

## CALIFORNIA CORPORATE DISCLOSURE ACT

### Overview

On September 28, 2002, the California Corporate Disclosure Act (the Act) was enacted. The Act, which goes into effect January 1, 2003, applies to publicly traded corporations incorporated in California or qualified to do business in California and greatly increases the annual disclosure that those corporations must make. The Act does not apply to business entities that are not-for-profit corporations, limited liability companies, limited liability partnerships, partnerships, and the like.

Currently, California domestic and foreign corporations qualified to do business in California must file a biennial statement (the Statement) listing officers, directors, principal place of business and other basic information. The Act changes the biennial filing to an annual filing and, more importantly, specifies substantial additional information that *publicly traded* corporations must include in the Statement. It is important to note, however, that a California subsidiary (whether incorporated in California or qualified to do business in California) of a publicly traded, foreign corporation will not, absent further guidance from the California Secretary of State, subject its foreign parent corporation to the Act. In addition, if a publicly traded, foreign corporation transacts business in California only through a subsidiary and not directly, then the subsidiary will not automatically be required to report under the Act, unless the subsidiary is both a corporation and publicly traded itself.

At this time, the California Secretary of State is required to mail a blank Statement to each corporation for completion. Under the Act, the Secretary must mail the Statement to each corporation no later than three months prior to its required filing date (*see discussion below*), but the Secretary will not be liable for a corporation's failure to file because it did not receive the blank Statement. The California Secretary of State must make publicly available, in an online database to be created no later than December 31, 2004, the information that filers include on their Statements.

The Act also creates the Victims of Corporate Fraud Compensation Fund (the Fund), which is to be funded by an increase in the Statement filing fees, which will remain nominal. One-half of the fee increase is to be utilized to further the provisions of the Act, including the development and maintenance of the online database, and one-half of the fee is to be deposited into the Fund. Section 1502.5 of the Code provides that the Fund, established in the California State Treasury, will be administered by the Secretary of State, who will adopt regulations regarding the administration of the Fund and the eligibility of victims to receive compensation from the Fund. The Act provides that the revenue in the Fund will be used for the sole purpose of providing restitution to the victims of corporate fraud.

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## IMPORTANT THINGS TO KNOW ABOUT THE NEW ACT

Each corporation incorporated in or qualified to do business in California that is a “publicly traded company” must include the following additional information in its annual Statement:

- The name of the corporation’s independent auditor and a description of “non-audit” services, if any, that the auditor (or its affiliates) performed for the corporation during the previous 24 months;
- A copy of the last report that the auditor prepared for the corporation;
- The “annual compensation” paid to each board member and each “executive officer,” which includes preferential share issuances or option grants (see discussion below regarding these terms);
- A description of any loans that the corporation made to a board member at a “preferential” loan rate during the previous 24 months, including the amount and terms of the loans (note that there is no requirement to disclose loans made to officers, and the term “preferential” is not defined in the Act);
- A statement indicating whether any bankruptcy petition was filed by (not against) the corporation, any of its executive officers, or members of the board of directors within the previous ten years (because of the length of time covered by this disclosure requirement, a public reporting company will need to revise its Directors and Officers Questionnaire to reflect the ten-year period);
- A statement indicating whether any member of the board of directors or executive officer of the corporation was convicted of criminal fraud (no definition given under the Act) during the previous ten years (again, because of the length of time covered by this disclosure requirement, a public reporting company will need to revise its Directors and Officers Questionnaire to reflect the ten-year period);
- A statement indicating whether the corporation violated any federal securities laws or any securities or banking provision of California law during the previous 10 years for which the corporation was found liable and in which a judgment of over \$10,000 was entered; and
- If the corporation is a California domestic corporation, a statement certifying that the information provided is true and correct.

Under the definition section of the Act: (i) “publicly traded company” means a corporation with securities that are either listed or admitted to trading on a national or foreign exchange or are the subject of two-way quotations, such as both bid and asked prices, that are regularly published by one or more broker-dealers in the “National Daily Quotation Service” or a similar service; and (ii) “executive officer” means the five most highly compensated officers of the corporation, excluding any officer who is also a member of the board of directors.

