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THE COMPLETE GUIDE TO  
**SARBANES-OXLEY**  
UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS

*by*

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*An Excerpt From*

**The Complete Guide to  
Sarbanes-Oxley**

**Understanding How Sarbanes-Oxley Affects  
Your Business**

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## Chapter 1

### An Overview of the Sarbanes-Oxley Act

The opening years of this decade were not kind to Wall Street. The stock market ended the year lower three years running in 2000 to 2002, which was the first time there had been three down years in a row since the 1930s. It wasn't just a weak economy that was pounding the market, however. It seemed like every week brought new reports of misdeeds at leading American corporations and financial institutions. The now infamous scandal at Enron turned out not to be an isolated case, as news of corporate shenanigans at companies like WorldCom, Global Crossing, Tyco, Adelphia, and others soon followed.

We soon learned that the rot extended far beyond the corporate executive suite. New York Attorney General Eliot Spitzer launched an investigation into conflicts of interest on the part of stock market analysts. Spitzer also turned up problems at many large mutual funds. And the beat went on.

By mid-2002, Congress decided it was past time to clean house. In July 2002, it passed the "Public Company Accounting Reform and Investor Protection Act" of 2002—popularly known as the Sarbanes-Oxley Act or just plain SOX. When President George W. Bush signed the Act later that month, he praised it for making "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."

Those reforms include:

- Creation of the Public Company Accounting Oversight Board to oversee the accounting profession.

- A number of mandates requiring companies to adopt more effective internal controls— i.e., the processes the company uses to ensure the reliability of the financial disclosures it makes to the public and that it complies with applicable laws and regulations.
- The chief executive officer and chief financial officer of a company must certify its financial statements and disclosure reports.
- A number of rules designed to ensure that a company’s auditor is truly independent of company management.
- A related requirement that companies have an audit committee consisting of independent directors to deal with the auditor and oversee the company’s financial processes.
- New restrictions on loans to insiders and stock trading by insiders.
- Changes in rules governing how corporations disclose information to the public, so as to increase the speed and transparency of such disclosures.
- Protections for whistleblowers and restrictions on document destruction, so as to prevent the sort of obstruction of justice witnessed at Enron.
- New and severe criminal civil penalties for corporate misconduct.

Who are Sarbanes and Oxley?

Paul Sarbanes is a five-term Democratic Senator from Maryland. In 2002, he was Chairman of the Senate Banking, Housing, and Urban Affairs Committee, which had primary responsibility for developing the legislation that became SOX. You can view his official web site at <http://sarbanes.senate.gov/>.

Michael G. Oxley is an 11-term member of the House of Representatives. In 2002, he was Chairman of the House Financial Services Committee, which oversees Wall Street, banks, and

the insurance industry, and had primary responsibility for SIX on the House side. His official website is <http://oxley.house.gov/>.

Both Sarbanes and Oxley will be retiring from Congress at the end of 2006.

These reforms benefit the American economy in a number of ways, including restored investor confidence in the integrity of the capital markets, enhanced corporate disclosures, and reduced incentives for corporate management to manipulate stock prices.

Unfortunately, Sarbanes-Oxley also imposes a much higher regulatory burden on U.S. public corporations than the law's sponsors ever imagined. According to the Wall Street Journal, for example, publicly traded U.S. corporations routinely report that their audit costs have gone up as much as 30%, or even more, due to the tougher audit and accounting standards imposed by SOX. Indeed, just paying the fees now required to fund the Public Company Accounting Oversight Board (PCAOB) can run as much as \$2 million a year for the largest firms.

Professional surveys of U.S. corporations confirm the Journal's report. Foley & Lardner, a law firm that has conducted a number of empirical analyses of SOX and its impact on American business, found that senior managers of public middle market companies expect costs directly associated with being public to increase by almost 100% as a result of corporate governance compliance and increased disclosure as a result of SOX, new Securities and Exchange Commission (SEC) regulations, and changes to stock exchange listing requirements.

The chief regulatory culprit is SOX § 404, which requires inclusion of internal control disclosures in each public corporation's annual report. This disclosure statement must include: (1) a written confirmation by which firm management acknowledges its responsibility for establishing and maintaining a system of internal controls and procedures for financial reporting;

(2) an assessment, as of the end of the most recent fiscal year, of the effectiveness of the firm's internal controls; and (3) a written attestation by the firm's outside auditor confirming the adequacy and accuracy of those controls and procedures.

The SEC initially estimated § 404 compliance would require only 383 staff hours per company per year. According to a Financial Executives International survey of 321 companies, however, firms with greater than \$5 billion in revenues spend an average of \$4.7 million per year to comply with § 404. The survey also projected expenditures of 35,000 staff hours—almost 100 times the SEC's estimate. Finally, the survey estimated that firms will spend \$1.3 million on external consultants and software and an extra \$1.5 million (a jump of 35%) in audit fees.

In fairness, some of these costs were one-time expenses incurred to bring firms' internal controls up to snuff. Yet, many other SOX compliance costs recur year after year. For example, the internal control process required by § 404 relies heavily on on-going documentation. As a result, firms must constantly ensure that they are creating the requisite paper trail.

Other on-going expenses include legal fees, directors and officers (D&O) insurance policy premium increases, and the need to pay higher director fees in order to attract qualified independent directors to serve on boards of directors.

These costs are disproportionately borne by smaller public firms. A study by three University of Georgia economists, for example, found that post-SOX director compensation increases have been much higher at small firms:

... small firms paid \$5.91 to non-employee directors on every \$1,000 in sales in the pre-SOX period, which increased to \$9.76 on every \$1000 in sales in the post-SOX period. In contrast, large firms incurred 13 cents in director cash compensation per \$1,000 in sales in the Pre-SOX period, which increased only to 15 cents in the Post-SOX period.

Likewise, a study by ARC Morgan found that companies with annual sales less than \$250 million incurred \$1.56 million in external resource costs simply to comply with one SOX provision (the internal controls required by section 404). Note that that figure includes internal costs, opportunity costs, and intangibles. In contrast, firms with annual sales of \$1-2 billion incurred an average of \$2.4 million in such costs.

In sum, SOX compliance weighs disproportionately on small public corporations. For many of these firms, the additional cost is a significant percentage of their annual revenues. For those firms operating on thin margins, SOX compliance costs can actually make the difference between profitability and losing money.

