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The New Form 8-K Regulations — Is Disclosure Required?

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New rules promulgated by the Securities and Exchange Commission ("SEC") requiring expanded and accelerated Form 8-K disclosure became effective on August 23, 2004. The new rules significantly expand the list of events requiring Form 8-K disclosure by registrants under the Securities Exchange Act of 1934 (the "Exchange Act") and shorten the deadline for most filings to four business days following the event. These expanded and accelerated reporting requirements follow the Congressional mandate under Section 409 of the Sarbanes-Oxley Act of 2002 that the SEC adopt rules requiring reporting companies to disclose material information on a "rapid and current basis," as well as previous SEC efforts that predate the Sarbanes-Oxley Act to expand such reporting requirements and move towards a "real time" reporting system.

Like many new regulations, these Form 8-K requirements have raised numerous interpretive issues. In response, on November 23, 2004, the Division of Corporation Finance of the SEC released answers to frequently asked questions ("FAQs") regarding the Form 8-K disclosure requirements. This article focuses on certain specific Form 8-K issues, including those related to employee compensation arrangements and other issues raised in the FAQs.

General

Disclosure for Subsidiaries. When evaluating their disclosure procedures, registrants must keep in mind that Form 8-K triggering events generally apply to registrants as well as their subsidiaries. Thus, for example, entry by a subsidiary into a non-ordinary course definitive agreement that is material to the registrant is a reportable event under Item 1.01 and definitive obligations or off-balance sheet arrangements of a subsidiary that are material to the registrant must be disclosed under Item 2.03. Note that materiality is judged, not based on the subsidiary, but on the registrant consolidated with its subsidiaries.

However, disclosure requirements related to executive officers and directors refer only to persons who are executive officers or directors of the registrant itself. But remember that under Exchange Act Rule 3b-7 an executive officer of a subsidiary may be deemed to be an executive officer of the parent registrant if he or she performs a policy-making function for the registrant.

Periodic Reports in Lieu of Form 8-Ks. Registrants may disclose a triggering event in a periodic report, such as a Form 10-Q or Form 10-K, rather than filing a separate Form 8-K if the triggering event occurs within four business days before the periodic report is filed. However, registrants may not use periodic reports to disclose triggering events under Item 4.01 (regarding changes in a registrant's certifying accountants) and or under Item 4.02 (regarding non-reliance on previously issued financial statements).

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Practice Notes

Shareholder Access to Company Proxies

What is Shareholder Access to the Proxy?: Shareholder access to a company's proxy refers to the right of shareholders meeting certain criteria to include board nominees whom they have selected in their company's proxy materials. These proxy materials are mailed by companies to all of their shareholders. The SEC has yet to issue a final rule making this right available to shareholders.

Although state law permits shareholders to appoint their own director nominees and launch what is referred to as a "proxy contest" against a company's director nominees, proxy contests can cost millions of dollars. Unlike the vast sums available to a large public company, shareholders may not have the resources to embark upon what can be a prohibitively costly battle.

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SEC Regulation

Ethics and Compliance

Second Annual General Counsel Roundtable – Tone at the Top: Getting it Right

On December 3, 2004, Stephen M. Cutler, Commissioner of the SEC, briefed the Second Annual General Counsel Roundtable on what the SEC is doing to induce companies to make matters of tone and culture a priority. Cutler urged the importance of going beyond individual adherence to the law, explaining that company officials should be just as concerned about the compliance of others—that a failure in corporate culture reflects a failure on the CEO, CFO and General Counsel's watch.

Cutler points to monetary penalties the SEC has imposed upon companies such as WorldCom, Inc. ($750 million), Qwest Communications International Inc. ($250 million), Bristol-Meyers Squibb Company ($100 million) and Alliance Capital Management L.P. ($100 million), to illustrate to senior executives that "there are real-world consequences to them if their institutions fail to adhere to the law—even if they aren't themselves scofflaws." On the flip-side, Cutler mentions that the SEC seriously considers factors such as self-policing, reporting problems to the government and establishing a culture of compliance when making charging and sanctioning decisions. He also notes that the SEC is not alone in its efforts to promote strong ethics and antifraud programs, citing the Justice Department's Thompson memo (a fifteen page memorandum drafted by Deputy Attorney General Larry D. Thompson) and the U.S. Sentencing Commission's amended organizational sentencing guidelines *(See the Practice Notes section in the October issue of Corporate Governance on CGLR <GO> for more on the amended organizational sentencing guidelines).*

Cutler emphasized that companies need to both "talk the talk" "walk the walk" to maintain a strong culture of compliance and ethics. He stressed that such standards must "infuse the day-to-day lives" of employees, meaning that an employee should know from day one that ethics and honesty are integral to the workplace. Quoting SEC Chairman William H. Donaldson, Cutler highlighted that a company must make "ethics part of [its] DNA." Moreover, Cutler stated that this "talk" needs to extend beyond a company's own walls to those with whom it does business (*i.e.*, vendors, consultants and contractors) because "[w]ithout their complicity, the public companies with which they had dealings may not have been able to violate the law."

Cutler advocates a means of ensuring that there is a "safe, reliable and well-known" mode of communication available to those who have questions regarding ethical issues or want to report possible compliance problems. He also emphasizes that a company make clear that retaliation against whistleblowers will not be tolerated. In addition, Cutler suggests appointing an ombudsman or business practices officer to receive and investigate complaints. He points to the SEC's settlement with Qwest as a situation where the SEC required a company to permanently maintain such a position.

As an example of how a company can "walk the walk," Cutler recommends that when a company fires or suspends a rainmaker or other significant employee for an ethical breach, it make clear to its employees (consistent with privacy concerns) both the punishment and the reasons behind such punishment, rather than sweeping it under the rug.

Finally, Cutler advises that good governance cannot be achieved by mere adherence to a checklist of best practices. Instead, checklists should be used at the end of the process to ensure that the company hasn't missed anything.

Announcements

SEC Advisory Committee to Study Impact of Sarbanes-Oxley on Smaller Public Companies

Release Nos. 33-8514 and 34-50864; File No. 265-23;
69 FR 76498

During a December 16, 2004 press conference, SEC Chairman William H. Donaldson announced the formation of the SEC Advisory Committee on Smaller Public Companies (See Release No. 2004-174). The committee will study the impact of Sarbanes-Oxley and federal securities laws on smaller public companies in the following areas: (i) internal control over financial reporting, corporate disclosure and reporting requirements; (ii) accounting standards and financial reporting requirements and (iii) the process, requirements and exemptions relating to securities offerings, namely public offerings.

Donaldson stated that the committee will be charged with conducting its work with "a view of protecting investors and considering whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits." The committee will also identify methods of minimizing costs and maximizing benefits, in addition to facilitating capital formation by smaller companies. Lastly, the committee is expected to provide guidance as to where and how to balance the regulatory treatment for companies based on size.

