Tuesday, October 21
2:30 pm-4:00 pm

612 When the SEC Says Great Companies Got it Wrong

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Faculty Biographies

Lanae Holbrook

Lanae Holbrook is chief counsel, office of general counsel and hearings, for NASDAQ OMX in Rockville, MD, where she supervises the company's delisting process. In this capacity, Ms. Holbrook has been involved in issues related to corporate governance, SEC filings, Sarbanes-Oxley compliance, stock option accounting, shareholder approval, audit committee investigations, and accounting/financial issues. Ms. Holbrook has also been involved in NASDAQ's stock offerings, SEC filings, and public disclosure issues.

Prior to joining NASDAQ, Ms. Holbrook was a partner at the law firm of Fried, Frank, Harris, Shriver & Jacobson LLP. Ms. Holbrook practiced in the area of corporate and securities law, where she advised public companies on Sarbanes-Oxley compliance, disclosure, proxy statements, annual meetings, executive compensation, securities offerings, and M&A transactions.

Ms. Holbrook serves as co-chair of the corporate and securities law committee of the Washington Metropolitan Area Corporate Counsel Association, and is an active member of the ABA committee on federal securities regulation.

Daniel L. Jablonsky

Daniel L. Jablonsky is senior corporate counsel at Flextronics International Ltd., a Singapore registered and NASDAQ listed company, and is responsible for corporate/securities and M&A. Flextronics is a leading electronics manufacturing services (EMS) provider that delivers design, engineering, manufacturing, and logistics services to automotive, computing, consumer digital, industrial, infrastructure, medical, and mobile OEMs.

Prior to joining Flextronics, Mr. Jablonsky was in-house counsel with the legal and compliance group at UBS Financial Services Inc. Before that, he served at the US Securities & Exchange Commission, Division of Enforcement. Mr. Jablonsky began his legal career as a corporate, M&A, and securities attorney with O'Melveny & Myers in Southern California.

Mr. Jablonsky is also an adjunct professor at the Denver University School of Law.

He received his BS from the US Naval Academy, and served as a surface warfare officer and nuclear engineer in the US Navy. He received his JD from the University of Washington School of Law.

Pravin Rao

Pravin Rao is a litigation partner in the Chicago office of Perkins Coie LLP, where he specializes in white-collar defense, internal investigations, corporate governance, and securities law enforcement, litigation, and compliance.

Prior to joining Perkins Coie, Mr. Rao served as an assistant US attorney in the Northern District of Illinois where he investigated and prosecuted violations of federal criminal laws; conducted parallel investigations with the SEC and SFTC in complex cases involving large publicly traded companies, directors and officers, broker-dealers and hedge funds; and tried 10 jury trials and argued 11 appeals. Mr. Rao also served as a branch chief with the SEC's enforcement division, where he directed numerous investigations and litigation involving violations of federal securities laws. Prior to the SEC, Mr. Rao was a Cook County assistant State's attorney where he served as first chair in a number of trials and argued over 25 appeals on behalf of the State.

Mr. Rao is currently a regional chair of the Association of Securities and Exchange Commission Alumni and is involved with a number of activities with Asian bar associations nationwide.

Mr. Rao received a BS from the University of Michigan and holds a MBA from the Olin School of Business at Washington University. He is a graduate of the College of Law at the University of Illinois.

Theodore Sonde

Theodore Sonde is partner with Patton Boggs LLP in Washington, DC. Mr. Sonde counsels corporate entities and audit committees, as well as individuals, involved in government investigations and related litigation, while also handling matters requiring complex litigation.

Before entering the private sector, Mr. Sonde held several senior positions in government, among them associate director of the Division of Enforcement at the SEC, in with he held supervisory responsibility for substantially all of the SEC's civil enforcement litigation and tried some of its most prominent cases. Mr. Sonde was also director of enforcement for the US Federal Energy Regulatory Commission. In addition, Mr. Sonde has acted as defense counsel in many government investigations involving options questions, insider trading, market manipulation, revenue recognition, and other accounting issues, as well as issues of compliance and supervision in the mutual fund and brokerage industry.

