

**SPOUSE’S DINNER PARTY COMMENT
LEADS TO BIG FINES**

Most officers and employees of public companies are aware of their potential liability for insider trading. However, their spouses and friends who receive confidential information may not realize that they are also subject to insider trading liability just by talking about it.

Recently, a Scholastic Corporation officer's spouse and her colleague were held liable under the insider trading laws. In the case, the officer confidentially told his wife that the company expected a quarterly loss, and the spouse related that

information to a colleague at a dinner party. Although the spouse did not actually act on the information, her colleague did, entering into certain transactions that resulted in a net profit of \$269,000. Based upon her single comment at the dinner party, a Federal court ordered that the spouse pay a \$100,000 civil penalty and be jointly and severally liable for disgorging the \$269,000 profit.

The insider trading policy of a company should warn its employees that just the possession of inside information,

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not its actual use, can result in significant personal fines and penalties to them and those whom they tell. ▣

**IRS ISSUES FINAL REGULATIONS
ON INCENTIVE STOCK OPTIONS**

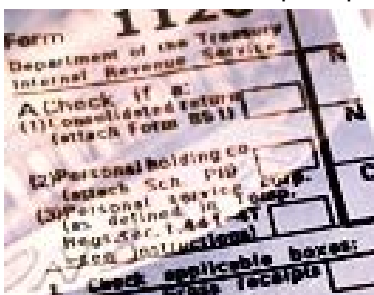
John Schembari of our Omaha office writes:

The IRS issued final regulations in August that place limits on stock option plans and could require companies to seek stockholder approval for existing and new stock option plans.

All plans must comply with the final regulations on the **earlier** of January 1, 2006 or the date of the first shareholders’ meeting in 2005 if such meeting is after February 2, 2005. Thus, for most companies, the effective date of the new regulations will be the date of their 2005 annual shareholders’ meeting.

The regulations address issues such as:

- **Maximum Aggregate Number of Shares.** A stock option plan



that allows for incentive stock options, or ISOs, must specify the total number of ISOs that can be issued under the plan. There are special rules for counting shares towards this total, such as in the case of a cashless exercise of an ISO, and each plan that permits the grant of ISOs must separately state its maximum number.

- **Corporate Transactions.** In a corporate combination such as a merger, outstanding ISOs of the target company may be assumed or substituted by the surviving company if the ISO plan is included in the merger agreement. However, future ISO grants from the target company’s plan must be separately approved by the stockholders of the acquiring company.
- **Section 83(b)/Elections.** Under the regulations, individuals may exercise a Section 83(b) election for purposes of the alternative minimum tax (“AMT”).
- **Post-Employment Qualification for Options.** An individual can continue to exercise an ISO for

up to three months after the employment relationship ends, or longer if the individual’s right to re-employment is guaranteed by statute or contract. Examples of a statutory right to re-employment include the Family Medical Leave Act and the Uniformed Services Employment and Reemployment Rights Act.

- **Inadvertent Modifications.** If an ISO is inadvertently modified in such a way that disqualifies either the ISO or the ISO plan, and the modification is later cancelled before the earlier of the exercise of an ISO or the end of the calendar year of the modification, then the regulations provide that the ISO is not disqualified. This inadvertent modification provision also applies to employee stock purchase plans.

Companies should determine whether they need to amend existing stock option or employee stock purchase plans soon, especially because of the rapidly approaching effective date for most companies and the need for shareholder approval to amend the plans. ▣

THE AUDITOR'S LETTER AND PROTECTING YOUR ATTORNEY-CLIENT PRIVILEGE

As the 2004 year-end audits approach, especially with the recent adoption by the Public Company Accounting Oversight Board of Auditing Standard No. 3, "Audit Documentation," companies should remember that even routine audit procedures such as requests to your attorneys for information can adversely affect the companies' protections under the attorney-client privilege.

Referred to as either "auditor letters" or "attorney letter requests," these letters are usually sent by the company's CEO or CFO to law firms that performed significant services for the company during the year. While an attorney's response may seem rather perfunctory, it is actually intended to strike the necessary balance between the auditor's desire for information and the attorney's duty to protect the confidentiality of attorney-client

communications. It is this confidentiality that provides a client with the protection of the attorney-client privilege, by which your attorney cannot be compelled to disclose the nature of communications with your company.



An attorney's response to auditors is generally not protected by the attorney-client privilege because it necessarily involves a third party rather than just the attorney and the client. Also, mere disclosure of a subject matter by the attorney could

destroy the privilege as to other communications with your company on the same subject.

Thus, to the extent that the attorney's communication to the auditor, including an evaluation of any claims, would disclose a confidence or secret of your company, the attorney should first obtain the company's prior consent after explaining the legal consequences of the consent.

A company should also decide whether its attorneys should disclose possible claims that have not even been asserted yet. In making this decision, you should consider, in part, whether it is "probable" that a possible claim will be asserted, whether there is a reasonable possibility of an unfavorable outcome and whether the resulting liability would be material to your company's financial condition. ■

A DEAL GONE BAD

A stockholder lawsuit against directors of an acquired company and challenging the "entire fairness" of the merger was recently allowed by a Delaware court to proceed. (*Deiterich v. Borland (Del. Ch. 8/3/04)*). The lawsuit alleged that the sale of the company was "the product of an unfair process that resulted in an unfair price." Among the allegations were that:

- the company's senior officers and chairman were secretly part of a group of investors trying to obtain control of the company for \$10 million;
- the company's CEO disclosed a \$25 million valuation of the company to a potential acquirer to discourage that acquirer from pursuing its \$41 million offer;
- the CEO repeatedly rebuffed expressions of interests from that and another potential acquirer in favor of continuing discussions with the investor group;
- the CEO deliberately failed to

obtain a clause in the agreement with the investor group that would have allowed the company to terminate the agreement if the board decided to accept a higher offer from a different party (a so-called "fiduciary out" clause);

- the board ratified the agreement with the investor group even though it knew the required clause was not included and that the potential acquirer was now prepared to offer \$47 million; and
- a majority of the board approving the merger was not independent.

The company was eventually acquired by the potential acquirer after the deal with the investor group collapsed. By then, the price offered was \$24 million rather than \$47 million.

The lawsuit, which still must proceed to trial, highlights the care that directors of target corporations must take when selecting the offers to pursue or reject. ■

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