EMPLOYEE BENEFITS PROVISIONS OF THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act (the "Act"), signed into law by President Bush on 7/30/02, makes sweeping changes to accounting and corporate governance rules.[1] However, the Act also contains important employee benefits-related provisions.

Specifically, the Act provides for (1) notification to employee benefit plan participants of plan blackout periods, (2) enhanced criminal penalties for ERISA reporting and disclosure violations, (3) securities trading restrictions on a public company's directors and executive officers during benefit plan blackout periods, with disgorgement of profits realized by such a director or executive officer selling in violation of these restrictions, and (4) a ban on personal loans from a public company to a director or executive officer.[2]

ERISA BLACKOUT PERIOD NOTIFICATION REQUIREMENTS

In General. The Act amends ERISA to require the administrator of an individual account plan (*i.e.*, a defined contribution plan such as a 401(k) plan, profit sharing plan, or ESOP) to give 30 days' advance written notice of a post-1/25/03 blackout period to affected plan participants and beneficiaries. This notice requirement applies to individual account plans maintained by public and private companies, but not to governmental plans, foreign plans or non-electing church plans.[3]

"Blackout Period" Definition. For purposes of the notice requirement, a "blackout period" is a period of more than 3 consecutive business days during which the otherwise-available right of a plan participant or beneficiary to direct or diversify plan account balances or to obtain loans or distributions from the plan is temporarily suspended, limited or restricted. However, "blackout period" does not include a suspension, limitation or restriction that (1) results from application of the securities laws (*e.g.*, insider trading restrictions applicable to certain public company executives), (2) is regularly scheduled and results from a plan amendment that is adequately disclosed to participants, or (3) is a consequence of a qualified domestic relations order. Because a right must be "otherwise available" in order for a suspension of the right to constitute a "blackout period," a permanent restriction on the trading of employer securities (*e.g.*, with respect to 401(k) plan matching contributions made in employer stock) or

[1] The August 2002 Kirkland & Ellis Alert from the firm's Corporate Practice Group (the "Corporate Alert") containing a description of the Act's non-employee benefits provisions is enclosed.

[2] The Act also requires a public company CEO or CFO to disgorge (1) bonuses and other incentive-based or equity-based compensation received and (2) profits realized from securities sales, if the public company is required to prepare an accounting restatement due to material noncompliance, as a result of misconduct, with financial reporting requirements. Please see the Corporate Alert for discussion.

[3] The Act also expressly excludes "one-participant retirement plans" from the blackout period notice requirements. For this purpose a "one-participant retirement plan" is a plan that (1) covers only the employer (and his spouse) where the employer owns the entire business or covers only one or more partners (and their spouses) in a business partnership, (2) meets the minimum coverage requirements of Section 410(b) of the Internal Revenue Code without being aggregated with any other plan that covers employees of the business, (3) does not provide benefits to anyone except the employer or the partners (and their spouses), (4) does not cover a business that is a member of a controlled group, and (5) does not cover a business that leases employees.

other limitation on such trading set forth in a plan document is not a "blackout period" for purposes of the notice requirement. If a plan is to be amended after the 1/26/03 effective date to provide for a regularly scheduled suspension, limitation or restriction of any of the rights described above (including a permanent restriction on trading), providing participants with a summary of material modifications appears to avoid the Act's notice requirement.

Form and Timing of Participant/Beneficiary Notice. The blackout notice must be easily understood by participants and must contain (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, (4) when investment rights will be affected, a statement that participants or beneficiaries should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets credited to their accounts during the blackout period, and (5) such additional information as may be required by the DOL pursuant to regulations. The notice must be in writing, although the Act permits electronic or "other form" of dissemination to the extent reasonably accessible to the participant.

