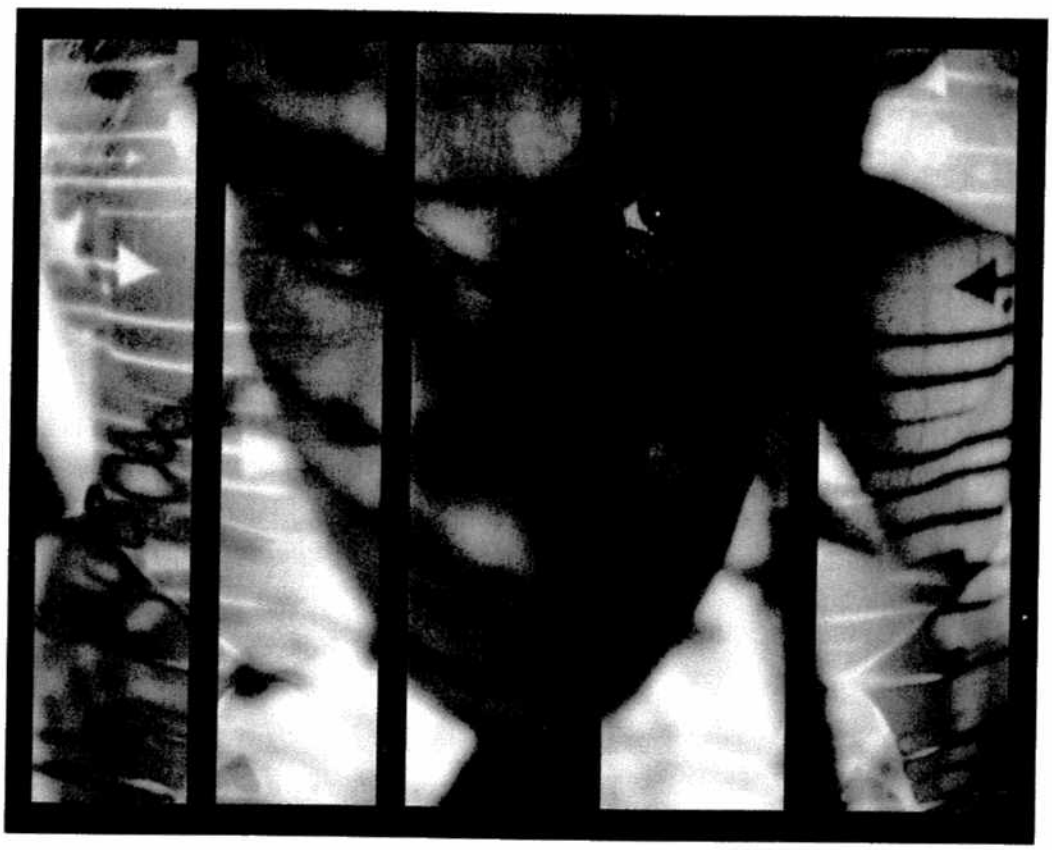
Coping With Sarbanes-Oxley

By Anthony Birritteri, Senior Editor



Attorneys Discuss Impact of Sweeping Securities Law Reform

In mid January, Enron Corporation's finance chief, Andrew Fastow, pleaded guilty to two counts of conspiracy charges for manipulating the energy company's financial statements with "members of Enron's senior management." He faces 10 years in prison and must return $29 million he fraudulently obtained from the company.

That same month, Enron's top accountant, Richard Causey, was alleged to be the "principle architect" of the Enron debacle. According to his indictment, he schemed to hide company debt, inflate profits and mislead investors.

As for Arthur Andersen - Enron's auditing firm that was convicted of obstruction of justice when it destroyed Enron documents while on notice of a federal investigation - the one-time "Big Five" accounting firm is no longer in operation.

No one yet knows what is in store for Enron Chairman Kenneth Lay and Chief Operating Officer Jeffrey Skilling as prosecutors probe what these men knew about the company's financial problems, when they made optimistic public statements about company finances, while selling their own Enron stock.

