Fiduciary Duty, Corporate Scandals, SOX and the Non-For-Profit
I. Fiduciary Duties
II. Corporate Scandals
III. Sarbanes-Oxley
IV. Application to Not-for-Profits
Fiduciary Duty 101

• Duty of Loyalty

• Duty of Care

• Business Judgment Rule: “Is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in honest belief that the action was taken in the best interests of the company”
Fiduciary Duty – Compliance & Ethics Programs

- Starts with Organizational Sentencing Guidelines
- Caremark Case (Del. Chancery)

Director’s fiduciary obligations include:

1) A good faith effort to assure adequate compliance and ethics program exist; and

2) That information regarding compliance with laws is brought to board’s attention on a regular and timely basis
• Stone vs. Ritter (Del. Supreme Court)
Director liability will be imposed if:

“The director failed to implement any reporting or information system controls [compliance & ethics program],” or

“Having implemented such a system or controls, consciously failed to monitor or oversee its operation.”
Implications for Directors*

- Need thorough understanding of compliance & ethics program
- Ask questions to identify and assess risks

* Adapted from “Courts Link Good Faith Oversight with Directors Personal Liability, Donovan & Corcoran, NACD-Directors Monthly, December 2007
Implications for Directors* (cont)

- Make its own assessment of effectiveness of compliance & ethics program
- Utilize outside expertise, if necessary, to conduct assessment
- Ensure proper remediation of risks
- Director liability tied to **failure to act** rather than bad decisions!!
Corporate Scandals

- Stock market boom of 1990s
- Lucrative compensation packages
- Increased use of stock options
- Focus on short term performance
- Explosion of individual investors
Corporate Scandals

- Enron Allegations
  - Off balance sheet transactions
  - Self-dealing
  - Excessive incentive compensation
  - Failure of auditors
  - Suspect legal counsel/advice
  - Inadequate audit committee oversight
Corporate Scandals

• Avalanche of Subsequent Events
  – MCI/WorldCom - AIG
  – Adelphia - ?
  – Imclone - ??
  – Tyco - ???
  – HealthSouth
  – Qwest
  – Fannie Mae
  – Freddie Mac
Corporate Scandals

- Accounting firms
- Insurance industry
  - AIG
  - Marsh McClennan
- Brokerage firms
- Fund Managers
Impact was severe
- Individual investors
- Employees
- Public and private pension funds
- Cities/counties
Congressional Response-sweeping reform legislation

1. Increased oversight – Public Company Accounting Oversight Board
2. Auditor independence/accountability
3. Corporate responsibility
4. Expanded financial disclosures
• Composition

- Non-profit corporation, funded by SEC registrants and public accounting firms
- Members appointed by SEC. 2 must be CPAs, 3 cannot be (or have been) CPAs.
- Members must be “prominent, financially literate, individuals of integrity and reputation.”
1. Public Company Accounting Oversight Board (PCAOB)

- **Duties**
  - Adopt, revise or repeal
    - Auditing standards
    - Quality control standards
    - Ethics standards for registered audit firms
  - Mandated rules
    - 2\textsuperscript{nd} partner review
    - Internal control reports
    - Inspection of registered audit firms
    - Work paper retention
Section 201: Services Outside the Scope of Practice of Auditors

- Prohibits registered audit firms from providing certain services to public companies
  - Bookkeeping
  - IT system design
  - Appraisal/valuations
  - Actuarial services
  - Management
  - Internal audit
  - HR
  - Legal
  - Broker dealer/investment
  - Expert
  - Other Services PCAOB determines improper
Section 202: Pre-Approval Requirements

- Requires audit committee to be directly responsible for oversight of auditors.
- Audit committee must pre-approve all audit and permissible non-audit services.
  - De minimis exception for aggregate services less than 5% of fees
- Policy disclosures
- Fee disclosures
Section 203: Audit Partner Rotation

- Limits audit partners to providing audit services to 5 or 7 consecutive years, depending on role.
- Audit partner includes:
  - lead audit partner
  - concurring partner
  - client service partner
  - partners who provide 10 or more hours of service
  - lead audit partners for significant subsidiary (20%)
Section 204: Auditor Reports to Audit Committee

