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EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

LEGAL PERSPECTIVES | August 2002

The Sarbanes-Oxley Act of 2002 — Employee Benefits and Executive Compensation Provisions

The Sarbanes-Oxley Act of 2002 (the "Act") was signed into law on July 30, 2002. The Act is aimed at restoring investor confidence in the U.S. securities markets. The Act, among other things, requires expanded and more frequent disclosure, as well as placing significant responsibilities (and significant penalties for failing to comply with these responsibilities) on corporations, their officers and their accountants.

Several provisions in the Act provide greater protections to benefit plan participants and are designed to prohibit abuses. The most significant provision relating to employee benefits in the Act concerns blackout periods. As described in more detail below, the Act (1) requires advance notice of blackout periods to participants, (2) limits insider trading during blackout periods, (3) prohibits loans to directors and certain executive officers, (4) increases penalties for ERISA violations, (5) imposes penalties for noncompliance with certain financial reporting requirements on the CEO and CFO, and (6) accelerates the deadlines for insider trading reporting.

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Blackout Period Notice Requirements

Interested Parties. The notice requirements described in this section are effective January 26, 2003 (180 days after the Act's enactment). The Act places a duty on plan administrators to notify all plan participants and beneficiaries of any blackout period that affects an individual account plan, such as a 401(k) or profit sharing plan. The plan administrator must also notify the issuer of any employer securities subject to such blackout period.

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Sarbanes-Oxley Act

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Blackout Period Defined for Notice Purposes. For purposes of the notice requirements, a "blackout period":

- *includes* any period of more than three consecutive business days in which participants in an individual account plan are suspended, limited or restricted from (1) directing or diversifying assets credited to their account, (2) obtaining loans from the plan, or (3) obtaining distributions from the plan; but
- *excludes* any suspension, limitation or restriction (1) which occurs by reason of the application of securities laws, (2) which results from a change to provide for a regularly scheduled suspension (if such suspension is disclosed to participants and beneficiaries through written materials including, for example, a summary of material modifications or materials describing specific investment alternatives), or (3) which applies only to one or more individuals each of whom is the participant or alternate payee, or any other beneficiary pursuant to a qualified domestic relations order.

Timing of Notice. Notice must generally be provided to all plan participants at least 30 days in advance of a blackout period:

- However, the thirty-day advance notice is not required if such advance notice would violate the general fiduciary duties of ERISA Section 401(a)(1) or if the inability to provide a 30-day advanced notice is due to unforeseeable events beyond the reasonable control of the plan administrator. In such circumstances, the notice must be provided as soon as reasonably possible.
- In addition to the initial 30-day notice requirement, if there is a change in the beginning date or length of the blackout period after the initial notice has been provided, all affected participants and beneficiaries must be provided with notice of the change as soon as reasonably practicable.

Form and Contents of Notice. The blackout period notice must be in writing. Electronic notices are allowed if reasonably accessible by all participants. The blackout period notice must contain:

- the reasons for the blackout;
- an identification of the investments and other rights affected;
- the expected beginning date and length of the blackout;
- a statement that the participant should evaluate the appropriateness of his or her current investment decisions in light of his or her inability to diversify his or her accounts during the blackout period; and
- any other information which might be required by the Department of Labor.

The Sarbanes-Oxley Act of 2002 enacted numerous changes to the securities laws and ERISA in order to redress public companies' accounting and financial reporting abuses.

DOL to Issue Guidance and Sample Notice. The Department of Labor is expected to issue guidance and a sample notice by January 1, 2003. The Department of Labor is also expected to issue interim rules not later than November 13, 2002.

Penalties for Failure to Provide Notice. Failure to provide a notice to the participants and the beneficiaries may result in a penalty of $100 per day from the date of the plan administrator's failure or refusal to provide such notice. Each violation with respect to any single participant or beneficiary will be treated as a separate violation.

If an individual account plan does not comply with the notice provisions of the Act currently, conforming amendments must be made before the end of the first plan year beginning on or after January 26, 2003.

Blackout Period Insider Trading Restrictions

Effective January 26, 2003, it will be unlawful for any director or executive officer of a public company to purchase, sell or otherwise acquire or transfer any interest in the equity securities of their company during any blackout period if the director or executive officer acquired such equity securities in connection with his or her service or employment with the issuer. Any violation of this rule by a director or officer may result in disgorgement to the issuer of any profits realized by the director or

officer. Actions to recover these profits may be instituted by the issuer or any holder of the issuer's securities in the name of the issuer within two years of the date the profit was realized.

