Corporations

Sarbanes-Oxley Hastily Charts New Ground in Federal Corporate Law

*By Robert Barker**

The Sarbanes-Oxley Act of 2002 represents a major shift in securities regulation in the United States. It is the first major foray of the Federal government into the area of corporate governance, and a shift of regulation from the States to the Federal government. It was hastily enacted and accelerated through Congress as it was written, with many provisions ending up as far more draconian than reported in precursor bills. Securities lawyers are still struggling to understand the implications of the Act for their clients, and for themselves.

Part of the reason for the confusion created by the Act stems from the fact that the Act represents a paradigm shift in securities regulation. The securities laws were originally based on a disclosure paradigm. Matters of internal corporate governance were left completely to State jurisdiction.[1]

In passing Sarbanes-Oxley, Congress felt great pressure to regulate the governance of U.S. publicly traded corporations. As a result, the Act has grafted new regulations onto the securities laws, imposing new regulatory duties on corporate directors and officers, accountants and even lawyers. It masks some of the effort under the guise of "disclosure", but does not even bother to disguise some of the more bizarre regulations imposed in the Act. In some cases, Congress gave the SEC the power to adopt regulations that could be adapted to existing corporate practice; in most cases, Congress simply enacted a prohibition, or a blanket direction to the SEC, mandating regulation complying with Congress' own words.

How Did We Get Here?

Before reviewing some major themes of the Act, it is important to review how the Federal Government decided that now was the time to step into areas of corporate governance, areas that have been reserved to the States and State courts for many years. It has been obvious to many observers that something was wrong in the redoubts of corporate America. Some argue that the failings of corporate America were due to an increase in greed, or to a lack of character in boardrooms and executive suites. While character faults may have played a role, it may be hard to argue, and more difficult to prove, that there was a spike in character faults in recent years. It may be more useful to review the changes in the regulation of corporate governance in the last quarter century that have led to the coziness of business and management in the boardrooms. How was it that an institution, the corporation, that started with an almost fiduciary respect for the investor became a Leviathan of cronyism and greed?

The answer may lie in developments throughout the 20th century that have separated the corporation from its original purpose: to make money for its investors. As a consequence, corporate law is no longer an equity-based body of law created to protect the private property of the investors, but a statutory-based regulatory scheme that, in many cases, has been specifically designed to insulate corporate directors from accountability to its investors.

In the beginning of this century, it was unlawful for corporations to do anything that did not serve the business purpose of the corporation — a director could be sued for giving corporate funds to charities or political causes. Such a use of corporate funds was *ultra vires*: an abuse of power by the executive or directors. Starting with the modern corporation codes in New Jersey and Delaware, various States recognized the need to give directors and management greater latitude as corporations played an increasingly prominent role in American society. State courts adopted the "business judgment rule" to deal with the new latitude granted to directors.

Beginning in the late 1970s, the courts started taking an even more expansive view of the business judgment rule as boards of directors experimented with novel securities, accounting techniques and takeover defenses. At the same time, State legislatures enacted laws to protect directors from the influence of the marketplace. Thus, for example, state takeover statutes authorized corporate boards to take into account factors other than economic factors, broadened indemnification statutes and permitted the board to exculpate itself from various types of liability. All these changes led to decreasing accountability at the board level.

The Delaware Supreme Court's decision in *Household International*, upholding the adoption of a poison pill as a valid exercise of business judgment, was a watershed decision that came as a shock to many corporate lawyers at the time. Coupled with court decisions like *Time-Warner*, it is not surprising that directors have become increasingly insulated from the interests of the shareholders. Management has, in some cases, been able to exploit this lack of accountability, giving increasingly greater perks to "independent" directors, who may not be as inclined to ask tough questions of management, to the detriment of shareholders.

It was some of the more notable failures of boards and management – at Enron, Global Crossing, Worldcom and Adelphia – that led to the hasty enactment of Sarbanes-Oxley.

In passing the Sarbanes-Oxley Act, Congress has stepped into the arena of corporate governance. There is likely to be great debate about whether the Federal government is the most appropriate source of regulation for corporate governance. On one hand, it brings the United States into line with other countries, which have a single unified body to regulate corporate governance, some with specific panels to make decisions on tough questions. On the other hand, it deprives the States of their traditional exclusive responsibilities in this area, and deprives the federal system of the benefit that comes from competing systems of law.

The Act has already garnered much criticism from lawyers and bar associations. Some foreign governments have already started to question Washington's "unilateralist" intrusion into the internal corporate affairs of the nearly 1,300 foreign companies registered with the SEC. Further, its "immediate effectiveness" has shocked many practitioners in some areas who had no idea that it was coming. The unintended consequences of the Act are sweeping across many areas of legal and business practice. For the immediate future, businesses and their employees will be struggling with learning the Act's intricacies, adapting to the new law and, perhaps, to its unintended consequences.

What the Act Does

The Act is clearly the most sweeping securities legislation since the 1930s. It extends beyond securities law and corporate governance and affects many areas of business conduct. To complicate things further, many portions of the Act are effective immediately and some portions of the Act have no exceptions to sweeping prohibitions. By sending corporate executives to their lawyers and accounting firms, maybe to multiple lawyers and accounting firms, it is likely that the first major consequence of the new Act will be an increased cost of doing business for public companies.

The major portions of the Act are summarized below. Of course, most public companies have already started complying with the portions of the Act that are relevant to them. But even private businesses, or businesses that aspire to the public markets, should pay special attention to the new Act.