- Auditors required to disclose to audit committee
  - All critical accounting policies and procedures
  - All alternative accounting/disclosure treatments of material financial information discussed with management
  - Other material written communications
2. Auditor Independence/Accountability

Section 205: Conforming Amendments
Section 206: Conflicts of Interest

- Cooling off period for audit team members becoming employed by issuer in certain capacities.
  - Board Member
  - CFO, COO
  - Chief Accounting Officer
  - Director Internal Audit
  - Treasurer
  - President/CEO
  - General Counsel
  - Controller
  - Director financial reporting
2. Auditor Independence/Accountability

Section 207: Study of Mandatory Rotation of Registered Public Accounting Firms

Section 208: Commission Authority

Section 209: Considerations by Appropriate State Regulatory Authorities
Section 301: Public Company Audit Committees

- Relationships with auditors
  - Appointment, compensation, oversight, dispute resolution
  - Audit committee independence
  - Hotline/complaint mechanism
  - Authority to hire advisors
3. Corporate Responsibility

Section 302: Corporate Responsibility for Financial Reports

- Certification by CEO/CFO that s/he has
  - Reviewed reports
  - Report is accurate, no material misstatements or omissions
  - Report fairly presents financial condition
  - Internal controls are in place
  - Significant control deficiencies disclosed to auditors and Audit Committee
  - Significant changes in internal controls
Section 303: Improper Influence on Conduct of Auditors

- Unlawful “to fraudulently influence, coerce, manipulate or mislead” an auditor
- Prohibitions include
  - Bribery/financial incentives
  - False/misleading legal analysis
  - Threatening auditor (blackmail, firing, removal, physical threats)
  - Deviation from GAAS
Section 304: Forfeiture of Bonuses and Profits

➤ Forfeiture of bonus/incentive compensation for chief executive(s)/financial officer(s) “if an issuer is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirements under securities laws.”
Section 305: Officer and Director Bars and Penalties

- Bars “unfit” as opposed to “substantially unfit” persons from serving as officers and directors.
Section 306: Insider Trades During Pension Fund Blackout Periods

- Prohibits directors/officers from buying/selling issuer shares during pension blackout periods
- Blackout period is any 3 consecutive business days when 50% or more of issuers plan participants/beneficiaries are prevented from trading accounts.
Section 307: Rules of Professional Responsibility for Attorneys

- Requires legal counsel to report violation of securities laws to chief legal counsel or CEO
- Duty to investigate or punt to “qualified legal compliance committee.”
- If response not “appropriate”, must report to audit committee or board
- Noisy withdrawal requirements?
Section 307: Rules of Professional Responsibility for Attorneys (cont.)

- Qualified Legal Compliance Committee
  - Independent members of board
  - Written P&Ps for review of allegations of impropriety
  - Established by board with authority to investigate, recommend changes and report to chief legal counsel, CEO and board; and if issuer fails to implement an appropriate response, report to SEC.
4. Expanded Financial Disclosures

Section 401: Disclosures in Periodic Reports
- Off-balance sheet arrangements
- Disclosure of contractual obligations (term debt, capital & operating leases, purchase obligations, etc.)
- Non-GAAP measures disclosure/reconciliation
Section 402: Enhanced Conflict of Interest Provisions
- Prohibits many loans by issuer to directors or officers
4. Expanded Financial Disclosures

Section 403: Disclosure of Transactions involving Management and Principal Stockholders

- Requires accelerated disclosure of insider transaction in issuer stock
Section 404: Management Assessment of Internal Controls

- Requires issuer to create and maintain adequate internal controls for financial reporting
- Annually assess/report on control effectiveness
- Report must include:
  1. Acknowledgement of management’s accountability
  2. Assessment of effectiveness
  3. Auditors evaluation of management’s assessment
Section 404: Management Assessment of Internal Controls (cont.)

