

**NEW CHANGES TO EXCHANGE ACT DISCLOSURES**

Recent guidance by the Internal Revenue Service and recent rules issued by the Securities and Exchange Commission have mandated new Form 10-K disclosure requirements and new cover pages to certain periodic reports.

The IRS recently published guidance on a new Form 10-K disclosure that public companies must make if they have been penalized for using tax-avoidance transactions. Section 811 of the American Jobs Creation Act of 2004 added a new Section 6707A to the Internal Revenue Code providing for the imposition of a tax penalty for the failure to disclose certain tax information under Item 3 of Form 10-K.

The new Form 10-K disclosure must include a description of the penalty, the amount of the penalty and whether the penalty has been paid. Among other things, public companies

must disclose accuracy-related penalties for gross valuation misstatements, accuracy-related penalties for understatements attributable to a nondisclosed listed or other avoidance transaction, failure to include listed transaction information with a tax return, or the failure to disclose the penalty in the Form 10-K.

Public companies are now required to make the disclosure in the Form 10-K for the period in which the IRS demanded payment. Where a public company fails to make the required disclosure, it will be obligated to make such disclosure on each successive Form 10-K until the disclosure is made.

Also, the SEC recently issued shell company rules that require all public companies to include a new check box on the cover page of their Form 10-K, Form 10-KSB, Form 10-Q,

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Form 10-QSB or Form 20-F. The new check box relates to whether the public company is a “shell company” as defined in Rule 12b-2 under the Exchange Act.

**Companies should continually monitor new disclosure requirements and ensure that their periodic reports are in compliance.**

**TAX-FREE SUBSIDY TO COMPANIES PROVIDING PRESCRIPTION DRUG COVERAGE**

Medicare Part D, created by the Medicare Prescription Improvement Act and Modernization Act of 2003 (MMA), will provide retirees the option to elect coverage under Medicare Part D or



through a qualified employer plan beginning on January 1, 2006. To encourage employers to continue offering prescription drug benefits to Medicare retirees, the MMA provides employers with a 28% tax-free subsidy for the allowable amount

of annual prescription drug costs incurred by qualified employer-sponsored plans.

Employers who continue to offer prescription drug coverage for Medicare-eligible retirees after January 1, 2006 have an excellent opportunity to evaluate their current prescription drug retiree benefits so that the program best achieves the overall benefit goals of the organization. Basically, most employers have two options which they should evaluate soon:

- (1) Continue providing coverage for retiree prescriptions and apply for the tax-free subsidy by September 30, 2005; or
- (2) Change the retiree drug coverage to “carve-out” the Medicare Part D drug benefit.

In addition, under the MMA employers are required to provide a notice of creditable coverage to Medicare-eligible retirees (including Medicare-eligible *active* employees) by November 15, 2005. This notice informs the retiree as to whether the employer’s prescription drug benefit is “actuarially equivalent” to that offered by the Medicare Part D plan and is required even if an employer’s plan offers no benefits to retirees.

**Employers offering prescription drug benefits to their Medicare retirees must evaluate which approach best fits their needs so they may take the necessary steps now, including applying to Medicare for the tax-subsidy by September 30, 2005 (an automatic 30-day extension is available).**

## SMALLER PUBLIC COMPANIES MAY GET REPRIEVE

In August, the SEC's Advisory Committee on Smaller Public Companies submitted recommendations to the SEC which would further delay the date on which smaller public companies (defined as those with a market capitalization under \$75 million) would need to comply with the internal control attestation process of Section 404 of the Sarbanes Oxley Act of 2002. The Committee also recommended that smaller public companies not be subject to any further acceleration of filing date deadlines for Forms 10-K and 10-Q (or 10-KSB and 10-QSB, if applicable).

In making its recommendations, the Committee took note of the unexpectedly high costs and time commitments that were imposed on larger public companies in connection with their assessment of internal controls over financial accounting and the attestation of the assessment by their independent auditors. The Committee felt that the impact would

be proportionately greater on smaller companies and recommended that implementation be delayed for one additional year.

If the Committee's recommendation is implemented, the Section 404 compliance date would be the first fiscal year ending after July 15, 2007. The delay would give the PCAOB and accounting firms additional experience



**The SEC's Advisory Committee on Smaller Public Companies is trying to reduce the disproportionate impact that unexpectedly high costs and time commitments have on smaller companies.**

with the internal control attestation process. It is hoped that this will eliminate much of the uncertainty that caused many of the problems for larger companies.

For similar reasons, the Committee recommended that there be no further phase-in of the accelerated filing dates for smaller public companies. The Committee pointed out that smaller companies typically have limited resources for preparing their SEC filings and to further accelerate the due dates for these reports would cause an increase in late or inaccurate filings with little or no benefit to the investing public.

**The Committee has asked the SEC to act promptly on these two recommendations. However, until adopted, smaller public companies will still need to prepare for compliance with current implementation deadlines.**

## RESCISSION OF D&O POLICY ALLOWED

Recently, a federal appeals court affirmed that insurers are entitled to rescind directors' and officers' insurance policies based on material misrepresentations in Exchange Act reports submitted with the insurance applications. *Federal Insurance Co. v. Homestore, Inc.*, 2005 WL 1926483 (9th Cir. August 12, 2005)

In the California case, the insurance policy provided that it would be void if the signing party knew of material misstatements in the insurance application or accompanying materials that affected the acceptance of risk or the hazard assumed by the insurer. The insurance application was accompanied by certain Exchange Act reports and was signed by the former chief financial officer of the insured company.

The chief financial officer subsequently pleaded guilty to

conspiracy to commit securities fraud by overstating advertising revenues and filing false Form 10-Qs. While the insured company contended that the misrepresentations were not material to the insurer's acceptance of risk, the court disagreed. The court held that under California law the fact that the insurer demanded answers to specific questions in an insurance application is sufficient to establish materiality as a matter of law. Further, the court also concluded that the chief financial officer's knowledge of misrepresentations was sufficient to void the entire policy.

**This case demonstrates that directors should not blindly rely on the existence of D&O insurance to protect them from liability. The best protection for a director is to always act in accordance with the fiduciary duties of due care, loyalty and good faith.**

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