

## **FINANCIAL REPORTING, TAXATION & ACCOUNTING**

### **Not Every Error Should Compel Restatement**

ABSTRACTED FROM: *Tips On Avoiding Unnecessary Restatements*

BY: Scott Taub, Financial Reporting Advisers, Chicago, IL (formerly SEC Deputy Chief Accountant)  
*Compliance Week*, June 2007, Pgs. 1, 72-73

**Size alone does not determine materiality.** Scott Taub, who was the deputy and the acting chief accountant for the SEC, believes that companies are restating their financials too often, particularly for errors that could simply be corrected in the next report. Not every error necessitates immediate restatement; only material errors trigger restatement, and size alone does not determine materiality. Small errors (i.e., those affecting net income by less than 5%) were once simply dismissed, considered too minor to be material. Yet some have a material impact on the future prospects of the company and thus would trouble investors upon discovery. A small error that has a cumulative effect may be more significant to investors than a larger error that is isolated. Most, however, are indeed immaterial and may simply be identified and corrected in the next statement.

**Large errors might be small problems.** Do not assume that all large errors require restatement, advises the author. While large ones more often are material, sometimes they too can just be corrected in the next report. For example, an error that has been exposed fully in bankruptcy proceedings could be considered immaterial because it is already public and has been addressed by the court. A large error in a very small item might also be considered immaterial; although the percentage of error is large, the item itself is too small to have much impact on investors. Nevertheless, even when an error does not compel restatement, the next periodic report should contain a correction. Investors (and regulators) realize that mistakes do happen, but failing to correct an immaterial error in a subsequent report is not wise. The error could become material after a change in circumstances, and restatement would then be overdue.

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**Consensus does not exist for every situation.** When the SEC asks a company to “revise or advise,” many CFOs panic and restate, rather than risk antagonizing the SEC. Where the executives genuinely believe that the error is immaterial, the author suggests the better course is to clarify the company’s position with the SEC. Once the SEC understands the company’s position, it often does not require restatement; even if it eventually does, these discussions give a clearer picture of the regulatory issues and thus prevent similar errors in the future. Nothing is jeopardized by exploring the SEC’s thinking with regard to a particular error. The SEC does not earmark an issuer for future scrutiny because the company would prefer to explain the error in the next report rather than restate the problematic report. Ask the SEC staff what is required to correct a particular error and why. Some errors occupy a gray area, where consensus among SEC staff has not yet been established. If company accountants disagree with SEC staff at the review level, the issuer may request a higher-level review by more senior SEC staff. These administrative procedures exist not merely for the protection of issuers but also to help the SEC clarify its own policies on the more unusual or difficult questions.

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## Likely No More US GAAP Reconciliation For Foreign Companies

ABSTRACTED FROM: *Saying Goodbye To U.S. GAAP*

BY: Ramona Dzinkowski

*Strategic Finance*, June 2007, Pgs. 47-49

**Dropping reconciliation.** Much to the SEC commissioners’ surprise, experts attending an SEC roundtable in early 2007 resoundingly agree: reconciling foreign financials to US GAAP is a useless, expensive exercise. Neither American investors, foreign investors, analysts, nor rating agencies rely on the reconciliation, and most view it as a hindrance to entering US markets, not a benefit. Economist Ramona Dzinkowski reports that of 165 foreign companies rated by Moody’s, only 13 have analysts within the United States; the rest are covered by foreign analysts, who neither need nor want reconciliation. Most interested parties rely on foreign comparables, information that is not in US GAAP. One investment banker indicated that investors will have adequate information without a reconciliation, in light of the impending standards convergence and the SEC oversight of foreign company reports.

**What to do until convergence.** Assuming that the SEC acts on the group’s recommendations, the author believes that the commissioners will likely drop the reconciliation requirement before 2009. *[EDITOR’S NOTE: On June 20, 2007, the SEC agreed to issue a proposing release on eliminating US GAAP reconciliation.]* SEC chair Christopher Cox imagines that until all issuers use a single, global reporting standard, the two accounting systems will operate side by side. An interim solution would allow issuers to choose between the global standard and US GAAP until convergence is complete. A former chief accountant for the SEC suggests that the United States should simply accept the international standards rather than run dual systems or require reconciliations.