Herbert S. Wander and James C. Thyen will co-chair the committee. Wander is a partner with the law firm of Katten Muchin Zavis Rosenman, specializing in corporate governance, securities law and mergers and acquisitions. Thyen is President and CEO of Kimball International Inc., an Indiana-based manufacturer of furnishings and electronics. Donaldson indicated that additional committee members will be announced within the next few weeks.

Recent Cases

Statute of Limitations

Sarbanes-Oxley Does Not Revive Expired Securities Fraud Claims

In re Enterprise Mortgage Acceptance Co., LLC Securities Litigation), No. 03-9261 (2d Cir. Dec. 6, 2004)

On December 6, 2004, the U.S. Court of Appeals for the Second Circuit held that Section 804 of Sarbanes-Oxley, which extends the statute of limitations for private securities fraud cases, does not revive previously expired securities fraud claims. While this issue is being contested in several federal courts across the country, the Second Circuit's decision is the first federal appeals decision on the matter.

Prior to the enactment of Sarbanes-Oxley in July 2002, private securities fraud claims were required to be brought within the longer of one year from the date of discovery of the alleged fraud or three years from the date of the alleged fraud. Section 804 of Sarbanes-Oxley increased these periods to two and five years, respectively.

The Court's decision addressed two separate cases which had not been formally consolidated on appeal, but were decided together because they involved almost identical issues (See In re Enterprise Mortgage Acceptance Co., 295 F. Supp. 2d. 307 (S.D.N.Y. 2003)) and McBride v. Ernst & Young LLP, No. 02-CR-1266, Mem & Order (E.D.N.Y. Dec. 3, 2003)). In each case, plaintiffs initiated securities fraud actions before the passage of Sarbanes-Oxley.

In the first case, Aetna Life Insurance Company and Great Southern Life Insurance Company brought suit against Enterprise Mortgage Acceptance Co., LLC (EMAC) alleging that EMAC fraudulently induced them to participate in private securities offerings between 1998 and 2000 in violation of Section 10(b) and Rule 10b-5 of the Exchange Act (prohibiting fraud and manipulation). Aetna filed its complaint on June 12, 2002, asserting federal claims pertaining to its 1998-2000 purchases. Two days later, on June 14, 2002, Great Southern filed a complaint asserting state claims concerning its 1999 purchases as well as federal claims with respect to its 2000 purchases. According to the Court, Aetna subsequently withdrew the federal claims relating to its 1998 and 1999 purchases, conceding that they were time-barred by the applicable statute of limitations. In May 2003, Aetna and Great Southern filed new complaints, also under Section 10(b) and Rule 10b-5, regarding Aetna's 1998 and 1999 purchases and Great Southern's 1999 purchases. EMAC moved to dismiss these claims as time-barred, but Aetna and Great Southern contended that Sarbanes-Oxley had revived their claims. The district court disagreed with Aetna and Great Southern, and this appeal followed.

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In the second case, Jack McBride and co-plaintiffs (collectively, McBride) filed a securities fraud class action against Computer Associates on February 25, 2002. Plaintiffs then filed an amended complaint on October 22, 2003, approximately three months after the enactment of Sarbanes-Oxley, joining Computer Associates' accounting firm, Ernst & Young (E&Y), as a defendant. McBride alleged that E&Y falsely certified the propriety of the methodology and the accuracy of the results reported in Computer Associates' 1999 and 2000 annual securities filings. E&Y then moved to dismiss the amended complaint as time-barred under the pre-Sarbanes-Oxley statute of limitations period. The district court dismissed the complaint, and McBride appealed.

To evaluate whether Sarbanes-Oxley applies retroactively, the Court applied the two-part test articulated by the U.S. Supreme Court in Landgraf v. USI Film Products (See 511 U.S. 244 (1994)). According Landgraf, first a court must determine whether Congress has expressly articulated the statute's reach. If so, the inquiry stops there and the court enforces the statute as written. If the statute is ambiguous or does not expressly state Congress's intent, the court must then proceed to the second part of the Landgraf test which requires the court to "determine whether the new statute would have retroactive effect, i.e., whether it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to the transactions already completed." If the new statute has any of these effects, it will not be applied retroactively pursuant to the Landgraf test "absent clear congressional intent to the contrary."

Applying the Landgraf test, the Court determined that (1) the language of Section 804 does not "unambiguously revive stale securities fraud claims," nor is there clear evidence in Section 804's legislative history indicating that Congress intended such. The Court then moved to the second part of the Landgraf inquiry and found that (2) retroactive application of Section 804 would indeed have a "retroactive effect." The Court explained, "in different contexts, a statute of limitations may fairly be described as either procedural or substantive." Here, extending the applicable statute of limitations would increase defendants' liability for past conduct by increasing the period during which claims could be brought against them, the Court reasoned. The Court points out that Landgraf cautioned against retroactive application absent unequivocal congressional intent supporting that result.

The Court also notes that it took judicial notice of the amicus brief filed by the SEC in a pending appeal that also involves the issue of whether Section 804 revives previously expired securities fraud claims (See AIG Asian Infrastructure Fund, L.P. v. Chase Manhattan Asis Ltd., Docket No. 04-2403). The Court acknowledges that in its amicus brief, the SEC urged the Court to hold that Section 804 revives these claims. The

Court stated that while it would "take the SEC's view under advisement, the Court [would] not defer to it," explaining that Section 804 "is not a statute that the SEC has been entrusted to administer, and further, since the SEC's position is put forth only in an amicus brief, it lacks the force of law."

Announcements

Shareholder Voting Rights

High River Limited Partnership v. Mylan Laboratories Inc., No. 04-CV-02677-SHR (M.D. Pa. filed Dec. 10, 2004)

On December 10, 2004, High River Limited Partnership, controlled by Carl Icahn, filed a complaint against Perry Corp., a Manhattan-based hedge fund and its President, Richard C. Perry, alleging unlawful vote-buying with respect to shares of generic drugmaker Mylan Laboratories. Inc. The complaint also names Mylan and its CEO, Robert Coury, and other hedge funds and arbitrageurs as defendants.

High River contends that Perry and other arbitrageurs employed a technique of purchasing large blocks of shareholder voting rights, without simultaneously acquiring economic interests in the shares. According to the complaint, Perry and others were able to do so through put contracts and the like with large brokerage firms that sell the stock and then agree to repurchase that stock at the same price at a later date. Thus, High River alleges, the stock is registered in Perry's name, which enables him to vote, yet Perry has no real risk, as he cannot lose or gain any money on the shares no matter how the market moves. Likewise, the complaint states that the brokerage firm assumes no risk because the broker has a call on the shares. Specifically, the complaint provides that by allowing a buyer to go long and short at the same time, these transactions separate a shareholder's voting right from any actual interest in the company, and that, "If shareholder voting rights are divorced from shareholder ownership, legitimate expectations of corporate democracy will be undermined."