These costs have substantially distorted corporate financing decisions. On the one hand, SOX has discouraged privately held corporations from going public. As law professor Larry Ribstein observed on his blog ([www.ideoblog.com](http://www.ideoblog.com)), start-up “companies are opting for financing from private-equity firms,” rather than using an IPO to raise money from the capital markets. In the long run, or perhaps the not so long run, this barrier to the public capital markets may have a very negative effect on the economy, according to Ribstein: “since going public is an important venture capital exit strategy, partially closing the exit could impede start-up financing, and therefore make it harder to get ideas off the ground.”

Conversely, a Foley & Lardner survey found that 21% of responding publicly held corporations were considering going private in response to SOX. Law professor William Carney confirmed this result, finding that of 114 companies going private in 2004, 44 specifically cited SOX compliance costs as one of the reasons they were doing so. As Ribstein summarizes the situation:

There is evidence that SOX [has] an effect in causing firms to eliminate or reduce public ownership. ... Evidence of smaller firms' negative share price reactions to SOX, and of more positive share price reactions to going private after enactment of SOX than before, supports the inferences that SOX caused at least some going private transactions, and that the costs of remaining public are higher after SOX. There is also evidence that firms with higher audit fees were more likely to go dark, thereby linking this decision with the costs of complying with SOX.

Unfortunately, the prospects for relief are dim. An SEC Advisory Committee tasked with assessing the impact of SOX and other securities laws on small public corporations released its final report on April 23, 2006. In that report, the Committee concluded that the costs imposed on smaller public corporations by a number of key SOX provisions significantly exceeded any benefit those provisions provide investors.

In particular, the Committee focused on SOX § 404, explaining that:

From the earliest stages of its implementation, Sarbanes-Oxley Act § 404 has posed special challenges for smaller public companies. To some extent, the problems smaller companies have in complying with § 404 are the problems of companies generally:

- lack of clear guidance;
- an unfamiliar regulatory environment;
- an unfriendly legal and enforcement atmosphere that diminishes the use and acceptance of professional judgment because of fears of second-guessing by regulators and the plaintiffs bar;
- a focus on detailed control activities by auditors; and

- the lack of sufficient resources and competencies in an area in which companies and auditors have previously placed less emphasis.

But because of their different operating structures, smaller public companies have felt the effects of § 404 in a manner different from their larger counterparts. With more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of § 404 compliance, these companies have been disproportionately subject to the burdens associated with § 404 compliance.

Accordingly, the Committee gave highest priority to a set of recommendations that would create a system of “scaled” securities regulation under which the smallest public corporations would be subject to less extensive disclosure and auditing requirements. In particular, the Committee recommended that the SEC exempt the smallest public corporations from SOX § 404, so long as they have a qualified audit committee and have adopted a qualifying code of ethics for disclosure and audit practices.

On May 17, the SEC responded by—to be blunt—tossing the Advisory Committee report in the circular file. Instead of even considering the Committee’s detailed recommendations, which went well beyond just the narrow problems created by § 404, the SEC announced a modest set of regulatory actions limited solely to § 404 issues. Even within those narrow confines, moreover, the SEC’s plans are surprisingly lame:

The Commission expects to issue a Concept Release covering a variety of issues that might be the subject of Commission guidance for management. With the Concept Release, the Commission will solicit views on the management assessment process to ensure that the guidance the Commission ultimately proposes addresses the needs and

concerns of all public companies. ... The Commission anticipates that this forthcoming guidance will help organizations of all sizes to better understand and apply the control framework as it relates to internal control over financial reporting. ... To ensure that this guidance is of help to non-accelerated filers and smaller public companies, the Commission intends that this future guidance will be scalable and responsive to their individual circumstances. ... The form of the guidance has yet to be determined.

In sum, the May 2006 announcement contemplated that, subject to SEC oversight, the PCAOB would amend its auditing standards so as to reduce costs to companies by focusing auditor attention on “areas that pose higher risk of fraud or material error.” Small public corporations would get an extension on the date by which they are required to be fully compliant with § 404. “It is anticipated that any such postponement would nonetheless require all filers to comply with the management assessment required by Section 404(a) of Sarbanes-Oxley for fiscal years beginning on or after Dec. 16, 2006.” And that’s it. Unlike the recommendations made by its own Advisory Committee, which would have provided significant and comprehensive regulatory relief for smaller public corporations, the SEC thus took a narrow and trivial approach to the problem.

In August 2006, however, the SEC issued a new statement backtracking on the hard line taken in May. One proposal made in the August announcement would give smaller firms until their fiscal year ending on or after Dec. 15, 2008, to become fully SOX compliant. (Note that because the firms will have to be SOX compliant for that fiscal year, it actually means that some will have to start the Sox compliance process in December 2007.) A second proposal would exempt newly public companies from having to be fully compliant with SOX a company until

the company files its second annual report with the Commission. As of this writing, neither proposal had been finalized, but some version of each seemed likely to be approved.

#### The Statutory Text

We'll excerpt relevant portions of Sarbanes-Oxley as we go along. If you want the entire text of the statute in one place, you can download it from [www.sec.gov/about/laws/soa2002.pdf](http://www.sec.gov/about/laws/soa2002.pdf). A useful related resource is the collection of SEC announcements of rules and other actions taken pursuant to Sarbanes-Oxley, which is available online from the SEC at [www.sec.gov/spotlight/sarbanes-oxley.htm](http://www.sec.gov/spotlight/sarbanes-oxley.htm).

#### **The Run-Up to SOX**

Because Sarbanes-Oxley is a response to a specific set of perceived problems in corporate governance and practice, the Act's historical context is essential to understanding the law and complying with its various mandates. After all, as the saying goes, those “who do not learn from history are doomed to repeat it.”

#### *The Big Picture*

The opening years of the new millennium were most unkind to Wall Street. In 2000-2001, the stock market recorded back-to-back years of losses for the first time since 1973-74. When the market suffered a third consecutive losing year in 2002, it was the first time such a run of bad years had occurred since the Great Depression. Worse yet, on top of the late 1990s stock market bubble bursting, there came a string of other bad news that deeply shook investor confidence.

We all know the litany, of course: Repeated accounting scandals, of which Enron and WorldCom were merely the most notorious; a high profile investigation by New York's attorney general called into question the integrity of stock market analysts; routine restatement of

earnings by many blue chip corporations; allegations of excessive executive compensation; the Martha Stewart insider trading case; and so on.

Much of the blame was laid at the feet of corporate managers and directors. For example, the New York Stock Exchange opined that during the early years of this century we observed a “‘meltdown’ of significant companies due to failures of diligence, ethics and controls” on the part of directors and senior managers. At Enron, perhaps the most notorious example, an internal investigation concluded that senior managers “were enriched, in the aggregate, by tens of millions of dollars they should never have received.” The report further concluded that Enron’s “Board of Directors failed ... in its oversight duties” with “serious consequences for Enron, its employees, and its shareholders.”

