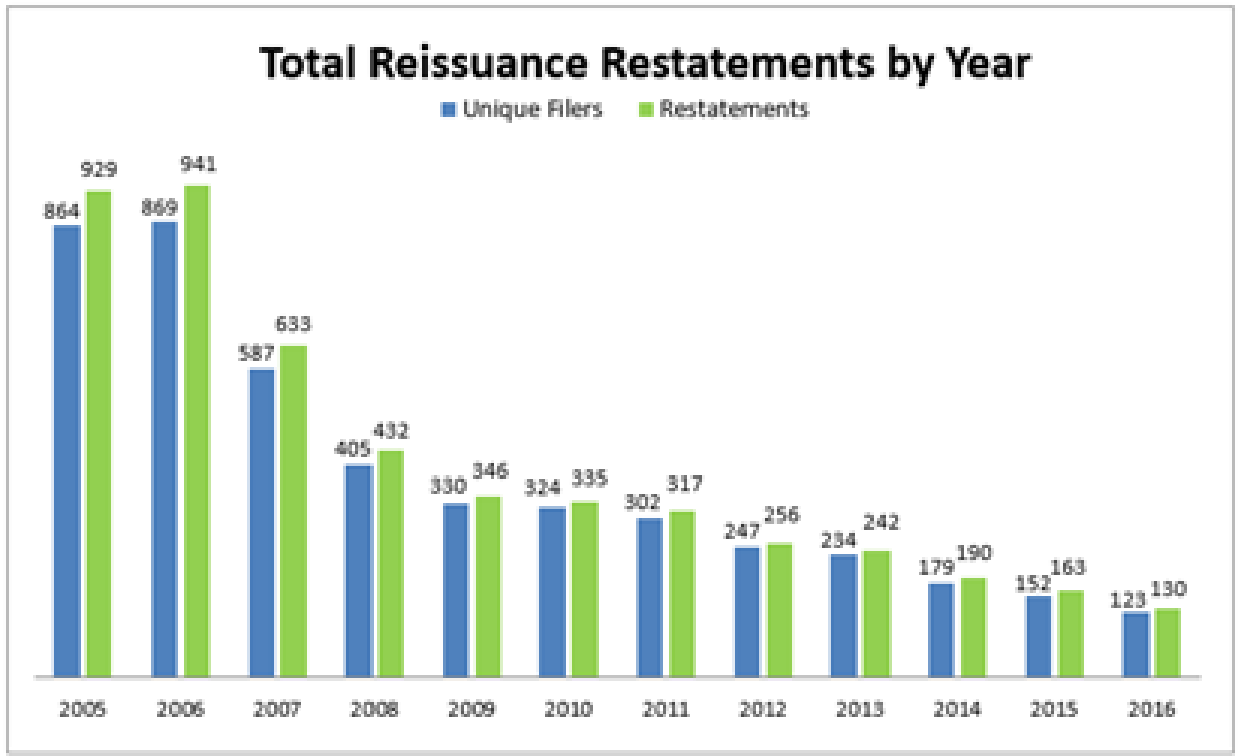
THREE POSSIBLE RESULTS FROM RESTATEMENT ANALYSIS

- Reissuance restatements (or “big R” Restatement)
  - Errors in previously issued financial statements are corrected—restated—and reissued
  - Involve amendment of previous SEC filings or “Super 10-K” filing
  - Often involve withdrawal of reliance on prior financial statements
  - Often, but not always, involve late periodic reports while possible restatement is under evaluation
- Revision restatements (or “little r” restatement)
  - Recast past information in current reports, such as for discontinued operations, changes in accounting principles, or to correct accounting errors not material enough to merit reissuance restatement
  - Sometimes involve late periodic reports while possible restatement is under evaluation
- No restatement
  - May still involve material weakness disclosure

REISSUANCE RESTATEMENTS

- Type of restatement that addresses material errors that call for the reissuance of a past financial statement
- Declined for the tenth year in a row since 2004, when the Form 8-K disclosure requirements came into effect for withdrawal of reliance on previously issued financial statements
- Record low of 130, a sharp decline from 2006's 941, the highest number in the past 11 years

REISSUANCE RESTATEMENTS (CONT.)

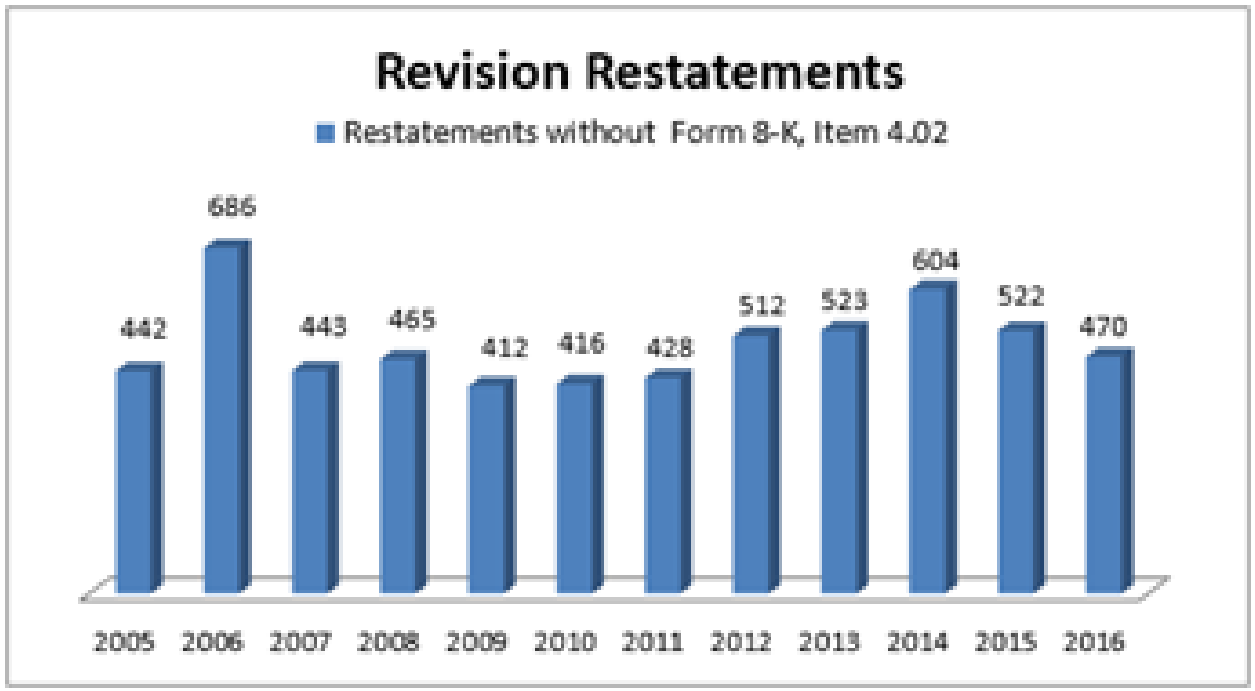


Source: Audit Analytics, *2016 Financial Restatements Review* (June 12, 2017)

REVISION RESTATEMENTS

- Type of restatement that deals with immaterial misstatements or adjustments made in the normal course of business
  - Generally less severe and not looked at as a sign of poor reporting
- The total number has remained fairly steady, but the overall percentage compared to all restatements has been gradually increasing
- The vast majority of all restatements in 2016 (78.8%) were revision restatements

REVISION RESTATEMENTS (CONT.)



