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Sills Cummis in the News

THE SARBANES-OXLEY ACT OF 2002

WILL YOU BE PREPARED WHEN YOUR CEO CALLS

STEVEN E. GROSS is Managing Partner of Sills Cummis Radin Tischman Epstein & Gross and Co-Chair of its Corporate, Banking and Securities Department and provides both national and international clients with highly specialized legal advice and services and regularly advises them on corporate, securities and regulatory compliance issues.

MAX CRANE is a Member of Sills Cummis Radin Tischman Epstein & Gross and Co-Chair of its Corporate, Banking and Securities Department and regularly counsels private and public companies and their executives in most aspects of law and business and has frequently published in the areas of corporate compliance, executive compensation and various types of financings.

Now that President Bush has signed into law the Sarbanes-Oxley Act of 2002, can most in-house counsel honestly respond that they are prepared for the onslaught of questions that will be forthcoming from their CEOs, CFOs, and Board members. For those legal departments of significant size, the answer is probably maybe. For those without the available resources to devote to the multitude of tasks that will now be required, the answer is a resounding no.

While the attention of the news media, Congress and the President have been focused on a few of the country's largest high profile corporations and their stunning failures in management, the recently enacted Sarbanes-Oxley bill applies to almost all publicly traded US companies as well as to non-US public companies listed in the United States. While many of the largest companies have enormous legal departments and may be in a position to reallocate some of their lawyers to dedicate themselves to understanding and implementing the new law's requirements, many more companies with already stretched legal department budgets will have enormous difficulties in understanding the Act's requirements and implementing the necessary measures to achieve compliance. This does not even take into account the multitude of questions and judgment calls that will be forthcoming from their CEOs, CFOs and Board members who have and will become more "sensitive" to the risks of corporate financial disclosure and other newly enacted practices promulgated to increase corporate responsibility. One thing is for sure … woe to the in-house legal counsel charged with understanding and advising management and the Board of Directors that does not have an understanding of the new Act at his or her fingertips as well as the ability to offer practical guidance to the questioner as to how to best ensure compliance with the Act.

While this article is not intended to review in detail all the provisions of the new legislation, it will attempt to highlight some of the key provisions and identify solutions that will better protect a company's management and its Board of Directors.

HIGHLIGHTS OF THE LEGISLATION

Much of the discussion to date has been focused upon the personal certifications that will be required of a company's Chief Executive Officer and Chief Financial Officer with regard to periodic financial reports that are filed with the Securities and Exchange Commission. While this portion of the legislation has received much attention, it only represents a small part of the bill, albeit a significant part for those CEOs and CFOs who will have to affix their signature. Many have argued that the legislation adds very little that is new since CEOs and CFOs have always theoretically been culpable for material misrepresentations relating to a company's financials prior to the enactment of the Sarbanes-Oxley bill. Nonetheless, the specific criminal penalties involved, including fines and imprisonment, have reached a magnitude (up to $5,000,000 and up to 20 years in prison in some cases) that this section seems to have gotten everybody's attention.

In addition to the CEO and CFO certifications, among other things, the Act also prohibits new loans to directors and executive officers and accelerates the timing for an insider to file a Form 4 from ten (10) days after the end of the month in which the transaction requiring the filing has occurred to two (2) business days following the transaction. It also specifically protects "whistle-blowers" against retaliatory discharge in certain circumstances. It also provides added incentives to make sure that a Company's financials are accurate since it requires CEOs and CFOs to disgorge incentive based compensation and trading profits following any accounting restatements. The Act requires that by a date certain, all public companies to have audit com-mittees comprised solely of independent directors and that the audit committee will be directly responsible for the appointment, compensation and oversight of the Company's outside auditors who will report directly to it. The Act also will require public companies to disclose whether they have established corporate codes of ethics for certain senior financial officers and will require an immediate disclosure by the Company in any change in or waiver of such code of ethics. Additionally, the Act also directs the establishment of rules setting forth minimum standards in professional conduct for attorneys appearing and practicing before the SEC in any way in the representa-tion of public companies. This will require a company's outside attorneys to report "material violations" directly to a Company's CEO or Chief legal counsel and in some cases, absent an appropriate response, to a Company's Board of Directors.

The above highlights only some of the areas in which the Sarbanes-Oxley bill has tried to address the excesses and omissions relating to recent corporate financial disclosure and management behavior in recent years. Many of the specific aspects of the areas touched on in the preceding paragraph are subject to further SEC rulemaking and exposition. Over the next several months, the business, legal and accounting community can expect more detailed guidelines as to the dos and don'ts of compliance in this area.

WHAT DO WE DO NOW

However, the fact that much awaits resolution by further SEC rule promulgation does not excuse companies, CEOs, CFOs, Boards of Directors and the lawyers advising them from putting in place certain procedures immediately. The following are some suggestions as to areas that in-house legal staff needs to consider and advise management and Board members on immediately.