None of this should have come as a surprise. History teaches that market bubbles are fertile ground for fraud. Cheats abounded during the Dutch tulip bulb mania of the 1630s. The South Sea Company, which was at the center of the English stock market bubble in the early 1700s, was a pyramid scheme. Fraud was rampant before the Great Crash of 1929. Hence, it was hardly a shock to find fraudsters and cheats when we started turning over the rocks in the rubble left behind when the stock market bubble burst in 2000.

Corporate scandals are always good news for big government types. After every bubble bursts, going all the way back to the South Sea Bubble, new laws always are enacted. Why? Because there is nothing a politician or regulator wants more than to persuade angry investors that he or she is doing something and being aggressive in rooting out corporate fraud.

Hence, it was entirely predictable that the shenanigans at Enron, WorldCom et al., coming after several years of steady decline in the stock market, would lead to regulation. Like a cook who throws spaghetti at the wall to see if it’s done, legislators and regulators threw a lot of

new rules at corporations to see what stuck: Sarbanes-Oxley; numerous SEC regulations; California's onerous corporate disclosure act; Spitzer's settlement with the analyst community; and countless law suits and indictments.

*Enron: Where it all began*

In many ways, Enron epitomized the rampant financial follies of the late 1990s. Granted, Enron was no Silicon Valley startup with just a dot-com address. To the contrary, Enron's roots went back to the 1930 formation of the Northern Natural Gas Company. By the early 1990s, following many mergers and name changes, Enron was a large and seemingly highly successful electricity and natural gas distributor with large investments in power plants, pipelines, and other energy utility infrastructure.

For much of the 1990s, the new financial giant looked like a roaring success. It was named one of America's most innovative companies and best employers. In fact, however, there were serious problems behind the façade.

Enron financed its rapid growth and expansion in the 1990s mainly by borrowing. By the late 1990s, Enron was deeply in debt but remained dependent on continued borrowing for expansion and debt service. As the debt mounted, it began to pose a significant threat to Enron's credit rating. In turn, because Enron's energy trading business was dependent on the company maintaining an investment grade rating for its debt securities, top Enron management began looking for creative new ways of raising money.

The solution Enron CFO Andrew Fastow hit upon was the use of so-called special purpose entities (SPE), typically limited liability companies or partnerships, which entered into complex transactions with Enron. Although the SPEs technically were independent companies,

Enron in fact controlled them and used the money they raised to finance Enron's business ventures.

At the risk of over-simplifying, the basic structure of these deals involved the creation of a limited partnership to which Enron sold stock (or other assets). Using the stock as collateral, the SPE would go to a bank or other lender and borrow money to finance some business venture. Because the SPE had no debts and Enron stock was appreciating so rapidly in value, banks would lend to these SPEs on very favorable terms.

The trick was that under arcane accounting rules, as long as someone other than Enron owned at least 3% of the SPE's equity, Enron's consolidated financial statements did not have to disclose the SPE's assets and debts. Hence, these SPE investments were "off balance sheet." By thus concentrating debt in these off balance sheet SPEs, Enron hoped that both its credit rating and stock price would remain high despite its increasingly precarious financial situation. So long as investors and analysts remained in the dark, the game could go on.

The SPEs weren't just part of an accounting game, however. Despite the obvious conflict of interest inherent in related party transactions between a corporation and one of its officers or directors, Enron's board routinely waived its ethics rules to allow Fastow's participation in the SPE deals as a part owner of the SPE. According to a subsequent internal investigation, Fastow made over \$30 million in profit from these deals. Several other Enron executives also participated in these deals and likewise made millions. In most of these transactions, Enron's internal controls proved inadequate, not least because Enron managers did not even bother to follow the accounting controls the firm had established.

Enron's Warped Corporate Culture
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While other scandals quickly came along to prove that Enron was not an isolated case, something about Enron's corporate culture made Enron executives especially vulnerable to the temptation to cheat. Law professor Larry Ribstein explains: "Enron insiders seem to be a new breed of corporate executives who are unconstrained by the traditional devices. These executives are hyper-motivated survivors of a highly competitive tournament (that Enron called "rank and yank") who have proven their ability to make money while putting on a veneer of loyalty to the firm. They are Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions, willing to take great risk as the company moves up and to lie when things turn bad, and nurtured by a corporate culture that instills loyalty to insiders, obsession with short-term stock price and intense distrust of outsiders."

It all started to unravel when investigative journalists and the SEC finally began taking a serious look at the minutiae of Enron's finances. On October 16, 2001, Enron announced that it was taking a \$544 million after-tax charge against earnings and reducing shareholders' equity by \$1.2 billion in connection with transactions with just one of Fastow's SPEs. A few weeks later, Enron announced a major restatement of its earnings for the four years 1997-2000 to account properly for transactions with two other SPEs. The restatement devastated Enron's earnings: It reduced Enron's 1997 earnings by \$28 million out of \$105 million total, 1998 earnings by \$133 million out of \$703 million, 1999 earnings by \$248 million out of \$893 million, and 2000 earnings by \$99 million out of \$979 million. The restatement also increased the amount of debt on Enron's balance sheet by \$711 million in 1997, by \$561 million in 1998, by \$685 million in 1999, and by \$628 million in 2000. As a result, Enron slashed shareholder equity by \$258 million in 1997, \$391 million in 1998, \$710 million in 1999, and \$754 million in 2000.

Enron's stock price collapsed, dropping from over \$90/per share to less than \$1. Shareholders and creditors filed numerous lawsuits. Criminal and civil fraud investigations ensued. In December 2001, Enron declared bankruptcy.

In 2004, CFO Fastow copped a guilty plea under which he agreed to testify against former Enron CEO Jeffrey Skilling and Chairman Kenneth Lay. Under the deal, Fastow was sentenced a 10-year prison term. Former Enron executives Michael Kopper and Ben Glisan struck similar deals.

In 2006, Lay and Skilling were convicted of numerous counts of securities fraud and conspiracy.

Lay passed away in July 2006. As this book went to press, Skilling was still awaiting sentencing.

#### Why Wasn't Skilling Convicted of Insider Trading?

During the period before Enron's financial woes came to light, Skilling sold off massive amounts of Enron stock. Presumably, he knew Enron was in trouble when he made those sales. But while the jury convicted Skilling of securities fraud for having made or authorized false statements about Enron's financial health, it acquitted him of all but one of the insider trading charges, which puzzled many trial observers.

