BLANK ROME LLP
COUNSELORS AT LAW
PUBLIC COMPANIES AND CAPITAL FORMATION GROUP

PRACTICE TIPS

DECEMBER 2012/JANUARY 2013 NUMBER 9

Say What? Smaller Reporting Companies Subject to Say-on-Pay in 2013

Smaller reporting companies are subject to say-on-pay and say-on- frequency votes for the first time this year. In January 2011, the SEC adopted final rules implementing the say-on-pay and say-on-frequency requirements of the Dodd-Frank Act. Under such rules, public companies are required to conduct shareholder advisory votes: (i) to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K, and (ii) to determine how often an issuer will conduct a shareholder advisory vote on executive compensation. Public companies, other than smaller reporting companies, were required to conduct such votes starting with the 2011 proxy season. Smaller reporting companies did not have to conduct such votes until their first annual or other meeting of shareholders occurring on or after January 21, 2013. (continued on page 2)

CONTENTS

PRACTICE TIPS

Say What? Smaller Reporting Companies Subject to Say-on-Pay in 2013 (continued from page 1)

In drafting their proxy statements for this year's annual meeting, smaller reporting companies should look to strategies utilized by other public companies during the past two proxy seasons to avoid a failed say-on-pay vote. For example, public companies have been using their proxy statements, especially their Compensation Discussion and Analysis section, as an opportunity to explain their executive compensation practices to shareholders. Although smaller reporting companies are not required to include a CD&A in their proxy statements, they may want to include disclosure similar to the CD&A, or, at a minimum, a summary of executive compensation practices in their proxy statements this year to discuss the company's compensation philosophy and how executive compensation is aligned with performance. ■ Return to Table of Contents

10b5-1 Plans Making Headlines

Rule 10b5-1 trading plans, and those using them, are making headlines. A Rule 10b5-1 trading plan is a written plan for buying or selling securities meeting the requirements of Exchange Act Rule 10b5-1(c). A properly adopted and implemented Rule 10b5-1 trading plan provides an affirmative defense against accusations of insider trading and allows the purchases and sales of securities even when the person using the plan is aware of material nonpublic information.

Rule 10b5-1(c) requires, among other things, that the (i) written trading plan be established in good faith and at a time when the person establishing the plan is not aware of any material nonpublic information, (ii) the written trading plan specify the amount, price and date of the transaction(s) (or include a written formula, algorithm, or computer program for determining the amount, price and date), and (iii) the person establishing the plan not exercise any subsequent influence over how, when, or whether to make purchase or sales. While anyone can establish a Rule 10b5-1 trading plan, they are mostly used by public company insiders, such as executive officers and directors, as company insiders are often aware of material nonpublic information which precludes them from trading. There is no SEC requirement that the existence or details of a 10b5-1 trading plan be made public.

On November 27, 2012, the *Wall Street Journal,* published "Executives' Good Luck in Trading Own Stock"[1] discussing how certain executives, including some executives using 10b5-1 trading plans, have benefitted from trading in their company's own stock. In a subsequent article, the *Wall Street Journal*[2] reported that federal prosecutors and securities regulators were taking a closer look into how company insiders use 10b5-1 plans, including an examination of some of the transactions discussed in the *Wall Street Journal's* November 27, 2012 article. Furthermore, a December 28, 2012 letter from the Council of Institutional Investors to the SEC detailed the Council's concerns with the potential misuse of 10b5-1 trading plans and asked the SEC to consider pursuing interpretive guidance or amendments to Rule 10b5-1 to provide additional restrictions on the use of such plans.

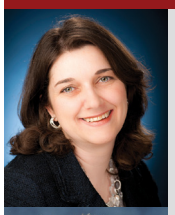
While it is impossible to determine whether there will be any lasting changes as a result of this current focus on Rule 10b5-1 trading plans, the recent attention is a reminder to public companies and their legal advisors to reevaluate periodically their policies regarding the use of Rule 10b5-1 trading plans to ensure that their policies are up to date. When reviewing such policies, companies may wish to consider the following:

- requiring that all Rule 10b5-1 plans be well documented and that copies of plans and related documentation be maintained as part of the company's records;
- a mandated period of delay between the adoption of the plan and the start of trading under the plan;
- public disclosure of the adoption, termination or amendment of 10b5-1 plans;
- requiring that insiders have only one 10b5-1 trading plan in effect at any time; and
- requiring that plans have a minimum duration of at least one year.

