

By Richard A. Wiley

Sarbanes-Oxley

Does It Really Apply to Non-Profit and Private Corporations?



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The 2002 Sarbanes-Oxley legislation adopted a series of provisions intended to help protect against the corporate governance abuses of the turn of the century, as exemplified by Enron and WorldCom. Those provisions include: (a) Section 201 – Auditor Independence requirements; (b) Section 301 – Audit Committee qualifications; (c) Section 302 – CEO/CFO Certified Quarterly Reports; (d) Section 404 – Management Assessment of Internal Controls; and (e) Section 406 – Code of Ethics for Senior Financial Officers.

A. Application to Non-Profits and Private Corporations

These new provisions are, on their face, only applicable to companies reporting under the Securities Exchange Act of 1934 (“Exchange Act”). However, there is an emerging consensus that non-profit corporations and for-profit corporations not subject to Exchange Act reporting should consider adopting policies reflecting various Sarbanes-Oxley requirements as a matter of “good corporate practice.” Many observers believe that several of the basic Sarbanes-Oxley requirements will become the new standard by which non-profit and private for-profit corporations will be measured as corporate governance and management issues arise for consideration in court decisions in the future.

The question has recently arisen as to what Sarbanes-Oxley legally mandates to non-profit corporations, as distinguished from those parts of Sarbanes-Oxley that are generally considered to be desirable or good practice. Due to the extensive

non-profit industry in Massachusetts, the answer to this issue is particularly relevant to Massachusetts practitioners. A Mass. Inc. study last year yielded several pertinent findings: (a) one out of every seven workers in Massachusetts is employed in the non-profit sector; (b) the sector employed 13.4 percent of the state’s total workforce (almost twice the national average); and (c) the non-profit sector in Massachusetts controls \$137 billion in assets. Of equal interest is the question of how Sarbanes-Oxley legally applies to private for-profit corporations.

The most significant part of the legislative history of Sarbanes-Oxley was an extensive statement by its chief sponsor, Senator Patrick Leahy of Vermont. An examination of that statement and various Department of Labor Administrative Law Judge rulings shows that only two parts of Sarbanes-Oxley appear to apply, as a matter of law, to non-profit and private corporations.

Records Retention

Section 802(a) of Sarbanes-Oxley (Title VIII, The Corporate and Criminal Fraud Accountability Act) prohibits, subject to criminal penalties, altering or destroying records in order to avoid federal investigation or to obstruct government function of any kind.¹ There is nothing to indicate any limitation on the types of corporations to which this section will apply. The records in question are not limited to financial-type records.

It should be noted that the Arthur Andersen case recently decided by the U.S. Supreme Court,

Arthur Andersen LLP v. United States, 125 S. Ct. 2129 (2005), is not relevant to this analysis. That case involved a charge of violation of a 1982 federal statute, the Victim and Witness Protection Act, which makes it a crime for one person to "corruptly persuade" another to destroy documents in order to make them unavailable to the government. The Sarbanes-Oxley provision includes a lesser standard of intent.

Whistleblower Policy

Three separate sections of Sarbanes-Oxley deal with this topic. While two sections are limited in application to Exchange Act-reporting companies, at least one arguably applies more broadly.

First, Section 301 requires that audit committees of Exchange Act-reporting companies establish procedures for: (a) the receipt, retention, and treatment of complaints regarding (only) accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.² This section on its face applies only to financial fraud matters in Exchange Act-reporting companies.

Second, Section 806(a) gives whistleblowers civil relief against retaliation.³ The language of this provision and the legislative history clearly indicate that this section is to apply only to Exchange Act-reporting corporations. Because of its experience with OSHA complaints, the Department of Labor was given administrative responsibility for hearing civil whistleblower claims. Department of Labor rulings⁴ have held, for example, that a civil whistleblower complaint under Section 806 could not be brought because, although the company had filed for an IPO, the filing had been withdrawn, and, therefore, the company had never become registered under the Exchange Act.

Third, Section 1107(a) creates a new criminal felony for retaliation against anyone who provides to a law enforcement entity or

agency truthful information relating to the commission of any federal offense, again subject to criminal penalties.⁵ As with the records destruction criminal provision, nothing in the legislative history indicates that Section 1107 would not apply to non-profit corporations. Department of Labor decisions exempting private companies from coverage are irrelevant to the scope of Section 1107 because Section 806, explicitly involving civil claims, applies only to Exchange Act-reporting companies.

