Corporate stewardship in the new millennium

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Worldcom. Adelphia. Global Crossing. Tyco. Warnaco. Enron. The roll call of fallen angels, those previous darlings of Wall Street, and Main Street Investors is daunting and the fallout has had an impact on every public corporation. The recent corporate scandals, which have cost investors billions of dollars, has caused revolutionary change in corporate America, as accountability, conflict of interest and fiduciary duty issues are now at the forefront of director's and officer's minds, along with fear of civil liability and criminal prosecution. In addition to the list of companies with scandals has to be added the fall of accounting giant Arthur Andersen. The changes for corporations and their outside professionals are far-reaching, but still somewhat unpredictable: no one could have foretold that alleged misconduct by and at one of the world's largest and pre-eminent accounting firms with respect to a single client could cause that entire firm to go out of business.

The focus on corporate malfeasance has transcended regulatory oversight and become not just public policy but political capital. Upon the arrest of Adelphia's founder, John Rigas and his two sons for fraud, President George Bush pointed to the arrest as evidence of the new tougher policies on corporate fraud: "This government will investigate, will arrest and will prosecute corporate executives who break the law."[1]

Accounting restatements and SEC investigations have become and will continue to be commonplace, as prior legal, accounting or tax strategies are investigated, analysed and increasingly charged as criminal conduct. In the second half of 2002, 196 companies filed with the SEC to correct earlier accounting errors, the largest number in five years.[2] These issues are increasingly being examined in insolvency situations, and in numerous cases, the accounting restatement issues either precipitate a bankruptcy filing, or can be a contributing factor. Bankruptcy practitioners, judges, lenders, creditors and equity stakeholders are all focused on corporate governance, disclosure and conflict issues as this new legal landscape unfolds.

Not often is a single law the revolutionary harbinger of fundamental change as the Sarbanes-Oxley Act of 2002, but that law, passed just over one year ago, is at the forefront of a series of major changes that ensure it is no longer business as usual in corporate America, or in the legal, accounting and professional firms that service corporate America. A short list of the changes made by Sarbanes-Oxley is dramatic:

- CEOs and CFOs now have to certify the accuracy of their company's financial statements and SEC reports.
- The penalties for a knowing false certification are civil and *criminal*, and the CEOs and CFOs bonuses are subject to forfeiture if an accounting restatement is required as a result of misconduct.
- Public companies can no longer make loans to their executives or directors.
- Outside counsel *must* report corporate misconduct to the Chief Legal Officer or a Board of Directors Committee, and *may* disclose misconduct, including breaches of fiduciary duty, to the SEC, notwithstanding traditional rules of attorney client confidentiality ("Reporting Up" Rules).
- Public company audit committees must be comprised of fully independent Board members.
- Criminal penalties have been dramatically increased for both existing and new securities law violations.
- A public company accounting oversight board has been created, ending self-regulation by Audit Firms.
- Accounting Firms are restricted in providing certain consulting services to their audit clients.
- Senior audit partners can only audit a company for five years, then they must rotate.
- Debts for securities law violations or for fraud in connection with the purchase or sale of securities are now non-dischargeable in personal bankruptcies.

Some of these changes are dramatic and will impact corporate practices previously considered quite normal. The non-profit Corporate Library Research Group reported that executives received loans from their companies totaling over $4.5 billion in 2001, many at low or no interest: that typical corporate perk will now be eliminated for public company executives.[3] By way of example, Bernie Ebbers, the former CEO of Worldcom, earned a $1 million salary and a $10 million bonus in 2000, he also received $408 million in loans during his Worldcom tenure. Under Sarbanes-Oxley, his bonus would now likely be subject to a forfeiture claim if he improperly certified the company's financial statements, and he could not receive any loans from the

company.