Rule 10b5-1 trading plans are undoubtedly a valuable tool to allow executives, directors and other insiders to manage their financial affairs and to diversify their investments. However, especially now with the increased scrutiny trading under Rule 10b5-1 plans is receiving, care should be taken to ensure that the plans are properly implemented and maintained. ■

Return to Table of Contents

This newsletter was authored by:



Yelena M. Barychev
215.569.5737
Barychev@BlankRome.com

Francis E. Dehel
215.569.5532
Dehel@BlankRome.com

Melissa Palat Murawsky
215.569.5732
Murawsky@BlankRome.com

Michael E. Plunkett
215.569.5471
Plunkett@BlankRome.com

The authors wish to acknowledge the assistance of Molly Crane, an associate of Blank Rome.

www.BlankRome.com/PublicCompanies

BLANK ROME LLP COUNSELORS AT LAW

Blank Rome LLP is an international law firm representing businesses and organizations ranging from Fortune 500 companies to start-up entities. The Firm's practices include public companies and capital formation; mergers and acquisitions and private equity; business tax; commercial and corporate litigation; employment, benefits and labor; financial services; bankruptcy and business restructuring; government relations; health law; intellectual property; maritime, international trade and procurement; matrimonial; product liability; public finance; real estate; trusts and estates; and white collar, internal and government investigations. More information about the firm is available at www.BlankRome.com.

BOCA RATON
CINCINNATI
HONG KONG
HOUSTON
LOS ANGELES
NEW YORK
PHILADELPHIA
PRINCETON
SHANGHAI
TAMPA
WASHINGTON
WILMINGTON

Directors Beware: This *Seinfeld* Not So Funny

Boards and committees that grant themselves awards under company equity plans should review those plans in light of a 2012 Delaware Chancery Court case.

In *Seinfeld v. Slager,*[3] a shareholder brought five derivative claims alleging breaches of fiduciary duties in the awarding of compensation to the board and officers. The only claim to survive the summary judgment motion of the defendant directors was a claim that the board had awarded itself excessive compensation when it granted each of the directors restricted stock units with a value of $743,000 and $215,000 per award in 2009 and 2010, respectively. The defendants argued that the awards did not violate the terms of the stockholder approved Stock Plan under which the awards were made and, therefore, were protected by the business judgment rule. However, the judge rejected the directors' contentions because, although the Stock Plan set limits on the size of the awards, it did not set forth "meaningful" limits in the judge's view, and therefore was subject to the more stringent requirements of the "entire fairness" doctrine.

Directors' actions generally are protected by the business judgment rule. In a lawsuit alleging a breach of the fiduciary duty of care, the court presumes the directors exercised proper business judgment unless the plaintiff can show the directors did not act on an informed basis, in good faith and in the reasonable belief that their action was in the best interests of the company. However, when the director is on both sides of a transaction, the "entire fairness" standard applies, which shifts the burden of proof to the directors to prove that the transaction is entirely fair to the company, a high hurdle.

The Stock Plan at issue provided that the Board could grant awards for a total of up to 10,500,000 shares and could grant up to 1,250,000 restricted stock units per year to an "Eligible Individual" (an employee, officer or director). The judge did not consider these limits meaningful because, in theory, the Board could have awarded itself one-time grants worth $21 million per director at the then current market value of the stock. This limitation, in the Court's view, did not satisfy the test previously laid down in an earlier decision in *In re 3Com Corp. Shareholders Litigation.*[4]

In *3Com,* the Court held that directors who granted themselves awards under a stockholder approved plan with "sufficiently defined terms" did not breach their duties and were entitled to the protections of the business judgment rule. Although not discussed in the *3Com* decision, an examination of the plan at issue in *3Com* shows that the plan contained the following limits on awards to directors:

- annual grants for services as a director not to exceed 60,000 shares per director (80,000 shares in the case of the Chairman); and
- annual grants for services as a member of a standing committee, not to exceed 24,000 shares per director.