B. What to Do?

Non-Profit Corporations

In order to minimize the possibility that non-profit corporations and/or their officers and directors might be subject to criminal penalties, non-profit corporations, based upon their size, resources, and nature of activities, should adopt a records retention policy with clear timelines. A modern electronic document management system may be desirable. A clear policy would minimize the possibility, as in the Arthur Andersen/Enron situation, of a dispute about whether the documents were purged (as the company claimed) in the ordinary course of business or (as the government alleged) were instead destroyed in order to avoid or frustrate a federal investigation. Deadlines for destruction of records would be derived from topic-by-topic applicable federal and state statutes of limitation and sound business practice.⁶

Similarly, in order to minimize possible criminal penalties in the event of whistleblower retaliation, a non-profit corporation should adopt both (a) an affirmative whistleblower policy; and (b) relevant internal mechanisms, such as reporting channels, hot lines (preferably managed by an independent firm offering such services), and the like. A whistleblower policy should, in turn, be supported by a general corporate code of ethics and values (at least for senior financial officers) of the general nature required by Section 406 of Sarbanes-Oxley.

In 2003, the National Association of College and University Business Officers published

guideline recommendations for Sarbanes-Oxley compliance. Shortly thereafter, one college and university debt-rating agency stated that adherence to the guidelines would be looked upon favorably as a rating consideration; the other two stated only that such action would be taken as a "sign of good management."

Private For-Profit Corporations

Here the analysis is essentially the same. However, private for-profit corporations, as a practical matter, would probably have to be of reasonably substantial size to have the internal personnel management and other resources to adopt these policies. Again, records destruction deadlines should be derived from general statutes of limitations.

C. State Law/Legislation

Nationally

Prior to Sarbanes-Oxley, state law in forty-two states and the District of Columbia provided some form of statutory or case law relief to senior officers and managers who "blow the whistle" by refusing to violate a law or regulation or by reporting violations. However, most statutes and cases addressed safety violations instead of financial fraud.

Since Enron and WorldCom, new state legislation is being enacted or considered to adopt measures similar to Sarbanes-Oxley to protect whistleblowers who flag financial problems in the non-profit arena. In 2004, California adopted such legislation. Currently, New York and Massachusetts are considering it.

Massachusetts

In 2005, the Massachusetts Attorney General filed a revised bill to amend Mass. Gen. Laws ch. 12, which has since been heard in the legislature by the Joint Committee on Consumer Protection. While the bill arose out of charitable foundation abuses, it applies to all charities and non-profits in Massachusetts. The essential features of the proposed legislation are as follows:

1. Board leaders and officers will be required to certify that the Board has reviewed and accepted the financial filings submitted to the Division of Public Charities, including any audits which a charity may be required to file.

2. A charity with over \$500,000 in revenues or with \$5 million in assets must have an audit performed and must have an audit committee of at least three members of the Board. A charity with \$500,000 or less in revenue need only file reviewed, but not audited, financial statements. The audit committee will be expected to review the management letter, furnished in connection with the audit, as to problems or issues flagged by the outside accountants. A majority of the committee members must be independent. "Independence" effectively means no "material" interest in any entity doing "significant" business with the charity or no engagement in any related party transactions within the three years prior to appointment to the audit committee. Any non-audit services performed by the firm conducting the audit or review must be done in accordance with the standards for auditor "independence" set forth in the latest revision of the U.S. Government Auditing Standards issued by the Comptroller General of the United States (the "Yellow Book"). Strangely enough, and in possible non-compliance with basic corporate law, the committee may have members who are not board members as long as a majority of the committee are board members.

3. Charities may not retaliate against whistle-blowing employees who complain about misuse of financial assets (as opposed to employment grievances). If such retaliation occurs, the Attorney General may seek compensation and back pay for the employee and an order to prevent reoccurrence.

4. Officers and directors may not receive "excessive" benefits. Only reasonable compensation may be paid to employees, officers or directors. Only "appropriate" related-party transactions will be permitted. "Reasonable compensation" will be determined by reference to the federal "intermediate sanctions" regulations.

5. Penalties would increase from \$500 to \$5,000 per violation. The Attorney General will have power to request fines, order restitution, or direct the removal of officers or directors.

The Attorney General's office and the Committee continue to discuss certain points arising in the bill.