The 30-day advance notice requirement may be shortened or eliminated if a plan fiduciary determines (in writing) that (1) the advance notice requirement would otherwise interfere with the plan administrator's fiduciary duties or (2) the plan administrator's inability to provide advance notice was due to unforeseeable circumstances beyond the plan administrator's reasonable control. Under such circumstances the blackout notice must be provided "as soon as reasonably possible" unless providing the notice prior to the end of the blackout period is "impracticable." In addition, if the blackout period occurs solely in connection with a participant or beneficiary becoming or ceasing to be a participant or beneficiary by reason of a merger, acquisition, divestiture or similar transaction, the blackout notice must be provided "as soon as reasonably practicable." If there is a change in the blackout period's starting date or duration after the notice has been provided, the plan administrator must give written notice of the changes to affected plan participants and beneficiaries "as soon as reasonably practicable."

Penalties. The Act creates a new civil ERISA penalty in connection with the blackout notice. Specifically, if a plan administrator fails to provide the timely blackout notice described above to plan participants and beneficiaries, the DOL may assess a civil penalty of up to $100 per participant and beneficiary for each day of the plan administrator's failure or refusal to provide the blackout notice.

Public Company Notice Requirement. A plan administrator must provide "timely" notice to a **public company** issuer of any employer securities affected by a defined contribution plan's blackout period (*e.g.*, if a blackout period will restrict participant trading or other rights in connection with an employer stock fund).[4] For a public company, the notice may also be necessary in order for the company to implement the director and officer securities trading restrictions discussed below.

Effective Dates and Plan Amendments. The Act's blackout notice provision is effective 1/26/03 (*i.e.*, 180 days after the Act was signed by the President). The Act directs the DOL to issue initial guidance and a model notice by 1/1/03. If the new blackout period notice provision requires a plan amendment (*e.g.*, because the plan document's language requires an amendment or future regulations require an amendment), the plan amendment is not required to be made before the first plan year beginning on or after 1/26/03 (*i.e.*, by 12/31/04 for a calendar year plan). However, starting on 1/26/03 the plan must be operated in good faith compliance with the new notice provision and any plan amendment must be retroactively effective to 1/26/03.

ENHANCED ERISA CRIMINAL PENALTIES

[4]For purposes of this Alert, "**public company**" means a company (1) with equity or debt securities traded on a national securities exchange, or (2) with a class of equity securities held by 500 or more shareholders of record, or (3) required to file 1934 Act §15(d) reports with the SEC (*i.e.*, a company which has previously sold equity or debt securities pursuant to a 1933 Act registration statement, until the registered securities are held by less than 300 persons on the first day of a subsequent fiscal year), or (4) which has filed a 1933 Act registration statement, not yet effective and not withdrawn.

In General. In addition to the new civil penalty described above for failure to provide a blackout notice to plan participants and beneficiaries, the Act enhances ERISA's criminal penalties. Under the Act, any individual willfully violating the blackout notice requirement or any other ERISA disclosure or reporting requirement (*e.g.*, the willful failure to provide a summary plan description or a summary annual report, or to file a required Form 5500 annual report) is subject to a criminal fine up to $100,000 (previously $5,000) and/or 10 years' imprisonment (previously 1 year); and any violator that is not an individual (*i.e.*, a corporation or other business entity) is subject to a criminal fine up to $500,000 (previously $100,000). Courts have interpreted ERISA's criminal liability provisions as applying to a "knowing and intentional" rather than an "accidental or mistaken" violation. However, a bad purpose or specific intent to disobey the law is not necessary to a finding of ERISA criminal liability.

Effective Date. The Act does not specify an effective date for the enhanced ERISA criminal penalties. Thus, these provisions are presumably effective immediately (*i.e.*, to an act on or after 7/30/02). However, because the new blackout period notice requirements of ERISA are not effective until 1/26/03, the criminal penalties will not become applicable to the blackout notice requirement before that date.

DIRECTOR AND OFFICER TRADING RESTRICTIONS DURING BLACKOUT PERIODS

In General. The Act prohibits any director or executive officer of a **public company** from acquiring or disposing of an equity security received in connection with such person's service or employment as a director or executive officer while the security is subject to a "blackout period." Future regulations are to address the extent to which this provision applies to members of the public company's controlled group.