In the *Seinfeld* decision, the Court gave the following guidance to directors:

> A stockholder-approved *carte blanche* to the directors is insufficient. The more definite a plan, the more likely a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the *total* pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair.[5]

The problem for directors (and their counsel) is determining exactly what is a sufficient or meaningful limit under the *Seinfeld* rubric. Many plans have general limitations on the number of shares or units that can be awarded to participants, including directors. Under the court's decision in *Seinfeld,* these general limitations are not sufficient to provide the protections of the business judgment rule. Directors that award equity to themselves under plans that do not have meaningful limits will have to defend the grants under the more rigorous "entire fairness" standard.

We recommend that directors carefully review the plans under which they grant themselves equity awards. We believe that the following types of provisions in stockholder approved plans will be more likely to be found to be "meaningful" and entitle the board to the protections of the business judgment rule:

- specific annual limitations on the number of shares that can be awarded to directors (and not just generic limitations on the number of shares that can be awarded to participants, as was the case in *Seinfeld*) that are far less than all of the shares that can be awarded under the plan; or
- formula provisions (e.g., awards based on a prescribed dollar value).

If these types of limitations are not in director equity plans, directors should act now to amend the plans to include them and submit them to stockholders for approval; otherwise, to paraphrase the "Seinfeld" show, there may be "no stock options for you!" ■ Return to Table of Contents

Are Your Executives Posting Company Information on Facebook or Other Social Media Websites? The SEC Is Watching.

On December 6, 2012, Netflix filed a Form 8-K announcing that, on December 5, 2012, Netflix and its CEO, each received a "Wells Notice" from the SEC Staff indicating its intent to recommend that the SEC institute a cease and desist proceeding and/or bring a civil injunctive action against Netflix and its CEO for violations of Regulation FD, Section 13(a) of the Exchange Act and Rules 13a-11 (Current Reports on Form 8-K) and 13a-15 (Controls and Procedures) under the Exchange Act. The 8-K itself represents an interesting piece of disclosure, but the CEO's follow-up Facebook post attached to it is even more interesting to read.

Please see below a few quotes from Reed Hastings' (Netflix' CEO) Facebook post attached to the 8-K, which describes Mr. Hastings' prior posts and his reaction to the SEC's Wells Notice.

> *"We use blogging and social media, including Facebook, to communicate effectively with the public and our members. In June we posted on our blog that our members were enjoying "nearly a billion hours per month" of Netflix, and people wrote about this. We did not also issue a press release or 8-K filing about this. In early July, I publicly posted on Facebook to the over 200,000 of you who subscribe to me that our members had enjoyed over 1 billion hours in June, highlighting how strong our content was. There was press coverage as there are many reporters and bloggers among you, my public followers. Some of you re-posted my post. Again, we did not also issue a press release or file an 8-K about this."*

> *"First, we think posting to over 200,000 people is very public, especially because many of my subscribers are reporters and bloggers. Second, while we think my public Facebook post is public, we don't currently use Facebook and other social media to get material information to investors; we usually get that information out in our extensive investor letters, press releases and SEC filings. We think the fact of 1 billion hours of viewing in June was not "material" to investors, and we had blogged a few weeks before that we were serving nearly 1 billion hours per month. Finally, while our stock rose the day of my public post, the increase started well before my mid-morning post was out, likely driven by the positive Citigroup research report the evening before."*

Netflix' debacle highlights the disparity between current news dissemination channels and Regulation FD rules, which date back to 2000 and are designed to address the problem of selective disclosure of material information by companies. In 2000, the SEC took a narrow view as to what constituted a broad, non-exclusionary distribution of material nonpublic information. For example, at such time, the SEC took the position that a company's website alone would not satisfy broad dissemination for Regulation FD purposes. In 2008, the SEC backed off of this position and provided guidance in an interpretative release on when information posted just on a company website would be considered public enough to serve as an alternative method for distribution of material information about the company under Regulation FD.