Source: Audit Analytics, *2016 Financial Restatements Review* (June 12, 2017)

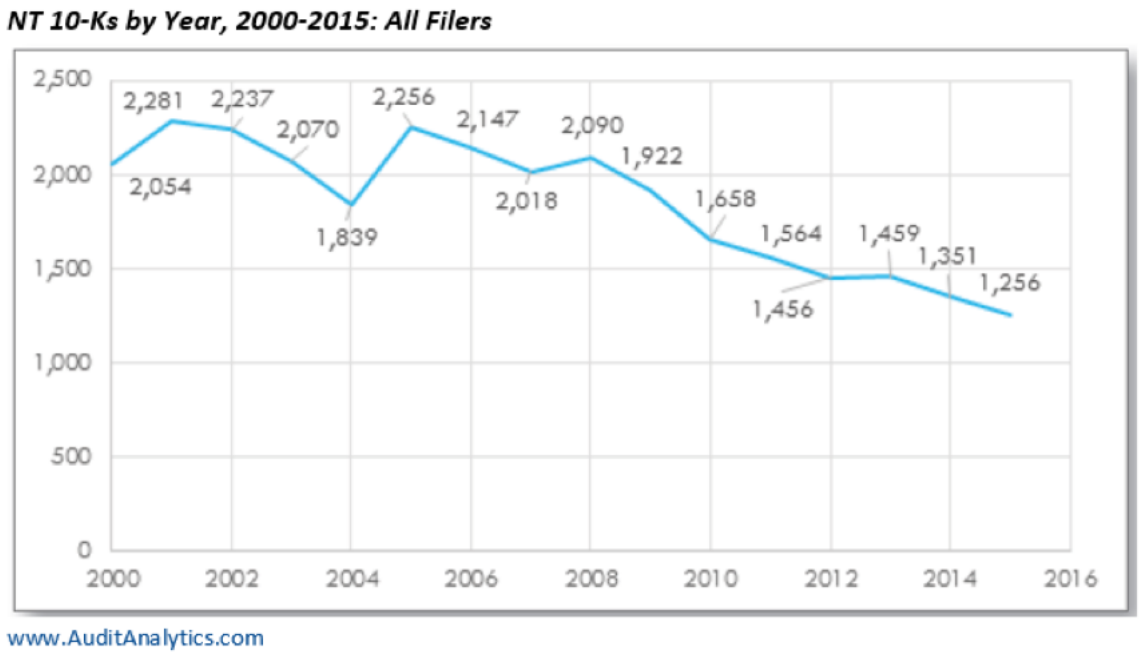
AUDITED REVISION RESTATEMENTS MAY BE REQUIRED
IF SECURITIES ACT REGISTRATION FOLLOWS RECAST 10-Q

- After its Form 10-K is filed, a registrant has a change in accounting principles (or changes in segment presentation or discontinued operations), which will cause the financial presentation in its subsequent Form 10-Qs to differ from that in the Form 10-K
- The registrant files one or more 10-Qs reflecting the recast financial information for the year-to-date and comparable prior-year periods
- The registrant thereafter files a new registration statement (other than Form S-8) incorporating previous Exchange Act filings
- Before filing the Securities Act registration statement, the registrant must file an 8-K containing annual audited financial statements that are restated to reflect the change in accounting principles (or changes in segment presentation or discontinued operations)

See Topic 13 of the SEC's Division of Corporation Finance *Financial Reporting Manual*

LATE PERIODIC REPORTS

- From 2000 through 2015, the number of late annual filings decreased significantly. Each year, between 18% and 24% of all filers were delinquent with their annual reports.



Source: Audit Analytics, Blog, “Hain Delays Filings: What to Expect”

LATE PERIODIC REPORTS (CONT.)

Most common reasons for late annual filings from 2002-2015:

NT Reason	Number of Filings	% of Filings
All accounting reasons	815	38.1%
Restatement of financials pending	457	21.4%
Internal control / Sarbanes Oxley (404 or 302) assessment issues	417	19.5%
Material weakness issues with ICFR or DC preparation	270	12.6%
Investigation underway, special committee (internal, external or SEC)	214	10%

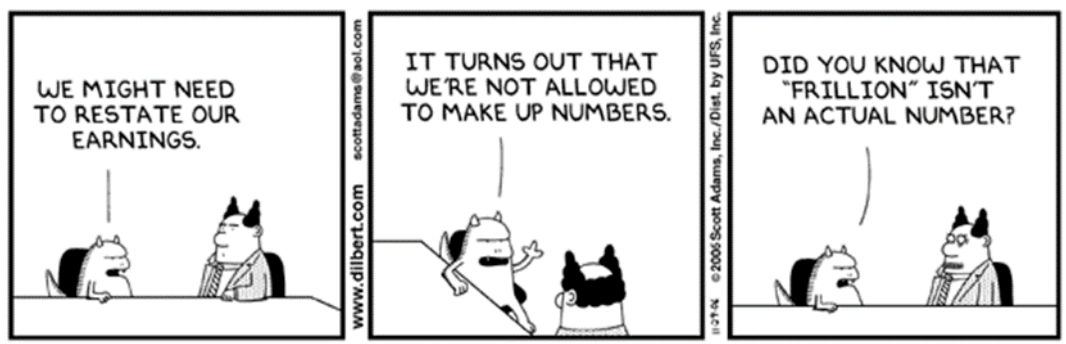
Source: Audit Analytics, Blog, “Hain Delays Filings: What to Expect”

LATE PERIODIC REPORTS: POTENTIAL CONSEQUENCES

- Inability to raise capital through issuance of public securities
- Debt covenant violations
- Late filers are prevented from issuing securities using the short-form shelf registration statement (Form S-3) in the year following the late annual report
- Issuers are unable to hold their annual meetings until their annual report is properly filed
- Signal of underlying problems to its stockholders, possibly resulting in a decline in the issuer's trading price
- Deregistration by the SEC and/or stock exchange on which the issuer trades
- Stockholder litigation

IT STARTS . . .

- After the earnings release, but the day before the 10-Q is due, the CFO calls and says her current auditors have informed her that they have identified a possible error in the audited and comparable period financial statements, which may result in a restatement. The auditors are new, and the possible error affects the financial statements audited by a different accounting firm. The current auditors are uncertain about their ability to complete their SAS 100 review because of the possible error.
- In a bit of a panic, she quickly conferences in the audit partner and company counsel and asks how to deal with this.



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PROCESS CONSIDERATIONS

- Assemble the correct team internally and externally
  - Accounting and financial reporting
  - Internal audit?
  - External auditors
  - Other external accounting consultants?
  - Legal (internal and external), both SEC and litigation
  - Investor relations
    - Depending on severity and stage in process, external strategic communications firm
- Advise Audit Committee and, if appropriate, Board
  - If management fraud appears to be a factor, then likely to move toward independent committee/independent counsel review and investigation

PROCESS CONSIDERATIONS (CONT.)

- Evaluate what is currently known about the possible errors, their cause, magnitude, and certainty or uncertainty
  - What more needs to be done to evaluate?
  - How long will it take?
  - How will press release and filing plans or deadlines likely be affected?
- Management normally should prepare a memorandum that will document the analysis under relevant accounting and SEC standards and make a recommendation about treatment
  - Reviewed by external legal counsel and auditor national office
  - See suggested memorandum outline in “Restatement Standards”
- Who decides whether to withdraw reliance or restate?
  - Should be the Audit Committee or full Board

SOME INITIAL ISSUES IF THE PERIODIC REPORT WILL BE LATE WITHIN GRACE PERIOD

- Press release and conference call
- Form 12b-25 (EDGAR Code NT)
- Careful application of restatement standards
- Possible applicability of Form 8-K, Item 4.02 (withdrawal of reliance on previously issued financial statements) if reissuance restatement is the conclusion

Press Releases

PRESS RELEASE/CONFERENCE CALL

- Timing—upon filing of 12b-25 or only if the deadline will be missed or a restatement will occur?
- Content—balance company's uncertainty about many things with the market's desire for information and completeness
  - What dollar amount is at issue, and where in the financial statements (e.g., revenues, net income, cash flow classification, balance sheet)?
  - What are the nature and scope of the issue or possible restatement?
  - What financial periods are potentially affected?
  - What caused the possible errors?
  - Who was responsible?
  - How will it be fixed?
  - When will it be resolved?
  - Effect on prior guidance?

MORE PRESS RELEASE CONTENT

- Ability to file SEC reports timely
- Effect on business, customers, material agreements
- Nature of internal review or investigation
- Nature of government inquiry, investigation or enforcement
  - Including any self-reporting to the regulators
- Internal control status
- Intention to update or not
- Risk factors and forward-looking statement disclaimers should be updated for the accounting issues or periodic report issues

Form 12b-25

Notification of Late Filing

FORM 12B-25: NOTIFICATION OF LATE FILING

- A notification of late filing on Form 12b-25 (EDGAR Form NT) must be filed no later than one business day after the due date of the periodic report and must explain in detail the reasons behind the late filing
- It must be filed **whether or not** an extension in the filing deadline is sought
  - Extensions are one-time; 5 calendar days for 10-Q; 15 calendar days for 10-K; not available to extend 8-K deadline; not available to extend 120-day rule to incorporate proxy statement into Part III of Form 10-K
- Check the box if the periodic report will be filed within the extended deadline
  - Don’t check the box if you won’t meet the deadline
- Periodic reports are timely if filed within the extended deadline, *assuming eligibility to use the extension*

FORM 12B-25 (CONT.)