United States public companies and executives are under intense scrutiny from shareholders and investor groups, the media, regulators and their own accountants and attorneys. That is why President Bush declared Sarbanes-Oxley was "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[4] It certainly will be costly, it is estimated that each Fortune 500 company will spend $3 to $8 million annually on Sarbanes-Oxley compliance.[5]

Reporting on the trends in corporate governance, *Businessweek* aptly summarised: "While many official reforms have already been passed following Enron's meltdown, boards are going even further, instituting sweeping changes in their composition, structure and practices."[6] Companies such as Apple Computer and Qwest Communications reacted by prohibiting their outside auditors from doing non-audit work for the company. Disney, which opposed an earlier shareholder resolution seeking to prohibit its outside auditors from providing non-audit consulting services, also reversed course and adopted such a prohibition. Only Deloitte Touche of the remaining "Big Four" US Accounting firms still has its consulting division, having recently decided not to spin off its consulting services, even though it had previously announced such a divestiture. That same day, General Motors Corp., one of Deloitte's biggest clients, ended its consulting relationship, which generated $131 million for Deloitte last year.[7]

Dramatically changing traditional notions of attorney client confidentiality, and designed to reinforce that outside counsel's duties run to the corporation and not to individual Officers and Directors, the SEC "Reporting Up" rules for lawyers became effective on August 5, 2003. While some states have reacted adversely, such as the Washington State Bar Associations' reaffirmation that state ethical rules prohibit lawyers from disclosing confidential information without the client's consent, the American Bar Association amended its Model Rules to allow for "Reporting Up," and to permit disclosures without client permission to prevent a fraud or a crime.[8]

Sarbanes-Oxley also enacted new and enhanced criminal penalties:

(a) A "willful" securities law violation or making a "willful & knowing" false or misleading statement in an SEC filing now has a penalty of up to a $5 million fine and 20 years in prison, for an individual (previously a $1 million fine and 10 years imprisonment) or a fine for an entity of up to $25 million (previously $2.5 million).

(b) A "knowing" false accounting statement certification, now exposes the CEO or CFO to a $1 million fine and 10 years in prison – if the false certification is "willful" it is up to a $5 million fine and 20 years in prison.

(c) A new "securities fraud" crime has been created: A person knowingly engaging in a scheme to defraud in connection with a public security (even if not in connection with a purchase or sale) can receive up to a 25 year prison sentence.

(d) A person who "knowingly" alters, destroys, conceals or falsifies documents or records with the intent to impede, obstruct, influence a federal investigation or matter, or in contemplation thereof, can receive a sentence of up to 20 years in prison.

(e) A person who attempts to "corruptly" obstruct, influence or impede an official proceeding, can receive a prison sentence of up to 20 years.

The clear trends for corporate governance as a result of this legal, regulatory, shareholder and public pressure include:

- More independent directors on boards.
- Independent audit committees with greater power and more financially sophisticated members.
- Significantly reduced non-audit consulting services provided by auditors to public companies.
- Deeper involvement by board members in strategic planning, management, evaluation of executive performance and setting of executive compensation.
- CEOs and CFOs will have to focus on detailed accuracy in financial and regulatory reporting, not just on "big picture" strategic planning.

Perhaps the ultimate harbinger of change, however, is the almighty "market." Sarbanes-Oxley was passed on July 25, 2002, and since then, the Dow Jones Industrial Average is up 13%. "Increasingly, institutional investors are flocking to stocks of companies perceived as being well governed and punishing stocks of companies seen as having lax oversight."[9] That behaviour, if it continues, will be the most important reason for improved corporate governance, and greater certainty in accounting and financing disclosures. The renewed emphasis on ensuring accurate financial reporting and disclosures for all companies will only be intensified in the restructuring and bankruptcy context, for all distressed companies, and their professional advisors. ■

[1] *CBC News Broadcast*, July 24, 2002.

[2] *Los Angeles Times,* "Financial Restatements Increase in First Half," July 30, 2003.

[3] *Los Angeles Times,* "Corporate Reforms Baby Steps," July 27, 2003.

[4] *Christian Science Monitor*, August 13, 2003.

[5] *Fortune*, "A Taste of Success; but the real test for Sarbanes-Oxley is still ahead," September 1, 2003.

[6] *Business Week*, "The Best and Worst Corporate Boards," October 7, 2002.

[7] *Wall Street Journal*, "Deloitte Chief Wrestles to Get Consultants Back in Firm," August 15, 2003.

[8] *Wall Street Journal*, "Attorneys Face a Paradox in the SEC's Conduct Rules," August 19, 2003.

[9] *Businessweek*, October 7, 2002; Los Angeles Times, July 27, 2003.

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