**Once the cat is out of the bag.** International standards are coming to America sooner, not later. The author recommends that US firms begin hiring and training executives and implementing corporate reporting systems to prepare for the change. Plenty of difficulties remain; for example, companies must change their accounting principles, audit in a consistent way, and work with parallel systems in the interim. Foreign firms may bask in the savings generated by their no longer needing to reconcile to US GAAP (e.g., French insurer AXA will save an estimated \$25 million a year), but other costs and risks will emerge. For example, if the SEC were to ask issuers to restate financials using international standards, French companies could be charged with having falsified the prior statements, an act subject

to criminal penalties in France. Most importantly, once the international standard is in place and reconciliation is out, there is no going back to US GAAP.

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## Lessons From The First Years Of Sarbanes-Oxley Reporting

ABSTRACTED FROM: *Two Years And Counting*

BY: Kathryn Scarborough and Prof. Mark Taylor

Office of the Chief Accountant, Securities & Exchange Commission (KS); Creighton University (MT)

*Journal of Accountancy*, June 2007, Pgs. 74-80

**Learning from mistakes.** CFOs of small public companies preparing to comply with controversial Section 404 of the Sarbanes-Oxley Act can focus their efforts by learning from issuers that have already conducted their reviews. The first year of compliance with the requirement for public companies to assess internal control over financial reporting proved more costly and burdensome than many expected. Yet their efforts appear to have paid off. In the first year of compliance, 15.7% of issuers reported one or more material weaknesses, compared with 10.3% in the second year. Many companies reporting missteps in the first year subsequently improved: only 38% of those reporting ineffective internal controls in the second year of compliance had also reported problems in the first year. Incidents of material weakness could increase when the smallest public companies and non-accelerated filers begin reporting. Bearing in mind the weaknesses among issuers that have already been through the process, those new reporters can use data gathered thus far to target potentially troublesome areas, advise Kathryn Scarborough, a general business specialist for the SEC, and Mark Taylor, a professor of accounting.

**Most common material weaknesses.** Among companies with material weakness, the most common trouble in both years was the failure to apply GAAP or the misapplication of GAAP. Over 97% of the issuers with ineffective internal controls reported such incidences in year one, and nearly 99% did so in the second year. Specific GAAP failures included taxes and other FAS 109 issues; estimating failures related to liabilities, payables, reserves, and accruals; and inventory, vendor, or sales cost issues. Other common problems tallied by the authors reflect problems with documenting accounting policy and procedures, material or auditor adjustments, accounting personnel, and restatement of company filings.

**Profile of companies with ineffective controls.** Certain types of companies and industries had a higher incidence of problems with their internal controls over financial reporting than others, the authors discovered. Those with under \$700 million in market capitalization accounted for 64.4% (compliance year one) and 63.4% (year two) of the issuers reporting material weaknesses. In both years, companies in the insurance, finance, service, and real estate industries accounted for more than 70% of those reporting ineffective controls. The wholesale trade, manufacturing, services, mining, agriculture, forestry, and fishing industries were the only industries in the second year where more than 10% of issuers reported material weaknesses. Among audit firms, nearly 29% of Grant Thornton's clients and over 34% of BDO Seidman's clients reported ineffective internal controls in year one, compared to 12.6% to 15.5% for clients of the Big Four firms. The larger number of smaller client/firms with higher incidences of material weakness accounts for the difference. In year two, the percentage of clients with material weakness fell for all audit firms.

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## CORPORATE GOVERNANCE & DIRECTORS' DUTIES

### How Sarbanes-Oxley Changed Directors' Duties On The State Court Level

ABSTRACTED FROM: *Director Oversight And Monitoring:  
The Standard Of Care And The Standard Of Liability Post-Enron*  
BY: Prof. Regina Burch, Capital University Law School  
*Wyoming Law Review*, Vol. 6, No. 2, Pgs. 481-531