## AREAS OF UNCERTAINTY

- Many of the definitions and disclosure requirements in the Act are ambiguous, and as discussed more fully below, the Act gives the California Secretary of State responsibility and authority to provide further clarification.
- Some of the provisions raise questions when compared to similar provisions under federal securities laws. First, “annual compensation” is not defined. For example, it is unclear whether “annual” means the last fiscal year, the current fiscal year, the last calendar year, the current calendar year, the last 12 months, or some other period. In addition, “compensation paid” creates an issue as to whether only salary and cash bonuses are to be included, or whether stock options, non-accrued benefits, and other items commonly included in federal compensation disclosure are included as well. Second, the definition of “executive officer” (for whom compensation information must be disclosed) is unclear. Under the Act, “executive officer” means the “five most highly compensated officers of the company, excluding any officer who is also a member of the board of directors.” This definition is different from the definition of “named executive officers” for whom a company must provide compensation disclosure under Item 402(a)(3) of federal Regulation S-K. In particular, under Regulation S-K, disclosure of executive compensation is based solely on salary and bonus and is limited to only those executive officers who are paid a minimum amount (other than the chief executive officer), as opposed to the five most highly paid executive officers, which is called for under the Act. Note also that the Act has an exception for executive officers who are also directors. Under this framework, a publicly traded corporation would be left with the curious position of disclosing the compensation level of – at a minimum – its chief executive officer, yet in California, if the chief executive officer is also a director (which is often true), no disclosure would be required. As a result, the compensation information that a public company must disclose pursuant to federal securities laws may be materially different from corresponding information that the company must disclose under the Act.
- The definition of “publicly traded company,” while covering any corporation with equity or debt securities listed on the NYSE, AMEX or other stock exchanges, or listed in the Pink Sheets (“two-way quotations . . . regularly published in the National Daily Quotation Service or a similar service”), arguably does not cover companies quoted on Nasdaq or the OTC Bulletin Board. Nevertheless, under the “similar service” catchall, companies that are listed on Nasdaq (whether it be the Nasdaq National Market or the Nasdaq SmallCap Market) and the OTC Bulletin Board should plan to comply with the Act, unless the California Secretary of State promulgates clarifying regulations to the contrary.
- There is also a question of timing that may play an important role in California’s new disclosure rules. The Act provides that a California domestic corporation must file the Statement each year during a six-month window *ending* with the calendar month in which the corporation filed its original articles of incorporation. The filing window is similar for a foreign corporation, except that the end of their filing window ends with the month in which the corporation first qualified to do business in California. At this point, it is unclear if corporations initially formed or qualified to do business in January are required to file by January 2003, or if some type of extension will be granted for the first year. Fortunately, the large filing window gives corporations considerable discretion in deciding when to file. Nevertheless, it is important to highlight the lack of uniformity between the end of a corporation’s fiscal year (*i.e.*, the time trigger for a publicly traded company to report to the SEC) and its requirement to file under the Act. Each corporation subject to the Act must sufficiently prepare for the potential issues this lack of uniformity may cause, including possible Regulation FD concerns (*e.g.*, sensitive information – non-audit services provided by its auditors, or information about its directors or officers – may be disclosed under the Act before it is disclosed to the SEC).

- Finally, the Act does not specify the type and scope of certification that each corporation or its officers will be required to make. We anticipate that regulations that the California Secretary of State is to propose will designate who must sign, what specific certification language will be required, and whether the certification will cover the contents of any attachments (e.g., audit report and financials).

## What To Expect

Overall, our review of the Act leads to the following conclusions:

- Substantial portions of the Act cover the same general categories of information that a reporting company already includes in its SEC filings;
- It is unclear if the information that a company must include in the Statement will cover the same time periods that the company includes in its SEC filings;
- There are numerous definitional ambiguities; and
- There is an apparent “gap” in the Act in excluding Nasdaq- and OTC Bulletin Board-quoted companies from the enhanced disclosure requirement.

In addition, responsibility for enforcing the Act and issuing rules, regulations and forms has been given to the California Secretary of State, who has little experience in corporate securities matters, since corporate securities matters are traditionally the province of the California Department of Corporations. (Note that a new California Secretary of State was elected on November 5, 2002, and the person elected to that position was also the author of the Act.) Moreover, the Act does not grant authority to the Department of Corporations to issue any interpretive advice on the Act. In addition, under California’s administrative procedures, the promulgation of rules and regulations could take several months.

If you have any questions concerning the matters discussed in this update, please contact:

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