For purposes of the insider trading restrictions, a "blackout period" includes any period of more than three consecutive business days during which at least 50% or more of the participants or beneficiaries of all of a company's individual account plans (as defined above) are temporarily suspended from purchasing, selling or otherwise acquiring or transferring an interest in the equity of the company under such plans. However, for purposes of insider trading restrictions, "blackout periods" do not include regularly scheduled blackout periods that are incorporated into an individual account plan and timely disclosed to the employees or any suspensions imposed solely in connection with a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.

Prohibited Loans to Directors and Certain Executive Officers

The Act makes it unlawful for any issuer to extend or maintain credit, in the form of a personal loan to or for any director or executive officer of that issuer. All loans made before July 30, 2002 are excluded from the prohibition provided that there is no material modification to any term of such loan or any renewal or extension of such loan on or after July 30, 2002. This prohibition does not preclude any:

- home improvement and manufactured home loans;
- consumer credit or any extension of credit under an open end credit plan;

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✓ STOCK BASED PLANS — SARBANES-OXLEY COMPLIANCE.

The Sarbanes-Oxley Act of 2002 enacted numerous changes to the securities laws and ERISA in order to redress public companies' accounting and financial reporting abuses as well as to redress restrictions on employees' control of their accounts in individual account plans. These changes are described in this month's newsletter (see page 1 through 4). Many of the Sarbanes-Oxley Act requirements are effective now, although some important provisions are effective in 2003.

✓ QUALIFIED RETIREMENT PLANS — EGTRRA AMENDMENTS.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made sweeping changes to pension legislation by increasing plan contribution and benefit limits significantly. Almost all of the EGTRRA amendments are effective for plan years beginning after December 31, 2001. Some of the amendments are mandatory, while others are optional. The Internal Revenue Service has indicated that the remedial amendment period for qualified plans is the last day of the first plan year *beginning on and after January 1, 2005.* However, plans will need to implement "good faith amendments" based upon the model amendments issued by the IRS for many of the EGTRRA changes in the years in which the amendments are effective. *Good faith amendments may be made no later than the end of the plan year for which the amendment is effective.* For example, if a 401(k) plan wishes to take advantage of the EGTRRA amendment which permits catch-up contributions (increased elective deferrals for those participants who have attained at least age 50 during the plan year) beginning in 2002 and later years, the 401(k) plan must have adopted a "good faith" EGTRRA amendment by the end of 2002 to allow catch-up contributions in 2002.

✓ HEALTH PLANS — HIPAA PRIVACY RULES.

Beginning April 14, 2003, new privacy rules under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA regulations") take effect for most health plans. The new HIPAA privacy rules are designed to protect individuals from having health information provided to unnecessary third parties. Health plans subject to the new privacy rules must take action to insure that the privacy rights of participants are protected. These actions include, for example, (1) updating contracts with "business associates" (such as claims processors, attorneys and recordkeepers) to

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insure that privacy is protected, (2) providing notice to health plan participants of their privacy rights under HIPAA, (3) preparing written participant authorization forms to disclose private information to certain parties, and (4) providing records and compliance reports (to indicate that they are complying with the HIPAA regulations) to the Secretary of Health and Human Services. Many of these actions are time-consuming and must be taken in advance of April 14, 2003, to ensure compliance with HIPAA regulations.

If your company has not already done so, now would be a good time to review your company's plans to ensure compliance with the Sarbanes-Oxley Act, EGTRRA and HIPAA.

- charge cards; or
- certain extensions of credit by a broker or dealer to an employee of such broker or dealer to buy, trade, or carry securities;

provided that the loan is (1) made or provided in the ordinary course of the consumer credit business of such issuer, (2) of a type that is generally made available by such issuer to the public, and (3) made by such issuer on market terms that are no more favorable than those offered by the issuer to the public.

This provision is very broad and does not give any guidance as to who is an "executive officer" and what types of transactions should be characterized as loans. For instance, until further guidance is issued by the SEC, it is unclear whether split-dollar life insurance arrangements are prohibited by this section and whether stock option cashless exercise programs are prohibited.

ERISA Violation Penalties Increased

Effective July 30, 2002, the Act increased the maximum criminal penalty under Section 501 of ERISA that may be imposed upon a conviction for willfully violating Title 1 from $5,000 to $100,000 for an individual and from $100,000 to $500,000 for an entity other than an individual. The maximum length of imprisonment has also increased from one year to 10 years.

Penalties for Noncompliance with Financial Reporting Requirements

Effective July 30, 2002, the Act penalizes the CEO and CFO if their company is required to prepare, with financial reporting requirements under the securities laws, an accounting restatement due to material noncompliance, as a result of misconduct. In such situations, both the CEO and CFO must reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received during the 12-month period following the first public issuance or filing of the financial document requiring the restatement and (2) any profits realized from the sale of securities of their company during the same 12-month period.