There is a long standing debate in the law as to whether a defendant can be convicted for trading while merely in the possession of material nonpublic information or whether the defendant must have traded on the basis of such information. In Skilling's case, the jury instructions specifically required the jury to find beyond a reasonable doubt that Skilling traded not just while possessing but also on the basis of material nonpublic information. The jury instructions further explained that the government had to prove beyond a reasonable doubt that Skilling "used the material, nonpublic information in making his decision to sell Enron stock." Skilling apparently had a sufficiently plausible explanation for most of the trades (excepting the last trade, as to which

there apparently was some sort of smoking gun), such as a plan of regular trading or a personal reason for selling when he did. Hence, because of the distinction between trading on the basis of material nonpublic information and trading while in possession of such information, there is no necessary inconsistency between the verdicts.

### *The Other Shoes Drop*

The Enron scandal produced a flurry of activity in Congress. Numerous reform bills were introduced. Most of these were mere publicity stunts, however. Given the exigencies of the post-9/11 political setting in which virtually everything was subordinated to homeland security concerns, meaningful legislative action seemed highly unlikely. But then the other shoes began to drop.

In January 2002, telecommunications giant Global Crossing filed bankruptcy. It soon came out that the company had been misrepresenting its financial situation and manipulating its recognition of revenues. A few months later, the SEC announced an investigation of accounting fraud at WorldCom. It turned out that WorldCom management had inflated the company's assets by over \$11 billion, capitalized expenses that should have been incorporated into the earnings statement, and reported phony revenues. WorldCom's own internal audit process uncovered the fraud, which it reported the discovery to the company's new outside auditor (KPMG), which notified the board of directors. In this case, unlike Enron, the company's internal controls thus eventually worked, a point that likely strongly influenced Congress' focus on such controls in drafting SOX.

By the time the Global Crossing and WorldCom scandals had wrenched Congress' attention back to corporate governance, the problem looked to be widespread. The SEC's Division of Enforcement, for example, announced that in the first two months of 2002 alone it

brought an unprecedented number of new financial reporting cases (almost triple the number of the comparable period in the prior year, which itself had been a record). In addition, unlike most prior periods, in which the SEC had focused mainly on small fry, the cases brought in 2001-2002 involved a record number of Fortune 500 companies.

Although they differed in their details, the scandals at Enron, Global Crossing, WorldCom, and most of the other companies investigated by the SEC during this period, all involved some form of accounting fraud. This commonality was underlined by the unfortunate coincidence that Enron, Global Crossing, and WorldCom had used the same accounting firm as their outside auditor; namely, Arthur Andersen. Indeed, Arthur Andersen's name figured prominently in many other cases of accounting fraud in the 1990s and early 2000s, including the scandals at Sunbeam, Waste Management, Qwest, and the Baptist Foundation of Arizona.

By mid-2002, the accounting firm had been indicted, subjected to SEC civil actions, and sued by many companies and their shareholders. In 2002, Arthur Andersen was convicted of obstruction of justice charges arising out of destruction of Enron documents. Although the U.S. Supreme Court later overturned the conviction on technical grounds relating to the jury instructions, the verdict sounded Arthur Andersen's death knell. The storied accounting firm is effectively defunct, with all of its clients and virtually all of its employees gone.

### *The Failure of the Gatekeepers*

Auditing firms such as Arthur Andersen function as gatekeepers—i.e., reputational intermediaries between investors and their corporate clients who vouch for those clients. The typical corporation relies on numerous such gatekeepers: auditors; rating agencies; securities analysts; investment bankers; and lawyers. Although the corporate client generally pays these service providers, investors trust information from such providers because the gatekeepers put

their own reputations at stake. Because the value of a gatekeeper's services depends on its reputation, the market believes that a gatekeeper is not willing to risk its accumulated goodwill for a single client.

In the 1990s, however, the incentives for gatekeepers to police corporate conduct substantially weakened. Accounting firms typically provided a whole host of services to companies whose books they audited, such as tax preparation and software consulting. Because these other lines of business were more profitable than auditing, the accountants feared to anger management by vigorously pushing audits and challenging management's aggressive accounting treatments.

During that decade, a number of legal changes also reduced gatekeeper liability risk. The Supreme Court's 1994 *Central Bank of Denver* decision, for example, eliminated aiding and abetting liability in private securities fraud cases. The 1995 Private Securities Litigation Reform Act ("PSLRA") imposed significant restrictions on private securities fraud litigation. The 1998 Securities Litigation Uniform Standards Act abolished state court securities fraud class actions. Taken together, Columbia securities law professor John Coffee argues, these changes "greatly reduced the incentives of plaintiffs in securities class actions to sue secondary participants such as auditors, analysts, and attorneys," which in turn reduced the incentive for auditors to protect investor interests in a vigorous manner.

Accountants were not the only gatekeepers who fell down on the job, of course. As we shall see, corporate boards of directors and lawyers also all too often failed to do their jobs. Sarbanes-Oxley and related reforms targeted all of these gatekeepers. Given the centrality of accounting fraud and auditor failures to the pre-SOX story, however, it is not surprising that

accounting firms were SOX's principal target. Ironically, we'll see that accountants have also been SOX's principal beneficiaries.

*The Root of All Evil*

Enron, Global Crossing, and WorldCom were not isolated cases. Between 2000 and 2002, hundreds of companies restated earnings to adjust for prior flawed accounting practices.

Allegations of improper revenue recognition, failure properly to recognize expenses, and cooking the books in a host of other ways were brought against numerous companies. But why did so many managers go bad during this period? In short, greed.

In a burst of financial populism, President Bill Clinton and Congress in 1994 changed the tax laws to cap at \$1 million the deduction corporations may take for executive compensation. Performance or incentive-based forms of compensation, most notably stock options, however, were exempt from this cap (as they still are). The result was a dramatic shift in executive compensation away from cash and towards stock options. The stock market bubble of the late 1990s didn't help matters, as constantly rising stock prices made stock options seem like a sure thing.

Compensatory stock options normally issue with a strike price equal to the company's stock market price on the options' issue date. If the company's stock price subsequently rises, the executive can exercise the options and sell the shares at the higher market price. In theory, the resulting potential for profit aligns shareholder and manager interests and thus incents executives to maximize the company's stock price. Both the executive and the corporation may also realize various tax benefits.

Example: On June 1, 2005, Acme Corporation issued me options on 1,000 shares with a strike price equal to the then-prevailing market price of \$10 per share. One year later,

the stock price has risen to \$15 per share. I exercise the option, paying Acme \$10,000 (the \$10 strike price times the 1000 shares I'm buying). I then sell the shares at the market price of \$15 per share, for a total of \$15,000, realizing a profit of \$5,000.