- Extension is predicated on good faith representations that
  - The reasons for the delay could not be eliminated without unreasonable effort
  - The report will be filed within the extension
- Part IV contains a representation regarding whether there will be any significant changes in results of operations from the comparable period of the prior year.
  - You must explain significant changes quantitatively and by narrative, or explain why a reasonable estimate cannot be made.
- Rule 12b-25(c) requires an accountant's letter to be attached if the reason for the late report is attributed to the accountant's inability to complete its report, opinion or review
- The Rule does not apply to reports required to be filed in electronic format if the sole reason the report is not filed within the time period prescribed is that the filer is unable to file the report in electronic format

ENFORCEMENT ABOUT FORM 12B-25

- ***SEC v. Spiegel***, SEC Litigation Release No. 18020 (Mar. 7, 2003): Spiegel's auditors stated its opinions may have a going concern qualification. SEC said Spiegel did not disclose that to the public, but filed various Forms 12b-25 stating that it could not file its reports because various lending agreements were not in place. SEC brought an action for injunctive relief, disgorgement, and civil penalties for violations of the reporting and anti-fraud provisions of the Exchange Act, resulting in a consent order in the SEC's favor.
- ***In re FFP Marketing***, SEC Proceeding 34-51198 (Feb 14, 2005): This cease and desist order includes findings that the company and its officers failed to disclose in a Form 12b-25 a pending study of certain accounts, did not disclose the fact that auditors would not provide an unqualified report, did not provide an appropriate narrative and quantification of changes from prior period, and failed to attach the letter required from the outside accountants.
- **Failure to file a Form 12b-25** may violate the Exchange Act. *SEC v. Learning Annex*, SEC Litigation Release No. 12418 (May 21, 1990).

Restatement Standards

THE REQUIREMENT TO RESTATE/ TRIGGERS TO RESTATEMENT

- FASB Topic 250 (formerly SFAS 154) – Accounting Changes and Error Corrections
  - Establishes GAAP analysis for reissuance and revision restatements
- SAB 99 – Materiality
  - Provides guidance in applying materiality thresholds to the preparation of financial statements filed with the Commission
  - Requires both quantitative and qualitative analysis of materiality
- SAB 108 – Considering the Effects of Prior Year Misstatements When Quantifying the Misstatement in Current Year Financials
  - Major objective is to eliminate inconsistencies in the treatment of historical accounting errors
  - Requires both iron curtain and rollover analysis of effects of errors

TOPIC 250 – ACCOUNTING CHANGES AND ERROR CORRECTIONS

Errors in previously-issued financial statement may include:

- An error in recognition, measurement, presentation or disclosure in financial statements
- Errors as a result of mathematical mistakes, mistakes in the application of GAAP, or oversight of facts that existed at the time the financial statements were prepared

Change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

TOPIC 250 – ACCOUNTING CHANGES AND ERROR CORRECTIONS *(CONT.)*

- Any error in financial statements of a prior period, discovered subsequent to their issuance, must be reported as a prior-period restatement by restating the prior-period financial statement.
- The registrant must disclose that its previously-issued financial statements have been restated, along with a description of the nature of the error.

SAB 99 – MATERIALITY

- SEC Staff Accounting Bulletin 99 ("SAB 99") addresses the application of materiality thresholds to the preparation and audit of financial statements and states that the test of materiality includes ***both*** a quantitative and qualitative analysis.
- Among the considerations that may make material a quantitatively small misstatement of a financial statement item is whether the misstatement:
  - Arises from an item capable of precise measurement or whether it arises from an estimate, and, if so, the degree or imprecision inherent in the estimate;
  - Masks a change in earnings or other trends;
  - Hides a failure to meet analysts' consensus expectations for the enterprise;
  - Changes a loss into income, or vice versa;
  - Concerns a segment or other portion of the registrant's business that plays a significant role in the registrant's operations or profitability;
  - Affects the company's compliance with regulatory requirements;
  - Has the effect of increasing management's compensation; or
  - Involves concealment of an unlawful transaction

SAB 99 – MATERIALITY

- There is not a bright-line threshold in assessing materiality; nevertheless, a quantitative threshold (such as 5%) is acceptable to use as an initial step in assessing materiality
- Insignificant misstatements resulting from the normal course of business do not require restatement
- Cost-benefit considerations are a factor in correcting small restatements
- The aggregate effect of a series of individually immaterial misstatements may result in the financial statements as a whole being materially misleading

SAB 108 –CONSIDERING THE EFFECTS OF PRIOR YEAR MISSTATEMENTS WHEN QUANTIFYING THE MISSTATEMENT IN CURRENT YEAR FINANCIALS

- Prior year misstatements should be considered in quantifying misstatements in current year financial statements
- Registrants must quantify the effect of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements; financial statements must be adjusted when either the rollover approach or the iron curtain approach results in quantifying a misstatement that is material

SAMPLE OUTLINE OF MEMORANDUM EVALUATING ISSUES

I. Statement of Issue

A. Nature of error/potential error

B. How the potential error was identified

II. Accounting treatment

A. Review of relevant accounting literature about the proper accounting

B. Recommended conclusion about accounting treatment

III. Assessment of materiality of the error under accounting standards

A. Summary of relevant accounting literature

1. SAB 108 (Considering the Effects of Prior Year Misstatements when Quantifying Misstatement in Current Year Financial Statements)

2. SAB 99 (Materiality)

3. ASC Topic 250 (former SFAS No. 154) (Accounting Changes and Error Corrections)

SAMPLE OUTLINE OF MEMORANDUM EVALUATING ISSUES (CONT.)

B. Application of accounting literature

1. Discussion (with attached spreadsheets) of rollover and iron curtain analysis and any numerical materiality (SAB 108)

2. Discussion of qualitative aspects of materiality (SAB 99)

3. Proposed conclusions about materiality

4. Proposed corrective actions or changes to internal controls and disclosure controls

IV. Assessment of materiality under general securities law standards (*Basic v. Levinson*) and line item disclosures

A. Materiality to investors

B. Line item disclosure issues (including interpretive guidance when relevant). In addition to the notes to the financial statements, the typical line items or customary disclosures to consider are:

1. MD&A (Reg. S-K, Item 303)

2. Significant accounting principles

SAMPLE OUTLINE OF MEMORANDUM EVALUATING ISSUES (CONT.)

3. Management's assessment of the effectiveness of internal control over financial reporting (S-K, Item 308(a))

—Is the error evidence of a material weakness or significant deficiency?

4. Changes in internal control over financial reporting (S-K, Item 308(c))

5. Disclosure controls and procedures (S-K, Item 307)

V. Assessment of need to withdraw reliance on prior financial statements

If the conclusion is that the error is material, consideration should also be given to whether the reliance on the prior financial statements should be withdrawn (Form 8-K, Item 4.02)

VI. Proposed course of action

This should include proposed disclosure (in general terms or specific language) and proposed amendments, if any

The memorandum often is completed in stages, but ultimately is an important guide for analysis and a contemporaneous record of analysis

Note: Clawback effects, if any, are generally not addressed in the accounting memorandum, but should be considered separately

Form 8-K Item 4.02

FORM 8-K ITEM 4.02

- Required to be filed for determination that previous financial statements should not be relied on
- Notice of withdrawal of reliance on previous financial statements must be made on Form 8-K Item 4.02, even if a 10-Q or 10-K containing the information is filed within four business days after the determination
  - See Exchange Act Form 8-K, CD&I 101.01 (April 2, 2008), stating that Form 8-K events can be reported on Forms 10-Q and 10-K filed within four business days of the triggering event **except for** events under Item 4.01 (changes in auditor) and Item 4.02 (announcement of non-reliance).

FORM 8-K, ITEM 4.02 TRIGGERING EVENT

- "If the registrant's board of directors, a committee of the board of directors, or the officer or officers . . . authorized to take such action if board action is not required" concludes that previously issued financial statements should not be relied on because of an error (Item 4.02(a))
- "If the registrant is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken" to prevent future reliance on previously issued financial statements (Item 4.02(b))
- Consider a resolution or Audit Committee Charter provision that only the audit committee or full board—but not management—can withdraw reliance on previously filed financial statements

IS FORM 8-K ITEM 4.02 FILING REQUIRED FOR EVERY RESTATEMENT?

- Item 4.02 refers only to cases where reliance on previous financial statements is being withdrawn. Does not apply to, for example:
  - discontinued operations, stock splits, changes in accounting principles
  - determination that restatement is not material
- **SEC Staff View**: Item 4.02 filing is not required for every restatement. Nevertheless, the staff would be surprised if financial statements were restated because of an error, but no Item 4.02 was filed, and the staff would likely question those situations.
  - See SEC Regulations Committee of the AICPA, Joint Meeting with SEC Staff, Sept. 13, 2004.