Assuming the information is viewed as material, it is unclear whether the SEC would extend its guidance set forth in its 2008 interpretative release to Facebook or other social media posts. If the SEC did apply such guidance to social media, a company would need to evaluate whether (i) the company's or executive's presence on these social media websites is viewed as a recognized channel of distribution of information about the company, its business, financial condition and operations and (ii) disclosure of information through social media tools makes it available to the securities marketplace in general.

(continued on page 5)

SEC Issues Compliance and Disclosure Interpretations on Disclosure of Activities Relating to Iran

In August 2012, the Iran Threat Reduction and Syria Human Rights Act of 2012 (the Act) became law. Among other things, Section 219 of the Act added Section 13(r) to the Exchange Act. Section 13(r) requires companies that file periodic reports under Section 13(a) of the Exchange Act to disclose in their quarterly and annual reports certain information related to activities that they, or any of their affiliates, knowingly engaged in involving Iran. Generally, the activities for which disclosure is required are defined by various laws and executive orders that already exist and govern activities relating to Iran. Importantly, Section 219 does not require the SEC to promulgate any rules. Thus, reporting companies will have to comply with the disclosure requirements with respect to periodic reports required to be filed after February 6, 2013.

To provide reporting companies assistance in interpreting and complying with new Section 13(r), in December 2012, the SEC released seven new C&DIs discussing the additional disclosure requirements. Among other things, the C&DIs affirm that activities covered by Section 13(r) that occurred during the fiscal year covered by an annual report must be reported in such annual report even if the activities occurred prior to August 10, 2012, the date the Act became law. In addition, the SEC confirmed that reporting companies should look to the definition of "affiliate" in Exchange Act 12b-2 when interpreting Section 13(r). ■

Return to Table of Contents

SEC NEWS

Are Your Executives Posting Company Information on Facebook or Other Social Media Websites? The SEC Is Watching. (continued from page 4)

While it still remains to be seen whether the SEC will recognize social media websites as appropriate Regulation FD disclosure vehicles, companies should consider revisiting the adoption of social media policies to establish parameters for appropriate social media disclosures of company information. ■ Return to Table of Contents

Welcome a New Type of SEC Filing—IRANNOTICE

On December 19, 2012, the SEC announced that the Notice required by the Iran Threat Reduction and Syria Human Rights Act of 2012 should be filed on EDGAR. This new EDGAR form is called IRANNOTICE, and it will be publicly available on EDGAR upon filing with the SEC. On January 14, 2013, the SEC adopted revisions to its EDGAR manual to add IRANNOTICE as a new submission type.

Section 219 of the Act added a new subsection (r) to Section 13 of the Securities Exchange Act of 1934, which requires an issuer that files Exchange Act periodic reports under Section 13(a) of the Exchange Act to disclose in its annual or quarterly report whether during the period covered by the report the issuer or any of its affiliates knowingly engaged in certain specified activities, including contacts with or support for Iran. Section 13(r) also requires an issuer that describes such activity in a periodic report to concurrently file with the SEC a notice, designated as IRANNOTICE by the SEC, that identifies the issuer and indicates that disclosure of the activity was included in its periodic report. ■ Return to Table of Contents

NASDAQ / NYSE NEWS

When Do You Need to Start Complying With New NASDAQ and NYSE Compensation Committee Rules?

On January 11, 2013, the SEC approved proposed changes to the listing standards of the New York Stock Exchange LLC and NASDAQ Stock Market LLC related to compensation committees. Both exchanges created transition periods to comply with the new rules.