The complaint goes on to state that this unlawful vote-buying technique encourages the purchase of voting rights for the sole purpose of causing the company to transfer its assets to entities in which the vote-buyer has an economic interest, as is what High River asserts happened with Mylan. High River alleges that unsuspecting shareholders were harmed because Perry and others improperly failed to disclose discussions and understandings they had with Mylan regarding the purchase of voting rights for the purpose of transferring assets of Mylan (in which they have no economic interest) to King Pharmaceuticals, Inc., a company that sells primarily branded drugs (in which they have a great economic interest). Consequently, High River argues that such a technique undermines the basic relationship between ownership and control, effectively generating profits for those who have no economic stake in the company, while robbing "true" shareholders.

Accounting and Auditing

American Institute of Certified Public Accountants

Remarks Before the 2004 AICPA National Conference on Current SEC and PCAOB Developments

The 2004 AICPA National Conference on Current SEC and PCAOB Developments took place on December 6 and 7, 2004 in Washington, D.C. The conference provided AICPA members and other attendees an opportunity to gain critical awareness of current SEC and PCAOB developments. Speakers emphasized many important corporate governance concepts, as well as the accounting community's role in improving the quality and accuracy of information disseminated to the investing public.

The first speaker, Chief Accountant of the SEC's Office of the Chief Accountant (OCA), Donald T. Nicolaisen, spoke generally on the state of the accounting and auditing profession, improving the reporting process, off-balance sheet arrangements, reporting on internal controls, the use of new risk management and technology tools and international activity. Before delving into these topics, however, Nicolaisen pointed out that the OCA has been more proactive this past year because it has been completely restructured, more than doubled in size and has streamlined its communications with other SEC Divisions. Nicolaisen then continued with a discussion of certain key Sarbanes-Oxley initiatives which took effect in 2004, including: the CEO and CFO certification requirements, the first PCAOB inspection reports on the Big Four accounting firms and the issuance of significant PCAOB auditing standards. The common thread echoed throughout Nicolaisen's speech was a continued focus on improving the accounting profession. To that end, Nicolaisen urged attendees to: (1) focus on their core business—the audit; (2) be open and transparent; (3) continue to instill a sense of ethics and integrity; (4) reward technical competence and (5) continue to play a public leadership role in our capital markets.

In addition, Nicolaisen highlighted the internal controls reforms of Sarbanes-Oxley, emphasizing that, "getting these processes right may have the greatest impact on improving the accuracy and reliability of financial reporting." Nicolaisen explained that certain reporting requirements regarding internal controls were postponed by the SEC to enable management and auditors a sufficient amount of time to get these disclosures right "the first time around."

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SEC Deputy Chief Accountant Scott A. Taub's speech addressed several issues, including what he describes as the "compliance mindset," as well as accounting and disclosure regarding contingencies, financial instrument disclosures, improving financial reports, problems associated with structured transactions, disclosures of structuring activities and working with registrants on accounting issues. He noted that many accountants, lawyers and other professionals view financial reporting as a compliance exercise. The unfortunate effect of this "compliance mindset," explained Taub, is that the goal becomes doing only what is necessary to comply with the rules, rather than what is necessary to communicate effectively with investors.

SEC Deputy Chief Accountant Julie A. Erhardt spoke on issues of international financial reporting matters. She highlighted five key "unpinnings" that are necessary to achieve a sustainable system of international reporting, including: standard setting, education, application, interpretation and regulation. Erhardt explained that each "underpinning" is at a different stage of development, noting that future decisions and progress on some of these infrastructure issues may be independent of decisions and progress on others.

Jane D. Poulin and G. Anthony Lopez, both Associate Chief Accountants of the OCA, addressed the conference next. Poulin spoke principally about consolidation of variable interest entities under FASB Interpretation No. 46 *"Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51."* Lopez discussed revenue recognition issues, such as how changes in a registrant's circumstances may necessitate a change in its revenue recognition policies, the time and income statement characterization of non-monetary exchanges that culminate in the earnings process and renewals and extensions of intellectual property.

The conference concluded with remarks from four OCA Professional Accounting Fellows. First, Chad A. Kokenge addressed various technical issues, such as disclosure of modifications to equity-based compensation arrangements and issues regarding intangible assets. With respect to the modifications of equity-based compensation arrangements, he noted that FASB is nearing completion of its project on share-based payment. He then focused on issues concerning intangible assets, including evaluation of material modification and substantial costs and conceptual differences between FAS 141 and 142. Next, Robert J. Comerford spoke about: (1) the application of EITF Issue No. 96-16 *"Debtor's Accounting for a Modification or Exchange of Debt Instruments,"* to modified convertible bond transactions, and (2) the classification of certain trade accounts payable transactions involving an intermediary.

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Russell P. Hodge discussed customer acquisition and related costs, and the concept of materiality. Finally, John M. James examined issues related to FASB Statement 115 *"Accounting for Certain Investments in Debt and Equity Securities."*

Public Company Accounting Oversight Board

Proposed Temporary Transitional Rule Relating to Auditing Standard No. 2

Release No. 34-50794; File No. PCAOB-2004-08

On December 3, 2004, the SEC issued a notice granting accelerated approval of and requesting comments on the PCAOB's proposed temporary transitional rule, Rule 3201T, which will serve as a companion to the recently issued SEC Exemptive Order to PCAOB Auditing Standard No. 2 *"An Audit of Internal Control Over Financial Reporting Performed in Conjunction With and Audit of Financial Statements" (See* Release No. 34-50754).

The Exemptive Order, issued by the SEC on November 30, 2004, grants accelerated filers with: (i) less than $700 million in common equity market value outstanding as of the second quarter of 2004 and (ii) a fiscal year ending on or between November 15, 2004 and February 28, 2004, an additional forty-five days to file their Form 10-Ks. Normally, accelerated filers are required to file their Form 10-Ks within seventy-five days after the end of their fiscal year *(Check out the November issue of Corporate Governance on CGLR <GO> for more on the SEC's Exemptive Order).* Rule 3201T complements the Exemptive Order's forty-five-day extension in that it would permit "eligible auditors" (*i.e.*, registered public accounting firms and their associated persons) relying on the Exemptive Order to date their report on management's assessment of the effectiveness of internal control over financial reporting later than the date of the report on the same issuer's financial statements. Moreover, Rule 3201T would also allow auditors to omit reference in their report on the issuer's financial statements to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting.

Rule 3201T will expire on July 15, 2005.

