

**OUTSIDE VENDORS SUED  
FOR AIDING AND ABETTING FRAUD**

Even outside vendors that are involved with a company accused of accounting fraud can become ensnared in the resulting investigations.

Earlier this month, nine persons who were employees or agents of vendors for U.S. Foodservice (USF), a subsidiary of Royal Ahold, were charged with aiding and abetting a \$700 million accounting fraud at USF and also face civil charges from the SEC. According to the US Attorney,

**“We strive to foster an environment, indeed a culture, in which insiders cannot turn to third parties for help in manipulating financial results. It is not only a crime for executives to falsify the books of their corporations, it is also a crime to help companies falsify.”**

-US Attorney David Kelley

these persons allegedly signed and sent audit confirmations to Royal Ahold’s independent auditors that materially overstated the promotional allowances owed to USF. Charges of trading USF stock on inside information are also pending against one of the persons. USF is the nation’s second-largest food distributor.

Most of those charged worked for relatively small companies. Several have claimed they were heavily pressured into aiding the fraud or went along to maintain good relationships with such an important client. Nonetheless, they face criminal and civil charges even though:

- the alleged fraud was not directly committed by the vendors themselves and occurred at an unrelated company over which they had no control; and
- the SEC did not seek penalties against USF itself because of the company’s “extensive cooperation” and possible double

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jeopardy complications in the Netherlands, where Royal Ahold is based.

This is the largest criminal or civil case involving employees of suppliers charged with helping a client inflate profits.

**Companies that believe their employees may be involved in aiding and abetting a client to commit fraud should consider following USF’s model for cooperation to avoid criminal charges or crippling civil penalties. Doing so, however, may require the companies to waive their attorney-client privileges.■**

**TO BE PUBLIC OR PRIVATE—THAT IS THE QUESTION**

As public companies begin to absorb the full impact of the Sarbanes-Oxley Act (SOX) on their operations and bottom line, smaller or more closely held ones continue to “go private” or consider doing so. Among the key issues facing smaller public companies are higher compliance costs, ongoing operational burdens of overall SOX compliance and the continuing internal control documentation requirements.

Since the adoption of SOX in July 2002, the number of companies de-listing their stock from NASDAQ and deregistering from the SEC to avoid its requirements has increased 30%, according to one accounting firm. Of

those de-listing, 23 have been community banks.

De-listing occurs either by reducing the stockholder base below 300 persons or selling the company. Among the various methods that are used to reduce the number of



**Many public companies are frustrated by the level of compliance that the SEC requires**

stockholders are (i) a repurchase of shares, (ii) a reverse stock split, (iii) a management buyout, or (iv) a squeeze-out merger.

The one-time nature of these costs can usually be offset by the related savings, provided the method chosen is successful in reducing the number of shareholders. Recently, one company found it necessary to use a reverse stock split after its initial method—a stock buyback—failed to lower its stockholder base below 300 persons.

**Non-listed shares are not carried by the Depository Trust Company, and a subsequent sell-off by the institutional stockholder base could further reduce post-transaction stock liquidity.■**

## DISCLOSURE FAILURE HAUNTS SELLERS IN MERGER

A recent court case highlights the importance of continuous disclosures by a target company to avoid later charges of securities fraud. In 1996, Media General acquired Park Communications for \$710 million, less adjustments and debt to be assumed. Prior to the January 1997 closing, a former Park employee threatened Park with a lawsuit for \$139,000 in damages. As a result, Media General and Park agreed at the closing to revise the merger price downward by \$147,000.

After the closing, Media General learned that:

- the former employee had also sent Park a letter two months before the closing, increasing his threatened damages claim to \$3-\$6 million, claiming a RICO violation and offering to settle for \$3 million; and
- Park's outside counsel advised Park's independent auditors of

the higher claim a month before the closing, and the auditors disclosed the potential loss in Park's draft audited financial statements prepared before the closing.

After the merger closed, Media General settled the lawsuit with the former employee and then sued Park for securities fraud and common law fraud for failing to disclose this information. Park argued that the



**Ask for all auditor information before finalizing any business deals**

information was not material to Media General because it was not included in Media General's post-merger SEC filing about the transaction. The trial court ruled for Park in a summary judgment, before the case even went to trial.

In reversing the trial court and sending the case back for trial, a federal court of appeals noted that the time to test whether a fact is "material" is "as of the time of the contested transaction" rather than at a later date. Thus, even though the potential effect of the threatened lawsuit was not disclosed in the post-merger SEC filing, it could still have been material at the time of closing based on the specific facts.

**The purchaser of a target company can avoid surprises with pending lawsuits by asking for all responses sent to auditors of the target company by its outside lawyers. ■**

## CREDIT UNION CONVERSION NOW MORE DIFFICULT

Recent changes to federal rules governing credit unions may further curtail the ability of a credit union to convert to a bank. The option to change form allows credit unions to eventually raise capital in the equity markets, also providing potential investor opportunities.

The change to a mutual savings bank charter is not an easy one, especially because a credit union will lose its tax-exempt status and have to operate in a different business environment. However, these

drawbacks can be offset by the potential increase in earnings funded by access to capital, especially from the lower-costing equity side.

Since 1998, when the federal Credit Union Membership Access Act was passed, 18 credit unions have converted to mutual savings banks and 10 of those have subsequently

used their new status to raise equity capital in the marketplace. There are currently 9,542 credit unions in the nation.

Under the rule changes, a credit union undergoing such a conversion must advise its members about the change in their voting rights and the possibility of a subsequent conversion to stock form, distribute a disclosure form prepared by federal regulators regarding the transaction, and use an independent third party to conduct a member vote.

These requirements are in addition to other procedural rules issued over the past two years.

**Investors are reportedly placing deposits in credit unions, anticipating that conversions to mutual savings banks could give them subscription rights in any subsequent IPO. ■**

**Credit union memberships currently total 85.6 million, with assets exceeding \$655 billion**

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