

COOPERATION WITH SEC HELPS COMPANY AVOID PENALTIES

A recent SEC action against corporate officers for fraud highlights the benefit to an affected company of cooperating fully with the SEC. Although the SEC leveled numerous charges against the individuals involved, it cited the company's high level of cooperation with the investigation in declining to assess penalties against the company. This is in stark contrast to recent SEC fines of up to \$25 million against companies that either failed to cooperate or were just tardy in doing so.

The Allegations. The fraud was first disclosed in a February 2003 announcement by Netherlands-based Royal Ahold NV that its recently-acquired U.S. subsidiary, U.S. Foodservice (USF), had materially overstated its earnings. A subsequent SEC investigation revealed that:

- net sales were overstated by approximately 20.8%, 18.6%, and

- 13.8% for the fiscal years 2000, 2001 and 2002, respectively;
- net income was overstated by approximately 17.6%, 32.6%, and 88.1% for the fiscal years 2000, 2001 and the first three quarters of 2002, respectively;
- operating income was overstated by approximately 28.1%, 29.4%, and 51.3% for the fiscal years 2000, 2001 and the first three quarters of 2002, respectively; and
- USF executives gave the independent auditors false and misleading information and also persuaded major vendors to falsely confirm overstated promotional allowances to the auditors.

Cooperation by Ahold. Ahold settled SEC charges against it by consenting to an entry of judgment permanently enjoining it from violating federal securities law. However, the SEC did not assess a penalty because Ahold cooperated fully in the investigation, including:

- self-reporting the misconduct to the SEC;
- immediately conducting an extensive internal investigation;
- promptly providing the SEC staff with internal investigative reports and supporting information;



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- waiving its attorney-client privilege and work-product protection for the internal investigation, thereby allowing the SEC full access; and
- making available all its personnel for interviews and testimony, and even arranging for interviews with former employees who were outside the US.

The experience of this company highlights the importance of a proactive approach in identifying and disclosing possible problems immediately, sharing that information with the SEC and helping the SEC gather the information it believes necessary for its investigation. ■

“ABOVE THE LINE” DEDUCTION ALLOWED FOR ATTORNEY FEES

A recently-signed tax law allows plaintiffs to fully deduct attorney fees and court costs when they receive a taxable judgment or settlement amount in a case alleging unfair discrimination or certain other claims (American Jobs Creation Act of 2004, Sec. 703).

Under the old law, a deduction was allowed, but only as an itemized deduction on the individual tax return. As a result, it was subject to the phase-out of itemized deductions that applies to higher-income taxpayers, and it could not be treated as a deduction when computing the

alternative minimum tax (AMT).

The new tax law removes both of these limitations. The fees and costs are fully deductible from gross income “above the line” to determine adjusted gross income, rather than being deducted under the less-favorable itemized deduction process on Schedule A of Form 1040. Also, the fees and costs are considered a deduction when computing AMT.

This new provision only applies to fees and costs paid after the effective date of the new tax law (October 22, 2004) and then only for judgments or settlements that occurred after that date. More

developments in this area are expected, because the U.S. Supreme Court has agreed to hear two separate cases in which taxpayers argue that contingent fees paid directly to an attorney should be excluded when determining the taxable amount of a settlement or judgment. ■

THE NEW TAX LAW ALLOWS SUCCESSFUL PLAINTIFFS TO FULLY DEDUCT ATTORNEY FEES

SEC WANTS SHAREHOLDERS TO RECEIVE SECTION 404 INTERNAL CONTROL REPORTS

Steven Amen and Heidi Toney of our Omaha office write:

A newly announced SEC policy cautions those companies that are subject to Section 404 of the Sarbanes Oxley Act to include the two required internal control reports – one from management and the other from the independent auditors – when sending their audited financial statements to stockholders as part of the annual meeting materials.

SECTION 404 REQUIRES PUBLIC COMPANIES TO ANNUALLY REPORT ON THEIR INTERNAL CONTROL SYSTEMS

Current rules only require these reports to be included in a company's annual Form 10-K that is filed with the SEC. In the SEC's view, if these reports indicate a problem with internal controls, the failure to include them with the documents mailed to stockholders for an annual meeting would be a material omission and thus cause those documents to be misleading.

Companies that already include their entire Form 10-K, including exhibits, in their annual report to stockholders could readily comply. If a company does not include the entire text of its Form 10-K in its annual report to shareholders, the SEC staff wants the company to

include this information in the annual report even though current rules do not explicitly require it. The SEC staff intends to recommend changes to the proxy rules that will require all companies to include these Section 404 reports in the materials sent to their stockholders.

Companies that are "accelerated filers" are now subject to Section 404 and should therefore determine how to comply with this new policy. Also, the SEC has cautioned that companies should disclose any material weaknesses in their management reports by actually using the term "material weakness." ■

DEFERRED COMPENSATION PLAN CHANGES REQUIRED

We previously reported that the new tax law, American Jobs Creation Act of 2004, would require significant

changes to nonqualified deferred compensation plans. More information is now available in the

form of a Client Alert on our website, www.kutakrock.com, under "Publications". ■

S CORP ELECTION GETS EASIER UNDER NEW TAX LAW

The new tax law enacted on October 22, 2004 makes it easier for corporations to elect the less-taxing S corporation structure by easing the rules on the maximum number of stockholders and the type of stockholders allowed.

Under the old law, an S corporation could not have more than 75 stockholders. The new tax law increases that number to 100 stockholders. It also allows all family

members, not just husband and wife as under the old law, to elect to be treated as a single stockholder for purposes of the 100-stockholder limit (American Jobs Creation Act, Secs. 231-233).

Further, under the old law, banks could not elect S corporation status if they had IRAs as stockholders. The new law allows IRAs to qualify as stockholders of S corporations.

The new stockholder limit provisions become effective after December 31, 2004 and will assist businesses held by larger or extended families in satisfying the stockholder limit, even after distributing stock to key employees. The IRA provision targets community banks with IRA stockholders, but it only applies to stock held by IRAs when the tax law was enacted. ■

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Banks with IRA stockholders can now become S corporations