PCAOB Proposes Ethics and Independence Rules

PCAOB Release No. 2004-015

On December 14, 2004, the PCAOB voted unanimously at an open meeting to propose for public comment certain rules concerning tax services, contingent fees and independence. The proposed rules focus on three main areas:

Circumstances which Impair an Auditor's Independence

Under proposed Rule 3521, a registered accounting firm would not be independent if it entered into a contingent fee arrangement with any of its audit clients. Similarly, pursuant to Sections (a) and (b) of proposed Rule 3522, a registered public accounting firm would not qualify as independent if it provides services to an audit client related to planning or opining on the tax consequences of a transaction that is a listed or confidential transaction under Treasury regulations. Moreover, proposed Rule 3522(c) contains a provision advising that a public accounting firm will not be independent if it provides services related to planning or opining on a transaction that is based on an aggressive interpretation of applicable tax laws. Finally, under proposed Rule 3523, a registered public accounting firm would not be independent if it provides tax services to officers of an audit client in a financial reporting oversight role.

Pre-Approval of Tax Services by Audit Committee

Proposed Rule 3524 delineates specific requirements a registered public accounting firm must satisfy when seeking audit committee pre-approval of non-audit services mandated by Section 202 of Sarbanes-Oxley. The proposed rule focuses on tax services (which are not prohibited by Section 201(a) of Sarbanes-Oxley) and provides that a firm must supply the audit committee of an audit client with certain information; discuss with the audit committee the potential effects of the services on the firm's independence and document the substance of that discussion.

Foundation for Other Independence Rules

Proposed Rule 3502 would incorporate as an ethics rule, the concept that persons associated with a registered public accounting firm should not cause the firm to violate relevant laws, rules, and professional standards due to an act or omission the person knew would contribute to the violation. Further, the proposed rule would include a general obligation requiring registered public accounting firms to be independent of their audit clients throughout term of the audit and professional engagement.

The PCAOB Release also mentions tax services that the proposed rules would not prohibit, such as routine tax return preparation and tax compliance, general tax planning and advice, international assignment tax services and employee personal tax services.

In a press release also issued on December 14, 2004, SEC Chief Accountant Donald T. Nicolaisen stated that "Since the passage of the Sarbanes-Oxley Act in 2002, there have been many questions about the types of services auditors may provide without compromising their independence, especially with respect to tax services. PCAOB guidance in this area will be helpful to audit committees . . . " *(See* Release No. 2004-169 *"SEC Chief Accountant Welcomes PCAOB Involvement in Independence Standards-Setting").*

There will be an opportunity for public comment before the PCAOB takes final action. The final rules adopted by the PCAOB will then be submitted to the SEC for approval.

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State Law Developments

Executive Compensation

Ovitz Trial Continues

After eight weeks of testimony, the list of witnesses in the trial challenging the payment of $140 million in severance to former Walt Disney Co. President Michael S. Ovitz continues to be a "who's who" of current and former Disney executives. In 1997, Disney shareholders filed a complaint on behalf of Disney alleging that the company's board of directors breached its fiduciary duty to Disney shareholders by rubber-stamping CEO Michael D. Eisner's decision to hire and fire Ovitz. Disney shareholders allege that the board failed to carefully review Ovitz's employment contract, particularly the no-fault termination provision which ended up costing Disney $140 million. Disney shareholders seek the return of the $140 million to Disney. Hired in 1995, Ovitz was previously one of Hollywood's most powerful talent agents and the co-founder of Creative Artists Agency, Inc. Ovitz served as Disney's President for only fifteen months.

The following provides an overview of the witnesses who have testified since the end of November *(For previous Disney trial testimony, check out "Witnesses Testify at Ovitz Trial" in the November issue of Corporate Governance on CGLR <GO>):*

Former President of Georgetown University and current Disney board member, Leo O'Donovan, testified that he believed Eisner had the authority to fire Ovitz without the board's approval. O'Donovan, who is also a Catholic priest, said he believed Eisner had final say on personnel matters and had the power to fire executives like Ovitz if he saw fit to do so.

Current Disney director and Chairman of Northwest Airlines Corp., Gary Wilson, testified that he started hearing rumors of problems between Eisner and Ovitz in early 1996. Wilson, who served as Disney's CFO from 1985 to 1989, said he got a first hand look at the problems between the two on a bike trip they all took together in June 1996. Wilson testified further that he learned from conversations with the two men that Ovitz was having trouble being accepted by other Disney executives and had not earned the respect of his colleagues. Wilson testified that he was asked by Eisner to convince Ovitz that it would be better for both Ovitz and Disney if Ovitz

agreed to step down. Wilson testified further that he believed it would not have been in the best interests of the company to have a high-powered executive like Ovitz "sitting in some corner office doing nothing." Wilson also said it would have been difficult to find another President if Ovitz had stayed to finish out his five-year contract.

Oscar-winning actor and former Disney director Sidney Poitier began his testimony by describing his childhood and his struggle to become an actor. Poitier also discussed his appointment as the Bahamian ambassador to Japan.

Poitier, who stepped down from Disney's board last year, testified that he supported firing Ovitz because the former agent did not fit in with other Disney executives. Poitier said that having Ovitz move to a lesser position in the company to avoid paying his severance would not have been in Disney's best interests.

Poitier testified that he originally thought hiring Ovitz was a good idea since he was a powerful Hollywood figure. However, Poitier said he heard relatively early into Ovitz's tenure that he was having trouble adjusting to life within Disney's corporate ranks and that Ovitz's relationship with Eisner had deteriorated. Poitier testified further that he believed there was "too deep a mismatch" among Ovitz and the other Disney executives to salvage Ovitz's position. Poitier also testified that he believed Eisner, as CEO, had the power to fire Ovitz without seeking board approval.

Fred Dunbar, Senior Vice President of National Economic Research Associates, disputed earlier testimony given by compensation expert Kevin Murphy, who called Ovitz's contract unusually generous. Dunbar testified that, even though Ovitz's compensation was not disclosed at the time he was hired, investors understood the level of compensation someone like Ovitz would command. He testified further that the cost of Ovitz's employment contract was outweighed by the stock gains realized when Ovitz's hiring was announced. Disney shares rose 4.4 percent on the day the company announced Ovitz would be Disney's new President. Dunbar stated that the stock market's reaction to the announcement showed that the deal was reasonable and would benefit the company which, at the time, was perceived as "talent poor."

Current Disney director and former Chairman and CEO of Capital Cities/ABC, Inc., (which was purchased by Disney in 1996) Thomas S. Murphy, testified that Ovitz's tenure at the company was "like a cancer." Murphy, who was a member of Disney's board from April 1996 until November 2003, said that Ovitz was just not working out and firing him was the right thing to do.

Murphy testified further that he did not remember the board voting on Ovitz's firing or approving his severance payments, but said he believed the payments were necessary. Murphy also said he believed Eisner was "tight with the dollar" and would not have paid Ovitz the money "unless he thought he had to."

Ignacio Lozano, a former U.S. ambassador to El Salvador and Disney director until 2001 testified that when he first heard Ovitz was being considered for the President position, he considered it a "bombshell" and wanted to hire Ovitz quickly before he changed his mind. However, Lozano said Ovitz's tenure turned out to be a problem that had no solution, and his firing was in the best interests of both Disney shareholders and employees.