As of July 1, 2013, NASDAQ and NYSE listed companies will be required to comply with the new rules relating to the authority of a compensation committee to retain compensation consultants, legal counsel, and other compensation advisers; the authority to fund such advisers; and the responsibility of the committee to consider independence factors before selecting such advisers. The requirement that such authority and responsibilities of the compensation committee be included in the compensation committee's written charter does not apply until a later date (see below) for NASDAQ listed companies and such companies should consider under state corporate law whether to grant such specific responsibilities and authority through a charter, resolution or other board action. In contrast, NYSE listed companies will have to amend their existing charters as of July 1, 2013 to address these additional rights and responsibilities of the compensation committee related to compensation consultants, legal counsel, and other compensation advisers. To the extent a NASDAQ listed company does not have a compensation committee by July 1, 2013, these requirements will apply to the independent directors who determine, or recommend for the board's determination, the compensation of the CEO and other executive officers of the company.

The remaining new rules, for example, compensation committee charter and independence standards for compensation committee members, will not have to be complied with by NASDAQ listed companies until the earlier of their first annual meeting after January 15, 2014, or October 1, 2014. NYSE listed companies will have until the earlier of their first annual meeting after January 5, 2014, or October 31, 2014, to comply with the new standards for compensation committee director independence. ■ Return to Table of Contents

SEC COMMENT LETTER TRENDS

Common Disclosure Flaws

In the 2012 proxy season, executive compensation disclosure continued to be an area of focus for the SEC staff. As such, the SEC staff issued numerous comments seeking additional information and disclosure about such matters as performance targets and their use and the use of benchmarking and peer groups in compensation decision making, as well as clarifications with respect to summary compensation tables. In addition to these types of comments, in the 2012 proxy season, a number of the SEC staff's comments focused on:

- **The use of non-GAAP financial measures.** A number of registrants use non-GAAP financial measures, such as pre-tax profit, to determine the level of equity and/or cash incentive awards. While under Instruction 5 to Regulation S-K Item 402(b), disclosure of target levels that are non-GAAP financial measures is not subject to Regulation G or Item 10(e) of Regulation S-K (the regulations generally governing the use and public disclosure of non-GAAP financial measures), the instruction does require disclosure of how any non-GAAP financial measure used was calculated from the registrant's audited financial statements.

  In the event that non-GAAP financial measures are used to set performance targets or measurements of achievement, or otherwise used in determining compensation, the registrants should identify each such non-GAAP financial measure explain how the non-GAAP financial measure was calculated from the registrant's audited financial statements. While most comment letters requested an "explanation" or "brief explanation", at least one comment letter did request a "reconciliation" to the comparable GAAP financial measure.

- **Comments from the prior year.** SEC staff comments to definitive proxy statements are, typically, "future" comments that request a registrant to provide additional information or an explanation to the SEC staff and to provide the enhanced or corrected disclosure in future filings in a manner consistent with the staff's

(continued on page 6)

New Form of Due Diligence: Relationships with Compensation Consultants

Due to recent SEC rulemaking,[6] conflicts of interest with compensation consultants are at the forefront of disclosure issues in 2013 proxy season. The SEC added paragraph (e)(3)(iv) to Item 407 of Regulation S-K concerning issuers' use of compensation consultants and related conflicts of interest to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. New Item 407(e)(3)(iv) disclosure, which should be addressed in any proxy or information statement for a meeting of shareholders at which directors will be elected occurring on or after January 1, 2013, expands disclosures related to compensation consultants.

Generally, Item 407(e)(3) requires public companies subject to the SEC proxy rules to describe the company's procedures for the consideration and determination of executive and director compensation. In 2009,[7] the SEC amended Item 407(e)(3) to bring to light conflict of interest situations arising when a consultant is paid for both compensation consulting services as well as other services (for example, benefits administration, human resources consulting and actuarial services) because such dual engagement may affect the independence of the advice related to compensation matters. Amendments to Item 407(e)(3) adopted in 2012 are broader in their scope and require[8] public companies, in the case of compensation consultants that played any role in determining or recommending the amount or form of executive and director compensation during the company's last completed fiscal year and whose work has raised *any* conflict of interest, to disclose the nature of the conflict and how the conflict is being addressed. Instruction to Item 407(e)(3)(iv) states that, among the factors that should be considered in determining whether a conflict of interest exists, companies should review the same factors as the ones that should be evaluated by the compensation committee in connection with its assessment of the independence of a compensation adviser.[9]

In order to prepare the disclosure related to compensation consultants for this proxy season, companies need to carefully due diligence their relationships with compensation consultants and solicit conflict information, whether via a formal compensation consultant questionnaire or otherwise, in order to evaluate whether a conflict of interest exists in their relationships with compensation consultants.