What is known, however, is that the federal government has had enough of the corporate scandals that emerged at the end of the dot-com boom. On July 30, 2002, President Bush signed the Sarbanes-Oxley Act, a sweeping piece of securities legislation that fully opens public companies to their shareholders and imposes strict rules promulgated by the Securities and Exchange Commission (SEC).

Among its many regulations, Sarbanes-Oxley, or SOX, calls for a company's audit committee to be fully independent, consisting of independent members of the company's board of directors, to stand between the CEO and the outside auditing firm. This audit committee must also have one independent "financial expert." The Act also requires a company's chief executive officer and chief financial officer to certify all financial statements, with criminal penalties imposed if these executives sign off on statements that are false.

SOX also prohibits personal loans or extensions of credit from the company to its executive officers and directors. In addition, it prohibits an accounting firm that acts as a company's auditor from providing a broad range of non-auditing services. Also, a public company must select a new auditing firm every five years. Gone are the days when a Big Six (now Big Four) accounting firm would stick with a client for 30 or more years.

The law seems complex and has many CEOs and CFOs worrying about compliance. According to many New Jersey law firms that are helping public companies adhere to SOX, however, the first thing executives should do is "calm down." The reason is that SOX, for the most part, is a return to the way business was once conducted years ago . . . with honesty, integrity and common sense.

"I tell my clients that SOX is not as terrible as the headlines are screaming. Companies, their executives and boards of directors have always had fiduciary duties to their shareholders," says Steven E. Gross, managing partner of the Newark-based law firm of **Sills Cummis Epstein and Gross**. "In the late '60s and '70s, businesses were very responsive to the dictates of the SEC. It wasn't a matter of ethics, but priority . . . you played under SEC rules."

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The boom of the '90s, however, tilted everybody's sense of priority. "There were excesses," says Gross. "Executives thought 'if something didn't stink or no one can point to what it violates, you could do it.' As a result, we had the Enron, Adelphi and Worldcom cases," explains Gross. "Shareholders, Congress, as well as the SEC were astounded at the deviation from the norm. As a result, we have SOX."

The corporate greed and excesses of the '90s were a result of the booming economy, but it didn't help that the SEC underwent budget cuts during that same time period. There were not enough examiners at a time when there was a tenfold increase in public companies. "The SEC just didn't have the capability to monitor this growth," says Gross. (When SOX was signed, it increased the SEC's budget by $300 million to $776 million. The money was destined to increase SEC staff by more than 200, fund information technology and security enhancements, and give pay raises to existing staff.)

"In helping businesses comply with SOX, I tell public companies to go back to their own commonsense way of doing business . . . to do what makes sense from a good practice standpoint," explains Warren Casey, head of the public company group at the Morristown-based firm of **Pitney Hardin**. "SOX is extensive, but it requires putting in place and in writing what successful companies have been doing all along."

One document a public company needs to disclose in writing is its Code of Ethics. According to Casey, this written policy focuses on key elements such as "the absolute requirement that everyone within the organization prepare proper and accurate records of all transactions, and that everyone acts with integrity on behalf of the company."

Codes of Ethics are not new to the business world. According to John Aiello, chair of the corporate and securities department at **Giordano, Halleran & Ciesla**, Red Bank, companies have been developing them due to federal sentencing guidelines. "SOX, however, has put them more into focus. The Act doesn't require a company to have a Code, but according to the SEC, a company has to disclose whether it has a Code or not. If not, it is required to say why it doesn't. "You can now see why boards of directors that are looking to discharge their fiduciary duties would be interested in making sure a company has a Code," he says.

According to the SEC, the Code of Ethics applies to principal executive officers, financial and accounting officers, controllers or any person with a similar function, but Aiello says that it can be applicable to all company employees.

As to where a Code should be displayed, Aiello says a business has three choices: its annual report, its Web site, or a mention in the annual report saying that a copy of the Code can be provided, without charge, by contacting the company. The company must also make a disclosure if it decides to change a Code or wave it.