Mr. Sonde speaks frequently on SEC enforcement and compliance issues and taught for many years at Georgetown University School of Law and George Washington University National Law Center, primarily on the subject of professional responsibility in a corporate setting, He is also and avid writer and speaker on various securities laws topics and on professional ethics for lawyers and accounts. Mr. Sonde has also taught at ALI-ABA programs in China and India. He specializes on compliance with the Foreign Corrupt Practices Act.

Mr. Sonde received a BA from City College of New York, a LLB from New York University School of Law, and a LLM from Georgetown University Law Center.

POTENTIAL PROBLEMS

- Improper Disclosures
- Earnings; Predetermined Targets
- Regulation FD
- Accounting Tricks and Short-cuts

The information in this presentation is drawn from public sources, primarily SEC documents, including company filings, SEC press releases, and complaints. None of the presenters take a position as to the validity or correctness of the allegations or outcome of the case studies in this presentation.

WHEN THE SEC SAYS GREAT COMPANIES GOT IT WRONG

- Coca Cola: MD&A
- Hewlett Packard: Form 8-K, Director Resignation
- Schering-Plough: Regulation FD
- K-Mart: Allowances
- IBM: Form 8-K, Earnings
- Bristol-Myers Squibb: Channel Stuffing; Cookie-Jar Reserves
- Time Warner/AOL: Round-trip Transactions
- Xerox: Predetermined Targets

Coca-Cola: MD&A

- Company offered favorable credit terms to encourage bottlers to gallons of concentrate in amounts larger than needed. This practice allowed company to meet earnings estimates in 8 of 12 quarters.
- As bottlers' inventory levels rose 60%, retail sales increases only 11%. The company made no disclosures of its "gallon-pushing" practice, until it was no longer sustainable.
- Ultimately, company disclosed a concentrate inventory reduction plan, (based on a past review of "optimum" levels), expected to have a significant impact on earnings.

Coca-Cola: MD&A

- SEC found MD&A disclosures to be false and misleading, since they omitted discussion of gallon pushing and its impact on financial results.
- SEC noted Item 303 of Reg S-K, which requires disclosure of known trends or uncertainties that are expected to be material.
- Company entered into cease-and-desist order, and implemented remedial measures: audit committee review of MD&A disclosures, hiring independent audit committee counsel, and establishing Ethics & Compliance Office.

Coca-Cola: Take-aways

- ***Remember intent of MD&A***: Allow investors to see the company "through the eyes of management." To facilitate this, in-house counsel should talk directly with senior management each quarter and facilitate discussions between management and different divisions and functions to make sure all are on the same page.
- ***Get behind the numbers.*** In Co*ca Cola,* company's accounting was correct but MD&A failed to disclose that company met earnings expectations by pushing excess sales to bottlers. In house counsel should ask appropriate questions of finance team to understand what is going on "behind the numbers."
- ***Management review of MD&A***. Senior management is in a position to assess whether MD&A addresses significant trends affecting the business. Too often, in house counsel drafts large portions of the MD&A without management input. Consider quarterly review and certification process that requires management to read disclosure, provide comments and attend a meeting with senior management to discuss MD&A.

Hewlett-Packard: Form 8-K

- SEC disagreed with the company's analysis, and deemed disagreements to be related to corporate governance matters and company policies on handling sensitive information, thus constituting disagreement over company operations, policies or practices.
- Company corrected its disclosures on September 6, 2006, and entered into cease-and-desist order with SEC.

Hewlett-Packard: Form 8-K

- Board of directors learned findings of company's leak investigation on May 18, 2006. Board voted to request resignation of director involved in leaks, based on belief that director had violated company policies by providing confidential information to press.
- Another director (not the source of leak) disagreed with the handling of this matter, announced his resignation, and left the meeting.
- Company filed a Form 8-K on May 19, announcing the resignation, but did not disclose disagreements. Company reasoned that it need not disclose reasons for the resignation, since disagreement had been with the Chairman of the Board, rather than with the company relating to operations, policies, or practices.

