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CORPORATE NOTES

A BIWEEKLY REVIEW OF CURRENT LEGAL ISSUES

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SEC PROPOSES DELAY OF ACCELERATED FILING

On August 20, the Securities and Exchange Commission proposed rules that would create a one-year delay of the final phase-in period for implementation of the accelerated filing requirements. These filing requirements provide large public companies with even less time to file their quarterly Form 10-Q reports and annual Form 10-K reports.

Currently, the due dates for annual reports and quarterly reports are 75 days and 40 days after the end of the respective periods. Unless delayed by the SEC as proposed, the due dates for annual reports and quarterly reports would be reduced to 60 days and 35 days, respectively. Without the delay, the shorter filing deadline for Forms 10-K and 10-Q would take effect for periods ending on or after December 15, 2004.

These accelerated filing deadlines are applicable to "accelerated filers," generally, issuers with a "public float" (or market capitalization for stock held by non-insiders) of $75 million or more that have filed periodic reports with the SEC for at least 12 months and have filed at least one annual report.

The proposed delay of the accelerated filing rules is prompted by the SEC's concern that companies should devote sufficient attention to meeting the new disclosure requirements required under Section 404 of the Sarbanes-Oxley Act. Under Section 404, companies must include both a management report and an auditor report on the effectiveness of internal controls over financial reporting in their annual reports filed for their first fiscal year ending on or after November 15, 2004.

To be able to prepare these reports, companies are implementing significant new company-wide internal control procedures, which are already imposing a significant administrative burden on them.

Even if the accelerated filing deadline is postponed, accelerated filers still face the internal control reporting requirements for the first fiscal year ending on or after November 15, 2004. ◘

IRS ARGUES FOR BROAD SCOPE IN DENYING INTEREST DEDUCTIONS TO BANKS

In two rulings recently issued by the IRS as guidance to its audit staff, a bank that transferred tax-exempt bonds to its controlled subsidiary still had to count those bonds when determining how much of its interest expense was thereby nondeductible. Further, even the tax-exempt bonds that were purchased directly by the subsidiary using its own earnings had to be counted by the bank. *TAM 200434029; TAM 200434021.*

These rulings are important because they increase the amount of interest expense that becomes nondeductible when a bank invests, directly or indirectly, in tax-exempt bonds. Under federal tax law, banks that invest in tax-exempt bonds may not deduct a percentage of their interest expense equal to the same percentage of their tax-exempt bonds to all their assets. With these rulings, all tax-exempt bonds held by a bank or its controlled subsidiary would be counted, thereby increasing its percentage of non-deductible interest.

Each IRS ruling noted that the bank controlled its subsidiary by having its bank officers comprise a majority of the board of directors and direct its investments, and this control was reflected in the bank's control of the subsidiary's dividend payments and the bank's occasional borrowing of the subsidiary's securities to secure the bank's repurchase agreements and public deposits. According to the IRS, when a bank and its subsidiary are under "common control," all tax-exempt bonds must be counted in reducing the bank's interest expense deduction to satisfy the Congressional purpose of the tax laws. Otherwise, a bank could unfairly reduce its tax liability, giving it "an unfair advantage over other taxpayers."

These IRS rulings could increase the tax costs to financial institutions of holding tax-free bonds, either directly or through a controlled subsidiary. Banks may wish to consider the use of a standard floater/inverse floater transaction to reduce its recognition of tax-exempt income when using tax-exempt bonds in an investment transaction. ◘

SHAREHOLDER'S EMPLOYMENT BY CLOSE CORPORATION NOT ASSURED

In a case of first impression, the Michigan Court of Appeals recently affirmed that a Michigan statute protecting minority shareholders in a close corporation does not provide a minority shareholder with a basis for suing a majority shareholder who terminated his employment and removed him from the board of directors.

A CLOSE CORPORATION IS A CORPORATION WITH A SMALL NUMBER OF SHAREHOLDERS AND THEREFORE IS USUALLY PERMITTED TO OPERATE MORE INFORMALLY THAN MOST CORPORATIONS.

The minority shareholder claimed that the majority shareholder acted in a "willfully unfair and oppressive manner" by terminating his employment, removing him from the board of directors and amending the bylaws of the close corporation. The minority shareholder argued that because he received the bulk of his share of corporate profits through his employment and directorship, his removal from the board and employment termination constituted oppression.

The Michigan Court of Appeals concluded that the statute does not specifically protect a minority shareholder's interest as an employee or director but only as a shareholder in the close corporation. According to the court, his termination

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and removal from the board had no effect on his interest as a shareholder.

A board should consider whether its state's own laws provides any additional employment protections to its stockholders.◘

OCC FINES BANK DIRECTORS FOR BREACHING THEIR FIDUCIARY DUTIES

Three former directors of First National Bank of Sumner in Olney, Illinois entered into consent orders with the Office of the Comptroller of the Currency (OCC) for breaching their fiduciary duties to the bank. Pursuant to the consent orders released on August 23, the three former directors were required to pay a total of $45,000 in fines.

According to the consent orders, one director, who was also an executive vice president of the bank, breached his fiduciary duty by failing to respond to insider abuse and the bank's growing credit risk, as well as by diverting loan proceeds to hide the past-due status of other loans. This caused the bank to understate its delinquent loan portfolio. The other two directors breached their fiduciary duties by allowing the president of the bank to dominate the decision-making process and failing to respond to the bank's growing credit risk.

Office of the Comptroller of the Currency

These consent orders are in addition to those that the OCC previously entered into with the bank and a former employee, all of which resulted from the OCC's examination of the bank in early 2001.

These consent orders illustrate the OCC's willingness to bring actions against individual directors as well as banks.

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