Kenneth E. Thompson of McCarter & English.

Michael Nita of Drinker Biddle.

A major ethics point enacted by SOX is the independence of the audit committee. According to Michael Mann, the co-managing partner of **Pepper Hamilton's** Princeton office, who specializes in corporate securities and mergers and acquisitions law, "The audit committee now stands between the CEO, CFO and the auditing firm. Before this, you had Enron-type dealings where the CEO would pressure the auditing firm to twist the company's books, while dangling the consulting business in front of the auditor. Now, the independent audit committee is responsible for hiring and firing auditors. It makes sure the auditor is completely independent."

As for SOX requiring that CEOs and CFOs sign off and certify financial documents, Mann explains that these executives, over the years, were separated from the process and were never really accountable for the financial reports. SOX has brought CEOs and CFOs back into the process and now makes them active participants without giving them "plausible deniability of what was going on within their company," says Mann.

What is signed and certified is a fair presentation of financials, including 10K annual reports, and 10Q quarterly reports. According to Mann, if a CEO or CFO certifies a statement *knowing* that the periodic report does not comply with requirements (section 906 of the Act) they will be fined up to $1 million and face up to 10 years in prison. If they *willfully* file a certification that they know does not comply, they face a fine of $5 million and up to 20 years imprisonment.

Additional civil penalties include the taking away of incentive compensation and, in extreme cases, prohibiting the executive from ever again working at a public company.

Peter Ehrenberg of Lowenstein Sandler.

Sharon T. Jacobson of Maundelbaum Salsburg.

Are CEOs and CFOs now under a lot of pressure? Mann responds with an absolute "Yes! They have to go through the checks - check with in-house counsel, the in-house accounting staff, make sure all the internal controls are being followed, and if they are not, they have to report that."

"The potential for criminal punishment associated with certification and disclosures started our phones ringing right away," says Kenneth E. Thompson, chair of the corporate securities department at Newark-based **McCarter & English**. What most company CEOs ask Thompson off the bat when they want to comply is: "What is everybody else doing?" But how one company complies, may be different from another company. This is because SOX doesn't tell you how to comply, it just "leaves it up to the company to get there," says Thompson.

While compliance is a challenge for public companies of all sizes, the cost of compliance for smaller businesses will be greater. "Compliance in general is expensive," explains Thompson. "One of the things the statute did was get auditors more involved, so audit bills will be going up. Businesses are calling their lawyers early on in the process with more questions, so legal bills are going up. For a *Fortune* 500 company, the cost may be easy to absorb, but for small public companies, the costs can be a burden."

Because of SOX, small public companies are asking themselves if it makes economic sense to remain public. "The benefits of being public include having access to money by offering stock to a For many companies, these benefits are appealing."

Promulgating and putting the "skin on the bones" of SOX is the domain of the SEC. According to Brian North, who serves in the corporate finance group and is co-chair of the securities practice at **Buchanan Ingersoll**, the Philadelphia-based law firm with New Jersey offices in Princeton, "Congress quickly enacted SOX and passed aggressive deadlines on the SEC to adopt regulations implementing the provisions of the Act. What the SEC has done is also require the stock exchanges to implement their own rules for corporate governance as a condition for companies to be listed and traded on the exchanges."

directors. There are also new rules on how a company must disclose independent auditor fees and the audit committee's pre-approval policy that would allow an audit firm to provide non-auditing services, explains Nita.

While SOX requires CEOs and CFOs to certify financial documents, such as annual and quarterly reports, in effect causing these executives to painstakingly review numbers with a fine tooth comb, the SEC will be, independent of SOX, shortening the time period allowed in making these reports. According to Peter Ehrenberg, chair of the corporate finance and M&A practice group at **Lowenstein Sandler**, Roseland, "The SEC wants companies to report sooner. Under the traditional

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free market," says Thompson, "but the cost of complying is increasing and there's a high level of scrutiny and potential for criminal liabilities."