CONTENTS OF FORM 8-K ITEM 402(a) DISCLOSURE

- The date that the registrant concluded the financial statements should no longer be relied upon and identify the financial statements and years or periods covered that should no longer be relied upon
- A description of the facts underlying the conclusion to the extent known to the registrant at the time of filing
- Whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer(s), discussed the disclosed matters with the registrant's independent accountant

See SEC Division of Corporation Finance, *Financial Reporting Manual*, 4600

CONSEQUENCES OF LATE PERIODIC REPORTS

IT CONTINUES . . .

- Instead of resolving the issues in time to make a timely filing (within the 12b-25 extension period), even if that includes filing of a restatement in that period, suppose that the issue remains unresolved
  - Either it looks like a restatement is likely but will not be completed in the extension period, or
  - It is unclear whether there are accounting problems, but there are sufficient indicia that the accountants will not give their SAS 100 review.

SOME ISSUES IF THE PERIODIC REPORT WILL BE LATE

- Reporting results of subsequent periods
- Insider trading
- Rule 144 availability
- Debt Instrument covenant compliance
- Ability to hold an annual meeting and send an SEC-compliant proxy statement
- Use of existing Form S-3 registration statements
- Effect on stock-based plans, including outstanding awards and new grants
- Stock exchange listing standards and compliance
- Civil and criminal liabilities
- D&O insurance

Results of Subsequent Periods

REPORTING FINANCIAL RESULTS DURING AN INVESTIGATION OR CONSIDERATION OF RESTATEMENT

- What should be included in a press release about completed periods?
  - "estimated"
  - additional warnings about the possible restatement
- Should the company continue past forecasting or guidance practices?
- Should the company file a 10-K or 10-Q even though it is not complete (missing financials or auditor's review)?
  - Does that count as a timely filed periodic report?
- Should it provide results under 8-K item 2.02, 7.01 or 8.01?

Insider Trading Issues

TRADING BY INSIDERS

- Section 10(b) and Rule 10b-5 of the Exchange Act create liability for trading by insiders or the company while in the possession of material, non-public information
- Trading windows may need to be closed under insider trading policies during the 12b-25 extension period or during a pending investigation into accounting issues prior to filing of the restatement or determination that no restatement is required

SHARE REPURCHASE PROGRAMS

- For the same reasons, the company should consider ending share buy-backs during periods when it has material, non-public information (such as unreported financial results for completed periods)
- Consider effect on 10b5-1 plans for both the company and insiders

Rule 144

RULE 144

- Rule 144(c) requires the issuer to be current in its periodic reports for the prior 12 months (with the exception of Current Reports on Form 8-K)
  - No timely requirement, just filed.
  - "There is a risk in selling under Rule 144 during the 5-day or 15-day period following the filing of Form 12b-25, because if the missing report or portion thereof is not filed during that period, the issuer may be deemed not current until it is filed." SEC Div. of Corp. Fin. Compliance and Disclosure Interpretations 131.01 [Sept. 30, 2008].
  - Shut down Rule 144 sales until filed (consider shut-down during the Rule 12b-25 extension).
- Rule 144(b)(1)(i)—for non-affiliates who satisfy the one-year holding period—does not require that reports be filed.

Debt Instruments

DEBT INSTRUMENTS

- Restatements of financial statements may give rise to claims or events of default when the prior financial statements were the subject of a representation and warranty or covenant in debt instruments.
- Failure to provide financial statements in a timely fashion may also constitute a default.
  - Grace periods may apply before a lender may accelerate the debt
- Credit facilities, trust indentures, hedging instruments, letters of credit, bonds and other contracts should be reviewed carefully to evaluate the effect of a late periodic report or a restatement on the arrangement.

QUALIFIED INDENTURES

- A late periodic report may be:
  - A breach of a specific covenant in an indenture ("periodic reports shall be filed with the trustee 15 days after the company is required to file such reports with the SEC"), or
  - a violation of Section 314(a) of the Trust Indenture Act of 1939 that is incorporated in the terms of every qualified indenture,
  - or both.
- Ability to negotiate
  - Reporting covenants can be negotiated and amended
  - Section 314(a) cannot be negotiated, although the consequences of a violation of Section 314(a) may be addressed in the Indenture
- Hedge Funds have actively bought debt of issuers that are late in their reports in order to accelerate the debt or obtain a large consent payment to waive the default

QUALIFIED INDENTURES *(CONT.)*

- ***The Bank of New York v. BearingPoint*** (Supreme Court of New York, Sept. 18, 2006) held that the company's failure to file reports with the trustee when they were required to be filed with the SEC was an event of default under the indenture. The court ruled that it violated the reporting covenant and Section 314(a) of the TIA.
- ***Affiliated Computer Services v. Wilmington Trust Co.*** (5th Cir. 2008) and ***UnitedHealth Group, Inc. v. Wilmington Trust Co.*** (8th Cir. 2009) reached a contrary conclusion on both points, even though the indenture had substantially the same language.

INDENTURE RESPONSES TO BEARINGPOINT

- Provide that the failure to file SEC reports with the trustee when required by the SEC is a default and can result in acceleration (i.e., reinforce BearingPoint)
- Provide a grace period
  - "failure on the part of the Company duly to observe or perform in any material respect any other of the covenants or agreements…contained in this Indenture for a period of 90 days after the date on which written notice specifying such failure…shall have been given to the Company by the Trustee, or to the Company and the Trustee by the holders of at least 25% in aggregate principal amount of the Securities of such series at the time outstanding"
- Provide remedies other than acceleration of the debt, such as:
  - Temporary increase in the coupon
  - Right of trustee to sue for specific performance

Annual Meetings & Proxy Statements

PROXY RULES

- Rule 14a-3(a) prohibits a solicitation of proxies by management unless the recipient is concurrently furnished or previously has been furnished a filed proxy statement complying with Schedule 14A.
- Rule 14a-3(b) requires proxy statements relating to an annual meeting at which directors will be elected to be accompanied or preceded by an annual report to security holders containing, among other things, audited financial statements.
- Registrants unable to file audited financial statements cannot solicit proxies for an annual meeting. Financials are needed for the meeting.

DELAWARE GENERAL CORPORATION LAW

- If a Delaware company fails to hold an annual meeting for 13 months after the last annual meeting, the Delaware Court of Chancery may order the meeting upon application of a shareholder or director. DGCL § 211(c).
- Delaware courts will mandate that the meeting be held, even if the company cannot deliver SEC-compliant annual reports
  - *Esopus Creek Value LP v. Mark S. Hauf, et. al. and Metromedia International Group, Inc.* (Del. Ch., Nov. 29, 2006)
  - *Newcastle Partners L.P. v. Vesta Insurance Group, Inc.*, 887 A.2d 975 (Del. Ch. 2005), *aff'd*, 906 A.2d 807 (Del. 2005)
  - *Rich v. Fuqi Int'l, Inc.*, C.A. No. 5653-VCG (Del. Ch. Nov. 5, 2012)

POSSIBLE SEC RELIEF

- SEC has delegated to the director of the Division of Corporation Finance, in Rules of Practice 200.30-1(e)(18), the authority to review and grant or deny (unconditionally or on specified terms) exemptions from Rules 14a-3(b) and 14c-3(a) when the company
  - is required to hold a meeting of security holders as a result of action taken by a security holder under state law,
  - is unable to comply with the requirement to include audited financial statements,
  - has made a good faith effort to furnish the audited financial statements, and
  - has disclosed all available material information for security holders to make an informed voting decision
- Non-management proxies do not require audited financials, freeing them to attack when the company can't defend

NOTICE OF CHANGE IN MEETING DATE

- If a registrant advances or delays the date of its annual meeting by more than 30 calendar days from the meeting date in the prior year, Rule 14a-5(f) requires registrants to inform stockholders “in a timely manner” of
  - the new date of the annual meeting,
  - the new deadline for submitting stockholder proposals for inclusion in the proxy statement under Rule 14a-8, and
  - the new deadline for timely submission of a stockholder proposal other than under Rule 14a-8
- Notice must be in Item 5 of the earliest possible quarterly report on Form 10-Q or, if that is impracticable, by any means reasonably calculated to inform stockholders.

LISTING STANDARDS FOR ANNUAL MEETING

- Nasdaq Marketplace Rule 5620 requires Nasdaq stock market companies to hold an annual meeting within 12 months of fiscal year end.
- NYSE Listed Company Manual § 302 requires an annual meeting each fiscal year.
- Failure to comply must be promptly notified to the exchange and may be a basis for delisting.
- Form 8-K, Item 3.01(b) must be filed to report the failure to meet the listing standard.

