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CORPORATE NOTES

A BIWEEKLY REVIEW OF CURRENT LEGAL ISSUES

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THE SUPREME COURT DISCUSSES DOCUMENT RETENTION AND DESTRUCTION

The Supreme Court's recent decision reversing the conviction of accounting firm Arthur Andersen LLP contains important lessons for businesses, as well as a reminder of the importance of scrutinizing all requests for information that the government makes. Although the news coverage of the decision has emphasized that the reversal came too late to resurrect Andersen as an operating accounting firm, the decision's more lasting effects may be to re-affirm the importance of establishing and following a standard corporate policy for the retention and destruction of documents.

Use caution when deciding whether to destroy documents

Andersen was indicted for obstruction of justice for its destruction of documents that could have been relevant to an SEC and criminal investigation of financial improprieties at Enron. Notwithstanding a SEC request for documents from Enron, inside counsel and managers at Andersen instructed employees to continue to follow the Andersen document retention policy, which resulted in the destruction of documents relevant to Andersen's audit of Enron. Andersen only suspended the destruction of its documents after it received a formal request from the SEC for documents.

Andersen was convicted at trial after the judge had instructed the jury that it could convict Andersen even if it found that Andersen had honestly and sincerely believed that its conduct was lawful. The Supreme Court reversed the conviction because the jury instruction permitted the jury to convict Andersen for conduct that may have been innocent.

The Court's opinion emphasizes the importance of document retention policies. The Court stated that it "is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances." In other words, a manager's instructions to his employees to comply with a valid document retention policy would only violate the obstruction of justice statute if the manager acted corruptly—that is, dishonestly—even where compliance with a document retention policy would have the effect of impeding the government's investigation by denying it access to documents. Furthermore, it is not, the court said, "inherently malign" to try to persuade someone to withhold documents from the government if that person has the right to do so—say by invoking a privilege or a Fifth Amendment right.

The Court also emphasized a point that is important for the practical operation of document retention policies when it struck down the jury instructions that permitted conviction without the jury's finding a link between the documents destroyed and a particular pending or imminent proceeding to which the documents were relevant. The Court held that document destruction is criminal only where undertaken dishonestly in anticipation of a foreseeable proceeding.

The Supreme Court's recent ruling could have far-reaching impact

For example, a manager does not commit a crime by persuading his employees to destroy documents out of fear that some unidentified government investigator will find them, but he may commit a crime if he foresees that, say, the SEC will want the documents for some particular investigation.

The Court's opinion provides a ringing endorsement of the creation and routine operation of document retention and destruction policies. Every organization should establish these policies *before* it foresees an official investigation, and the organization should routinely follow its own policies. Once the organization learns that a particular official proceeding may begin, it is time to consult counsel about the continued operation of the policy.¤

MATERIALITY MISJUDGEMENTS BRING CONSEQUENCES

On June 2, 2005, the SEC approved a settlement of its investigation into the accounting practices of Huntington Bancshares, Inc. The investigation stemmed from alleged inflation of earnings for the years 2001 and 2002 which allowed Huntington to meet or exceed Wall Street expectations along with enabling executives to reap performance bonuses.

The misstatements, ranging from improper capitalization of commission costs to inappropriate deferral of pension expenses, were discussed by executives at several due diligence meetings. The due diligence meetings were undertaken to address material facts, financial reporting, and accounting issues related to the certification requirements under the Sarbanes-Oxley Act. Despite the due diligence discussions, executives of the corporation determined that the misstatements were not material.

Upon its investigation, the SEC disagreed and asserted that the CEO, former CFO and former Controller knew or should have known of the effect that the misstatements had on Huntington's ability to meet or exceed Wall Street expectations along with their performance bonuses. The SEC stated that the executives were aware of and failed to follow the procedures for determining materiality under SAB 99, including the consideration of the impact of the accounting misstatements or omissions on executive compensation or the ability to hit analyst consensus expectations.

It is important to be diligent and consider all the relevant facts to determine materiality

Pursuant to the settlement, Huntington agreed to pay a penalty of $7.5 million, and its CEO, former CFO and former Controller agreed to pay, in aggregate, penalties of $1.1 million. Moreover, the former CFO agreed to not act as an officer or director of a public company for 5 years and the former Controller agreed to a suspension from appearing or practicing before the SEC as an accountant for 2 years.

This settlement highlights the importance of considering both qualitative and quantitative materiality individually and in the aggregate.◘

CHANGING RULES FOR QUIET PERIODS?

In the wake of the near-derailment of Google, Inc.'s highly anticipated IPO last year after an interview with company executives was published, the SEC plans to vote June 29 on new rules that would let companies talk more freely in the period leading up to a public stock offerings. If adopted, the rules would largely end the so-called "quiet period" before stock offerings that was designed to limit marketing hype prior to public stock offerings.

After complications with Google's IPO last year, quiet period rules may be rewritten

At present, companies must limit communications about securities offerings primarily to formal SEC documents and must be careful when making any public announcements whether or not directly related to the upcoming offering. The new rules would let companies talk more freely to the public and very large companies with a record of well-managed offerings would even be permitted to advertise offerings in some circumstances.

While providing more freedom to speak during stock offerings, these new rules would be balanced against strict rules imposing legal liability for misstatements or omissions of important facts in interviews, ads, or other communications outside traditional SEC filings for an offering.◘

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