D. Emerging/Recommended Good Practice

In light of all of these developments, it is important, without waiting for further state legislation, that management and boards of sizable Massachusetts (and other) non-profits and privately-held corporations give serious consideration to the adoption of the essential substance of a number of the provisions of Sarbanes-Oxley and the implementing regulations/guidelines of the SEC, NYSE, and NASDAQ. Such action would be particularly desirable for "semi-public" private corporations, e.g., an Employee Stock Ownership Plan ("ESOP") company with several hundred stockholders.

Considering all of the "source guidance" to date—Sarbanes-Oxley, NYSE and NASDAQ guidelines, and actual and pending state legislation—good corporate practice would clearly recommend the following:

General

a. Director Independence. Sarbanes-Oxley requires that a majority of the board of publicly-held companies be "independent." The NYSE leaves the determination to judgment. NASDAQ is more specific, i.e., payments of more than \$60,000 per year, for any of the past three years (except for Board of Directors fees) cannot have been made to a director. This is similar to Internal Revenue Code Section 162(m), applicable to publicly-held corporations, which generally disallows an income tax deduction for compensation over \$1 million to a corporation's chief executive officer and other highly compensated executive officers. There is an exception for "performance-based compensation" which meets certain requirements and is approved by

an "independent" Compensation Committee and the stockholders. Here IRS Regulation Section 1.162-27(e)(3) sets the limit at payments over \$60,000 per year to "service" providers, e.g., lawyers, accountants, investment bankers and management consultants. Such a de minimis rule would make good sense.

b. Code of Ethics. Under Section 406 of Sarbanes-Oxley, such a code is required only for CEOs and senior financial officers. The code should apply company-wide. The NYSE requires such a code to cover, at a minimum, conflicts of interest, corporate opportunities, confidentiality, fair dealing, use of corporate assets, legal and regulatory compliance, and reporting of unethical behavior (i.e., whistleblowing). Again, "good practice" is to have new employees read and sign a copy of the code on employment, and to have all employees acknowledge their continuing awareness by re-signing the code once a year. Monitoring of compliance with the code would rest with any internal audit or legal staff. As NASDAQ requires, the code should be posted on the company website.

c. Board Committees. Sarbanes-Oxley and the exchanges concentrate on requirements for three standing Board Committees: Audit, Governance, and Compensation. Each is important and should have clear charters as to responsibilities and authority.

First, Sarbanes-Oxley requires that Audit Committee members in particular should receive no compensation from the company other than regular Board or Committee member compensation. Further, the Audit Committee should have at least one financial expert member. The SEC definition construes this term quite liberally. Substantial relevant experience on other boards and the like can satisfy this requirement. This committee's charter should specify the policies and procedures by which the committee would pre-approve both outside audit and non-audit services, subjecting the latter to strict scrutiny for possible conflicts. Audit lead and concurring partners of the outside audit firm should rotate every five years. The "black" reporting line of the

outside auditor should be to the committee, the dotted line to internal financial management. Any internal audit staff should have the same reporting relationship.

Second, the Governance (or "Nominating") Committee, comprised of independent directors, should be responsible for such matters as writing the code of ethics, considering and proposing nominees for the Board, procuring suitable directors' and officers' liability insurance, and fixing director compensation, if any.

Third, the Compensation Committee should be comprised entirely of independent directors and have the following authority: (a) setting CEO compensation; (b) approving new compensation plans, subject to full board approval; (c) approving non-substantive scope amendments for pre-existing plans (e.g., for legal compliance) without the necessity of going to the full Board); and (d) making compensation and awards under approved executive compensation plans. For non-profits, this committee will be responsible for compliance with federal "intermediate" sanctions, and, in Massachusetts, the similar state requirements, if enacted.

E. Conclusion

These "good practice" requirements may seem burdensome and expensive at first sight. Their observance, however, will result in more effective management and governance in the interests of all corporate stakeholders (i.e., the community, shareholders, and employees) and provide better protection to the entity and its officers and directors against possible liability.

Endnotes

¹ 18 U.S.C. § 1519.

² 15 U.S.C., § 78j-1(m)(4).

³ 18 U.S.C. § 1514A.

⁴ See *Roulett v. American Capital Access*, Case No. 2004-SOX-00078, 2005 WL 2102471 (Dec. 22, 2004).

⁵ 18 U.S.C. § 1513(e).

⁶ For additional background on records retention policies, see Stephen M. Honig and Bronwyn L. Roberts, *The Morning After: Employment Law and Sarbanes Oxley*, - "Legal Analysis," Boston Bar Journal, Vol. 47, No. 5 (November/December 2003) p. 12.