Section 16 Reporting

The Act also accelerated the deadline for filing reports by insiders under Section 16(a) of the Securities Exchange Act of 1934, as amended. On August 27, 2002, the SEC adopted final rules and amendments to help implement this acceleration. Such rules are effective on August 29, 2002. Under the new rules, directors, officers and more than 10% owners of publicly traded companies must now report transactions in their company's equity securities within two business days of the transaction, with certain limited exceptions.

One of the limited exemptions from the two-day reporting requirement includes acquisitions pursuant to tax qualified plans, excess benefit plans, stock purchase plans (other than transactions defined as "Discretionary Transactions") and the reinvestment of dividends or interest pursuant to broad-based dividend or interest reinvestment plans. In contrast, transactions pursuant to non-qualified deferred compensation plans and other dividend or interest reinvestment plan transactions (such as acquisitions pursuant to voluntary contributions of additional funds) will be reportable within two business days after the date of execution.

Retiree Health Benefits — Sixth Circuit Allows "Reverse Discrimination" Claim Under ADEA

In a recent decision, the Sixth Circuit held that employees protected by the Age Discrimination in Employment Act, as amended (the "ADEA"), alleged a valid cause of action under the ADEA against their employer based upon the employer's commitment to provide certain retiree benefits to *older* employees and retirees, and not to the plaintiffs. The case, *Cline v. General Dynamics Land Systems, Inc.*, decided July 22, 2002, is noteworthy because it gives credence to claims of so-called "reverse discrimination" under the ADEA (*i.e.*, not only does the ADEA prohibit discrimination against individuals 40 and older in favor of those younger than 40, but also prohibits discrimination in favor of older individuals within the 40 and older protected class). Indeed, in dissent, Judge Williams noted that prior to the court's decision in *Cline*, "no court in the nation ha[d] recognized a claim for age discrimination under the ADEA when brought by younger workers within the protected class arguing that they were discriminated in favor of older workers."

In 1997, General Dynamics Land Systems, Inc. ("General Dynamics") negotiated a new collective bargaining agreement which required the company to provide health benefits to retirees who had accumulated thirty years of service *and* who were age 50 or older as of July 1, 1997. Before this collective bargaining agreement, all retirees who had accumulated thirty years of service were provided with retiree health benefits, regardless of their age at the time the collective bargaining agreement was entered into. As a result of the new collective bargaining agreement, employees who were between the ages of 40 and 49 as of July 1, 1997 (and thus not entitled to retiree health benefits) instituted a lawsuit against General Dynamics alleging that they were unlawfully discriminated against because of their age. They alleged that employees and retirees age 50 and older were being provided with retiree health benefits while employees between the ages of 40 and 49 were not provided such benefits for no reason other than age.

The lower court in *Cline* ultimately granted the company's motion to dismiss based on its belief that the ADEA does not recognize claims of "reverse discrimination." According to the lower court, the ADEA was enacted to assist older workers and not those employees who are discriminated against because they are too young. The Sixth Circuit reversed and reinstated the plaintiffs' claims against the company. Relying on the plain language of the ADEA, the Sixth Circuit refused to hold, as the lower court did, that allowing claims of reverse discrimination would defeat Congress' intent in enacting the ADEA. The Sixth Circuit also relied upon a concurring interpretation of the ADEA issued by the EEOC, noting that the "EEOC's interpretation of the ADEA is a true rendering of the language."

Whether the *Cline* decision ultimately gets appealed to and heard by the United States Supreme Court remains to be seen. Nonetheless, employers must now be more prudent than ever in deciding to what groups of employees it will offer retiree benefits and in what manner it decides to reduce or eliminate such benefits. If age is a factor in those decisions, an employer may be exposing itself to a class action lawsuit similar to the suit currently being litigated in *Cline*. ◎

For Additional Information
For any questions relating to any of these articles, please contact:

Edward P. Smith
(212) 408-5371
esmith@chadbourne.com

Marjorie M. Glover
(212) 408-1016
mglover@chadbourne.com

Sarah C. Richards
(212) 408-5426
srichards@chadbourne.com

Scott D. Segal
(212) 408-5109
ssegal@chadbourne.com

David Gallai
(212) 408-1033
dgallai@chadbourne.com

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Chadbourne & Parke LLP

30 Rockefeller Plaza
New York, NY 10112
(212) 408-5100

1200 New Hampshire Ave., NW
Washington, D.C. 20036
(202) 974-5600

350 South Grand Ave.
Suite 3300
Los Angeles, CA 90071
(213) 892-1000

also in London (Chadbourne & Parke, a multinational partnership), Moscow and Hong Kong

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