If the company had a compensation consultant that played any role in determining or recommending the amount or form of executive and director compensation during the company's last completed fiscal year, the company needs

(continued on page 7)

SEC COMMENT LETTER TRENDS

Common Disclosure Flaws (continued from page 5)

comment and the registrant's response. As such, the comment letter process may not be reflected in the registrant's last filed proxy statement. As most registrants probably start with last year's proxy statement when preparing the current year's proxy statement, it is very important to review any comment letters from prior years to be sure that disclosure the registrant has committed to make is in fact made. The SEC staff has from time to time insisted that filed definitive proxy statements be revised to make changes a registrant committed to make in response to the prior year's comments.

- **Related party transactions.** In the 2012 proxy season, the SEC staff issued a number of comments seeking additional disclosure with respect to related-party transactions, and in particular loans by financial institutions to related parties. With respect to loans by financial institutions to related parties, the SEC staff focused on the detailed disclosure requirements of Instruction 4.c. to Item 404(a) of Regulation S-K, which require disclosure with respect to whether loans by certain financial institutions to related parties were made on substantially similar terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the lender and/or involved more than the normal risk of collectability or presented other unfavorable features. The staff's comments made clear a preference for use of the exact wording from Instruction 4.c., such as "persons not related to the lender" as opposed to "other persons."

While for the 2012 proxy season the SEC staff seemed to focus its review of related party transaction disclosure on loans by financial institutions to related parties, the SEC staff also provided comments on related party transaction disclosure to a number of registrants involved in other industries. With the SEC's recent focus on related party transaction disclosure, for the 2013 proxy season, registrants should carefully review Item 404 of Regulation S-K to be sure that all required information with respect to related party transactions is properly disclosed. ■

Return to Table of Contents

New Form of Due Diligence: Relationships with Compensation Consultants (continued from page 6)

to clearly understand the parameters of this role. If such role in executive or director compensation was limited to *only:*

- consulting on any broad-based plan that does not discriminate in favor of executive officers or directors of the company and that is available generally to all salaried employees (for example, 401(k) plan or health insurance plan), or
- providing information that is not customized for a particular company or, if customized, is based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice,

then activities of such compensation consultant are not covered by the SEC disclosure rules.

If the compensation consultant's role was broader than just providing the general services described above, then the company should be able to clearly identify (i) the nature and scope of the compensation consultant's assignment and (ii) the material elements of the instructions or directions given to the consultants with respect to the performance of their duties. The company should identify all types of services provided by the compensation consultant or its affiliates, including the person that employs the compensation consultant, during the company's last completed fiscal year *in addition* to recommendations on the amount or form of executive and director compensation. Such information not only affects the level of disclosure, but also is a factor in the company's determination of whether the conflict of interest exists in the relationship with the compensation consultant.

The company should also focus on the role played by the compensation committee (or persons performing the equivalent functions) or management in the engagement of the compensation consultant. For example, if the compensation consultant was engaged by the compensation committee, the company should determine whether:

- the decision to engage the compensation consultant or its affiliates for other services was made, or recommended, by management; and
- the compensation committee or the board approved such other services of the compensation consultant or its affiliates.

The amount of fees[10] paid to compensation consultants should be very carefully tracked and companies should distinguish fees paid for compensation consulting services and additional services performed by the consultant or its affiliates during the company's last completed fiscal year. If fees for such additional services did not exceed $120,000, then public companies are *not* obligated to disclose the aggregate fees paid to the compensation consultant for (i) determining or recommending the amount or form of executive and director compensation or (ii) any additional services provided by the compensation consultant or its affiliates. However, the amount of fees paid by the company to the person that employs the compensation consultant (irrespective of the amount) as a percentage of the total revenue of such person is one of the factors that should be considered in determining whether a conflict of interest with the compensation consultant exists.

