BROWN RUDNICK BERLACK ISRAELS LLP

CLIENT ALERT

THE SARBANES-OXLEY ACT OF 2002 – EMPLOYEE BENEFITS & COMPENSATION CONSIDERATIONS

IN THE WAKE OF a spate of recent corporate accounting scandals and stock market reversals, a major piece of securities, employment, employee benefits and accounting legislation, the Sarbanes-Oxley Act of 2002 (referred to herein as the "Act"), has recently been enacted. Although the Act primarily focuses on financial, accounting and corporate governance matters, it contains a variety of provisions that will require all publicly traded companies, and many private companies (particularly those with 401(k) or similar retirement plans), to change the manner in which they deal with important employment and employee benefits issues. The purpose of this Client Alert is to make corporate executives and financial and human resources personnel aware of the significant employment and employee benefits-related changes affecting their areas of responsibility.

I Insider Trading of Employer Stock During Blackout Period

The Act contains an important insider trading prohibition that applies to any publicly traded company that offers company stock as an investment option in a 401(k) or similar type retirement plan (referred to as an "individual account plan"). An *executive officer* or a *director* of a *publicly traded company* is prohibited from purchasing, selling or otherwise acquiring or transferring any *company stock* acquired in connection with his or her employment or service as an executive officer or director (other than an "exempted security," which does not appear to be defined in the Act) during any *blackout period.*

- *Executive Officer* — Unfortunately, the Act does not define the term "Executive Officer" for purposes of the insider trading prohibition. However, it seems fair to assume that, at the very least, a company's chief executive officer and chief operating officer would be covered by the prohibition.
- *Blackout Period* — For purposes of the insider trading prohibition, the term "Blackout Period" is defined as any period of *more than three consecutive business days* during which the ability of *at least 50% of the participants and beneficiaries* (under *all* individual account plans maintained by the issuer of the publicly traded stock) *to purchase, sell or otherwise acquire or transfer an interest in such stock held under an individual account plan* is temporarily suspended by the *issuer or by a fiduciary of the plan* (e.g., a trustee). A blackout period, however, does not include (1) a regularly scheduled period during which the purchase, sale or other acquisition or transfer of company stock is prohibited, provided that such period is "timely" disclosed to employees either before they become participants or as a subsequent amendment to the plan; or (2) any suspension that is imposed solely in connection with a participant or beneficiary becoming or ceasing to be a participant or beneficiary by reason of a corporate merger, acquisition, divestiture or similar transaction involving the plan *or* plan sponsor. Although the exception to the definition of term "blackout period" for corporate transactions is somewhat broad, it does not cover the most common type of blackout period under a retirement plan — a blackout period necessitated by a change in an investment provider or plan record keeper.

- *Notification Requirements* — The Act requires the issuer of the company stock to "timely" notify each director or executive officer *and* the Securities and Exchange Commission (SEC) of such blackout period. "Timely" is not defined in the Act. Presumably this will be covered in upcoming regulations to be issued by the SEC.
- *Available Remedies* — If an executive officer or director violates the insider trading rule and profits from such violation, the issuer in the first instance, and secondarily, any shareholder in a derivative suit, may seek to recoup such profit on behalf of the issuer. The intention of the executive officer or director in engaging in the transaction is irrelevant. A two-year statute of limitations on any suit applies (dating from the date on which the profit is realized).
- *Effective Date* — The insider trading prohibition becomes effective on January 26, 2003. The SEC has been directed to issue regulations, in consultation with the United States Department of Labor (DOL), implementing the insider trading prohibition. In this regard, it is noteworthy that specific direction has been given to the SEC to issue guidance on the application of the insider trading prohibition to related employers within the meaning of Internal Revenue Code (Code) Sections 414(b), (c), (m) and (o). In practical terms, any such guidance is likely to address the use of controlled groups of corporations (e.g., a parent corporation that owns at least 80% or more of the voting stock of a subsidiary corporation) as a means of circumventing the insider trading rule.

Best Practices — A publicly traded company should (1) develop a list of "executive officer" titles whose trading is subject to the restriction on insider trading, (2) develop a model notice to send to each insider and the SEC and (3) determine which of its retirement plans, and the retirement plans of its subsidiaries and affiliates, need to be included in determining whether a blackout period has occurred.

II Blackout Notice Requirements Under ERISA

Although the insider trading prohibition of the Act relating to blackout periods has been widely reported in the press, it should be noted that the Act contains another set of requirements involving blackout periods. Unlike the insider trading prohibition of the Act, which applies only to public companies, the Employee Retirement Income Security Act of 1974, as amended (ERISA) notice provisions of the Act (the second set of requirements involving blackout periods) apply to all employers (including privately held companies) who sponsor individual account plans, and whether or not those plans permit investments in employer securities. Under the ERISA notice provisions of the Act, a plan administrator of an individual account plan (e.g., a 401(k) plan) must give 30 days' advance written notice to participants and beneficiaries of any blackout period that will affect such participants and beneficiaries.