**Standards of care before Sarbanes-Oxley.** Directors are bound by three types of fiduciary duties: loyalty, good faith, and care (which includes the duty to monitor and oversee the corporation and to be informed about corporate affairs). Before the Sarbanes-Oxley Act, state courts provided the primary guidance to directors on the level of oversight they must provide. Case law dealt in particular with their responsibility to ensure that the company has appropriate systems for supplying material information on a timely basis. Law professor Regina Burch offers as an example the Delaware Chancery Court's decision in *Caremark International Inc. Derivative Litigation* (1996). After Caremark employees violated the law, plaintiffs claimed that the directors had breached their duty to actively monitor the company's performance. The *Caremark* court required boards to establish reasonable information systems and to question employees when the directors see red flags indicating possible misconduct. If a plaintiff can demonstrate that the board might have known of a red flag but did not act, the court will excuse demand on the directors in a derivative action. Under *Caremark*, as long as there is a reasonable monitoring system in place, the directors do not need to look into the effectiveness of internal controls but can instead rely on the recommendations of senior managers as to the controls' effectiveness.

**After Sarbanes-Oxley.** Since Sarbanes-Oxley became law, companies have adopted codes of conduct and procedures for reviewing their internal controls. These activities are changing the industry standard, the author suggests. Courts have not yet considered whether a violation of Sarbanes-Oxley constitutes a breach of the directors' duty of care. However, they have required greater care by directors in approving CEO compensation—a decision in the ordinary course of business that, under *Caremark*, would not have resulted in liability in the absence of red flags. The Southern District of New York, applying Delaware law in *Pereira v. Cogan*, found that the directors had breached their duty of care when they approved the CEO's compensation on the recommendation of the compensation committee without knowing what the compensation was or comparing it to the compensation of other CEOs. Similarly, in *Walt Disney Company Derivative Litigation*, the Delaware chancery court declined to dismiss the complaint, which alleged that the Disney board's decision to approve the president's compensation without review had violated its duty to act in good faith in the company's interests. The court faulted the directors for not asking sufficiently probing questions and not weighing the costs and benefits of their decision for the stockholders.

**Standards of care going forward.** In enacting Sarbanes-Oxley, Congress did not intend to affect the duty of due care under state law. State courts can impose an increased standard for liability because Sarbanes-Oxley has set a higher bar for what would be a director's minimum reasonable conduct, and behavior that was once considered negligent may now be considered grossly negligent. Plaintiffs may also challenge whether information systems are reasonably designed and whether the testing done on those systems is appropriate to determine if the systems are effective, citing the statute and its related rules. According to the author, private plaintiffs in the future will bring actions in state court alleging a breach of duties under Sarbanes-Oxley, since the federal statute lacks a private right of action and its

remedies—prison, forfeiture, and delisting—do not directly benefit the shareholders. Yet Sarbanes-Oxley's standards for directors' oversight duties will raise the bar in state courts.

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## **Distinguishing Between The Independent, Outside, And Disinterested Director**

ABSTRACTED FROM: *Three Concepts Of The Independent Director*  
BY: Prof. Donald Clarke, George Washington University Law School  
*Delaware Journal of Corporate Law*, Vol. 32, No. 1, Pgs. 73-111

**Refining the taxonomy of directors.** The prevailing view in the United States—since long before the scandals at Enron and WorldCom—has been that independent directors improve corporate performance. This view persists even though a majority of the empirical studies have found no such effect, and some have even detected a negative correlation. To law professor Donald Clarke's surprise, the different conceptions and the various functions of what is usually termed an independent director remain unexplored. A more general (and therefore more suitable) term would be *nonmanagement director*, which describes the single common element of the many other terms used in America and other countries: the director is not currently a member of senior management.

**A most familiar species.** The most frequently considered subtype of nonmanagement director is the *independent director*, someone who neither needs nor desires to curry favor with management and who will privately and publicly decry management's misconduct while defending the stockholders' interests. A rival concept (which, the author observes, is unpopular in the United States) is the director who is independent of both management and stockholders and whose responsibility to reconcile the interests of the corporation's various constituencies sometimes necessitates protecting the employees, for example, from the stockholders. One of the very few US laws, federal or state, that actually requires independent directors is Section 301 of the Sarbanes-Oxley Act. It states that every member of the audit committee at a company listed on a national stock exchange must be an independent director, i.e., one who neither receives fees (except director's fees) from the issuer nor is an affiliate of the issuer. Other federal laws (e.g., the Investment Company Act, the Internal Revenue Code, and the 1934 Act's Rule 16b-3) require independent directors but do not use that term.