Attorney Reporting Obligations. The Act requires new Federal regulation for lawyers who practice or appear before the SEC. Those lawyers, independent of any State obligation, must report "evidence" of securities law violations or breaches of fiduciary duty to the general counsel of their client. If the general counsel does not respond "appropriately," the lawyer must report the evidence to the client's audit committee. While some lawyers believe that the Act does not expand the duties of corporate securities lawyers, others believe it was an attempt to impose a new duty to make them liable to shareholders in class-action litigation. It is not clear what penalties apply to lawyers who do not comply, or whether the Act is attempting to impose a new Federal duty on securities lawyers independent of their duties under the State bars that regulate them.

Executive Compensation Issues. The Act also follows the "regulatory paradigm" in prohibiting all "extensions of credit" to officers and directors of public companies. As several law firms have already pointed out in client alerts, travel advances to directors and executive officers are now illegal. Depending on structure, the Act may have banned several common types of deferred compensation plans as well. Corporate relocation programs are also subject to scrutiny, as is any program that involves an "extension of credit." These provisions may need to be amended, as it is likely the breadth of the Act has led to some immediate unintended consequences.

In other cases, executives will be required to forfeit all gains from incentive compensation and bonuses for a full year. It is unclear whether the forfeited gain is repaid to the company, the shareholders, plaintiff's lawyers, or to the new restitution fund created by the Act. Since the law does not grant any room for regulatory interpretation, the courts may need to clarify the intent of Congress.

Changes in the Accounting Profession. The Act's most sweeping regulatory changes were directed at the accounting firms that audit public companies, which will now be subject to a to-be-created Public Company Accounting Oversight Board. Partners in charge of auditing any public company must be "rotated" after five years. This provision is effective immediately, so some long-standing relationships will be affected now. Audit committees must approve in advance any hiring of accounting firms and must expressly approve certain kinds of "non-auditing" services. Finally, auditors must adopt quality control procedures and keep their work papers for up to seven years.

Certification. There are two new personal certifications in the Act, requiring CEOs and CFOs to certify that (1) the financials and SEC reports have been properly prepared (Section 906), and (2) internal corporate controls are in place and adequate (Section 302). These certifications are in addition to the much-ballyhooed SEC order requiring certifications by the largest Fortune 1000 companies. Congress followed the "disclosure paradigm" in requiring the SEC to adopt new rules requiring public companies to disclose certain internal control policies.

Corporate Governance. The Act mandates that every public company have an audit committee comprised completely of independent directors. The Act defines the audit committee as the entire board in the absence of a formal audit committee; presumably, the Act means that the audit committee is all the independent directors. The Act defines which directors are "independent", a standard that State legislatures and courts have not been willing to define with certainty, possibly out of a reluctance to hamstring the flexibility of corporate boards.

While the Act does not require new forms of internal compliance programs, it is clear to many that Boards, CEOs and CFOs will be implementing new compliance programs to ensure the accuracy of the internal control reports for public companies. While some might deny it, these provisions are likely to cause Boards, CEOs and CFOs to reexamine the internal reporting systems inside their companies, and maybe to create duplicate lines of reporting.

In addition, the Act requires that the audit committee, and only the audit committee, may hire and fire auditors, and approve most non-audit functions performed by outside audit firms.

Criminal Provisions. The criminal provisions of the Act are particularly difficult to comprehend. "Knowing" violations of some of the new securities laws are subject to 10 years imprisonment. "Willful and knowing" violations are subject to 20 years imprisonment. Prosecutors and former prosecutors cannot tell the difference and many agree that courts will not be likely to impose such serious jail time for certification offenses. But it plays well in Peoria for any congressperson to note that he or she voted for "prison terms for corporate executives."

Whistleblower Protection/Analyst Protections. The Act contains new provisions to protect whistleblowers at all public companies, and to ensure that securities analysts are not punished for preparing an unfavorable report on a public company. Again, these provisions create a new regulatory structure for analysts and for public companies.

Faster Securities Filings. The Act requires the SEC to enact new regulations requiring faster reporting of insider trades: within two business days. In fact, the Act directs the SEC to adopt several new regulations. In a year's time, all public companies with web sites will be required to post insider trades on that web site.

The Act imposes greater regulation on public companies, and will likely create greater compliance costs. Congress was compelled by public opinion to pass something. But the Act does not fit well with existing legislative paradigms, and its internal inconsistencies alone will mean uncertainty for years to come. Even in its initial stages, it has been beset with ambiguous timetables and deadlines. Time will tell whether this is a quirky aberration caused by unique pressures, or the beginning of a new system of Federal corporation law.

For more information, see the Corporate Responsibility section of The Federalist Society's website at www.fed-soc.org, and in particular, the article by Peter L. Welsh, The Public Company Accounting Reform and Investor Protection Act of 202: Public Markets and Government Oversight (July 25, 2002).

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Footnotes

[1] The original securities laws did not empower the SEC to ban any particular type of offering – or to regulate at all. In fact, there was no SEC to enforce the Securities Act of 1933 – the SEC was created the next year in the Securities Exchange Act of 1934. Further, the 1933 and 1934 Acts did not address internal corporate governance issues. By the end of the 1930s, Congress was more confident of its ability to enact laws to regulate the securities markets – and the Supreme Court was more pliant in upholding Federal regulation. Thus, the Trust Indenture Act of 1939 specifies the powers that must be held by a trustee – the "internal corporate governance," so to speak, of a bond offering. And the Investment Company Act of 1940 created a broad, complex regulatory scheme that still catches some unwitting promoters – even those represented by competent securities counsel.