BAILEY CAVALIERI LLC
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

THE SARBANES-OXLEY ACT OF 2002: HOW SHOULD DIRECTORS AND OFFICERS RESPOND?

Prepared by
Dan A. Bailey
J. David Washburn
Quentin C. Faust

The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

Much has been written summarizing the recently enacted Sarbanes-Oxley Act of 2002 ("Act"), which constitutes the most sweeping corporate governance legislation in decades. Although the Act does not create any new bases for civil lawsuits against directors and officers, it undoubtedly will aggravate an already dangerous legal environment in which D&Os must operate.

Directors and officers should embrace the new Act as an opportunity to improve governance practices and to restore credibility in their company's financial and business disclosures. Instead of searching for the minimum behavior mandated by the Act, D&Os should seek to identify and implement wide-ranging internal reforms which maximize the likelihood of effective oversight and accurate disclosures.

The following summarizes various actions which, depending on the circumstances, D&Os should consider in response to the key provisions of the Act. Adopting and documenting these actions can help reduce the potential for litigation, can serve as helpful evidence in defense of litigation and can potentially comfort D&O insurance underwriters in this difficult insurance market.

I. SET UP PROCEDURES TO SUPPORT CEO/CFO CERTIFICATIONS

➢ Background:

The Act requires contemporaneous certification by the CEO and CFO of the accuracy of all company financial statements filed with the SEC after July 30, 2002.

➢ Suggested Actions:

- The company should adopt policies that ensure that the CEO and CFO receive drafts of all Exchange Act reports with sufficient time to adequately review them before they are filed.
- CEOs and CFOs should document their active involvement in revising and shaping such Exchange Act reports.
- CEOs and CFOs should consider delegating portions of the reporting process to appropriate subordinate individuals. These individuals should be given the responsibility to report, in writing, directly to the CEO or CFO, including the possible certification by that individual as to all facts and circumstances under that person's supervision that affect the applicable portion of the report.
- CEOs and CFOs should be encouraged to retain independent financial and legal advisors (funded by the company) if significant issues arise regarding the content or accuracy of the certification or the due diligence related thereto.
- CEOs and CFOs should hold one or more meetings with the company's audit committee to allow for questions and answers on any issues that

have come up during the report preparation, particularly questions about accounting practices and internal controls management.

- Each CEO and CFO should maintain a comprehensive file containing all of the back-up information, reports and certifications relied upon in giving the CEO/CFO certification.

II. TAKE STEPS TO TIMELY REPORT SECURITIES TRADING BY COMPANY INSIDERS

➢ Background:

Effective August 29, 2002, the Act requires insiders to disclose trading in the company's securities within two business days of the trade, and no longer allows insiders to defer certain transactions in the company's securities, such as qualifying stock option grants.

➢ Suggested Actions:

- Prepare a memorandum to affected officers and directors describing the new reporting rules.
- Review all trades since the end of the company's last completed fiscal year and consider making a filing to bring any unreported prior trades "current" with the new reporting system.
- Review any automatic option grants to make certain these provisions do not result in unintentional reporting violations.
- The company should require "pre-clearance" of all insider trades with a specifically designated compliance officer.
- The company should require insiders to conduct transactions with a single broker who is aware of the company's pre-clearance policies.
- Insiders should grant the company a power of attorney to allow it to sign Section 16 reports on their behalf, giving the company the ability to quickly file such reports on their behalf.
- The company should retain a complete list of insider EDGAR filing codes to allow for faster electronic filing.
- Companies should consider adopting a policy requiring all pre-established Rule 10b5-1 trading plans of its insiders be publicly disclosed, in anticipation of stricter disclosure requirements relating to such pre-established trading plans.

III. SET UP GUIDELINES FOR MANAGEMENT AND INTERNAL ACCOUNTING STAFF TO FLAG EVENTS OR CIRCUMSTANCES REQUIRING IMMEDIATE PUBLIC DISCLOSURE

➢ Background:

The Act requires a public company to disclose to the public, on a "rapid and current basis," material changes in the company's financial condition or operations in accordance with specific rules to be issued by the SEC. Until the SEC publishes regulations defining these new "real time" disclosure obligations, directors and officers should consider establishing a general policy on what items and events it considers to be "material" and therefore appropriate for immediate disclosure.

➢ Suggested Actions:

- Develop a specific list of events pre-established as requiring disclosure. In this regard, it is good practice to examine the disclosure documents of similarly situated companies to determine how they are addressing common concerns. If other companies are disclosing a certain level of information, an implication may be created that such information is material and should be disclosed.