- *Blackout Period* — It should be noted that the term "blackout period" is more broadly defined for purposes of the ERISA notice provisions of the Act than for purposes of the Act's insider trading provisions. The term "blackout period" is defined as any period of *more than three consecutive business days* during which any ability of participants or beneficiaries, which is otherwise available under the terms of the plan, *to (1) direct or diversify assets credited to their accounts, (2) obtain plan loans or (3) obtain distributions from the plan* is temporarily suspended, limited or restricted. A blackout period, however, does not include a suspension, limitation or restriction that (1) occurs by reason of application of Section 3(a)(47) of the Securities Exchange Act of 1934, as amended, (2) is a regularly scheduled suspension, limitation or restriction that is disclosed to participants and beneficiaries through a Summary of Material Modifications or other materials describing specific investment alternatives under the plan, or (3) applies only to the participant or any alternate payee under a qualified domestic relations order. Unlike the case with the insider trading prohibition, a plan need not have employer stock as an investment option to be covered by the ERISA notice provision of the Act. Unlike the blackout period for insider trading purposes, there is no requirement that 50% of participants and beneficiaries be affected.
- *Exceptions to the 30-Day Advance Notice Requirement* — The 30-day advance notice requirement is waived if (1) a deferral of the blackout period for such time would violate ERISA's exclusive benefit or prudence requirements, or (2) the inability to provide such advance notice is due to unforeseeable events or circumstances beyond the control of the plan administrator *and* a fiduciary of the plan reasonably so determines in writing. If (1) or (2) applies, the notice must be furnished as soon as administratively practicable, unless notice in advance of the termination of the blackout period is impracticable.
- *Contents of the Notice* — The Act contains several provisions regarding the content of the notice to be distributed in advance of a blackout period. The notice must be written in a manner calculated to be understood by the average plan participant and include (1) the reasons for the blackout period, (2) an identification of the invest-

ments and other rights affected, (3) the expected beginning date and length of the blackout period, (4) in the case of the investments affected, a statement that the participant or beneficiary should evaluate the appropriateness of his current investment decisions in light of his inability to direct or diversify assets credited to his account during the blackout period, and (5) any other matters as the DOL may require by regulation.

- *Delivery of the Notice* — The notice may be distributed in person, by mail or by electronic delivery (provided that such form of delivery is reasonably accessible to the recipient).
- *Second Notice Requirement* — Any change in the beginning date or length of the blackout period will require the plan administrator to furnish a second notice. It appears that the same penalties (discussed below) will apply if the plan administrator fails to issue a second notice.
- *Non-Compliance Penalties* — The Act provides harsh penalties for non-compliance with the notice provisions. Penalties of up to $100 a day may be imposed on the plan administrator by the DOL for the failure or refusal to provide the notice, with each violation with respect to any single participant or beneficiary being treated as a separate violation. For example, if a plan administrator issues the notice on the date the blackout period is imposed (i.e., 30 days late), and there are 100 participants in the plan, a penalty of $300,000 may be imposed. ($100 per day X 30 days X 100 participants = $300,000).
- *Effective Date* — The ERISA notice provisions of the Act become effective on January 26, 2003. The DOL has been directed to (1) issue regulations implementing the notice requirement by October 13, 2002, and (2) issue additional guidance and model notices.

Best Practices — Because of the severity of the penalties for non-compliance, it is imperative that plan sponsors and plan administrators carefully monitor the content and the timing of issuance of the notices.

III Prohibition Against Personal Loans to Executives and Directors and Their "Equivalents"

The Act contains a very broadly worded prohibition against "personal loans" to directors and executive officers of publicly traded companies. An issuer of a publicly traded security may not directly or indirectly, *including through any subsidiary*, extend or maintain credit, arrange for the extension of credit, or renew an extension of credit, in the form of a *personal loan* to or for any director or executive officer or *equivalent thereof*. Because this section of the Act is broadly worded and somewhat ambiguous, it appears to prohibit certain techniques commonly used to compensate executives and directors.