Vice Chairman of Irvine Co. and former Disney director Raymond Watson testified that he performed a computer analysis and prepared spreadsheets regarding the potential costs of Ovitz's severance package to Disney, which he shared with other board members prior to Ovitz's hiring in 1995. Watson, who was a member of the Disney board's compensation committee when Ovitz was hired, said the committee reviewed the terms of Ovitz's contract, including the proposed compensation and potential cost to the company if Ovitz left Disney on a no-fault basis.

Watson testified further that there had been many complaints regarding Ovitz's performance and management style, and when Eisner told him that things were not working out with Ovitz, Watson suggested Eisner address the problem quickly. Watson stated that, although it would have been destructive to keep Ovitz on, Eisner and other Disney officials wanted to fire Ovitz in "the most civil way possible."

Former Disney director Robert A.M. Stern, the final witness to take the stand until the trial resumes in January, testified that the company made a "wise investment" when it fired Ovitz and paid the $140 million severance, considering the counterproductive climate Ovitz had created. Stern said that he was enthusiastic when he first learned that Ovitz would be joining Disney, but warned Eisner that good friends do not always make good partners.

Stern testified further that Ovitz had a reputation for mistreating lower-level Disney employees and for spinning presentations and stories to make himself look good. In addition, Stern said former Disney General Counsel Sanford Litvack advised Disney's board that there was no way to oust Ovitz without paying him severance.

Stern, head of Yale University's architecture school, owns a New York-based architectural firm that does work on Disney theme parks.

The trial will resume on January 11, 2005, when more expert witnesses are scheduled to take the stand.

Top Legal News

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Legislative Activity

Accounting Fraud

Oxley Issues Statement Regarding SEC Announcement on Fannie Mae Accounting Irregularities

On December 15, 2004 House Financial Services Committee Chair and co-sponsor of Sarbanes-Oxley, Congressman Michael G. Oxley (OH), issued a statement that he was, "deeply disturbed that investors, the markets, and Congress were misled by deceptive practices" at Fannie Mae. Oxley's comments were in response to a statement by SEC Chief Accountant Donald T. Nicolaisen issued on the same day with regard to the SEC's examination of Fannie Mae's questionable accounting practices (*See* Release No. 2004-172).

Following the issuance of the OFHEO report detailing its findings with respect to Fannie Mae's accounting policies, OFHEO director Armando Falcon testified in October 2004 before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises that "the accounting violations at Fannie Mae cannot be dismissed as mere differences of interpretation in accounting rules. Fannie Mae understood the rules and simply chose not to follow them" *(For a more detailed discussion of the OFHEO report and the committee hearing, see the October issue of Corporate Governance on CGLR <GO>).*

In the wake of the OFHEO report, Fannie Mae requested guidance from the SEC concerning its accounting practices for deferred purchase price adjustments (FAS 91—*"Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases"*) and hedging activities (FAS 133—*"Accounting for Derivative Instruments and Hedging Activities"*). Though it is unusual for the SEC's accounting staff to issue guidance while there are pending investigations by the SEC and other agencies, Nicolaisen stated that, "Fannie Mae requested [its] guidance because, in its view, these accounting issues have received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty."

Nicolaisen explained that the SEC's accounting staff did not evaluate the appropriateness of Fannie Mae's business decisions to use financial or derivative instruments or to hedge its risk. Instead, the SEC accessed whether the accounting practices used by Fannie Mae to record those transactions complied with FAS 91 and FAS 133. Based on the SEC's review, Nicolaisen stated that from 2001 to mid-2004, Fannie Mae's accounting practices failed to comply in material respects with FAS 91 and FAS 133.

Nicolaisen recommended that Fannie Mae take the following actions in order to bring itself into compliance with FAS 91 and FAS 133: (1) restate its financial statements to eliminate the use of hedge accounting; (2) evaluate its accounting under FAS 91 and restate its financial statements if the amounts to be corrected are material and (3) re-evaluate both the GAAP and non-GAAP information previously provided by Fannie Mae to investors.

Oxley indicated that the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises will hold hearings in early 2005 to "continue to work toward sweeping legislative reform."

On December 21, 2004, Fannie Mae announced that its CEO and CFO were leaving the company.

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Entry into a Material Definitive Agreement

Under Item 1.01 of Form 8-K, registrants are required to disclose entry into a material definitive agreement (or a material amendment) not made in the ordinary course of business. An instruction to this Item clarifies that certain types of agreements are required to be disclosed, even if they are considered ordinary course. These include agreements with directors, officers or underwriters, contracts on which the registrant's business is substantially dependent, contracts involving the purchase or sale of property in excess of 15% of the registrant's fixed assets and material leases, as described in Item 601(b)(10)(ii)(A)-(D) of Regulation S-K.

Registrants are not required to file a Form 8-K for an agreement that was not material at the time that it was entered into, but becomes material at a later date, unless the registrant later amends the agreement after it has become material.

Exhibits. Although the final rules do not require that a material agreement required to be disclosed on a Form 8-K also be filed as an exhibit to the Form 8-K, the SEC encourages companies to do so when feasible. Nonetheless, the agreement must be filed as an exhibit to the periodic report for the applicable reporting period in accordance with Item 601 of Regulation S-K. In addition, if an agreement later becomes material at any time during the period, it must be filed with the periodic report, even if, as stated above, no Form 8-K was required.

Material Definitive Agreements. The SEC has defined a definitive agreement as an agreement enforceable against or by the registrant. Thus, disclosure is not required for entry into letters of intent or other non-binding agreements, even if they contain non-material binding elements such as confidentiality or "no-shop" provisions. However, disclosure is required of a binding agreement that remains subject to customary closing conditions, such as delivery of legal opinions, completion of due diligence or regulatory approval.