- Develop categories of events to be brought to counsel and management's attention for determination of materiality. Dollar thresholds may be useful guides in certain circumstances.

- Consider items the SEC has indicated to be likely material, including earnings information; new products or discoveries; changes in control or in management; calls of securities for redemption; adoption of repurchase plans; effectuation of stock splits or changes in dividends or other changes to the rights of security holders; entering or terminating material agreements outside the ordinary course of business; terminating or reducing a material business relationship with a customer; or reaching a conclusion that security holders should no longer rely on the company's previously issued financial statements or any related audit report.

IV. DETERMINE IF A CONFLICT OF INTEREST EXISTS SUFFICIENT TO REPLACE THE COMPANY'S INDEPENDENT AUDITOR

➢ Background:

The Act prohibits conflicts of interest between a company's independent auditor and certain of its executive officers, and also prohibits the same accounting firm from providing audit and non-audit services to public companies.

- Suggested Actions:

    - Survey the company's directors and officers to determine if the accounting firm that currently serves as the company's independent auditor has previously employed any of them. Consider obtaining certifications from the accounting firm as deemed necessary.

    - Discharge the company's independent auditor if the company's CEO, CFO, controller and/or chief accounting officer was previously employed by the independent auditor within the twelve months prior to the most recent audit year.

    - Consider discharging the independent auditor if any of the preceding individuals were employed by the independent auditor outside of this one-year period or if any other executive officer or a director has been employed by, or has a significant relationship, with the independent auditor.

    - Review all services that the company's independent auditor has provided to the company to determine if it has provided any non-audit services, including bookkeeping or accounting services; appraisal or valuation services, fairness opinions; actuarial services; internal audit outsourcing services; management or human resources functions, including compensation consulting; broker or dealer, investment adviser, or investment banking services; and legal services or other expert services unrelated to an audit.

    - If so, consider whether to:

        - Appoint a new independent auditor and allow the existing firm to continue providing the non-audit services; or

        - Maintain the company's existing independent auditor and seek a separate accounting firm to provide it with the non-audit services.

V. REPLACE MEMBERS OF THE COMPANY'S AUDIT COMMITTEE WHO ARE NOT "INDEPENDENT" UNDER THE NEW SEC GUIDELINES

- Background:

The Act requires the audit committee to be composed entirely of independent directors.

- Suggested Actions:

    - Identify any member of the audit committee who has accepted any consulting, advisory or other compensatory fee from the company other than as a director.

- Until the SEC adopts rules which further define "independence," carefully consider whether any members of the audit committee have other relationships with the company that might call their independence into question.

- Obtain resignations from directors who are not independent and appoint individuals to fill the resulting vacancies who qualify as independent.

VI. REVISE AUDIT COMMITTEE CHARTER

➢ Background:

The Act imposes many additional requirements on a company's audit committee. Including these requirements in an audit committee charter demonstrates the company's good faith attempt to comply with such rules and "institutionalizes" the new requirements into the audit review process.

➢ Suggested Actions:

A revised audit committee charter addressing the following matters should be adopted by the Board:

- Require pre-approval of all audit and non-audit services performed for the company by any accounting, auditing or other financial services company.

- Require the audit committee to approve *any* transaction between an officer or director and the company, or any subsidiary or affiliate of the company, to ensure that such "related-party" transactions have been approved by an independent body as an "arm's-length" transaction that benefits the company.

- Require independent auditors to report to the audit committee in writing all of the critical accounting policies to be used and all alternative treatments of financial information within GAAP that have been discussed with the company's management, including the treatment the independent auditor has recommended.

- Provide the audit committee with the authority to directly appoint, supervise and compensate the company's independent auditors.

- Require the audit committee to discuss annual and quarterly financial statements during one-on-one meetings with each of the company's auditors, management, internal accountants, and outside counsel.

- Circulate specific agendas for each meeting, prepare detailed records of each meeting, and consider having financial and legal advisors attend.

- Require the review of any representation letter that management provides to the independent auditor.

- Require the periodic review of the company's risk management and risk assessment policies.

- Establish procedures for the audit committee to receive, retain, investigate and respond to complaints relating to the company's accounting controls.

- Establish procedures for the audit committee to receive submission of confidential and anonymous information about the company's financial controls from the company's employees.

- Provide the audit committee with the authority and funds to engage independent counsel and other advisers regarding accounting or audit practices.

VII. TAKE NO ACTION AS A BOARD OR AS AN INDIVIDUAL DIRECTOR OR OFFICER WHICH CAN BE CONSTRUED AS INTERFERING WITH THE AUDIT PROCESS

➢ Background:

The Act prohibits any officer or director of a public company to fraudulently influence, coerce, manipulate or mislead an independent auditor engaged in auditing the company.

