

# SARBANES-OXLEY ACT

Authored by David Bond

## An Introduction

The Sarbanes-Oxley Act (the "Act"), signed on July 30, 2002, made several significant changes in the regulation of public company accounting practices and standards and imposed enhanced responsibilities on executives, board members, audit committees, auditors and lawyers. Although primarily drafted with public companies in mind, the Act will have an impact on privately held and not-for-profit companies. In part, this is because the Act made some changes to the federal criminal code itself that expressly apply to everyone. In part, this effect is expected to result from pressure brought by enforcement agencies, regulators, insurers and lenders, as well as shareholders and sponsoring organizations, who likely will seek to hold private and not-for-profit companies to the same elevated standards of corporate governance as are prescribed in the Act for public companies. This communiqué briefly describes those changes and sets out some preventative measures that private and not-for-profit boards should consider implementing.

## The Act's Changes to the Criminal Code

The Act prescribes two changes to the criminal code that could potentially affect private and not-for-profit companies. These relate to document destruction as a form of obstruction of justice and retaliation against whistleblowers.

- **Document Destruction** - The Act strengthens the Federal government's ability to prosecute document destruction undertaken in an effort to obstruct justice. The new provision proscribes:

*"Knowingly alter[ing], destroy[ing], mutilat[ing], conceal[ing], cover[ing] up, falsify[ing], or mak[ing] a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States...."*

Before the Act, the government could punish obstruction by destruction of documents, but there were significant restrictions on its ability to do so. For example, if no government proceeding were already underway, it could only prosecute one who "corruptly persuaded" another to destroy documents; it could not punish the destroyers of the documents themselves. The new provision (a) is not limited to pending proceedings, broadly reaching instead any matter within the jurisdiction of any federal body, (b) authorizes punishment for both the "persuader" and the "persuaded" and (c) eliminates the requirement of a "corrupt" intent.

- **Whistleblower Protection** - The Act, for the first time, makes it a federal crime to retaliate against "whistle blowers." More specifically, the Act states that it is unlawful for anyone, having "the intention to retaliate [to] take any action harmful to that person, including interference with lawful employment or livelihood, for providing to a law enforcement officer any truthful information" about the "possible commission of a federal crime."

## Corporate Governance Standards

Several provisions of the Act prescribe governance standards that are likely to become relevant in assessing whether directors of private or not-for-profit companies have fulfilled their fiduciary duties of loyalty and care. These are:

- **Formation of Audit Committees** - The Act requires that public companies form audit committees, which will be responsible for retaining and supervising the companies' outside auditors. The members of such audit committees must be independent directors, i.e., no members of management may serve and no member of the committee may receive consulting or advisory fees from the company. The committees are also charged with establishing procedures for receiving whistleblower complaints.
- **Adoption of Codes of Ethics** - The Act encourages public companies to adopt corporate codes of ethics for its senior officers, by requiring that each company disclose whether it has such a code and, if not, why not. The Act requires that the code of ethics address conflicts of interest, disclosure of information and compliance with rules and regulations.

*President George W. Bush shakes hands with Congressman Mike Oxley, R-OH, during the signing of the ceremony of the Sarbanes-Oxley Act in the East Room, July 30. "This new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law," said the President in his remarks.*



- **Certification of Financial Statements** - The Act requires that CEOs and CFOs of public companies certify that the company's annual reports were reviewed by them, that they are not misleading and that they fairly present the company's financial condition. The same officers must certify that they have established internal controls to ensure discovery of material information. Also, they must certify that they have disclosed to the company's auditors and audit committee any fraud involving key personnel as well as any financial control deficiencies.
- **Auditor Certification Regarding Internal Controls** - The Act requires public company auditors to include a statement in this audit report regarding the adequacy of the company's internal accounting controls and procedures.
- **Prohibition on Loans to Executive Officers** - The Act prohibits corporate loans to directors and executive officers.

## Recommendations

Boards of private and not-for-profit companies should consider taking the following proactive measures:

- Institutionalize good board recruitment and education practices. Make sure all board members are aware of and sensitive to the changing regulatory environment.
- Develop written policies mandating the regular flow of information from management to the board and requiring regular board review of management performance.
- Adopt a code of ethics and appoint an audit committee of independent and disinterested directors.
- Examine and, where needed, improve internal financial controls.
- Requiring management certification of financial disclosures and prohibiting loans to executives.

In the wake of the corporate accounting scandals of 2002, corporate boards face intense scrutiny of their governance practices. It is highly likely that the same heightened scrutiny will be brought to bear on the internal practices of boards of private and not-for-profit organizations. Sarbanes-Oxley will often provide the new standards in many areas of corporate governance. Consequently, the boards of not-for-profits and private companies should consider whether adopting these new standards make sense for them. ■

**ABOUT THE AUTHOR:** *With over twenty-years of experience as a litigator, my practice has spanned the full spectrum of commercial and business litigation, including contracts, business torts, securities, antitrust, civil RICO, accounting malpractice, lender liability and insurance coverage disputes. I am of counsel to Boyar & Miller in the Litigation and Bankruptcy Group and can be contacted directly by phone at 832.615.4290 or by email at [dbond@boyardmiller.com](mailto:dbond@boyardmiller.com).*



BOYAR & MILLER

4265 San Felipe, #1200

Houston, Texas 77027

[www.boyardmiller.com](http://www.boyardmiller.com)