

A Biweekly
Newsletter of
Federal Securities,
Corporate &
Banking Law
Developments

Directors of Private Company Held to Public Company Standards

A recent federal bankruptcy case suggests that the directors of privately-held companies could be held to the same fiduciary standards of due care and loyalty as those of public companies, particularly if the private company is insolvent or nearing insolvency (*Pereira v. Cogan, No. 00 Civ. 619 (RWS) SDNY May 27, 2003*). In this case, Marshall Cogan was the majority stockholder and chief executive officer of Trace International Holdings, Inc., a privately-held company that operated primarily as a holding company. Trace's principal assets consisted of majority ownership of two public entities, and it borrowed against these investments to fund its cash needs.

After Trace declared bankruptcy, the trustee in bankruptcy brought an action against the company's directors for violating their fiduciary duties by permitting Cogan to pay himself lavishly, to authorize illegal dividend distributions, and to give loans to himself and his family members, among other things. The court held for the trustee, even though the directors did not actually approve Cogan's actions but instead failed to hold any meetings during the period in question. If the court's ruling is upheld, the directors could be personally liable for the \$44 million owed to creditors even though the directors did not benefit personally.

Directors of private companies should be aware that their actions may receive the same scrutiny as directors of public companies and accordingly should exercise diligence, be fully informed of all significant or unusual corporate actions, and insist on adequate record-keeping of board deliberations and actions.

■ SOME COMPANIES SHIFTING FROM STOCK OPTIONS TO RESTRICTED STOCK FOR COMPENSATION

With the recent announcement by Microsoft that it is terminating its stock option plans in favor of restricted stock plans, companies may be considering whether such a move makes sense for them as well. Restricted stock are shares of a company's stock issued to employees and subject to vesting provisions (usually three to five years) and transfer restrictions. Restrictions may include, among other things, forfeiture of the stock in the event of employment termination or failure to meet certain performance criteria.

The benefits of using restricted stock instead of options include:

- Less stock dilution (as compared to options) because fewer shares of restricted stock are usually granted than options;
- More tangible benefit and better alignment of the company and employee interests because employees would have an immediate ownership interest in the company; and
- Ability to receive dividends.

Disadvantages of issuing stock rather than options include an immediate dilution of earnings per share, recognition as compensation expense, and deductibility for tax purposes only if performance-based.

With the requirement of expensing stock options becoming more of a possibility, and with stock prices leveling off, companies

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may wish to consider restricted stock grants as a cost-neutral alternative to stock options.

■ NEW RULES FOR CEO/CFO CERTIFICATIONS

The SEC finalized rules on June 5, 2003 which affect the certifications that CEO's and CFO's must file with Forms 10-K and 10-Q under Sections 302 and 906 of the Sarbanes-Oxley Act. (<http://www.sec.gov/rules/final/33-8238.htm>) The new rules:

- Expand the text of the 302 certification to reflect a company's internal accounting controls that are required by Section 404 of Sarbanes-Oxley. (However, given that Section 404 rules apply only to reports filed for fiscal years ending after June 15, 2004 for accelerated filers and for reports for fiscal years ending after April 15, 2005 for non-accelerated filers, companies would not need to change their Section 302 certifications at this time.)
- Require that both the 302 and the 906 certifications be filed as exhibits 31 and 32 to the 10-Q or 10-K.

Previously, companies had filed such certifications in various ways due to a lack of guidance. The 906 certifications will be treated as "furnished" rather than filed, for liability protection purposes, under the new SEC rules. **These filing rules apply to all 10-Q's and 10-K's that are due on or after August 14, 2003, including the upcoming second quarter Form 10-Q's.**

■ SEC PUBLISHES REPORT ON PROXY REVIEW PROCESS

On July 15, 2003, the SEC published a much-anticipated report by its staff advocating greater shareholder control over the nomination and election of directors when proxy statements are used. ([http://](http://www.sec.gov/news/studies/proxyreport.pdf)

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The report recommends that the SEC adopt rules requiring public companies to:

- Provide greater disclosure of their nominating committee processes, including how candidates recommended by shareholders are considered for nomination by the board;
- Disclose how shareholders may communicate with directors; and
- Provide major and long-term shareholders with the ability to use the company's proxy materials to nominate their own directors under certain circumstances, such as if the proxy process does not represent the views of a majority of shareholders.

Proposed rules implementing these recommendations are expected as early as August. **The SEC expects to have these new shareholder participation rules in place in time for the 2004 annual meeting proxy season.**

Kutak Rock LLP is a national law firm with more than 325 attorneys located in 16 offices throughout the United States practicing in the areas of corporate, banking and securities law, public and corporate finance and complex commercial litigation matters.

For more information on these or other related topics, please contact any of the following attorneys:

Paul D. Borja..... 202-828-2310
paul.borja@kutakrock.com

Stephen P. Candelmo 202-828-2413
stephen.candelmo@kutakrock.com

Jeremy T. Johnson 202-828-2463
jeremy.johnson@kutakrock.com

Editor

Kathleen M. Cochrane 202-828-2308
Administrative Assistant
kathleen.cochrane@kutakrock.com

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