- *Personal Loan* — The term is not defined in the Act. Many commentators believe, however, that the breadth of the prohibition against the extension, maintenance or renewal of credit will operate to prohibit split dollar life insurance arrangements, cashless exercises of stock options and participant loans from retirement plans (all of which involve some form of a personal employee loan) that involve executive officers, directors and "equivalents." Pending further clarification, prudent employers will refrain from engaging in activities that may be deemed to be personal loans.
- *Individuals Affected* — In addition, the Act does not clearly define the groups of individuals who are prohibited from receiving loans. Although the term "director" is reasonably clear, and the term "executive officer" is defined elsewhere in various SEC rules (but not in the provisions of the Act implementing the prohibition against personal loans — see discussion of insider trading prohibition above), the term "equivalent thereof" is not defined in the Act. The use of such term clearly suggests that an additional class of individuals is subject to the prohibition against personal loans. We are waiting for additional guidance concerning the SEC's view of the scope of this term.
- *Effective Date* — The section of the Act prohibiting personal loans became effective on July 30, 2002. However, an extension of credit maintained by the issuer on July 30, 2002, is not covered, provided that there is no material modification to any term of any such extension of credit *or* any renewal of any such extension of credit on or after such date. This grandfather rule does not appear to address the situation in which a loan is made to an employee (who is not an executive officer) after July 30, 2002, and such employee subsequently becomes an executive officer or "equivalent thereof."

Best Practices — All publicly traded companies are well advised to review their current compensation arrangements for executives and directors to determine whether any prohibited or grandfathered loans exist. In this regard, it should be noted that additional post-June 30, 2002 payments (pursuant to pre-June 30, 2002 split-dollar arrangements) may be deemed to result in a new extension of credit not covered by the grandfather rule. In addition, publicly traded companies should establish procedures for identifying directors and executive officers and monitoring the compensation programs that are made available to these employees in order to ensure that such individuals do not receive personal loans in violation of the Act.

IV Insider Reporting of Stock Transactions

The Act contains an important new requirement for "insiders" of issuers of equity securities. Specifically, any beneficial owner of more than 10% of any class of equity securities of the issuer of any class of publicly traded securities or officer or director of any such issuer (each, an "insider") who engages in a "discretionary transaction" under his 401(k) plan, employee stock ownership plan (ESOP), profit sharing plan, employee stock purchase plan or nonqualified deferred compensation plan generally must report such transaction on SEC Form 4 by the second business day following the execution date of the transaction. The two-business-day rule also applies to *all* grants, awards and other acquisitions of employer stock and stock options as well as to all exercises and conversions (including cancellations, regrants and repricings) of "derivative securities" (e.g., stock options, stock appreciation rights).

- *Discretionary Transaction* — A "discretionary transaction" is a transaction pursuant to an employee benefit plan that (1) is at the volition of the plan participant, (2) is not made in connection with the participant's death, disability, retirement or termination of employment, (3) is not required to be made available to the participant pursuant to a provision of the Code, and (4) results in either an intra-plan transfer involving an issuer equity securities fund or a cash distribution funded by a volitional disposition of an issuer equity security. Examples of discretionary transactions include an insider altering his investment allocation under a 401(k) plan or ESOP or receiving an in-service cash distribution from such plan that is funded, pursuant to his election, by a disposition of employer stock. Each transaction would have to be reported on SEC Form 4 within two business days.
- *Date of Execution* — For most "discretionary transactions," the date on which the plan administrator notifies the insider that the transaction has been executed is deemed to be the date of execution, if the insider is notified by the third business day following the trade date. The insider must report the transaction on Form 4 by the end of the second business day following the deemed date of execution.
- *Effective Date* — The insider reporting requirements took effect on August 29, 2002.

Best Practices — All publicly traded companies should move quickly to identify the full range of transactions (especially under their qualified plans and stock option plans) requiring accelerated reporting, to identify the individuals who qualify as "insiders" for purposes of the accelerated reporting requirement and to develop a model notice to provide to insiders who execute "discretionary transactions."

V Stiffer Criminal Penalties

The maximum criminal penalties for willful violations of ERISA have been increased. For an individual, the maximum fine has been increased from $5,000 to $100,000 and the maximum prison term has been extended from one year to ten years. The maximum non-individual (e.g. corporate) fine has been increased from $100,000 to $500,000.

Examples of willful violations would include the purposeful use of funds intended for the plan for other corporate purposes, or the invasion of plan assets to pay personal expenses of a trustee or fiduciary of an ERISA Plan.

For more information, please contact your Brown Rudnick attorney or one of the following attorneys:

Harvey M. Katz
212.209.4860
hkatz@brbilaw.com

George L. Chimento
617.856.8503
gchimento@brbilaw.com

Adam B. Cantor
212.209.4896
acantor@brbilaw.com

James L. Hauser
617.856.8130
jhauser@brbilaw.com

BR BI BROWN RUDNICK BERLACK ISRAELS LLP

www.brownrudnick.com

Boston
Dublin
Hartford
London
New York
Providence

Brown Rudnick Berlack Israels LLP is a full-service, international corporate law firm with offices in the United States and Europe. We have 200 attorneys who provide advice across four areas of the law: Business, Banking & Finance, Real Estate and Litigation.