**A rare breed in the US.** Other countries' laws dealing with directorial independence are less strict than Sarbanes-Oxley, notes the author. Although often mistaken for independent directors, *outside directors* serve a different function. They are simply board members not employed by the corporation, regardless of whether they satisfy an independence standard. Studies in the United Kingdom envision outside directors as providing specialized advice, a wider view of the corporation's operations than in-house executives could, and connections to other organizations. British and Japanese (but not American) corporate law contains requirements for outside directors. In Japan, for example, attorneys or vendors who do a lot of business with the corporation can sit as outside directors.

**Deal-by-deal classification.** State law, which plays a much bigger role than federal law in US corporate governance, employs the concept of the *disinterested director*. Under Delaware corporate law, if a director stands to benefit personally from a transaction to which the corporation is a party, the stockholders can sue to void the deal unless it is approved by a majority of the disinterested directors, i.e., those without such a conflict of interest. (The statute provides other means of preserving a transaction if all the directors have a conflict.) Directorial disinterestedness, unlike independence, can vary, so the statute as well as Delaware case law dictate an examination of the facts of each questionable

transaction to ascertain who is disinterested. This approach is burdensome, the author recognizes, but it frees management from having to administer an abstract requirement of independence, which might never be needed, and protects against stockholder suits alleging self-dealing.

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## SECURITIES ENFORCEMENT & FRAUD

### Option Backdating And Springloading Under Recent Delaware Case Law

ABSTRACTED FROM: *Delaware Law Developments: Stock Option Backdating And Spring-Loading*  
BY: C. Stephen Bigler and Pamela Sudell, Richards Layton & Finger, Wilmington, DE  
*Review of Securities & Commodities Regulation*, Vol. 40, No. 10, Pgs. 115-122

**While you're up, get me a grant.** While the backdating and springloading (i.e., dating forward) of stock options has attracted the attention of securities regulators, the manipulating of option grant dates for personal gain or to enhance another employee's compensation has significant ramifications under state corporation law. A company grants options based on plans approved by the shareholders, and these plans contain specific limitations on how to authorize the issuance of options and at what price to issue individual awards. Although backdating executives attempt to establish an "as of" date for awards made by written consent of the directors, Delaware corporate law does not allow such misdating, attorneys Stephen Bigler and Pamela Sudell argue. Under DGCL Section 141(f), the effective date of a consent resolution cannot be earlier than the actual date on which all the directors signed the consent, if not the later date on which the resolution enters the corporate records. An option granted at a price fixed earlier than the date of grant would therefore be invalid if the plan requires the option to be priced on the grant date.

**Care, loyalty duties implicated.** At least one Delaware case addresses whether backdating violates the directors' fiduciary duties. In *Ryan v. Gifford* (2007), the chancery court held that the "intentional violation of a stockholder-approved stock option plan, coupled with fraudulent disclosures" relating to whether the defendants complied with the plan, violates the directors' loyalty duties. That court refrained, however, from making so sweeping a statement about a springloaded option grant. In *In re Tyson Foods Consolidated Shareholder Litigation*, decided the same day as *Ryan*, the chancery court nevertheless concluded that misleading disclosures, misuse of inside information (i.e., news that would cause the stock value increase), and an obvious intent to subvert the option plan's pricing requirements tipped the scale against the directors. The authors observe that backdating and springloading cases normally involve allegations that would defeat directors' reliance on the business judgment rule to protect themselves from liability. Even in cases implicating the duty of care, if directors who approved an award failed to review the documents establishing the grant date, they would fail the requirement of informed judgment.

**The plaintiffs' challenge.** Based on *Tyson Foods*, plaintiff/shareholders need only allege that directors awarding or approving manipulated options acted in knowing violation of the option plan and used inside information. However, the authors suggest, other doctrines may be available to save option

grants—for example, to innocent, nonexecutive employees—that somehow contravene the option plan. Optionees might claim that the granting officials had apparent authority or that equitable or promissory estoppel prevented rescission. Since estoppel cannot apply if the underlying act is illegal or void, the authors contend that those seeking to uphold their options must argue that the improper dating made the grant voidable rather than void, thus allowing the directors to ratify the grant.