STOCKHOLDER PROPOSALS IN PROXY STATEMENT

- When 120-day deadline in Rule 14a-8(e) applies, the SEC excludes shareholder proposals that are not timely. See, e.g., *Procter & Gamble Co.* (Aug. 1, 1983).
- When meeting is moved more than 30 days from the prior year, Rule 14a-4(c) [discretionary voting] and Rule 14a-8 [inclusion of stockholder proposals] require the proposal be submitted "a reasonable time" before printing and mailing.
- "Reasonable time" is not defined in Rule 14a-8 and is based on facts and circumstances
  - A fundamental consideration is whether the time of submission of the proposal affords the registrant reasonable time to consider the proposal without causing excessive delay in the distribution of proxy materials to its shareholders.
- *Avaya Inc.* (Dec. 4, 2001) and *Crescent Real Estate Equities Company* (Mar. 27, 2006) appear to reach opposite results on similar facts about what is a reasonable time.

RELATED REMINDERS

- The rules for changes in meetings of more than 30 days from prior year will likely apply in the year following the late annual meeting as the registrant seeks to return to its normal schedule.
- Record date requirements are in DGCL § 213(a) and typically also in the registrant's bylaws.
- Notice requirements are in DGCL § 222(b) and typically also in the registrant's bylaws.
- Bylaw or charter requirements for proper submission of stockholder proposals also apply.

Form S-3 Registration Statements

FORM S-3—NEW REGISTRATIONS

- Requires the issuer to have been current in its Exchange Act reports for the last 12 months (except for some 8-K items that can be delayed to the 10-Q or 10-K)
- Also requires that the issuer have been timely in those reports for the prior 12 months
- Under Rule 12b-25(d), cannot file new S-3 during extension
- Late periodic reports means issuer loses ability to file new S-3s (and loses WKSI status) for at least 12 months after it becomes current
- Do restatements have the same effect if reliance is withdrawn on previous financial statements? Does that depend on how soon restated financials are filed after reliance on prior statements is withdrawn?

FORM S-3—EXISTING REGISTRATIONS

- Anti-fraud—
  - Rule 10b-5 and Sections 11 and 12 considerations will often prevent underwritten transactions
  - Liability (private and government) under anti-fraud provisions should be considered in all transactions when a periodic report has not been filed or financials may be restated

FORM S-3—EXISTING REGISTRATIONS (CONT.)

- Sufficiency of the Statutory Prospectus—
  - Section 5(b)(2) requires a prospectus meeting the requirements of Section 10(a) to be delivered before or concurrently with the confirmation of sale of a security
  - Form 10-K and Form 10-Q are incorporated by reference and may be necessary for the prospectus to be sufficient under Section 10(a)
  - Rule 408 requires a prospectus to contain any material information
  - Sufficiency depends on the facts and circumstances
    - Late report issues may differ from timely reports when there is uncertainty about whether there will be a restatement
  - Violation may give rescission under Section 12(a)(1)
  - May be liable under Section 11, Section 12(a)(2) and Rule 10b-5

FORM S-3—EXISTING REGISTRATIONS (CONT.)

- **Staleness**
  - Section 10(a)(3) provides that a prospectus used more than nine months after the effective date of the registration statement must contain audited financial statements as of a date no more than 16 months before the date of use.
  - This results in a staleness date at the end of April for issuers with a calendar year end that fail to file a 10-K for the latest year (assuming nine months have passed since effectiveness).
  - Query whether staleness occurs upon due date of the 10-K (if the Form 10-K is not filed) because of the undertakings in Reg. S-K, Item 512, to update the registration statement by post-effective amendment unless the issuer files its annual report containing that information. See SEC: Securities Act Rules CD&I 198.02 [November 6, 2008], where the staff treats the 10-K as the equivalent of a post-effective amendment to the registration statement.
  - If the conclusion is that the 16-month standard applies, filing of late 10-K within the 16 months nevertheless causes loss of the use of the registration statement (eligibility retested under Rule 401 upon 10-K filing).

FORM S-3—EXISTING REGISTRATIONS (CONT.)

- Selling Stockholder Shelf Registration
  - During a Rule 12b-25 extension, ongoing secondary offerings from an effective S-3 may continue if the company determines the prospectus is valid and there are no anti-fraud concerns, but must be discontinued if the 10-K is not filed by the end of the extension. SEC: Exchange Act Rules CD&I 135.06 and 135.07 [Sep. 30, 2008].
  - Does the issuer have the contractual right to suspend use of the shelf?
  - If so, is there a time limit on the period of suspension?
  - Does it have the legal obligation to do so regardless of its contractual rights?
  - What are the contractual and other liabilities if it suspends the shelf?
  - Do selling stockholders have other means of selling?
    - Rule 144
    - Section 4(a)(1)

EFFECT ON OTHER FINANCING EXEMPTIONS

- Private Placements
  - But offerings to non-accredited investors under Regulation D, Rule 506, will generally require the same audited financials as a public offering
  - Anti-fraud issues must be addressed
- Regulation S
  - No general condition that the issuer be current or timely in Exchange Act filings
  - Loss of “reporting issuer” status under Regulation S until the reports are current
    - Affects some Category 2 offerings under Rule 903
    - Also affects some directed selling efforts
    - Anti-fraud issues must be addressed
- No effect on Section 1145 under the Bankruptcy Code

Stock-based Plans

FORM S-8—NEW REGISTRATIONS

- Requires the issuer to have been current in its Exchange Act reports, required under Section 13, 14(a), 14(c) or 15, namely Form 10-Q, Form 10-K, Form 8-Ks and proxy information statements, for the last 12 months (except for some 8-K items that can be delayed to the 10-Q or 10-K)
- Does not require timely reports for the prior 12 months, but only requires that the issuer be current
- No prohibition in Rule 12b-25(d) to file new S-8 during extension
  - Is eligibility retroactively lost if report is not filed within the extension?
- Late periodic reports means issuer loses ability to file new S-8s until it becomes current
- Do restatements have the same effect if reliance is withdrawn on previous financial statements? Does that depend on how soon restated financials are filed after reliance on prior statements is withdrawn?

FORM S-8—EXISTING REGISTRATIONS

- Same general considerations as S-3 about
  - Anti-fraud
  - Sufficiency of statutory prospectus
  - Staleness
    - Except if a late 10-K is filed within the 16 months, the issuer would be Form S-8 eligible but not Form S-3 eligible.
- Difficult to file 11-K for 401(k) plans if sponsor is delinquent
- Does risk analysis for ongoing sales differ?
  - Transactions are with employees, not generally open market
  - Transactions may be at fixed prices or without monetary consideration
  - Concern about effects on employee morale and retention if use of S-8s is suspended
  - But employees may include many less-sophisticated persons

FORM S-8—EXISTING REGISTRATIONS *(CONT.)*

- May an issuer resume use of previously filed S-8s once it is again S-8 eligible, or must it file new S-8s?
  - SEC staff's general position is that a new registration statement must be filed if the old registration statement went stale
  - As a policy exception for benefit plans, the staff has been allowing issuers to resume using prior S-8s once the periodic reports have been caught up
  - Judgment call whether to confirm this policy exception with the staff in any particular situation

SUSPENSION OF STOCK-BASED PLANS

- Communication plan with employees
  - Be clear about what is suspended and what is not
  - Try to give notice far enough before the staleness date so employees can exercise before the suspension
- Regulation BTR
  - May also require suspension of trading by insiders in employee benefit stock
    - This will likely have occurred already under insider trading policies
  - Item 5.04 of Form 8-K will require filing of information about the notice

STOCK-BASED PLANS—EXISTING AWARDS DURING STALENESS

- Expiring options—possibilities include
  - Extend them—consider
    - Plan limitations
    - Award agreement limitations
    - Accounting treatment for extension
    - IRS Code 409A limitations on extension period
  - Cash them out at or after expiration
    - Some companies have only done this for non-executives
    - Consider applicability of tender offer rules, receipt of release
  - Let them expire—liability may depend on plan terms
    - Specific enforcement v. damages

STOCK-BASED PLANS—EXISTING AWARDS DURING STALENESS

- Can an issuer effect a “deferred settlement” of an expiring option so that it exercises while the S-8 is not available, but shares are delivered after an S-8 is again available?
  - When is investment decision (sale) made?
  - What are the tax consequences?
- Can an issuer settle an option granted under an S-8 by issuing restricted securities in a private placement to the option holder?
  - Bar seems split on this
  - Can you close a public offering as a private placement?
- Can the issuer issue new securities in a private placement to replace the expiring option?
  - What are the tender offer consequences?
- Consider 8-K, Item 5.02(e) disclosure for material amendments

STOCK-BASED PLANS—AWARDS WITHOUT S-8

- Bonus Stock Exemption (SEC Release 33-6188 (Feb 1, 1980)) if
  - The issuer is subject to the periodic reporting requirements
  - The stock is actively traded
  - The number of shares distributed is small in relation to the number of the class outstanding
- Shares would not be restricted securities and affiliates would not have to comply with the Rule 144 holding period for resales
- Cannot include the payment of consideration (that's why it's called the bonus stock exemption)
- Query: Does failure to have filed reports make the first test fail?