According to a study by **Grant Thornton, LLC**, the number of public companies to announce privatization plans increased 30 percent from the time SOX was enacted to November 2003. Edward Nusbaum, CEO of the accounting, tax and business advisory organization, says, "SOX is most likely creating the desired effect in making businesses realize that very strong responsibilities come with being a public company. By going private, companies can greatly reduce their level of risk associated with shareholder litigation, while cutting costs and regaining a sense of control and confidentiality.

Asked if these rules differ from SEC rules, North says, "Initially, the exchanges had different approaches for corporate governance. The SEC has brought them all together and tried to harmonize them," he says.

"The SEC and exchanges have always been adopting new rules for companies," says Michael Nita, a partner in the corporate and securities group at Florham Park-based **Drinker Biddle**. "It's just that SOX is more pervasive and companies have no choice but to comply."

Among the rules that went into effect this past year is the disclosure to shareholders on the processes and standards that a board's nominating committee uses when selecting directors and how shareholders would communicate with

system, companies filed their quarterly reports 45 days after the end of the quarterly period. Annual reports were filed 90 days after the year-end. "Those time frames have been in place as long as I could remember," he says. "This year, companies will have to file their 10Ks within 75 days. Next year, that will move up to 60 days."

One reason for the faster reporting is the Enron debacle. "Information about Enron was not out on the market in time. Had information been out sooner, perhaps a lot less people would have suffered significant stock losses," says Ehrenberg.

He also agrees that it is difficult for smaller public companies, with fewer resources than larger *Fortune* 500 firms, to comply. "The SEC has come out with rules that may be 50 to 60 pages long and everyone is swallowing this, reading it sentence by sentence to glean everything they can," he says. If one considers the shorter time frames on reporting, plus the 50 to 60 pages of proposed rules that have to be deciphered, then compliance seems to be a monumental task.

McCarter & English's Thompson explains that one reason the SEC is shrinking the reporting timetable is because of computer automation. It expects companies to file reports more quickly due to technology, but again, he says smaller companies will have a difficult time, especially those with complex operations, such as subsidiaries in various locations.

"Part of the issue is that we have more advanced and quicker communications systems than we used to, so the SEC is requiring faster, more comprehensive reports," adds Sharon T. Jacobson, who specializes in securities and corporate work at West Orange-based **Maundelbaum, Salsburg, Gold, Lazris, Discenza & Steinberg**. "People are getting deluged with information and there is more transparency about a business than there was in the old days."


Brian North of Buchanan Ingersoll.


Peter Spirgel of Flaster/Greenberg.

At the same time, Jacobson views SOX as an attempt to move corporate America from thinking about quarter-to-quarter results to long-term outlooks and taking the company away from the "imperial" CEO and giving it back to shareholders, the board of directors and the management of the company.

"I don't think there is as much to fear in the Act as companies originally thought. All they have to do is dust the cobwebs off of the rules and procedures that they already have. These rules are now being reviewed and adhered to," she says.

Some the of SOX rules, however, that were not part of a company's everyday regulations, according to Jacobson, include criminal penalties if a company has shredded documents which the SEC has subpoenaed. This part of the Act applies to both public and private companies. Also, if a company has committed securities fraud, which results in bankruptcy, debts cannot be discharged under a reorganization plan.

Because of SOX, people are also hesitant about serving on a board of directors. "What used to be a prestigious, plum job with a decent pay and access to some stock options, is now something you have to think twice about because being an outside director brings a tremendous amount of exposure and the obligation to undertake and investigate issues and statements that are being submitted and released by the company," says Peter Spirgel, managing shareholder at Cherry Hill-based **Flaster/Greenberg**. "The ability to say, 'I am an outside director and wasn't privy to company actions on a day-to-day basis' has been whittled away substantially."

William Skinner, a shareholder at the firm, says board members should engage counsel to help them work through SOX compliance. "We would help the board adopt operating rules

Castro II Appointed to NJ Sports & Expo

George Castro II, of Elizabeth, is appointed a commissioner at the NJ Sports and Exposition Authority, by Governor James E. McGreevey.