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## Overzealous SEC May Be Overcharging Corporate Gatekeepers

ABSTRACTED FROM: *Attorneys As Gatekeepers: SEC Actions Against Lawyers In The Age Of Sarbanes-Oxley*

BY: Lewis Lowenfels, Prof. Alan Bromberg, and Michael Sullivan  
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Southern Methodist University, Dallas, TX (AB); Coughlin Duffy, Morristown, NJ (MS)  
*University of Toledo Law Review*, Vol. 37, No. 4, Pgs. 877-930

**Strait is the gate.** Noted securities lawyers and scholars Lewis Lowenfels, Alan Bromberg, and Michael Sullivan have analyzed the cases brought by the SEC against lawyers since enactment of the Sarbanes-Oxley Act. They are trying to discern the SEC's intentions underlying its pronouncements on a lawyer's duty to be a gatekeeper in securities matters. While the Commission occasionally pays lip service to the lawyer's role as an advocate for the client, it has never in practice sought to balance that function against the duty it seeks to impose: securing, regardless of cost, the SEC's idea of compliance. Those costs are extremely high for the lawyer, whose reputation and career can be ruined simply by having the SEC bring an action, valid or not. Significantly, only one of the reported actions resulted in a decision; the rest were settled, usually with consents to an injunction and sometimes with payment of a fine.

**They did nothing wrong but wait.** The SEC has charged lawyers on various grounds. For example, defendant/lawyers allegedly participated in a fraud directly by concealing or falsifying material information; filed a false notice on Form 12b-25 concerning a registrant's failure to file periodic 1934 Act reports; participated in filing the false periodic reports themselves; sought to evade 1933 Act registration requirements; or issued false opinions in connection with a securities sale or registration. While some of the actions in the first and third categories seem straightforward, closer examination suggests the defendant did nothing wrong other than wait for solid information before pressing for greater disclosure. In *SEC v. Isselmann*, for example, an in-house general counsel gave proper advice concerning the disclosure of pension costs for certain foreign employees. He then accepted—until he obtained evidence to the contrary—a statement from an executive about outside counsel's opinion on the pension accounts' status under foreign law. In *SEC v. Spiegel Inc.*, a Form 12b-25 case, outside counsel pressed as far as possible its advice to file a Form 10K with a highly damaging qualified auditors' opinion. Counsel then filed Form 12b-25, using a technically correct but arguably misleading rationale for the failure to file the 10K. The authors contend that under the circumstances, which involve an uncooperative controlling stockholder, a blunter statement on the form would have done nothing to protect other shareholders.

**Good advice, bad outcome.** In a case involving registration exemptions under the 1933 Act, the SEC sought to discipline Google's general counsel. It alleged that counsel had failed to inform the Google board that it had issued too many options to employees, thereby exceeding its private placement limit under Regulation D. The authors disagree, praising the attorney's analysis of the exemptions and the quality of his advice, including his conclusion that even if too many options were issued, a rescission offer could cure the defect without voiding the entire option program. The parties settled the case,

perhaps to facilitate Google's subsequent IPO. The one contested case in the review involved counsel who issued a tax exemption opinion in a municipal bond offering. The client/school district decided after the bond sale had closed to change its use of the bond proceeds. The SEC argued that the lawyer should have compelled the district to revise its bond prospectus, since the change could affect the bonds' tax exemption. The SEC's administrative law judge did not concur, ruling that the lawyer had acted properly based on the information available to him and was not responsible for requiring corrective disclosure after his representation had ended.

**Rough waters ahead.** The authors question the soundness of the SEC's legal theories and judgment in bringing many of its cases, which often fail to distinguish between major offenses and low-impact errors in gray areas. Nevertheless, they caution, the rapid proliferation of such cases, the disparity of contexts in which charges arise, and the variety of legal theories invoked by the SEC show that the SEC is aggressively seeking to charge lawyers with responsibility to police issuers' and registrants' internal information. To the SEC, the lawyer should independently verify nearly all statements of any significance, raise any issues to the highest levels, and—in effect—not take no for an answer. The authors believe that the SEC is seeking to exploit lawyers' vulnerability to reputational damage to advance its own agenda. Given this vulnerability, lawyers may have little choice but to comply.

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