Under Item 1.01, registrants must report entry into a material placement agency or underwriting agreement. However, for proposed unregistered securities offerings, registrants should

Legislative Activity Summary

Date Introduced	Bill No.	Short Title	Purpose	Most Recent Action
10/8/04	H.R. 5313	Corporate Advance Disclosure Act	To require the advance disclosure to shareholders of certain executive pension plans.	Referred to House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 11/03/04
6/4/04	H.R. 4520	American Jobs Creation Act of 2004	Adds new Internal Revenue Code Section 409A, which will radically influence the design and function of all nonqualified deferred compensation plans.	Signed by the President and became Public Law 108-357 10/22/04
6/03/04	H.R. 4505	Mutual Fund Reform Act of 2004	To improve the governance and regulation of mutual funds under the securities laws.	Referred to House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 6/28/04
6/03/04	S. 2497	Small Investor Protection Act of 2004	To amend the securities laws to provide for enhanced mutual fund investor protections.	Referred to Senate Committee on Banking, Housing and Urban Affairs 6/03/04
4/22/04	H.R. 4208	Executive Stock Option Profit Recapture Act	To discourage the abuse of stock options by executives of public companies by preventing unjust enrichment through the recapture of profits when shareholders suffer losses.	Referred to House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 5/17/04
4/01/04	H.R. 4125	Publish What You Pay Act	To require corporations to publish what they pay to foreign governments.	Referred to House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 4/20/04
3/11/04	H.R. 3955	Democracy Development Act of 2004	To require public companies to disclose to the SEC their payments to foreign governments for the purposes of natural resources exploration, development and extractions rights.	Referred to House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 3/29/04
2/10/04	S. 2059	Mutual Fund Reform Act of 2004	To improve the governance and regulation of mutual funds under the securities laws.	Referred to Senate Committee on Banking, Housing and Urban Affairs 2/10/04
11/21/03	H.R. 3574	Stock Option Accounting Reform Act	To require the mandatory expensing of stock options granted to executive officers.	Referred to Senate Committee on Banking, Housing and Urban Affairs 9/07/04
5/21/03	H.R. 2179	Securities Fraud Deterrence and Investor Protection Act	To enhance the authority of the SEC to investigate, punish and deter securities laws violations and to improve its ability to return funds to defrauded investors.	Discharged by House Judiciary Committee and placed on Union Calendar, Calendar No. 298 6/01/04

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make sure to omit the identity of the underwriters from the disclosure in the Form 8-K to remain within the safe harbor for notices under Rule 135c under the Securities Act.

Registrants are not only required to report entry into a material acquisition or disposition agreement under Item 1.01, but must remember to later disclose the closing of the transaction under Item 2.01. However, the Item 2.01 requirement remains subject to a bright-line reporting threshold different from the criteria under Item 1.01. Financing in connection with the transaction could require disclosure under Item 2.03 and, if unregistered equity securities were issued, under Item 3.02.

In the context of employment agreements and other compensatory plans and arrangements, Item 1.01 requires disclosure of all such arrangements and material amendments thereto for directors and "named executive officers" unless the arrangement is otherwise exempt under Item 601(b)(10)(iii)(C) of Regulation S-K. Named executive officers are identified by reference to those who are named executive officers as of the end of the prior year, as required by Item 402(a)(3) of Regulation S-K. However, persons who will almost certainly be a named executive officer for the current year, such as a new CEO, should also be considered a named executive officer for purposes of this Item. Employment and other compensatory agreements and amendments with executive officers who are not named executive officers must be disclosed on Form 8-K only if they are material in amount or significance.

Material Amendments. A material amendment to an agreement may need to be disclosed even if the underlying agreement did not. For example, if an agreement was entered into before the effective date of these new 8-K rules and the agreement was amended after the effective date, the amendment may need to be disclosed even though the underlying agreement did not. Similarly, the amendment itself may be material, even if the original agreement was not.

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Delayed Disclosure of Compensatory Plans Subject to Shareholder Approval. While compensatory plans and arrangements must generally be disclosed on Form 8-K within four business days of adoption or amendment by registrants, regardless of whether awards thereunder have actually been granted, disclosure of plans or arrangements subject to shareholder approval is not required until after such approval. Separate Form 8-K disclosure is thus required in shareholder approval situations despite the extensive disclosure in the registrant's proxy statement. However, inducement grants that are not under a shareholder-approved plan would need to be disclosed following the grant.

Performance Criteria. After disclosure of the plan or arrangement upon adoption or shareholder approval, additional disclosure on Form 8-K is required when registrants set the specific performance criteria for a performance period if such performance criteria were not initially disclosed. This would require subsequent disclosure of the adoption of specific performance targets for a performance period even if the initial disclosure sets forth all of the potential performance targets on which compensation may be based. However, target levels with respect to specific quantitative or qualitative performance-related factors and criteria involving confidential commercial or business information are not required to be disclosed if such disclosure would have an adverse impact on the registrant.

Oral Compensation Arrangements. Item 1.01 applies to both written and unwritten material definitive agreements. Therefore, written descriptions of oral compensatory agreements or arrangements not otherwise committed to a formal written document must be disclosed on Form 8-K. The filing must be made within four business days of the date the agreement or arrangement is entered into or established rather than some later date when an informal summary is prepared and distributed to the recipients. The SEC specifically identified director compensation arrangements (which may not typically be memorialized in a written agreement) as requiring disclosure; however, it is unclear whether salary levels also need to be disclosed when set by the board.

Individual Award Agreements. Where a registrant has previously disclosed the material terms of an equity compensation plan or arrangement and has filed the plan (and the form of award agreement, if the plan provides for broad discretion as to the terms and conditions of awards under the plan) as an exhibit to its next periodic report or registration statement, subsequent individual equity awards granted to an executive officer or director that are consistent with the material terms and conditions of the plan and award agreement (other than the identity of the recipient, the grant date, the number of securities covered by the award, the exercise prices and the vesting schedule) generally need not be separately disclosed on a Form 8-K. This same analysis applies to plans adopted before the effective date of these Form 8-K rules, where the plan (and award agreement) was filed. However, where the material terms of an individual equity award are materially different from those previously disclosed, the individual agreement must be disclosed on Form 8-K and subsequently filed with the registrant's periodic report.

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Where a registrant has not previously disclosed the form of award agreement in a Form 8-K, the registrant may disclose the material terms of the form of award agreement in a Form 8-K and subsequently file the form of award agreement, thereby eliminating the disclosure requirements for subsequent individual awards to directors or officers containing the same material terms.
Similarly, once a cash bonus plan and the performance criteria thereunder have been disclosed on Form 8-K, the payment of a cash award to an executive under the bonus plan in accordance with the previously disclosed performance criteria is not required to be disclosed, unless disclosure is necessary for an investor's understanding of that executive's compensation under the plan. Thus, payment of a bonus where the performance criteria were not met would trigger disclosure.

Termination of a Material Definitive Agreement

Under Item 1.02, registrants must disclose termination of a material definitive agreement not made in the ordinary course of business. Under this Item, disclosure is required only following termination of the material agreement, other than upon expiration or completion, if such termination is material to the registrant.

Notice of Termination. Registrants must report receipt of notice to terminate a material definitive agreement, even if the party intends to negotiate the terms of the agreement and believes in good faith that the agreement will ultimately not be terminated. Note that disclosure is not required during negotiations or discussions regarding the termination of a material agreement; however, once notice of termination is received, disclosure is required, regardless of the efforts to continue the contract.

The SEC has clarified that disclosure is not required if the registrant believes in good faith that the agreement has not been terminated, unless it has received a notice of termination. However, if the registrant decides to voluntarily disclose the circumstances relating to this agreement despite such good faith belief that no termination has occurred, it may be required to file an amended Form 8-K if its belief changes.