Castro is also a member of the New Jersey Investment Council, the first Hispanic to serve as its commissioner and presently as vice-chair. In addition, Castro is president and CEO of Century 21 Atlantic Realtors, Inc.

The New Jersey Sports and Exposition Authority, created in 1971, is the administrative agency for the Meadowlands Racetrack, Giants Stadium and the Continental Airlines Arena, which occupy a 750-acre tract in East Rutherford. The Authority had an $8.5-million profit for the year 2003.

for the establishment of an audit committee. It needs to be made up of independent directors. Those people can't receive substantial compensation for serving on that committee. And once you have established the audit committee, you have to empower it. It can engage counsel of its own choosing if it should decide it is appropriate," he says.

William Skinner of Flaster/Greenberg.

Gary Gordon of Riker Danzig.

While SOX mostly regulates public companies, many private firms are adhering to the Act as a "best practice." According to Gross at Sills Cummis, private firms are beginning to ask about and adhere to SOX because the legislation resets a tonal quality as to propriety and fiduciary duty. "Perhaps it is not done with the same legal enforcement," he says of private companies that want to comply, "but nevertheless, by virtue of this setting, there is a moral clock ticking for everybody."

Adhering to SOX may be a smart thing to do if the private company plans to either go public down the road or be acquired by a public company. The results of not complying can mean a lower asking price at the bargaining table. According to Spirgel, "I have heard stories about private companies being offered a lower purchase price by a public company because of the added compliance, restructuring and due diligence work that had to be done. So one benefit of a private company adhering to SOX is that it makes it easier for the public suitor to acquire you."

Asked if there are gray areas in adhering to SOX, or if certain regulations are open to interpretation, Gary Gordon, an associate within the corporate M&A and securities law practice at Morristown-based **Riker, Danzing, Scherer, Hyland & Perretti**, says, "A lot of it is black and white, simply because Congress was annoyed with the scandals." The black and white items he refers to include auditor independence and the prohibition of directors and executive officers of buying or selling company securities (acquired in connection with that person's service or employment) during a pension fund blackout period.

He says that the prohibition of loans to executives is a "pretty harsh thing. I have never seen a company that does not have that in place. Loans have been a common way of compensating management. This flat-out prohibition has a lot of people upset."

What is upsetting lawyers is the concept of the "noisy withdrawal." Being considered by SEC, this provision would require a lawyer who discovers a problem at his or her public company client, to report the problem by going up the chain of command until the issue is handled in a satisfactory manner. "If a lawyer feels the issue still isn't addressed properly, he must announce publicly (to the SEC) that he is withdrawing from company representation for professional reasons. You are basically saying, 'this company is having problems and we're blowing the whistle,'" says Gordon.

"This idea has every attorney and bar association in a tizzy because you are basically betraying attorney/client privileges. That's crazy stuff," he says.


Larry Goldman of Gibbons, DelDeo.

The regulations are many, but law firms are giving their public and private clients the advice and assistance they need in complying with SOX. According to Larry Goldman, an attorney at the Newark firm of **Gibbons, DelDeo, Dolan, Griffinger & Vecchione**, lawyers are proactive in helping companies comply, informing clients about all of the new provisions of the Act, when they become effective and how to comply with them.

He explains that law firms that have traditionally been involved in securities law have always had to engage in a high degree of due diligence and have a high degree of expertise when undertaking such services because of the complex nature of the regulatory regime. Now the changes due to SOX are making "an already complex area even more complex," he says. $

Mintax Promotes Specialists

Mintax, Inc., East Brunswick, names John Polizzano, Sr., of South Plainfield senior tax manager. Also, Al Pertowski, of Edison is named a tax manager, as is Barry Denneler of Westampton.

For more than 23 years, Mintax has focused on obtaining and maximizing tax credits and government incentives for corporations. It has assisted more than half of the *Fortune* 1000 companies in identifying, obtaining and administering tax incentive packages of all types.