In practice, however, stock options put tremendous pressure on managers to keep the stock price headed up no matter how the company actually was doing. CEOs insisted that the company beat—or, at least, make—the “number”; i.e., the consensus forecast by analysts of the company’s quarterly earnings. A company that failed to do so could see its stock price fall drastically as analysts complained and investors jumped off the bandwagon, with resulting catastrophic consequences for the value of the firm’s executives’ stock options. Under this compulsion to make the number, the temptation to resort to accounting trickery proved too much for many managers to bear.

### *SOX to the Rescue*

By mid-2002, then-SEC Chairman Harvey Pitt declared that restoring investor “confidence is the No. 1 goal on our agenda.” As a first step, the SEC ordered over 900 of the country’s largest corporations to certify under oath the accuracy and completeness of their corporate disclosures. This requirement triggered a new wave of high profile earnings restatements. With the 2002 elections looming, pressure thus grew within Congress for legislative action.

In a remarkably brief period, with minimal legislative processing, Congress slapped together a number of reform proposals that had been kicking around Washington for a long time and sent the mix to President Bush for signing. As Yale law professor Roberta Romano explains:

Simply put, the corporate governance provisions were not a focus of careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of

limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases. These occurred in conjunction with an economic downturn, what appeared to be a free-falling stock market, and a looming election campaign in which corporate scandals would be an issue. The healthy ventilation of issues that occurs in the usual give-and-take negotiations over competing policy positions, which works to improve the quality of decision-making, did not occur in the case of SOX.

It's hardly surprising that legislation crafted in such a haphazard fashion turned out to be far more costly than anyone expected. For readers of this book, the task is to minimize those costs while still complying with the mishmash of mandates created by SOX.

### **SOX in its Legal Context**

SOX is not a freestanding statute. Instead, it built upon the existing framework of state corporation codes and federal securities laws that have long governed corporate governance. Accordingly, a quick review of the pre-SOX legal landscape provides the necessary context for understanding the changes worked by SOX.

#### *The Corporation and State Law*

A leading legal dictionary defines the corporation as “an artificial person or legal entity created by or under the authority of the laws of a state or nation . . . .” Although technically correct, this definition is not especially enlightening. You may find it more helpful to think of the corporation as a legal fiction characterized by six attributes: formal creation as prescribed by state law; legal personality; separation of ownership and control; freely alienable ownership interests; indefinite duration; and limited liability. Taken together, these six attributes—all

grounded in state corporation codes—give the corporate form considerable advantages for large businesses as compared to the other forms of business organizations available under U.S. law.

#### State Corporation Law: Delaware's Dominance

Delaware is to corporate law, as Michael Jordan is to basketball— the undisputed all-time champ.

The extent to which Delaware dominates the incorporation market is really quite astonishing.

Fully 60 percent of Fortune 500 companies are incorporated in Delaware. As a result, when Delaware speaks, corporate lawyers and business people listen. Its corporation statute and the cases decided by its courts are the single most important source of corporate law in this country.

*Formalities of Creation:* Someone creates a corporation by drafting articles of incorporation that comply with the statutory requirements of the state of incorporation. The articles are the most important of the corporation's organic documents. The articles set out the corporation's essential basic rules of the road—the basic terms under which it will operate. Each state's corporate statute sets forth the minimum provisions the articles must contain. Model Business Corporation Act § 2.02, for example, requires the articles to include the corporation's name, the number of shares the corporation is authorized to issue, the name and address of the corporation's registered agent, and the name and address of the incorporator. In addition, the comments to § 2.02 list numerous other provisions that must be included in the articles if the corporation wishes to avail itself of certain statutory options. Among the more important of these options are provisions relating to division of shares into classes and series and liability of directors.

The incorporator then files the articles with the appropriate state agency, which in most states is the Secretary of State's office. In some states, the Secretary of State's office then issues

a document called the certificate of incorporation. In other states, the Secretary of State will simply return a copy of the articles of incorporation along with a receipt to the incorporator. At this point, the corporation has come into existence. The initial board of directors thereupon holds an organizational meeting at which corporate bylaws are adopted, officers are appointed, and other loose ends are tied up.

The bylaws adopted at that meeting are the corporation's chief set of internal operating rules. Other than certain issues that must be addressed in the articles of incorporation, such as the number and types of shares of stock the company is authorized to issue, the bylaws govern most of the corporation's internal affairs. Indeed, the bylaws can address virtually anything one desires. Model Business Corporation Act § 2.06, for example, allows the bylaws to "contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation."

*Separation of Ownership and Control.* Corporations differ from most other forms of business organizations in that ownership of the firm is formally separated from its control. Although shareholders nominally "own" the corporation, they have essentially no decision-making powers, other than the right to elect the firm's directors and to vote on certain very significant corporate actions. Instead, the statute vests management of the firm in the hands of the board of directors, who in turn delegate the day-to-day running of the firm to its officers, who in turn delegate some responsibilities to the company's employees.

#### Managers and Others

The corporation's senior employees are referred to as its managers (known collectively as the corporation's management). Officers are the most senior managers. A corporation's officers

typically include its president (or chief executive officer), one or more vice-presidents, a treasurer or chief financial officer, and a secretary.

*Legal Personality.* As a legal matter, the corporation is an entity wholly separate from the people who own it and work for it. For most purposes, the law treats a corporation as though it were a legal person, having most of the rights and obligations of real people, and having an identity wholly apart from its constituents. Corporate law statutes, for example, typically give a corporation “the same powers as an individual to do all things necessary or convenient to carry out its business and affairs.”

*Perpetual Duration.* A corporation is said to have perpetual duration. A more accurate statement, however, is that the corporation has an indefinite legal existence that can be terminated only in rare circumstances. Among these are liquidation in bankruptcy, a vote of the shareholders to dissolve the company, an involuntary dissolution suit, or a merger or consolidation with another corporation.

*Free Transferability of Shares.* One of the great advantages of the corporate form is that shares of stock are freely transferable. Absent special contractual restrictions, shareholders are free to sell their stock to anybody at any price. A transfer of stock has no effect on the corporation, except that there is now a new voter of those shares. For public corporations, the secondary trading markets greatly facilitate this process.

Contractual exceptions to the rule of free transferability are often found in close corporations, which is one of the many ways in which such firms resemble partnerships more than other corporations. Although shares of stock in a closely held corporation are freely transferable in theory, the lack of a readily available secondary trading market for such shares means they seldom are easily transferable in practice. Moreover, investors in a closely held

corporation often prefer to restrict transferability. Like any other personal relationship, the success or failure of a small business often depends upon maintaining a rather delicate balance between the owners. Free transferability of ownership interests threatens that balance. In closely held corporations, shareholders therefore often agree to special contractual restrictions on the alienability of shares.