> "[W]oe to the in-house legal counsel charged with understanding and advising management and the Board of Directors that does not have an understanding of the new Act ...."

1. Since, as stated above, much of the attention to date in connection with the new corporate governance reforms has focused on the CEO/CFO certifications relating to financial reporting, the first step that every public company should promptly take is a relatively detailed review of its most recent financial filings as well as its upcoming filings. This certainly extends to any form 10-Qs due on August 14, (which is the due date for the third quarter form 10 Q filing for any calendar year reporting company). Even as to those CEOs and CFOs who find the additional "burden" of the certification a non-event in view of their confidence in their Company's financial numbers, it would be wise to advise both the CEO and the CFO to re-review the Company's financials.

2. In connection with this review, it would certainly be prudent for each of the certifying officers to have an opportunity to question the managers responsible for generating the numbers contained in the Company's financials as well as reviewing the Company's financial accounting control process to determine that the number gathering procedures are more "science" than "art."

3. In particular, CEOs and CFOs should take the opportunity to speak with their independent auditors and determine if there are any particular areas where the auditors believe the Company's accounting methodology was aggressive and whether there are more "accepted" forms of accounting in a particular area.

4. It would also benefit the CEO and CFO to meet with the Company's audit committee to confirm that it has had the opportunity and time to ascertain whether any significant issues need further attention or alternate treatment.

5. A written record or summary of the "diligence" steps taken by management and the Board of Directors and/or Audit Committee in connection with the review process should be maintained. Obviously, the more diligence performed, the more likely to obtain better results.

6. New procedures relating to the buying and selling of stock, the timing of Form 4 filings and applicable "blackout periods", during which insiders should refrain from buying or selling Company stock should be created.

7. The Company should establish and/or review its code of ethics. Significant attention should be paid to a code that captures the intent and spirit of the Act while still permitting the Company to maintain the necessary flexibility to achieve its business goals and protect shareholder interests.

8. Outside legal counsel should be contacted prior to embarking on a revised compliance analysis and plan. Once a plan has been agreed to, outside counsel should be contacted regarding issues that arise in implementing it. Companies should remember that a variety of information exchanges between its personnel and outside counsel are subject to the attorney-client privilege.

AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE

In view of the spotlight and feeding frenzy accompanying the enactment of this legislation, it is the wise CEO, CFO, Board member or in-house legal counsel responsible for the area that takes the extra step of consulting with outside counsel to assure that the company has taken the necessary prudent steps to insure compliance with the Act. While no outside counsel can sign off on a Company's financials, it can advise whether the procedures and the process which a Company undertakes and has instituted relative to financial reporting, 16(b) compliance, executive compensa-tion, etc. is appropriate for compliance under the Act. Whether we like it or not, the corporate compliance programs of all public companies in the United States just got more complicated. As with any other in-house compliance program, it is the smart General Counsel that will ask outside counsel either to craft the necessary procedures for it or will go to outside counsel and receive an appropriate "blessing" to any additions to its existing programs. The good news in all this is that while many senior management have in the past ignored or trivialized the importance of compliance programs and the resources attached to them, in view of the personal liability involved in some instances and the scrutiny under which all corporate manage-ments and Boards have been placed, it will not be surprising to find that Company compliance programs, particularly in so far as the new Sarbanes-Oxley Act is concerned, receive more support and attention than in the past

WHO WILL CARE ABOUT THIS A COUPLE OF YEARS FROM NOW

Whether as some have stated, the Sarbanes-Oxley bill is watershed legislation and the most important legislation since the 1930s' laws created the fundamental tenets of the current market regulation system or whether the legislation will have any long term impact on the conduct of corporate manage-ment and Boards remains to be seen. Much still awaits the specific rulemaking of the Securities and Exchange Commission which is to follow in the next several months. In addition to some of the internal Company items outlined in this article, the ultimate creation and operation of a Public Company Accounting Oversight Board and its mandate will go a long way in determining whether the Sarbanes-Oxley bill is a short term fix intended to appease a disgusted public and their elected representatives or whether the very nature of the way public companies act viz. a viz. their shareholders, executives and Boards remains to be seen. In the meantime, the Sarbanes-Oxley bill has been signed into law and counsel should immediately begin making it their focus within the Company and outside the Company to be assured that their CEOs, CFOs and Board members are not embarrassed because their in house representa-tives took action too late or in an insufficient amount.

[*For further Information, please contact*
Steven E. Gross
at 973.643.5080 or
sgross@sillscummis.com
or Max Crane
at 973.643.5055
or mcrane@sillscummis.com]

Sills Cummis Radin Tischman Epstein Gross

The Legal Center
One Riverfront Plaza
Newark, NJ 07102
973.643.7000
www.sillscummis.com

Atlantic City	New York	San Francisco
609.344.2800	212.643.7000	415.643.7000