STOCK-BASED PLANS—AWARDS WITHOUT S-8

- Consider whether option grants may be made so long as the options are not exercised before S-8 is filed
  - Offer is made when option becomes exercisable
  - Policy decision was made at SEC to treat employee options more liberally and allow registration on Form S-8 any time before actual exercise, without regard to when option became exercisable. Securities Act Forms Compliance and Disclosure Interpretations 126.02.
- No-Sale theory for restricted stock units, deferred stock and similar arrangements. See *Verint Systems Inc*. (May 24, 2007).
- Section 4(a)(2) provides a statutory exemption for transactions not involving a public offering
  - Must be an offering to persons who are shown to be able to "fend for themselves;" whether an individual can fend for oneself turns on whether the offeree (i) has access to the kind of information which registration would disclose and (ii) is financially sophisticated. See *SEC v. Ralston Purina*, 246 U.S. 119 (1953)

STOCK-BASED PLANS—AWARDS WITHOUT S-8 (CONT.)

- Regulation D – Rule 506 of Regulation D provides a safe harbor for an issuer engaged in a non-public offering to accredited investors and not more than 35 sophisticated yet unaccredited investors
  - The issuer must satisfy disclosure requirements with respect to non-accredited investors
- Regulation S for Non-U.S. employees (see prior discussion)

STOCK-BASED PLANS—NEW AWARD TERMS

- New grants
  - Consider automatic extension of term and post-termination exercise period when S-8 is not available. See August 29, 2007, letter of Frederic W. Cook & Co., Inc. This letter suggests an extension for 90 days after an S-8 is available again but notes the period may need to be limited to 30 days if it is added to existing options because of Internal Revenue Code Section 409A.
  - Consider ability to suspend exercises or other issuance during insider trading black-outs applicable to the employee.
  - Clarify consequences if S-8 is not available or if there is a black-out in effect at expiration of an in-the-money award (extension, termination without liability if unexercised, or other).

STOCK-BASED PLANS—RESALES OF INADVERTENT UNREGISTERED ISSUANCES

- A company may learn that some of its shares were issued or sold under employee benefit plans after the S-8 was stale or in excess of the registered amounts
- Securities Act Rules CD&I 529.03 [Jan. 26, 2009]: Securities were inadvertently sold to a Company's employees under a "stale" Form S-8 registration statement. For purposes of resale by the purchasing employees, the securities would be treated as if they were unrestricted so as not to penalize innocent purchasers under the "stale" Form S-8.
  - Note that this is for "stale" registration statements, not issuances in excess of amount registered
- Rule 144(d) compliance: if a non-affiliate has held the stock he or she can resell without regard to virtually all of the limitations of Rule 144
- Consider the availability of Section 4(a)(1) for non-affiliates (See SEC Rel. No. 33-285 (Jan. 24, 1935)
  - Exempts transactions by a person other than the issuer, underwriter or dealer
- Consider resale registration after S-8 is available again

Listing Standards

LISTING REQUIREMENTS

- Many events related to a late periodic report or restatement may also violate listing standards
  - Failure to deliver annual report (NYSE 203.01; Nasdaq 5250(d))
  - Failure to timely file SEC reports (Nasdaq 5250(c)(1))
  - Failure to notify exchange of untimely filings (NYSE 203.01)
  - Failure to issue press release indicating delay of Form 10-K, reasons, and anticipated filing date (NYSE 203.01)
  - Significant delay in annual meeting (discussed previously)
  - Failure to disclose delisting proceedings promptly (Nasdaq 5810(b))
- Coordination with the exchanges is recommended to avoid a premature and unnecessary delisting.

DELISTING TIMING AND PROCESS

- In the event of a filing delinquency, the Nasdaq staff allows a Company 60 days to provide a plan to regain compliance. The Staff may extend the deadline for up to 180 days from the due date of first late report. (Nasdaq 5810-2(f)).
- The NYSE will notify and require the Company to issue a press release regarding the delinquency and will monitor the Company for six months from the date of the delinquency. If not cured, the NYSE may allow an additional six months of monitoring. (NYSE 802.01E).
- If the NYSE finds delisting necessary, it will suspend trading unless the Company files a request by a committee of the board of directors of the NYSE to review. Then the process will be suspended until such committee makes a determination. (NYSE 804.00).

Liabilities

SEC INVESTIGATIONS: THE ROLE OF RESTATEMENTS

- **A Restatement Can Lead to a SEC Investigation**
  - In 2017, the SEC brought 95 enforcement actions relating to financial reporting and audit-related matters. This was 25% of all actions brought by the Division of Enforcement.
  - Because of limited resources, the SEC looks to information disclosed by companies that might evidence fraud.
  - The SEC has consistently identified restatements, along with whistleblowers, internal and external referrals, and company self-reports as ways that the Division of Enforcement has historically learned of potential violations of the federal securities laws.
  - Companies that initiate an internal investigation in response to accounting issues evidenced in a restatement and promptly begin a remediation program can obtain a better result in an enforcement action.

SEC INVESTIGATIONS: FRAUD TASK FORCE

- **Financial Reporting and Audit Task Force (FRAud Task Force)**
  - Created in 2013 as part of the SEC's shift away from financial crisis cases towards accounting fraud cases.
  - Looks towards more preventative steps to detecting accounting fraud before the information becomes public in the form of restatements and disclosures.
    - Utilizing new methods, such as the Corporate Issuer Risk Assessment Tool, which helps to identify matters in the pubic company space that the Division of Enforcement would not otherwise find by aggregating and organizing issuer financial information.
    - More specifically, the Tool allows Division of Enforcement to analyze an issuer's period-over-period disclosure and compare an issuer to its peer group.
  - Has helped the SEC increase its actions in the issuer reporting and disclosure area.

SEC INVESTIGATIONS: BOOKS AND RECORDS VIOLATIONS

- **Section 13(b)(2)(A) of the Securities Exchange Act**
  - Every reporting issuer "shall make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."
  - Previous SEC actions against MicroStrategy, Inc., Stein Mart, Inc., and Hampton Roads Bankshare found books and records violations after each company issued a restatement.
  - SEC has indicated its intentions to "pursue even the smallest infractions," with the goal of creating a culture of compliance, including "control failures," "negligence-based offenses," and "violations of prophylactic rules with no intent requirement."
  - However, the SEC also has a stated policy to not use the books and records provisions to expose companies and individuals to enforcement actions "as a result of technical and insignificant errors in corporate records or weaknesses in corporate internal accounting controls."
  - Still, the principal take-away is that significant restatements resulting from multiple years of inaccurate information, multiple areas of error, or significant amounts at issue are likely to attract the attention of the SEC's Division of Enforcement.

SEC INVESTIGATIONS: RESPONDING TO SEC INVESTIGATION FOLLOWING A RESTATEMENT

- **Responding to a SEC Investigation Following a Restatement**
  - Because the causes of restatements clearly vary, a careful assessment of the reasons for the restatement is critical to responding to a SEC investigation. These include:

    1) determining the cause and significance of the error

    2) determining the likelihood of reoccurrence

    3) describing the remediation put in place following the restatement, the effectiveness of those remediation, changes/upgrades in internal controls
  - If it can be shown that there is a low likelihood of reoccurrence of the circumstances leading to the restatement because there has been an effective and prompt response to the causes of the restatement, it may be possible to convince the SEC that no enforcement action or sanction is called for.