*Limited Liability.* The limited liability doctrine holds that shareholders of a corporation are not personally liable for corporate obligations and thus put at risk only the amount of money that they invested in buying their shares. Suppose, for example, that an employee of Acme Co. commits a tort against Paula Plaintiff. Under the tort and agency law doctrine of vicarious liability, Acme is held liable to Plaintiff for \$10 million in damages resulting from the employee's tortious conduct. Acme has only \$1 million in assets. The limited liability rule bars Plaintiff from seeking to recover the unsatisfied \$9 million remainder of her claim from Acme's shareholders. The shareholders' investment in Acme stock may be worthless if Acme becomes bankrupt as a result of Plaintiff's lawsuit, but the shareholders will have lost only that portion of their wealth they invested in Acme.

In rare circumstances, courts may invoke an equitable exception to the limited liability rule called "piercing the corporate veil." If invoked, the veil piercing remedy allows creditors to hold shareholders personally liable for the corporation's obligations. In the immediately preceding example, if Paula Plaintiff successfully invokes the veil piercing doctrine, the court will allow her to recover the unsatisfied portion of her claim from Acme's shareholders.

#### *Some Key Corporate Law and Governance Terms*

**Authorized shares:** All states require that the articles of incorporation specify the number and classes of shares the corporation is authorized to issue. A corporation may not sell more

shares of a class than the number of authorized shares. If the board of directors wishes to issue a greater number of shares than the articles authorize, it must ask the shareholders to amend the articles to increase the number of authorized shares.

**Authorized but unissued shares:** Shares authorized by the articles of incorporation but have not been sold. Example: The articles authorize the corporation to issue up to 20,000 common shares. It has 20,000 authorized shares. The firm sells 4,000 shares to investors. At that point, it has 4,000 outstanding shares and 16,000 authorized but unissued shares.

**Bonds:** Long-term debt securities.

**Classes of shares:** A class of shares is a type or category of stock. Thus, common stock is a class of stock. Preferred stock would be a second class of shares. The articles must authorize multiple classes, which must set forth the number of shares of the class the corporation is authorized to issue and the class' basic rights.

**Debentures:** Unsecured long-term debt securities.

**Directors:** Although shareholders nominally own the corporation, they do not control it. Instead, control of the firm is vested in the board of directors, a body of individuals elected by the shareholders to manage the business.

**Dividend:** A pro rata distribution of the corporation's assets to shareholders. A liquidation dividend occurs when the firm dissolves and has assets remaining after all other claims have been satisfied. The residual assets are distributed pro rata to the corporation's shareholders as a final dividend.

**Issuer:** Used in connection with sales of securities to refer to the corporation that originally sold the securities.

**Junk bonds:** High yield, high-risk corporate bonds frequently used to finance takeovers.

Notes: Short-term debt securities, usually unsecured.

Outstanding shares: The number of shares the corporation has sold and not repurchased. Only outstanding shares have the voting and economic rights associated with stock.

Series of shares: A series of shares is a subclass of stock. Thus, the corporation might have a class of preferred shares divided into series. All members of the class will have some preference over the common stock, but each series may have different rights and preferences from the others.

Shares: The units into which the ownership interest of a corporation is divided. Shares typically carry two basic rights: (1) voting rights, which allow their owners to elect the corporation's directors and to vote on certain other matters; and (2) economic rights, which entitle their owners to a pro rata share of dividends and, in the event of liquidation, any residual assets remaining after all other claims on the corporation have been paid.

Shareholder: Person or legal entity who owns shares.

Stock: Sometimes used interchangeably with the term "shares," but also used in a more technical sense to refer to the corporation's aggregate outstanding shares; hence the term, "a share of corporate stock."

Treasury shares: Shares that were once issued and outstanding, but have been repurchased by the corporation. Example: If the corporation described in the preceding example repurchased 1,000 of its outstanding shares, it would now have 3,000 outstanding shares, 16,000 authorized but unissued shares and 1,000 treasury shares. In many states, the concept of treasury shares no longer has any legal significance. In such states, reacquired shares are simply classified as authorized but unissued shares.

*The Federal Securities Laws*

The two federal statutes of principal importance for our purposes are the Securities Act of 1933 and the Securities Exchange Act of 1934. Both statutes share two principal goals: assuring adequate disclosure of material information to investors and preventing fraud.

The 1933 Act is principally concerned with the sales of securities by issuers in the primary market—i.e., sales by a corporation of its stock or debt securities to investors. It therefore follows a transactional approach to disclosure model: the Act focuses on getting information about the specific transaction in question from the issuer to investors.

Because a firm must make the disclosures required by the Act every time it publicly sells securities, but need not make the disclosures at other times, the information made available to investors pursuant to its transactional disclosure regime quickly would go stale. Accordingly, the Securities Exchange Act created a companion system of periodic disclosures under which so-called reporting companies are required to provide disclosure to the market on an ongoing basis.

#### *Stock Exchange Listing Requirements*

Listing of a company's equity securities for trading on a prestigious stock market, such as the NYSE or NASDAQ, confers significant benefits on the company and its management. The greater liquidity of listed securities relative to those sold in the over-the counter (OTC) market reduces listed issuers' cost of capital. Listing also confers considerable prestige on the firm and its managers. Listed companies therefore desire to remain so, while many unlisted firms pursue eligibility for listing as their primary goal.

Corporate governance thus is regulated not only by the corporation law code of their state of incorporation and the federal securities laws, but also by the contract they sign with the stock exchange on which they have their principal listing. For New York Stock Exchange-listed

companies, the NYSE's Listed Company Manual governs. For NASDAQ-listed companies, the Listing Qualifications set out the relevant rules.

Read the Text

The NYSE Listed Company Manual is available online at [www.nyse.com/lcm/lcm\\_section.html](http://www.nyse.com/lcm/lcm_section.html).

NASDAQ's Listing Qualifications are available at [www.nasdaq.com/about/LegalComplianceFAQs.stm](http://www.nasdaq.com/about/LegalComplianceFAQs.stm).

After the Enron scandal broke, the NYSE appointed a blue ribbon panel of usual suspect Brahmins to ride to the rescue. In turn, the panel “anointed boards of directors, especially ‘independent directors’ as the capitalist cavalry.” Specifically, the panel made five major sets of recommendations:

- Enlarging the role and power of independent members of listed companies’ boards of directors.
- Requiring listed companies to adopt codes of business conduct and corporate governance guidelines.
- Requiring shareholder approval of all equity-based compensation plans.
- Requiring the CEOs of listed companies to certify annually that the company is complying with NYSE listing standards and that information provided to investors is accurate.
- Encouraging the SEC and other regulatory bodies to address accounting, auditing, and disclosure standards.

