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CORPORATE NOTES

A BIWEEKLY REVIEW OF CURRENT LEGAL ISSUES

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IN THIS ISSUE:

- FASB Clarifies 'Mutual Understanding' 1
- SEC Defers SOX 404 Compliance for Smaller Public Companies...1
- Nonqualified Plan Guidance Issued 2
- No Shareholder Suits for Disgorgement Under SOX 2

FASB Clarifies 'Mutual Understanding' Requirement in Valuing Equity-Based Compensation

On September 14, 2005, the Financial Accounting Standards Board ("FASB") announced a clarification to earlier interpretations of the "mutual understanding" requirement of FAS 123R relating to the valuation of stock options and other equity-based compensation.

In August, FASB indicated that the value of stock options and other equity awards would not necessarily be fixed at the time of board or compensation committee approval of the awards, but rather would be set when both the company and the grantee have reached a "mutual understanding" of its terms. As interpreted, this mutual understanding could not occur until the terms of an award were actually communicated to a grantee. Therefore, the date upon which a stock option or other award to any grantee would be valued for purposes of FAS 123R depended on when that particular grantee was actually notified of the award. Such an approach would obviously cause many difficulties for the administration of equity compensation plans since fluctuating stock prices between the date of board approval and the date of actual communication of the terms to each grantee would affect the valuation of the awards and could differ among grantees depending on the vagaries of the communication.

In proposed FASB Staff Position 123(R)b, FASB stated that the "mutual understanding" component of the FAS 123R fair value determination is satisfied on the date of board approval if:

- The grantee does not have the ability to individually negotiate the key terms and conditions with the employer; and
- The key terms of the award are expected to be communicated to all grantees within a "relatively short period" of time from the date of approval.

In most cases, this would eliminate the administrative issues associated with FASB's initial interpretation of the "mutual understanding" requirement. However, it means that companies must be diligent in communicating awards to grantees in order to rely on the date of board action as the relevant valuation date. Of course, any equity awards that are individually negotiated do not fall within this new interpretation.

Companies making equity-based awards to large numbers of grantees should review their procedures for communicating grant terms in order to avoid unnecessary valuation complications.

SEC Defers SOX 404 Compliance for Smaller Public Companies

At its meeting on September 21, 2005 the SEC voted to extend by one year the date for complying with Section 404 of the Sarbanes-Oxley Act by companies with less than $75 million of public float. Section 404 requires a public company to include in its annual report a report by management on the company's internal control over financial reporting and an accompanying auditor's attestation. This one-year extension means these "nonaccelerated filers" need not comply with Section 404 until their first fiscal year ended on or after July 15, 2007.

Despite this extension, smaller public companies should continue to devote the necessary resources to make sure these Section 404 requirements are implemented effectively when they become applicable. Many larger companies already subject to Section 404 discovered a number of weaknesses in their internal controls which they were not able to correct in time to avoid reporting in their Form 10-K. The SEC hopes smaller companies will use the extra time to avoid similar problems.

In a related action, the SEC also proposed modifications of the periodic report filing deadlines so that only accelerated filers with public float of $700 or more will be required to file Form 10-K within 60 days after the end of their fiscal year. Under the proposal, even these large accelerated filers would continue to file Form 10-Q under the current 40-day deadline rather than the 35-day deadline scheduled to apply beginning next year. Other accelerated filers would continue to file Form 10-K within 75 days of year-end and Form 10-Q within 40 days of quarter-end.

Nonqualified Plan Guidance Issued

On September 29, 2005 the IRS issued proposed regulations which constitute the long-awaited guidance on nonqualified deferred compensation plans and arrangements under Internal Revenue Code Section 409A. The proposed regulations are generally effective as of January 1, 2007. However, employers and individuals must act in good-faith compliance with Section 409A *now*, and compliance with the proposed regulations will be considered "good faith compliance." Therefore, we recommend that employers and individuals comply with the proposed regulations as soon as possible.

The IRS proposed new guidelines on Section 409A, but companies and individuals are expected to act in good-faith compliance *now*.

The new proposed regulations provide guidance under Section 409A with respect to the following topics:

- The definition of a "nonqualified plan."
- Short-term deferrals (e.g., amounts received within 2½ months of the year they are no longer subject to forfeiture).
- Stock options, stock appreciation rights, restricted stock and other equity-based compensation.
- Separation and severance pay.
- Split-dollar life insurance arrangements.
- Deferral and distribution elections (including election changes).
- Performance-based compensation and commissions.

The proposed regulations extend much of the transitional relief provided under previous guidance from December 31, 2005 to December 31, 2006. For example, employers will have until the end of 2006 to amend their plans to incorporate the new provisions. However, some significant transitional relief has not been extended. For example, after 2005, a plan amendment terminating a grandfathered nonqualified plan and distributing the assets will be considered a material modification subjecting the plan to Section 409A.

Employers should keep in mind that for purposes of the proposed regulations, "nonqualified deferred compensation plans" may include formal nonqualified plans and severance and employment agreements.

No Shareholder Suits for Disgorgement Under Sarbanes-Oxley

A federal judge recently held that shareholders cannot file derivative lawsuits under Section 304 of the Sarbanes-Oxley Act of 2002. *Neer v. Pelino*, Case No. 04-4791 (E.D. Pa. Sept. 27, 2005). Instead, the judge held that Congress intended that Section 304 be enforced only by the Securities and Exchange Commission. Section 304 allows for the disgorgement of profits and bonuses from corporate executives in alleged accounting scandals.

In the case above, a shareholder sued the company and several directors and officers for allegedly violating Section 304 and several state laws, including breach of fiduciary duty and waste of corporate assets. The claims arose from multiple restatements made to the company's financial statements since 2003, significantly reducing the company's net income.

In discussing Section 304, the judge noted that it does not expressly provide for a private right of action, and no court had ruled on whether an implied right is created. Because Congress expressly created a private right of action under Section 306, the judge determined that the inference is that a private right of action under Section 304 was not intended. The judge dismissed the state law claims without prejudice so that the shareholder may refile them in Delaware, which he concluded was better suited to consider the state law claims.

Even though shareholders may not bring cases under Section 304, companies must be aware that the SEC has the authority to disgorge profits and bonuses from corporate executives.

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