In order to be able to evaluate whether the relationship with a compensation consultant during the company's last completed fiscal year presented any conflict of interest issues, the company should also go through the following "due diligence" steps:

- request either a copy or a description of the policies and procedures of the person that employs the compensation consultant that are designed to prevent conflicts of interest;
- inquire about any business or personal relationship of the compensation consultant with a member of the compensation committee (or persons performing the equivalent functions) as well as any business or personal relationship of the compensation consultant or the person employing the consultant with an executive officer of the company; and
- obtain information regarding any company stock owned by the compensation consultant (the SEC believes that this inquiry should also include the stock owned by family members of the compensation consultant).

Generally, for the purposes of these conflict of interest determinations, the term "compensation consultant" is viewed broadly and includes members of the consultant's team working on the company's engagement.

There are no materiality thresholds included in the foregoing factors related to the conflict of interest determinations, which makes it more difficult for companies to determine which compensation consultant had a conflict of interest. A public company is not required to use only those compensation consultants that are free from any conflict of interests. However, through disclosure rules regulations, the SEC sends a clear message that the consultants' recommendations regarding executive and director compensation should not be influenced by various conflicts of interest that may exist between the company and the compensation consultant. ■ Return to Table of Contents

CORPORATE GOVERNANCE

Indemnify Me, Maybe

A recent Delaware Chancery Court letter opinion is a reminder that directors, officers and their counsel should carefully review the mandatory indemnification and advancement of expenses language in their bylaws and indemnification agreements to ensure that they mean what they think the mean.

In *Miller v. Palladium Industries, Inc.* (Del. Ch. Dec. 31, 2012, available at http://courts.delaware.gov/opinions/download.aspx?ID=182530), the Court dismissed an action for mandatory (continued on page 8)

Indemnify Me, Maybe (continued from page 7)

advancement of legal defense costs brought by a former director who was being sued by the corporation. The relevant provisions of the bylaws provided for mandatory indemnification and advancement of expenses; however, another section of the bylaws provided that expenses incurred in defending a proceeding "shall be paid by the corporation in advance of such proceeding's final disposition unless otherwise determined by the Board of Directors in the specific case …" Here, the Board had determined that the advancement of expenses was not in the best interests of the corporation for various reasons and denied the request.

The Court did not consider the two bylaw provisions ambiguous and construed them together: "Palladium must advance legal fees and expenses if the board does not adopt a contrary directive… Failure of the board to act in a specified time after receipt of a request for advancement will leave the request as a mandatory one. Here, the board acted in a timely fashion—within roughly thirty days from the date of Miller's demand." As a result, the Court dismissed the former director's claim for advancement of expenses.

So blow the dust off your bylaws and indemnification agreements, read the applicable language and make sure it says what you think it says. ■ Return to Table of Contents

The SEC Approved PCAOB Rules on Communications with Audit Committees

In December 2012, the SEC approved PCAOB proposed rules on Auditing Standard No. 16, *Communications with Audit Committees.* Auditing Standard No. 16 supersedes PCAOB's interim standards AU section 380, *Communication with Audit Committees,* and AU section 310, Appointment of the Independent Auditor. Auditing Standard No. 16 is effective for audits of financial statements for fiscal years beginning on or after December 15, 2012 and applies to the audits of all issuers, including emerging growth companies established under the JOBS Act and foreign private issuers.

It is interesting to note that, among other matters, Auditing Standard No. 16 expands the inquiries of the audit committee required by Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* which requires the auditor to inquire of the audit committee regarding its knowledge of the risks of material misstatements, including fraud risks. The inquiry required by Auditing Standard No. 16 goes beyond material misstatements and fraud risks and provides that the auditor "should inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations."