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Renewal and Non-Renewal Notices. Registrants must file a Form 8-K if a party to a material definitive agreement that provides for automatic renewal periods sends a non-renewal notice. However, automatic renewal of the agreement pursuant to the terms of the agreement is not considered a triggering event.

Conversely, if the agreement automatically terminates unless a renewal notice is sent, a Form 8-K is not required upon such termination. However, if a party sends a renewal notice, a Form 8-K is required after the passage of any rejection deadline.

Direct Financial Obligations and Off-Balance Sheet Arrangements

Item 2.03 of Form 8-K requires disclosure of the creation of a material direct financial obligation[1] or off-balance sheet arrangement. Disclosure is required once an enforceable agreement is entered into, or, if no such agreement exists, within four business days after the closing or settlement of the obligation.

Materiality as to a financial obligation is a facts and circumstances determination. Factors that determine materiality include the amount of the obligation, whether the financial obligation is a refinancing and the impact on covenants, liquidity, debt capacity and other debt requirements. Thus, the refinancing of privately placed long-term indebtedness with new long-term indebtedness of the same principal amount and similar terms may not be a material event requiring Form 8-K disclosure.

Disclosure of registered debt offerings is exempt from this Item, as long as a prospectus containing the information required by Item 2.03 is timely filed. Thus, Rule 144A debt offerings, which are not registered when consummated, would trigger a Form 8-K filing.

Disclosure is required even if the registrant is not a party to the agreement or transaction that created the contingent liability. If this is the case, disclosure must be made within the four business day period following the earlier of (1) the fourth business day after the obligation arises or (2) the day on which any executive officer of the registrant becomes aware of such obligation. Note that the period under clause (1) above provides a second four business day grace period, but is triggered even if the registrant's executive officers are not aware of the contingent liability to which the registrant is not even a party.

Credit Facilities. Entry into an agreement for a credit facility must be disclosed, even if no funds are immediately borrowed. Each time a registrant borrows money under such facility it will have to analyze whether such borrowing, together with any previous undisclosed borrowings, is material, which would trigger a further disclosure obligation. Disclosure of the agreement may also be required as a material agreement under Item 1.01.

Disclosure of Triggering Events that Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement

Under Item 2.04 of Form 8-K, events of default and other triggering events that accelerate or increase a material direct financial obligation or a material obligation under an off-balance sheet arrangement must be disclosed. Disclosure is also required for a triggering event that causes a registrant's contingent obligation under an off-balance sheet arrangement to become a direct financial obligation.

Disclosure is required only following the occurrence of a triggering event according to the terms of the agreement or transaction. This includes the sending of any notice required under the agreement and the satisfaction of any other conditions to the acceleration event, other than the passage of time. Thus, a Form 8-K does not need to be filed if all the facts necessary to an event triggering acceleration or increase in a direct financial obligation have occurred but the counterparty has not provided notice of default if such notice is required. However, if the increase or acceleration is triggered automatically on occurrence of an event without notice, disclosure is required.

Disclosure of Costs Associated with Exit or Disposal Activities

Item 2.05 requires disclosure of commitments to an exit or disposal plan or other disposal of a long-lived asset or termination of employees under a plan of termination under which material charges will be incurred by the registrant.

This reporting obligation is triggered by the commitment of the registrant's board of directors or, if board action is not required, an authorized officer to the course of action. However, if the plan involves the termination of employees, a registrant does not need to disclose this commitment until it has informed the affected employees.

If a registrant is unable to give a good faith estimate of the charges at the time of the filing, the Form 8-K may omit the estimate, provided that once an estimate is formulated, an amendment including the estimate must be filed within four business days.

Disclosure of Non-Reliance on Financial Statements, Audit Report or Interim Review

Under Item 4.02, registrants must report non-reliance on previously issued financial statements or a related audit report or interim review. Registrants must file a Form 8-K if its board of directors or, if board action is not required, an authorized officer concludes that the registrant's previously issued financial statements should not be relied upon because of an error in such statements.

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Similar disclosure is required if the independent accountants have notified the registrant that a previously issued audit report or interim review should not be relied upon. In such event, the registrant must provide the independent accountants with a copy of the disclosure on or before the day the registrant files the related Form 8-K and request a letter from the accountants indicating whether or not they agree with the disclosure. The accountants' letter must then be filed as an exhibit to an amendment of the Form 8-K. However, a registrant that has taken appropriate action to prevent reliance on the financial statements and has also filed a Form 8-K does not need to file a second Form 8-K indicating that the registrant's auditors separately concluded that future reliance should not be placed on its audit report, unless the auditor's conclusion relates to an error or matter different from the one that triggered the registrant's filing.

Disclosure of Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers

Under Item 5.02, disclosure is required if (a) a director resigns or refuses to stand for re-election because of a disagreement known to an executive officer of the registrant relating to the registrant's operations, policies or practices or the director has been removed for cause; (b) a principal officer retires, resigns or is terminated or a director retires, resigns, is removed or refuses to stand for re-election other than as a result of a disagreement or for cause or (c) a principal officer is appointed or a new director is elected.

Notice of Resignation, Retirement or Refusal to Stand for Re-Election. Registrants are required to report an event under Item 5.02(b) when a director or executive officer gives notice, written or oral, of a decision to resign, retire or refuse to stand for re-election. The disclosure must specify the effective date of the resignation or retirement and, in the case of refusal to stand for re-election, when the election will occur. No disclosure is required for discussions regarding resignation, retirement or refusal to stand for re-election. Whether communications represent discussions, a non-reportable event, or notice, which is reportable, must be determined based on the relevant facts and circumstances.
A registrant does not need to file a Form 8-K if the registrant decides not to nominate a director for re-election at its next annual meeting. However, if the director resigns upon receiving notice that the registrant does not intend to nominate him, or refuses to stand for re-election, a Form 8-K is required.

Demotion. "Termination" under Item 5.02 includes situations where an officer has been demoted or has had his or her duties and responsibilities removed such that he or she no longer functions in such officer position. Thus, if a registrant's principal operating officer has his or her duties and responsibilities as principal operating officer removed and reassigned to other personnel within the organization, the registrant must file a Form 8-K to report the termination, even if the officer remains employed by the registrant and retains the formal title.

Circumstances Surrounding Termination. While registrants are not required to disclose the reasons for an officer's departure, as originally proposed under Item 1.02, if such departure involves the termination of a material agreement, registrants must disclose the other material circumstances surrounding the termination, such as severance payments or other consequences.

Newly Appointed Officers and Directors. When a new officer is appointed, registrants may delay disclosure until a public announcement of the event is made. Entry into an employment agreement with the officer, as well as appointment of the officer to the board of directors, may be delayed until the day of public announcement (but without a further four day grace period).

The disclosure obligations under Items 5.02(b) and (c) apply to all of the specified officers (including the principal accounting officer and principal operating officer), even if the position does not otherwise fall within the definition of an executive officer for purposes of Item 401 or 404 of Regulation S-K.