Hewlett-Packard: Take-aways

- ***Timing of director resignations.*** Although the HP director resignation was made before entire board, directors often communicate resignation privately to CEO or Chairman. Even if departure is amicable, notice of the departure triggers a disclosure within four business days. Management and Chairman should be aware of need to communicate resignations immediately to in-house counsel.
- ***Resignation with Disagreements***. Director resignations with disagreements are rare but, when they occur, they trigger supplemental disclosure requirements.
- ***Not just directors.*** Form 8-K requirement extends to all directors and certain officers: CEO, President, CFO, COO, principal accounting officer or anyone serving those functions at the company.

Schering-Plough: Reg FD

- Management held several private meetings with buy-side investors at end of third quarter 2002.
- CEO said the company would take a "hard hit" to earnings in 2003, that 2003 would be a "very, very difficult year," and that analysts had not sufficiently lowered earnings estimates for the quarter. CEO also mentioned increase in manufacturing costs.
- Previous disclosures indicated only that expiration of Claritin patent would likely have a "rapid, sharp and material adverse effect on the company's results of operation," which might be "mitigated by successful patent litigation."
- After private meetings, analysts downgraded company's stock, noting the CEO's "downbeat" demeanor and "incrementally negative" statements. This prompted a sell-off of company stock.

Schering-Plough: Take-aways

- ***Timing of meetings.*** In-house counsel should advise management to use caution in scheduling analyst meetings toward end of a quarter.
- ***Updating guidance.*** Almost any statement about earnings guidance, particularly toward end of quarter, will be material. Even confirming earnings guidance, well into the quarter, will likely be material information.
- ***Questions.*** In-house counsel should advise management and IR team to respond with "no comment" on inappropriate questions about guidance.

Schering-Plough: Reg FD

- SEC said that based on "language, tone, emphasis and demeanor," at investor meetings, the CEO selectively disclosed negative and material non-public information about company prospects.
- The SEC noted definitive nature of CEO's statements in meetings, vs contingent statements in earlier disclosures.
- It was fine for company to signal to investors that it would miss numbers, but company should have disseminated this information publicly.
- CEO fined $50,000; company and CEO entered into cease-and-desist orders.

Kmart: Vendor Allowances

- Vendors like Coca-Cola paid Kmart "**Allowances**" for advertising, special displays, price protection, exclusivity, and other marketing activities.
- "Allowances" would filter into financial statements in a way that would <u>prematurely increase</u> earnings. Kmart recognized allowances <u>before</u> they were earned.
- Kmart "pulled forward" allowances from a future fiscal year into the current fiscal year in order to meet earning expectations. This practice overstated earnings by $24 million.
- Kmart falsified documentation, threatened vendors, and made misrepresentations to auditors.
- The Vendors made misrepresentations to auditors, falsified documentation, and executed side agreements.

Kmart: Vendor Allowances

- SEC charged executives based on the improper recognition of vendor allowances
- Executives settled and paid civil penalties ranging from $25,000 to $55,000

IBM Corporation: Form 8-K, Earnings

- SEC found that IBM did not disclose its 2005 expected stock option expense (.10/ share), because management thought analysts would use that number to increase expectations, though earnings would be down.
- IBM entered into cease-and-desist order for future violations of Form 8-K rules and SEC Rule 12b-20.

IBM Corporation: Form 8-K, Earnings

- In a pre-earnings call for first quarter 2005, management said that it would include stock options expense in its results for the first time, and suggested that analysts adjust their earnings expectations to account for this change.
- Management referred to a chart filed with its 8-K that showed 2004 options expense (.14/share), and stated that 2005 options expense would not be higher than 2004.
- Analysts came away from call with misunderstanding that 2004 chart depicted 2005 numbers, and adjusted estimates accordingly.