In light of this inquiry, audit committees will need to discuss procedures for evaluating violations, including possible violations, of laws and regulations, especially considering the fact that this requirement does not include any materiality threshold. ■ Return to Table of Contents

ENDNOTES

1. Available at http://online.wsj.com/article/SB10000872396390444100404577641463717344178.html. [Return to Article]
2. "Insider-Trading Probe Widens, Dec. 10, 2012, available at http://online.wsj.com/article/SB10001424127887323339704578171703191880378.html. [Return to Article]
3. *Seinfeld v. Slager,* 2012 Del. Ch. LEXIS 139 (Del. Ch. June 29, 2012), available at http://courts.delaware.gov/opinions/download.aspx?ID=174870. [Return to Article]
4. *In re 3COM Corp. Shareholders Litigation,* 1999 Del. Ch. LEXIS 215 (Del. Ch. Oct. 25, 1999). [Return to Article]
5. *See Seinfeld* at 41. [Return to Article]
6. *See* SEC Release No. 33-9330, Listing Standards for Compensation Committees (June 20, 2012). [Return to Article]
7. *See* SEC Release No. 33-9089, Proxy Disclosure Enhancements (Dec. 16, 2009). [Return to Article]
8. This new change implemented the mandate of Section 10C(c)(2)(B) of the Securities Exchange Act of 1934 (Exchange Act). [Return to Article]
9. *See* Exchange Act Rule 10C-1(b)(4)(i) through (vi). [Return to Article]
10. No disclosure regarding the fees is required for the compensation consultant hired by management if the compensation committee also hired its own consultant, regardless of how much it may have been paid. [Return to Article]

QUESTIONS: If you have a question regarding the issues raised in this newsletter, you may obtain additional guidance from the authors and other members of our Public Companies Group.

PHILADELPHIA

Yelena Barychev
215.569.5737 ▪ Barychev@BlankRome.com

Frank E. Dehel
215.569.5532 ▪ Dehel@BlankRome.com

Barry H. Genkin
215.569.5514 ▪ Genkin@BlankRome.com

Timothy French
215.569.5394 ▪ French-T@BlankRome.com

Alan H. Lieblich
215.569.5693 ▪ Lieblich@BlankRome.com

Frederick D. Lipman
215.569.5518 ▪ Lipman@BlankRome.com

Richard J. McMahon
215.569.5554 ▪ McMahon@BlankRome.com

Arthur H. Miller
215.569.5544 ▪ AMiller@BlankRome.com

Melissa Palat Murawsky
215.569.5732 ▪ Murawsky@BlankRome.com

Michael E. Plunkett
215.569.5471 ▪ Plunkett@BlankRome.com

Josh Strober
215.569.5491 ▪ Strober@BlankRome.com

Larry R. Wiseman
215.569.5549 ▪ Wiseman@BlankRome.com

NEW YORK

Kathleen A. Cunningham
212.885.5175 ▪ KCunningham@BlankRome.com

Richard DiStefano
212.885.5372 ▪ RDistefano@BlankRome.com

Pamela E. Flaherty
212.885.5174 ▪ PFlaherty@BlankRome.com

Eliezer M. Helfgott
212.885.5431 ▪ EHelfgott@BlankRome.com

Robert J. Mittman
212.885.5555 ▪ RMittman@BlankRome.com

Brad L. Shiffman
212.885.5442 ▪ BShiffman@BlankRome.com

Jeffrey N. Siegel
212.885.5173 ▪ JSiegel@BlankRome.com

Kristina Trauger
212.885.5339 ▪ KTrauger@BlankRome.com

Thomas R. Westle
212.885.5239 ▪ TWestle@BlankRome.com

WASHINGTON, D.C.

Edward L. Lublin
202.772.5933 ▪ Lublin@BlankRome.com

LOS ANGELES

Dennis P. Codon
424.239.3441 ▪ Codon@BlankRome.com

SHANGHAI

Jeffrey A. Rinde
+86.21.2089.3206 ▪ JRinde@BlankRome.com