➢ Suggested Actions:

Directors and officers should avoid any action that could be construed as an attempt to exert improper influence over the independent auditor, including:

- "Suggesting" to the company's independent auditors, either directly or indirectly, a "preferred" accounting treatment for any specific item or transaction;

- Using the incentive of additional or increased use by the company of the independent auditor's services to induce the independent auditor to utilize a "preferred" accounting method in the company's financial audit; or

- Providing any information to an independent auditor that is false or misleading in order to achieve a specific accounting result.

VIII. DETERMINE IF ANY MEMBER OF THE AUDIT COMMITTEE IS A FINANCIAL EXPERT, AND IF NOT, CONSIDER APPOINTING ONE

- Background:

The Act requires the SEC to adopt rules which will require that a company to disclose in its Exchange Act reports whether it has a "financial expert" serving on the company's audit committee, and if not, why.

- Suggested Actions:

  - Determine if any of the audit committee members qualify as a "financial expert" based on (i) their understanding of GAAP and financial statements; (ii) experience in preparing or auditing financial statements of similar companies and applying such principles in connection with accounting for estimates, accruals, and reserves; (iii) experience with internal accounting controls; and (iv) understanding of audit committee functions.

  - Appoint at least one financial expert if none is currently serving on the audit committee.

  - Require all members of the audit committee to possess a defined minimum level of financial skills.

IX. DISCLOSE ALL MATERIAL OFF BALANCE SHEET TRANSACTIONS AND ANY MATERIAL CORRECTING ADJUSTMENTS

- Background:

The Act requires disclosure of off-balance sheet transactions and accounting adjustments and directs the SEC to adopt specific requirements for the presentation of pro forma financial statements.

- Suggested Actions:

  - Directors and officers should be informed about the need to disclose in the company's periodic Exchange Act reports whether it has any off-balance sheet transactions, arrangements, obligations (including contingent obligations) or other relationships with unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operation, liquidity, capital expenditures or resources.

  - Directors and officers should be informed about the need to disclose in the company's periodic Exchange Act reports whether the independent auditor has informed the company of any material correcting adjustments in accordance with GAAP and the SEC rules.

- Procedures should be implemented to “flag” these transactions for review on an ongoing basis.

X. TAKE STEPS TO ENSURE THE DIRECTORS AND OFFICERS DO NOT RECEIVE ANY IMPERMISSIBLE EXTENSIONS OF CREDIT FROM THE COMPANY

➢ Background:

The Act prohibits a public company from entering into certain credit arrangements with its directors and officers or otherwise renewing, extending or modifying the terms of any credit arrangement in place before July 3, 2002.

➢ Suggested Actions:

- Adopt and circulate to directors, officers and appropriate personnel clear policies and procedures which define and prohibit the proscribed extensions of credit.
- Extend the credit ban to the company “arranging” or otherwise assisting its directors and officers in obtaining credit from unrelated third parties, family members and affiliates of directors and officers, as well as the company providing travel advances and company-supported credit cards if used for “personal” uses.
- Identify all outstanding loans or other extensions of credit by the company to any officer or director, including loans made by any of the company’s subsidiaries, and set up procedures to prevent any modifications to existing credit agreements or further extensions of credit, even if future advances were contemplated by the original arrangement.
- Do not forgive loans previously made to directors and officers without careful consideration whether such forgiveness will be viewed as a “modification” of an existing credit arrangement.
- Review for compliance with the new rules any arrangements with directors or officers that have credit-like features, such as cashless exercise of stock options or procedures in stock option plans for loans to purchase option shares.

XI. REVIEW AND CONSIDER REVISING THE COMPANY’S DOCUMENT RETENTION PLAN

➢ Background:

The Act prohibits document destruction in connection with a federal inquiry or investigation. Compliance with an appropriate pre-established document retention plan may be useful evidence to support an affirmative defense against a charge of improper document destruction.

- Suggested Actions:

The following key points should be kept in mind when creating and maintaining a records retention policy:

- Policies should be applied uniformly.
- There must be legitimate reasons for the policy and a rationale for the way documents are slated for destruction.
- Policies should take into account any administrative or regulatory record-keeping requirements**.**
- Policies should not be adopted in bad faith or with the primary purpose to avoid preserving potential evidence.
- When litigation is reasonably foreseeable, the policy should prohibit the destruction of potentially relevant documents even if the documents would otherwise be destroyed. Adequate safeguards should exist to assure documents are not inadvertently destroyed under those circumstances.