- **Restatements often lead to civil litigation and allegations of fraud**
  - A well-respected District Court in New York recently ruled: "A restatement is simply a correction, after the fact, of an accounting or other error in financial results. The fact of an error, even a large error, does not suggest knowledge or intent to misstate when the financial statements were originally published, particularly when the error was a matter of judgment."
  - But: a restatement often leads to a drop in stock prices, and investors who lose money as a result often initiate a lawsuit, frequently being Rule 10b-5 actions.
- **Section 10(b) violation**
  - A restatement is often relied upon by plaintiffs to try to establish the scienter element of a securities fraud allegation.
  - To plead scienter in a securities fraud claim, a complaint may (1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness, or (2) allege facts to show that defendants had both motive and opportunity to commit fraud.
  - **A restatement, on its own, cannot create an inference of scienter which is necessary to establish a 10(b) violation.**

CIVIL LITIGATION: SECOND CIRCUIT APPROACH TO 10(b)

- **The size of the restatement alone does not create an inference of scienter.**
  - The magnitude, at least in certain circumstances, can be relevant to the scienter inquiry, but it is not enough.
  - Instead, the magnitude of a restatement must be presented in tandem with other circumstantial evidence to suggest scienter.
  - *Dobina v. Weatherford Intern. Ltd.*: Officer's personal involvement in designing and evaluating the company's internal controls, audit delays, control deficiencies, and the stark realities of the inadequacies of the internal controls evidenced in the restatement created an inference of scienter.
  - *In re Scholastic Corp. Securities Litigation*: The misrepresented sales figures corrected through the restatement, along with evidence that showed a picture different from what the company presented to the public, created an inference of scienter.
  - *SEC v. Espuelas*: The SEC successfully alleged a fraudulent scheme by pleading facts showing that defendant "knew or was reckless in" not knowing the accounting at issue was wrong and, therefore, that the financials recognizing the revenue was wrong.

CIVIL LITIGATION: FIFTH CIRCUIT APPROACH TO 10(b)

- **Similarly, the Fifth Circuit has held that GAAP violations that require a restatement are not, in and of themselves, sufficient to establish scienter.**
  - Courts will scrutinize the number, size, timing, frequency, context of the misapplication of accounting principles leading to a restatement or restatements.
  - The greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly.
  - *In re Dell Inc., Securities Litigation*: A 1% drop in the revised net income was too small to support an inference of scienter, despite the fact that the restatement of financials covered a four-year period and brought to light numerous accounting irregularities.

CIVIL LITIGATION: FIFTH CIRCUIT APPROACH TO 10(b)

- **Similarly, the Fifth Circuit has held that GAAP violations that require a restatement are not, in and of themselves, sufficient to establish scienter.**
  - *In re Arthrocare Corp. Securities Litigation*: A restatement that covered four years, brought to light numerous irregularities and fraudulent practices, and reduced gross revenue by a significant amount for each year (12.4%, 7.3%, 4% and 1%, respectively) together contributed to a finding of scienter. "Thus, the magnitude of the Restatement . . . the fact that it occurred over a substantial period of time, the relative simplicity of the issues involved – while perhaps not sufficient on their own to establish scienter – do contribute [together] to a finding of scienter."

CIVIL LITIGATION: SECTION 11 VIOLATION

- **Section 11 violation**
  - To find a violation of Sections 11 and 12 of the Securities Exchange Act, a registration statement must contain (1) an omission or misstatement (2) of a material fact required to be stated or necessary to make other statements not misleading.
  - Unlike a 10(b) claim, scienter is not a requirement. If a plaintiff purchased a security issued pursuant to a registration statement, he need only show the existence of a material misstatement or omission to establish a case.
  - May not require an investor who lost money on his or her securities purchase to prove that the false statement caused his or her loss.

CIVIL AND CRIMINAL CAUSES OF ACTION OVERVIEW

- Civil and criminal causes of action for reporting violations arise principally under Section 10 (15 USC Section 78j) and Section 32 (15 USC Section 78ff) of the Securities Exchange Act of 1934
  - Private cause of action under Rule 10b-5 for material misstatements and omissions in connection with the purchase and sale of a security.
  - Separate private cause of action under Section 18 of the Exchange Act for material misstatements and omissions in SEC reports, but most cases are brought under Rule 10b-5 because Section 18 has a more stringent reliance requirement, a shorter statute of limitations, and a good faith defense. Unlike Rule 10b-5, scienter is not an element of a Section 18 claim.
  - SEC can also bring a variety of civil enforcement actions for material misstatements and omissions in SEC reports and other public statements.
  - U.S. Attorney can assert criminal liability based on the "willful" violation provisions of Section 32 of the Exchange Act. When it does so, it frequently asserts criminal liability under other federal anti-fraud statutes.

CIVIL LIABILITY UNDER SECTION 10

- To state a claim under Section 10(b) and Rule 10b-5, plaintiff must allege, in connection with the purchase or sale of securities, "(1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which the plaintiff relied (5) that proximately caused [the plaintiff's] injury" (*Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07 (5th Cir. 2001) (quoting *Tuchman v. DSC Communications Corp.*, 14 F.3d1061, 1067 (5th Cir. 1994)).
- *Scienter* is a mental state embracing intent to deceive, manipulate, or defraud (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S. Ct. 1375 L.Ed.2d (1976)).
- *Scienter* is not explicitly mentioned in the text of Rule 10b-5 or Section 10(b), but it has been interpreted to be an essential element of these claims.
- Plaintiffs can demonstrate *scienter* by a showing of severe recklessness, which is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

CRIMINAL LIABILITY UNDER SECTIONS 10 AND 32

- 15 USC Section 78ff (Section 32 of the Exchange Act) provides: "Any person who willfully violates any provision of this chapter . . . , or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder . . . which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

CRIMINAL LIABILITY (CONT.)

- The elements of a criminal violation of the securities laws generally track the elements of civil securities case, but the burden of proof and *mens rea* are heightened, respectively, to proof beyond a reasonable doubt and willfulness.
- For a criminal violation of Section 78j(b) to be established, the government must prove a "willful" violation—defined by the 2nd Circuit as "one in which the defendant acted with knowledge that his conduct was unlawful." *United States v. Schlisser*, 168 Fed. Appx. 483, 485-86 (2d Cir. Feb. 24, 2006) (unpublished opinion) (internal quotation marks and citation omitted).
- The government must prove that the defendant was aware that his act was wrongful under the securities laws but need not show the defendant's specific intent to violate a particular law. Id. In other words, it is sufficient for the government to establish that the defendant generally knew his conduct was unlawful under the securities laws without showing that the defendant intended specifically to violate a particular law, rule, or regulation. See *United States v. Peltz*, 433 F.2d 48,54-55 (2d Cir. 1970).
- The Supreme Court has said that the word "willfully" does not necessarily mean done with a bad purpose, but may be "employed to characterize a thing done without ground for believing it is lawful . . . , or conduct marked by careless disregard whether or not one has the right to so act."

CRIMINAL LIABILITY (CONT.)

- Section 78ff also prohibits knowingly and willfully making a false statement of material fact in a securities filing. "[A]n act is done knowingly if done voluntarily and intentionally and not because of a mistake or accident or other innocent reason" (*United States v. Dixon*, 536 F.2d 1388, 1396 (2d Cir. 1976)). In other words, the false statement must not be the result of negligence or inadvertent mistake. In addition, a violation requires materiality, which is defined as a fact that a reasonable shareholder would consider important in making an investment decision. *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991).

OTHER POSSIBLE CRIMINAL CHARGES

- Conspiracy to defraud the United States by impeding the operations of the SEC in violation of 18 U.S.C. § 371
- Mail or wire fraud in violation of 18 U.S.C. § § 1341 or 1343
- Making a false or fraudulent statement to the SEC in violation of 18 U.S.C. § 1001

OTHER POSSIBLE PENALTIES

- The SEC and the Department of Justice may seek a variety of civil and criminal penalties depending on the circumstances of the case. Which penalties will be sought, if any, is a matter of prosecutorial discretion.
- The SEC may enter a cease and desist order against the company and its officers and directors (Exchange Act Section 21(d)(1)).
- The SEC may permanently or temporarily bar any person from service as officer or director of a public company (Exchange Act Section 21(d)(2) and Section 21C(f)).

OTHER POSSIBLE PENALTIES (CONT.)

- The SEC may seek civil penalties of $9,054 for an individual and $90,535 for an entity for violations not involving fraud; $90,535 for an individual and $452,677 for an entity if it involved fraud or deliberate or reckless disregard of a regulatory requirement; or $181,071 for an individual and $905,353 for an entity if it involved fraud or deliberate or reckless disregard of a regulatory requirement AND resulted in substantial losses or created significant risk of substantial losses for other persons (Exchange Act Section 21(d)(3); SEC, Adjustments to Civil Monetary Penalty Amounts, 17 C.F.R. Pt. 201). Note that each day is a separate violation for which the fine can be assessed separately.
- Under Dodd-Frank, the SEC may seek civil penalties in cease-and-desist proceedings. (Dodd-Frank, 929P)

OTHER POSSIBLE PENALTIES (CONT.)