IBM Corporation: Take-aways

- ***Disclose complete and accurate financial projections***.
- ***Ensure that total mix of information presented in conference calls is not misleading (Rule 12b-20).***
- ***In-house counsel should carefully review charts and attachments to earnings release/Form 8-K***.
- ***Correct analyst misunderstandings as soon as they surface.***

Bristol-Myers Squibb: Earnings

- SEC charges brought for violations relating to overstated sales and earnings that created a false appearance that Bristol-Myers Squibb was able to meet or exceed its financial projections
- Allegations referred to Bristol-Myers Squibb's actions as channel-stuffing and utilizing cookie-jar reserves
- Settled charges for payment of $100 million civil penalty, establishment of $50 million shareholders fund, and undertaking of remedial actions

Time Warner/AOL: Revenue

- AOL and AOL Time Warner employed round-trip transactions to boost its online advertising revenue to mask business slow-down
- Round-trip transactions ranged in complexity and sophistication
- Effectively funded its own online advertising revenue by giving counterparties the means to pay for advertising they would not have otherwise purchased
- Structured and documented the transaction as two separate ones
- Inflated number of subscribers in order to report that it met a predetermined target

Bristol-Myers Squibb: Earnings

- In June 2005, Bristol-Myers Squibb entered into a Deferred Prosecution Agreement with the U.S. Attorney's Office for the District of New Jersey relating to alleged criminal violations of the securities laws.
- As part of the settlement, Bristol-Myers Squibb agreed to install an independent Monitor to oversee the company's compliance with the Agreement.
- In September 2006, the independent Monitor recommended that the Board terminate the employment of the company's CEO and General Counsel. The CEO and General Counsel resigned soon thereafter.

Time Warner/AOL: Revenue

- SEC charged Time Warner with materially overstating online advertising revenue and subscribers
- $300 million in civil penalties
- Time Warner agreed to restate its financials
- Charges also brought against 3 executives – CFO, Controller, and Deputy Controller – each entered into cease and desist order
- Recent charges brought against 8 additional executives relating to the overstated advertising revenue
  - Four settled and four face fraud charges in federal court

Xerox: Earnings

- Xerox utilized "one-time actions," "one-offs," accounting opportunities," and "accounting tricks" to achieve earnings targets
- Xerox falsely portrayed its ability to achieve these targets
- The undisclosed accounting maneuvers resulted in accelerated recognition of equipment revenue and increased earnings

Xerox: Earnings

- SEC initially charged Xerox alone with violations based on a scheme to defraud investors that was directed and approved by senior management
- Subsequent charges brought against Xerox's auditors, KPMG, and later Xerox executives
- All charges settled
  - Xerox – $10 million fine and special review of accounting controls
  - KPMG - $22 million total, $10 million of which was civil penalties
  - Executives - $22 million total – between $75,000 and $1 million in civil penalties, remainder was disgorgement and relinquishment of rights to certain deferred bonuses

Wrap-Up

- Tone at the top
- Good faith – is it a defense?
- Cooperation
- Better late than never: Issue a press release, even if the disclosure was intentional
- Never make a mistake alone

Cases with SEC Lit. Release Cites

- Schering-Plough: Regulation FD
  - www.sec.gov/litigation/litreleases/lr18330.htm
- Coca Cola: MD&A
  - http://www.sec.gov/news/press/2005-58.htm
  - http://www.sec.gov/litigation/admin/33-8569.pdf
- Hewlett Packard: Form 8-K, Director Resignation
  - http://www.sec.gov/news/press/2007/2007-103.htm
  - http://www.sec.gov/litigation/admin/2007/34-55801.pdf
- IBM: Form 8-K, Earnings
  - http://www.sec.gov/news/press/2007/2007-109.htm
  - http://www.sec.gov/litigation/admin/2007/34-55858.pdf

Lit. Release Cites (cont.)

- Bristol-Myers Squibb: Channel Stuffing; Cookie-Jar Reserves
  - http://www.sec.gov/litigation/litreleases/lr18822.htm
- K-Mart: Allowances
  - http://www.sec.gov/litigation/litreleases/lr18989.htm
- Time Warner/AOL: Round-trip Transactions
  - http://www.sec.gov/litigation/litreleases/lr19147.htm
- Xerox: Predetermined Targets
  - http://www.sec.gov/litigation/litreleases/lr17465.htm