

## SEC Takes Actions Affecting Smaller Public Companies

At its meeting on May 23, the SEC took a number of actions which should have a positive effect on smaller public companies.

The first of these was the adoption of its long-awaited guidance for management's assessment of internal controls over financial reporting.

Although not specifically related to smaller companies, the guidance is designed

to provide a framework to help public companies avoid some of the unnecessary costs associated with the implementation of **Section 404** of the **Sarbanes-Oxley Act of 2002** by larger companies that resulted in numerous deferrals of its implementation for smaller companies.

The new guidelines use a "principles-based" framework that allows companies more flexibility to use evaluation methods that fit their particular situation.

In general, management will be expected to evaluate whether it has implemented controls that address the

risk that a material misstatement in the financials would not be prevented or detected in a timely manner. This evaluation should be focused on the principal areas of risk in the company's operation.

Under new rules adopted by the SEC,

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a company that performs an evaluation of internal control in accordance with the new guidance satisfies the annual evaluation required by **Exchange Act Rules 13a-15** and **15d-15**.

In related actions, the Commission also amended its rules to define the term "material weakness" to mean "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

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Finally, the SEC revised the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to more clearly convey that the auditor is opining directly on internal control over financial reporting, but is not evaluating management's evaluation process.

In light of its new guidance and rules changes, the SEC decided that no further delays were necessary in the implementation of **Section 404** of the **Sarbanes-Oxley Act** for public companies with less than \$75 million in market capitalization.

## SEC Proposes New Framework for Raising Capital

In addition to the actions taken with respect to reporting on internal controls, the SEC also proposed a new framework for smaller company capital raising that would include:

- **A new system of securities regulation** for smaller public companies that would make scaled regulation available to all companies with up to \$75 million in public float and eliminate Regulation S-B and the SB Forms;

- **Modified eligibility requirements** so companies with

a public float below \$75 million can use shelf registration;

- **A new Regulation D exemption** from '33Act registration requirements for sales of securities to a newly defined category of "Rule 507 qualified purchasers" for which limited advertising would be permitted;



- **Reducing Rule 144 holding periods for restricted securities** from one year to six months and changes to Rule 145;

- **New exemptions for compensatory employee stock options** so Exchange Act registration requirements would not be triggered solely by a company's compensation decisions; and

- **Electronic filing of Form Ds.**

The SEC is currently soliciting public comment on these capital-raising proposals.

## Recent Case Raises Questions About Extent of D&O Insurance Coverage

A recent decision by the U.S. District Court for the Middle District of Florida (*CNL Hotels & Resorts, Inc. v. Houston Casualty Co.*) may provide a good excuse to review the extent of your company's directors' and officers' liability insurance coverage.

The case arose out of a shareholders' class-action lawsuit relating to a public offering of stock by CNL Hotels & Resorts.

The lawsuit named CNL and its directors as defendants for alleged violations of Section 11 of the Securities Act of 1933.

Section 11 provides that if a registration statement declared effective by the SEC for the public sale of securities contains untrue statements or omits to state material facts necessary to make the

statements therein not misleading, then any individual acquiring the securities may sue, among others,

every individual who signed the registration statement and all directors of the issuing company.

The plaintiffs alleged that they had purchased their stock from CNL at an artificially inflated price, and CNL settled the action for \$35 million. CNL and its directors then sought to recover under the company's directors' and officers' liability insurance policy.



While the primary carrier settled with CNL, the two excess insurers contended that the underlying settlement represented a disgorgement of CNL of ill-gotten gain, which did not constitute an insurable loss under the D&O policy language.

While the court did not hold that such payments could not be covered by insurance, it agreed with the insurers in this case that their policies did not cover the payments made to the plaintiffs under Section 11 of the Securities Act.

Accordingly, companies should review the coverage provided by their D&O insurance carriers to clarify whether coverage for Section 11 liability is provided.

### U.S. District Court Decision

## Merger Agreement Not a Separate ERISA Plan

A recent decision by the U.S. District Court for the Southern District of Ohio (*Ljubisaveljevic v. National City Corp.*) held that a merger agreement did not create a separate plan under the Employee Retirement Income Security Act ("ERISA") entitling an employee to additional severance benefits.

In that case, the plaintiff worked for a company that was merged into National City.

The merger agreement provided that employees of the acquired company who continued to work at National City after the merger would receive the greater of the severance benefits available under the target's severance plan or the National City severance plan if they were terminated within the first year of the merger.

The plaintiff claimed that he qualified for severance benefits under National City's severance plan, which provided more generous severance benefits

than the target company's plan. This contention was rejected since the National City plan only applied if there was a change of control of the company, which had not occurred.

However, plaintiff argued that the merger agreement itself created a separate ERISA plan that entitled him to the greater National City severance benefits.

In granting National City's motion for judgment, the court noted that the merger agreement failed to meet the requirements to be considered an independent and separate ERISA plan.

The court said that it must be clear from the surrounding circumstances that a reasonable person could ascertain the intended benefits, beneficiaries, source of financing and procedures for receiving benefits in order for a plan to exist and found that the merger agreement did not satisfy this test.

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