"Blackout Period" Definition. The definition of "blackout period" for purposes of this insider trading restriction is different from the definition of "blackout period" for the new ERISA notification requirements discussed above. For purposes of the insider trading restriction, a "blackout period" is a period of more than 3 consecutive business days during which there is a temporary suspension of the ability of at least 50% of the participants in all defined contribution plans sponsored by the public company to acquire or dispose of the security. It is not clear whether a defined contribution plan of the public company which does not hold the employer security at issue and/or a defined contribution plan maintained by another controlled group member is included for purposes of the 50% test (which issues will presumably be addressed by regulations).

However, neither a regularly scheduled suspension incorporated in the terms of the plan document and adequately disclosed to participants nor a suspension imposed solely in connection with a participant or beneficiary becoming or ceasing to be a participant or beneficiary under a plan by reason of a merger, acquisition, divestiture or similar transaction is a "blackout period." In addition, the SEC, in consultation with the DOL, may issue rules setting forth other exceptions to the insider trading restrictions, including for purchases under an automatic dividend reinvestment program or purchases or sales pursuant to advance elections.

Notice Requirements. If a public company director or executive officer is subject to the securities trading restrictions in connection with a blackout period, the company must "timely notify" the director or officer and the SEC of the occurrence of the blackout period (with no specific time period or form of notice prescribed by the Act).

Penalties. Any profits realized by the insider in violation of the insider trading restrictions are recoverable by the public company, or in a derivative action by an owner of any security of the public company if the public company has failed to take action within 60 days of a request for such action having been made (subject to a 2-year statute of limitations).

Effective Date. The new blackout period trading restrictions for a public company's directors and executive officers are effective on 1/26/03 (*i.e.*, 180 days after the Act was signed by the President).

BAN ON LOANS TO DIRECTORS AND EXECUTIVE OFFICERS

In General. The Act amends the 1934 Act to prohibit a public company from extending or maintaining credit, arranging for an extension of credit, or renewing an

extension of credit (directly or indirectly, including through a subsidiary), in the form of a personal loan to or for any director or executive officer or "equivalent thereof."

Exceptions. The Act contains no exception for personal loans to a director or executive officer to purchase company stock (a fairly common practice among both public and private companies), although the Act does not appear to prohibit a compensatory bonus of property (other than cash) to an executive officer or director subject to vesting (*e.g.*, company stock which must be returned to the company only if the person quits prior to a specified date). The Act likely does not cover a cash payment to such a person (*e.g.*, a signing bonus) which must be returned to the company only if the person quits prior to a specified date, since such a transfer is not "in the form of a personal loan."

The Act also does not apply to a loan from a qualified employee benefit plan (such as a 401(k) or other profit sharing plan loan), but the extent to which the Act applies to split-dollar life insurance policies is unclear. Specifically, a collateral assignment split-dollar policy (*i.e.*, a policy owned by an executive, where the company pays the premiums and the company is entitled to repayment from the executive's policy proceeds) may be subject to the Act, while an endorsement split-dollar policy (*i.e.*, where the policy is owned by the company, which reimburses itself out of policy proceeds) is less likely to be subject to the Act, although the life insurance lobby is likely to seek governmental guidance.

Penalties. A violation may result in an SEC civil fine or a cease and desist order, and/or the SEC may bar the executive from serving as a public company officer or director. In addition, a willful violation is subject to the criminal penalties generally applicable to a willful violation of the 1934 Act or regulations thereunder, which the Act increased to: for an individual violator a fine up to $5 million (previously $1 million) and 20 years' imprisonment (previously 10 years) and for an entity a fine up to $25 million (previously $2.5 million).

Effective Date. The loan prohibition applies immediately (*i.e.*, as of 7/30/02), but the Act grandfathers an extension of credit existing on 7/30/02, so long as there is no material modification or renewal after 7/29/02. However, it is unclear whether the grandfather provision applies to an agreement in existence on 7/30/02 to make a future loan, *e.g.*, a post-7/30/02 premium payment on a collateral assignment split-dollar life insurance policy.

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