The NYSE board has adopted all of these recommendations. Similar changes were made to the NASDAQ Listing Qualifications. Because these stock exchange listing requirements

overlap with SOX in many respects, we'll expand our discussion of SOX and the SEC rules thereunder to include the exchange rules where appropriate.

### **Enter SOX: Highlights of the New Mandates**

Why did the regulatory scheme created by state corporation law, federal securities regulation, and stock exchange listing requirements fail to prevent Enron et al.? As we've seen, corporate scandals of 2000-2002 arose out of the confluence of two major trends: (1) the incentives to cheat provided by stock option-based compensation and (2) the all too frequent inadequacy of existing internal controls and the audit process to detect and prevent cheating. In response, Congress intended for SOX to increase the penalties for securities fraud by corporate executives, require more effective systems of internal control, and improve the audit process. Although we'll examine SOX's key operative provisions in detail in the Chapters that follow, a brief overview of the most important provisions will help put things in context.

#### *New Disclosure Rules*

Although SOX is mainly a process statute, it does mandate a number of new disclosures. Explicit disclosure is required of off-balance sheet and related party transactions, for example. Pro forma earnings statements must be presented in a way that is not misleading and be reconciled with an accompanying presentation prepared in compliance with generally accepted accounting principles (GAAP). Insider stock transactions now must be disclosed within two business days rather than at the end of each month. In the annual report, management must acknowledge its responsibility for maintaining an effective system of internal controls and must provide a written assessment of those controls.

Many of the new disclosure rules are of the therapeutic variety. For example, SOX requires companies to disclose whether they have adopted a code of ethics for their senior

financial managers and, if not, why not. Likewise, SOX requires companies to disclose whether the audit committee of their board of directors includes at least one financial expert and, if not, why not. Congress doubtless didn't care about the content of these disclosures. Instead, Congress expected companies would adopt the requisite code of ethics and appoint the requisite financial expert rather than having to offer investors a presumably embarrassing explanation for their recalcitrance.

### *Auditing, Accounting, and Internal Controls*

As noted, while SOX added some new disclosures to those required of public corporations, Congress was concerned principally with the process why disclosures are prepared and the information within them is gathered and verified. Much of the Act thus is concerned with accounting and auditing.

Prior to SOX, the accounting profession was largely self-regulating. Although the 1934 Act gave the SEC authority to impose financial accounting standards, the SEC had never done so. Instead, it allowed private sector organizations, especially the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA), to take the lead in developing the standards by which corporate audits are conducted (known as Generally Accepted Auditing Standards or GAAS) and the way in which financial statements are presented (GAAP).

Although FASB continues to play an important role under SEC oversight in developing accounting standards, SOX created the PCAOB as an independent oversight body for the accounting profession. As a result, the AICPA's role in developing auditing standards is now limited to those governing closely held corporations. The SEC is encouraging the PCAOB, FASB, and AICPA to cooperate in ensuring consistent rules for both types of corporations.

The PCAOB has an enormously broad Congressional mandate to create accounting rules and to enforce them. It is funded by a general power of de facto taxation over all publicly held companies. There are early indications that the PCAOB's independence and ability to raise its own revenue through taxation is supporting a dramatic expansion in its size and scope. Its 2004 budget was \$103 million, and its staff started the year at 126 employees and ended the year with 262 employees. The PCAOB's 2005 budget is another 30 percent higher, at \$136 million, and it expects to end the year with 450 employees.

Not everything was left in the PCAOB's lap, however. Instead, Congress took a number of specific actions directed at accounting and auditors. As we saw in our review of the business failures of 2000-2002, for example, a key concern motivating SOX's drafters was the conflicts of interest inherent when accounting firms sell other services to the corporations whose books they audit. Title II of the Act therefore limited the extent to which accountants may provide consulting services to their audit clients.

In order to make the outside auditor more independent of corporate managers, SOX's drafters codified the longstanding stock exchange requirement that the board of directors of public corporations must have an audit committee. This board committee must consist entirely of outside directors who meet specified independence standards (we'll look at this requirement in much more detail in Chapter 4). Towards the same end, Congress also made it a crime for company managers to attempt to mislead or coerce an outside auditor.

### *CEO and CFO Rules*

Title III of SOX requires the corporation's CEO and CFO to certify that the company's SEC disclosure documents are free of material misrepresentations or omissions and that the financial statements therein fairly and accurately reflect the company's financial and business

condition. Title IX imposes stiff criminal penalties for failing to comply with the certification requirements and even stiffer ones for willfully filing a false certification. In effect, the statute gives the CEO and CFO primary responsibility for the establishment, design, and maintenance of the corporation's internal financial controls. If a corporation is obliged to restate its financial statements due to misconduct, the CEO and CFO must return to the corporation any bonus, incentive, or equity-based compensation they received during the 12 months following the original issuance of the restated financials, along with any profits they realized from the sale of corporate stock during that period. The Act prohibits a corporation from directly or indirectly making or even arranging for loans to its directors and executive officers, subject to some minor exceptions. Finally, the Act prohibits executives from trading during so-called blackout periods in which the employees participating in 401(k) and other stock-based pension plans are forbidden from trading. If the executive does so, the corporation may sue to recover any profits. If the corporation fails to do so, a shareholder may bring a derivative action akin to those traditionally available to enforce the short-swing profit provision under §16(b).

### *New Legal Ethics Rules*

When one runs down the now all too familiar list of corporate governance scandals of the new century—Enron, WorldCom, Tyco, ImClone, and Adelphia, to name but a few—one encounters a distressing number of instances in which negligence by corporate lawyers allowed management misconduct to go undetected. Worse yet, lawyers sometimes even acted as facilitators and enablers of management impropriety.

During the Senate floor debate on SOX, Senator John Edwards (D-NC) proposed a last minute amendment to the bill, which added § 307 and commanded the SEC to develop new legal ethics rules for lawyers appearing before it. In January 2003, the SEC responded by

promulgating new rules, the principal substantive feature of which is a so-called up-the-ladder reporting requirement. This requirement creates an early warning system about management wrongdoing through mandatory attorney disclosures to the board of directors.

When a lawyer who appears and practices before the SEC becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the lawyer's initial duty under the new rules is to report such evidence to the issuer's chief legal or executive officer. Unless the lawyer reasonably believes that that officer has provided an appropriate response within a reasonable time, the lawyer shall report the evidence of a material violation to the audit committee of the board of directors (subject to several exceptions and alternatives).