- Distinguishing financial statement audit from internal control assessment
  - Financial Statement Audit – express opinion on fairness of financial statements in accordance with GAAS
  - Internal Control Assessment – express opinion on whether issuer’s internal controls are effective in ensuring accurate financial reporting
Section 405: Exemption

- Exempts entities registered under Section 8 of the Investment Company Act of 1940 from provisions of Section 401, 402 and 404.
Section 406: Code of Ethics for Senior Financial Officers

- Requires issuer to disclose whether it has adopted a code of ethics for senior financial officers
- Disclosure of any changes or waivers of code of ethics.
4. Expanded Financial Disclosures

Section 407: Disclosure of Audit Committee Financial Expert

- Issuer must identify and disclose independent financial expert, or explain why it does not have such an expert
- Expert is one who: (1) understands GAAP (ii) can apply GAAP (iii) has experience preparing/auditing financial statements similar to those of issuer, (iv) understands internal controls; and (v) understands role of audit committee
4. Expanded Financial Disclosures

Section 408: Enhanced Reviews of Periodic Disclosures by Issuers

➢ Requires SEC to more carefully examine reports by issuers
Section 409: Real-Time Issuer Disclosure

- Requires prompt disclosure (frequently within 5 days) of material changes in financial condition or operations.
Application to Non-for-Profits (NFPs)

- Why Should Not-for-Profits Care?
  - NFPs 2nd largest source of all financial restatements from 1971-2000\(^1\) representing 9.3% of all restatements
  - Multiple companies have been exposed and suffered increased scrutiny

\(^1\) USA Today, October 29, 2002
• Why Should Not-for-Profits Care? (cont.)
  ➢ Access to and cost of capital
  • Bondholders in identical position to shareholders
  • Rating agencies very concerned about governance practices
  • Banks/lending consortiums heavily focused on reliability of reporting
  • Tight credit markets
Application to Non-for-Profits (NFPs)

- Why Should Not-for-Profits Care? (cont.)
  - Tax-exempts under scrutiny by federal/state policymakers and regulators
    - Fiduciary/trust status
    - Fraud and/or waste
    - Improper use of funds
    - Charity care
• Why Should Not-for-Profits Care? (cont.)
  ➢ Sound business practices may be good business
    • Increased access to capital
    • Lower cost of capital
    • Improved organizational business processes
    • Reduced risk of financial mismanagement
Application to Non-for-Profits (NFPs)

• Why Should Not-for-Profits Care? (cont.)
  ➢ Organizations which fail to address issue may increase organizational/personal exposure
  • Fiduciary failure
  • Other legal exposure
Application to Non-for-Profits (NFPs)

- What are Not-for-Profits Doing?
  - Adding/Enhancing audit committees
  - Creating audit committees
  - Adding financial experts
  - Greater independence
Application to Non-for-Profits (NFPs)

- What are Not-for-Profits Doing? (cont.)
  - Modifying audit committee charter
    - Authority to hire advisors
    - Greater direct oversight of auditors
    - Expanded meetings/more detailed review
    - Increased use of executive sessions with auditors/compliance/legal counsel
Application to Non-for-Profits (NFPs)

- What are Not-for-Profits Doing? (cont.)
  - Enhanced conflict of interest management
  - Modifying policies
  - Greater disclosure
  - Thorough review of conflicts
  - Elimination/limitation of loans to management
Application to Non-for-Profits (NFPs)

- What are Not-for-Profits Doing? (cont.)
  - Adoption of SOX like standards/policies and procedures
    - Non-audit services by auditors
    - Forfeiture of bonus/incentive compensation for misstatements/omissions
    - Improper influence on auditors
    - Frequent use of certifications by financial officers/key management
Application to Non-for-Profits (NFPs)

• What are Not-for-Profits Doing? (cont.)
  ➢ Adoption of SOX like standards/policies and procedures (cont.)
    • Greater discipline in interim closing processes
    • Prompt/complete disclosure
    • Attorney reporting obligations
    • Improving internal controls
    • Expansion of ethics/compliance programs to address financial misconduct
Questions?