Disclosure of Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

Disclosure under Item 5.03 is required only if the proposed amendment or change was not previously disclosed in a proxy or information statement. The registrant must disclose the effective date of the amendment and describe the amendment and the previous provision if applicable. If only the amendment is filed as an exhibit to the Form 8-K, the restated articles of incorporation or bylaws must be filed as an exhibit to the next periodic report. Only companies with registered equity securities are required to report amendments to articles of incorporation and bylaws; changes in fiscal years must be disclosed by all reporting companies.

If they have not already done so, registrants should review their disclosure controls and procedures to ensure that the information required to be disclosed by Form 8-K is brought to the attention of management and disclosed within the requisite timeframe. As described above, these new Form 8-K requirements may be triggered by arrangements that are not documented, may require disclosure under multiple items and may even require multiple filings. Especially given the shortened time constraints under the regulations, appropriate training and other control mechanisms are critical to satisfying these new Form 8-K reporting requirements.

[1] A "direct financial obligation" is defined as a long-term debt obligation, capital lease obligation, operating lease obligation or short-term debt obligation arising other than in the ordinary course of business.

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Practice Notes
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- **SEC Rule Proposal—Rule 14a-11**: In October 2003, the SEC proposed new Exchange Act Rule 14a-11 which would require public companies in certain instances to include director nominees chosen by shareholders in that company's proxy materials (See Release No. 34-48626; 68 FR 60784). As proposed, Rule 14a-11 would be triggered upon the occurrence of one of the following events:

  - at least one of the company's director nominees receives "withhold" votes from more than 35% of the votes cast at an annual meeting of shareholders; or

  - a shareholder (or group of shareholders) holding at least 1% of a company's stock for over one year submits a proposal under Exchange Act Rule 14a-8 seeking the right to the nomination procedure delineated in proposed Rule 14a-11, and a majority of the shareholders approve such proposal at the company's annual meeting.

  According to proposed Rule 14a-11, only those shareholders who own over 5% of the company's stock continuously for two years or more (and intend to hold those shares through the date of the annual meeting of shareholders) would be eligible to nominate directors, and would only be entitled to such right upon the occurrence of one of the two triggering events described above. In addition, a shareholder holding 5% or more of a company's stock must be eligible to file a Schedule 13G rather than a Schedule 13D, and is further required to have filed a Schedule 13G or an amendment thereto before the submission of a nomination.[1] The Schedule 13G (or amendment) must certify that the shareholder(s) have held over 5% of the company's stock for the past two years.

- **Application:** The proposed Rule would apply only to those companies that are subject to the SEC's proxy rules. The proposed Rule would not apply to non-reporting, private companies and foreign issuers, which are not subject to the proxy rules. Further, note that proposed Rule 14a-11 applies only when state corporation law provides shareholders with the right to make nominations to a company's board.

- **Eligibility of Nominees:**
  - the nominee may not be the nominating shareholder, a member of the nominating shareholder group or a member of the immediate family of the nominating shareholder or nominating shareholder group;
  - neither the nominee nor any member of the nominee's immediate family can have been an employee of the nominating shareholder or member of the nominating shareholder group during the current or prior calendar year;
  - neither the nominee nor any member of the nominee's family can have received any fees from the nominating security holder or a member of the nominating security holder group during the year of the nomination or the previous year (other than fixed retirement or deferred compensation in connection with prior service);
  - the nominee may not be an executive officer or director of the nominating shareholder or member of the nominating shareholder group, or an affiliate of either; and
  - the nominee may not control the nominating shareholder or any member of the nominating shareholder group.

Practice Notes

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- **Number of Nominees:** The number of nominees that shareholders would be permitted to nominate under proposed Rule 14a-11 depends upon the number of seats on a company's board (with exceptions for staggered boards):

  - Eight or fewer seats: one shareholder nominee
  - Nine-Nineteen seats: two shareholder nominees
  - Twenty or more seats: three shareholder nominees

  In the event that more than one eligible shareholder or shareholder group desires to include a nominee or a short slate of nominees in the company's proxy materials, the company is only required to include the nominee(s) of the shareholder or shareholder group with the largest ownership interest.

- **Notices:** A nominating shareholder or shareholder group must provide notice to the company of its nomination submission at least eighty days before the date the company mails its proxy materials for the annual meeting, including certain information regarding the nominating shareholder or shareholder group, the nominee's eligibility and the nominee's consent. If the requirements of the proposed Rule have been met, the company would be required to include information regarding the nominee in its proxy statement and in its proxy card.

- **Comments to Proposed Rule 14a-11:** The SEC has received thousands of letters in support of the proposed reforms from labor unions, pension funds, institutional investors and institutional investor associations. However, while these groups support proposed Rule 14a-11, some question whether the events that trigger application of the proposed Rule are too rigorous. In particular, much dispute has centered on the proposed 35% trigger, which proponents of the proposed Rule claim is too high a hurdle, while opponents argue it is not high enough.

Moreover, opponents of the proposed Rule argue that by removing the effort and cost associated with a proxy contest, the SEC may in effect be enabling shareholders with special-interest or even frivolous agendas to divert management's attention away from its primary function of running the company's business. Opponents argue further that the proposed Rule is unnecessary because Sarbanes-Oxley already addresses the accountability concerns that have recently undermined investor confidence. In response, supporters of reform are quick to point out that the minimum ownership and holding requirements described above provide effective filtering mechanisms against hostile take-over attempts by investors with short-term goals as well as special-interest candidates.

- **Status of Proposed Rule 14a-11:** In the wake of the heated controversy surrounding proposed Rule 14a-11, SEC movement toward issuing a final rule has been slow. In a September 27, 2004 speech before the Financial Services Leadership Forum, SEC Chairman William H. Donaldson explained, "While we continue to work on structuring appropriate improvements to the [R]ule, the goal is simple: to provide long-term shareholders with an effective means, under certain circumstances, of adding shareholder nominees to a management-proposed slate." Still, over two years have passed since the Rule proposal's October 2003 arrival.

In the meantime, despite the absence of a final rule, proponents of proposed Rule 14a-11 have not given up. Shareholders at Walt Disney Co., Qwest Communications International Inc. and Verizon Communications Inc. have submitted proposals requesting access to their respective company's proxy. These requests, however, have not been successful as of yet. In separate No-Action Letters, the staff of the SEC's Division of Corporate Finance has concurred with each company's position that such proposals may properly be excluded from its proxy (See SEC No-Action Letter, avail. December 28, 2004 (Disney); SEC No-Action Letter, avail. March 22, 2004 (Qwest) and SEC No-Action Letter, avail. January 28, 2004 (Verizon)).

[1] Certain investors may file a Schedule 13G in lieu of a Schedule 13D, such as passive investors, qualified institutional investors and foreign institutional investors.

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