The SEC thus tried to give lawyers a very simple obligation: You report the violation. If the officers don't properly resolve the violation, you go to the board. As we'll see in Chapter 3, however, it's not that simple.

### **SOX's Scope**

Most of SOX's key operative provisions apply only to reporting companies; i.e., corporations required to register with the SEC or, in colloquial terms, public corporations. Out of the 4 million-plus corporations in the United States, SOX therefore directly affects only about 13,000-odd corporations. Of course, those corporations account for the lion's share of the United States' economic output.

Two of SOX's provisions—those relating to document destruction and protection of whistleblowers—apply not only to reporting companies, but also closely held businesses and nonprofit entities. In addition, many nonprofits and small businesses comply voluntarily with many SOX provisions.

### *Reporting Companies*

Among the reporting companies subject to SOX, so-called “non-accelerated filers”—i.e., companies with a float of less than \$75 million—were initially exempted from compliance with SOX § 404’s internal control requirements, which are SOX’s most costly provisions with which to comply. In August 2006, the SEC announced a proposal for bringing those firms within SOX. Under that proposal, non-accelerated filers would have to begin providing the management report required by § 404 assessing the effectiveness of the company’s internal controls over financial reporting in fiscal years ending on or after Dec. 15, 2007. In addition, non-accelerated filers would have to begin complying with § 404’s requirement to provide the external auditor’s attestation report on internal controls over financial reporting in their annual reports as of the first annual report for a fiscal year ending on or after Dec. 15, 2008.

### **Non-Reporting Companies**

What about non-reporting companies, such as closely held corporations or nonprofit corporations? Only two of Sarbanes-Oxley’s provisions apply directly to non-reporting corporations: (1) The protections for whistleblowers and (2) the prohibition of destroying, altering, or falsifying documents so as to prevent their use or discovery in any official proceeding. As to the former, Board Source and Independent Sector, two leading organizations of nonprofits, recommend that:

Written policies vigorously enforced by executive staff and the board send a message that misconduct isn’t tolerated. These policies should cover any unethical behavior within the organization — including sexual harassment.

Each organization must develop procedures for handling employee and volunteer complaints, including the establishment of a confidential and anonymous mechanism to

encourage employees and volunteers to report any inappropriateness within the entity's financial management. No punishment for reporting problems — including firing, demotion, suspension, harassment, failure to consider the employee for promotion, or any other kind of discrimination — is allowed. Even if the claims are unfounded, the organization may not reprimand the employee. The law does not force the employee to demonstrate misconduct; a reasonable belief or suspicion that a fraud exists is enough to create a protected status for the employee.

#### Sample Policy

A good example of a combination document preservation and whistleblower protection policy for nonprofits is available from the Council of Michigan Foundations at [www.cmif.org/documents/whistleblower.doc](http://www.cmif.org/documents/whistleblower.doc).

As for the prohibition of document destruction, it applies to any closely held or nonprofit corporation that is potentially subject to official federal proceedings, which could range from tax cases to bankruptcy to criminal or civil investigations of violations of the host of federal laws. Accordingly, all closely held and nonprofit corporations should create written document retention policies and communicate those policies to any administrative personnel who handle the nonprofit's books or records. The policy should specify the period for which documents are retained and procedures for destruction of documents older than the required retention period. Education of personnel handling documents is critical to prevent accidental or innocent destruction in violation of the established policy.

#### *What About Mom-and-Pops?*

The universe of closely held for-profit corporations ranges from giants like Cargill (with over \$66 billion in revenue and 115 thousand-plus employees in 2005) down to the proverbial

mom-and-pop. Technically, so long as they are non-reporting companies, none of these corporations are obliged to comply with SOX.

Larger close corporations, however, face a number of pressures to “voluntarily” comply with the main SOX provisions: First, larger close corporations often have at least some independent board members, who may see SOX compliance as a way of limiting their liability exposure and enhancing their ability to oversee management. Second, larger close corporations often use one of the Big Four accounting firms for auditing or other services. These firms reportedly are pressuring their non-reporting clients to develop policies for substantially complying with SOX’s core provisions. Finally, close corporations considering going public in the near future will be required to be SOX compliant thereafter and, accordingly, typically begin implementing SOX’s mandates even while they are still private.

There is no bright line that divides close corporations that ought to be SOX compliant from those that need not do so. As a rule of thumb, however, many lawyers and accountants suggest that any company with annual revenues of \$50 million or more should seriously consider implementing at least the basic SOX mandates, especially those relating to auditor independence and effective internal controls.

### *Nonprofit Entities*

As with closely held corporations, the other provisions of SOX do not apply directly to nonprofit corporations. However, California has adopted a Nonprofit Integrity Act, which extends a number of SOX-like provisions to nonprofits, most notably:

- Nonprofit corporations with gross revenues of \$2 million or more must prepare annual financial statements and have them audited by an independent certified public accountant.

These financial statements must be audited in accordance with GAAS and prepared in accordance with GAAP.

- Nonprofit corporations with annual gross revenues of \$2 million or more must establish and maintain an audit committee. The audit committee is to be appointed by the nonprofit's board of directors or comparable governing body. The committee may include persons who are not members of the board of directors, but may not include employees or staff members of the nonprofit, the nonprofit's treasurer or CFO, or the nonprofit's president or CEO. Subject to oversight by the board of directors, the audit committee supervises the hiring, firing, and compensation of the nonprofit's independent CPA.

Similar legislation has passed or is under active consideration in a number of other states.

Nonprofits face two other sources of pressure to become SOX compliant. First, many nonprofit boards of directors include a substantial number of members who are also directors of public corporations. These individuals typically are familiar with SOX compliance and reportedly are pressuring their fellow board members to adopt voluntarily SOX-like policies. Second, nonprofits that have their financial statements audited by independent CPAs report significant pressure from their accountants to adopt SOX-like policies, especially with respect to internal controls and audits. This development isn't particularly surprising. As we'll see in Chapter 5, accountants turned out to be the chief beneficiaries of Sarbanes-Oxley.

In the face of these pressures, many larger nonprofits have opted to become more-or-less SOX compliant. Indeed, a 2006 study by Foley & Lardner confirms that "nonprofit organizations continue to adopt more aspects of the Sarbanes-Oxley Act than for-profit companies. Overall, nonprofits were more likely to have implemented or planned to implement whistle-blower

procedures, board approval of non-audit services by auditors and restrictions on executive compensation, among other areas of reform.”