- As previously noted, any person who willfully violates any provision of the Exchange Act can be criminally punished by a fine of up to $5 million and imprisonment of up to 20 years, or both, except that if the person is not a natural person the fine can be up to $25 million (Exchange Act Section 32(a)).
- The company may be required to forfeit $534 for each day of the ongoing failure to file periodic reports (Exchange Act Section 32(b); SEC, Adjustments to Civil Monetary Penalty Amounts, 17 C.F.R. Pt. 201).

OTHER POSSIBLE PENALTIES: DISGORGEMENT

- If the company is required to restate financials because of material noncompliance, as a result of misconduct, with financial reporting requirements, the chief executive officer and the chief financial officer can be required to reimburse the company for any bonus or other incentive-based or equity-based compensation received during the twelve months following the first public issuance or filing of the financial document and any profits realized from the sale of securities of the company during those twelve months (Sarbanes-Oxley Act of 2002, Section 304).

ERISA LITIGATION: 401(K) PLANS WITH COMPANY STOCK

- ERISA is attractive as a litigation tool because it avoids much of the specificity in pleading requirements of federal securities suits
- Four common claims
  - The stock was an imprudent investment choice
  - Fiduciaries failed to disclose problems with the company
  - Fiduciaries failed to monitor the company and administrators
  - Fiduciaries/administrators had a conflict of interest (breached duty of loyalty) by both operating the issuer and administering the plan
- Defendants include board of directors, sponsoring company, corporate officers (usually including the CEO and CFO), inside fiduciary committees (plan investment committee, administrative committee), and any board committee with authority to appoint plan fiduciaries.

Director & Officer Insurance

PUBLIC COMPANY D&O INSURANCE

- Covers directors and officers for most claims alleging wrongful acts in their capacity as directors and officers, and also covers the company for "Securities Claims" against the company
- If coverage was issued based on prior financials or representations about the quality of internal controls, insurer may try to repudiate coverage, although there is a high standard for repudiation:
  - Most policies state that the insurer has relied on statements made in all of the company's SEC filings, as well as the company's initial application for coverage
  - Most policies allow the insurer to void coverage only for those individuals who knew that facts were not accurately disclosed and only allow coverage to be voided for claims against the company if the CEO or CFO knew the facts were not accurately disclosed.
- If the policy is valid, it will generally provide coverage unless there is a final adjudication of fraud, intentional wrongdoing, or wrongful profit to which the defendant was not legally entitled
  - Most policies provide that the finding of fraud or intentional wrongdoing destroys coverage only for the wrongdoers

PUBLIC COMPANY D&O INSURANCE (CONT.)

- Although defense costs are generally covered, fines and penalties are often not covered
- When to notify insurer?
  - D&O policies allow for a notice of circumstances that may give rise to a claim, and it may be appropriate to notify an insurer of a restatement even if no lawsuits have been filed and no demand letters received
  - Once any kind of demand letter is received or lawsuit is filed, the company should notify the D&O insurer of the claim
  - Several types of communication from third parties could trigger coverage, including an informal SEC request for an interview with a director or officer, a books and records inspection demand letter from a shareholder, or a request to toll the statute of limitations
- Note: If there are ERISA claims, coverage is available under a separate policy called fiduciary liability insurance; most D&O policies exclude coverage for ERISA claims since coverage is expected to exist under separate fiduciary liability policy

Catching Up

BASIC PRINCIPLES

- For late reports, file everything that was not filed (including 8-Ks)
- Generally, restate all annual and quarterly periods included in the restated financial statements.
  - Reassess materiality based on new financial statements for items that were not material prior to the restatement. Consider SAB 108.
  - Restated financial statements are generally filed as amendments to all the periodic reports for the relevant periods, not just the latest 10-K and 10-Qs.
  - To amend just the latest 10-K, the SEC will no longer issue comments asking an issuer to file separately all of its delinquent filings if the issuer elects to file a comprehensive 10-K that includes all material information that would have been included in those filings. Companies filing a comprehensive 10-K or restating for option-grant errors should follow the guidance in the SEC's *Sample Letter Sent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants* (January 2007).
- Include explanatory note after cover page to explain the amendment or restatement
- Label financial information columns as "restated"; notes to financials

MORE CONSIDERATIONS

- Update risk factors
- Discuss changes to internal controls
- Update evaluation of disclosure controls
- New certifications are required with financial statements
- Amend only those portions of prior reports that need updating in connection with a restatement

SEC COMMENT REGARDING RESTATED 10-Q

We remind you that when you file your restated Form 10-Q, you should appropriately address the following:

- Full compliance with Statement of Financial Accounting Standards No. 154, May 2005
- Fully update all affected portions of the document including MD&A
- Updated item 4 disclosures should include the following:
  - A discussion of the restatement and the facts and circumstances surrounding it,
  - How the restatement impacted the CEO and CFO's original conclusions regarding the effectiveness of their disclosure controls and procedures,
  - Changes to internal controls over financial reporting, and
  - Anticipated changes to disclosure controls and procedures and/or internal controls over financial reporting to prevent future misstatements of a similar nature.

  Refer to Items 307 and 308(c) of Regulation S-K.
- Include all updated certifications

GETTING CURRENT

- Recommend that filings be made in the order they would normally have been filed
- Can a late 10-K incorporate a proxy statement filed more than 120 days after year end (e.g., filed simultaneously)?
- File late 11-Ks before filing new or resuming use of S-8s registering interests in plans
- New registration statements (S-3 versus S-1, depending on whether periodic reports were untimely)

MATERIAL WEAKNESS

- Can a company have a restatement for errors in its financial statements but determine that there was no material weakness in its internal control over financial reporting?
  - "Neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Rather, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in controls. Such an evaluation should be based on all the facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the company's internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of 'reasonable assurance.'" (The Office of Chief Accountant of the Division of Corporation of Finance of the SEC, "Staff Statement on Management's Report on Internal Control Over Financial Reporting," May 16, 2005).
- Nevertheless, it is rare to have a restatement because of an error without a material weakness, and the SEC will likely comment if the company concludes otherwise.
- Consider what the internal control and disclosure control sections of late or amended periodic reports will say about the nature of problems and whether they have been corrected.

Further Considerations & Resources

COMMUNICATION PLANS

- Press Releases
- Conference calls—Q&As, talking points
- Investor Relations plans and scripts
- Letters to stockholders, creditors, customers, employees and others
- What is plan to update on developments?
  - Anticipate issues such as further litigation, government investigations, etc.
  - When will report on internal investigations be provided, and how?

COMMUNICATION AND OTHER ISSUES

- Web site information should be updated
  - Remove financial statements on which reliance has been withdrawn and replace with restatement
  - Before restatement is filed, prominently legend the appropriate page or reports to warn of the withdrawal of reliance
- Communications with ratings agencies
- Communications with creditors
- Get appropriate help from counsel
- Possibility of Section 10A report by auditor of illegal acts

MULTIPLE FORM 8-K POTENTIALS

- Many actions during a late periodic report or restatement event may give rise to a Form 8-K filing, including
  - Item 1.01 Material amendments to material agreements (such as amendments or waivers to indentures or credit agreements)
  - Item 1.03 Bankruptcy or receivership
  - Item 2.04 Default and acceleration of indebtedness
  - Item 2.06 Material impairments
  - Item 3.01 Delisting or failure to satisfy listing standard
  - Item 3.02 Unregistered sales of equity securities (e.g., if sold after S-8 is stale)
  - Item 4.01 Change of accountants (usually after the restatement)
  - Item 4.02 Non-reliance on financial statements
  - Item 5.02 Departure of officers or change in compensation
  - Item 5.04 Suspension of trading under benefit plans

ADDITIONAL RESOURCES

- SEC Investor Bulletin: Delinquent Filings (November 1, 2013), available at: www.sec.gov/investoralertsandbulletins
- Fried Frank, *Key Considerations in a Restatement & Internal Control Crisis* (Feb. 23, 2006) (available at www.friedfrank.com).
- Chart, What to Do When Auditing Goes Awry (7/07) (search archive at www.thecorporatecounsel.net)
- Jeffrey M. Stein, *Restatement of Financial Statements*, SEC Hot Topics Institute, Atlanta, Georgia (May 22, 2007), available at www.realcorporatelawyer.com/events/archivedevents.html.
- Eli Bartov, Yaniv Konchitchki, *SEC Filings, Regulatory Deadlines, and Capital Market Consequences*, New York University Law & Economics Working Papers (June 27, 2017)