

# **What Real Estate Lawyers Need to Know About the Sarbanes-Oxley Act of 2002**

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## What Real Estate Lawyers Need to Know About the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 (the “Act”), signed into law on July 30, is an attempt to help eliminate accounting fraud and restore confidence in the nation’s financial markets. The Act makes significant changes in laws affecting directors, officers, and corporate reporting obligations. While the Act has no direct impact on real estate laws, real estate lawyers should be aware of the significant amendments to federal securities laws, including expanded CEO/CFO certification requirements for annual and quarterly reports filed with the SEC, increased current reporting requirements, enhanced enforcement, stiffer civil and criminal penalties, and closer review of periodic filings by the SEC. The Act also establishes a new Accounting Oversight Board responsible for regulating accounting firms that audit companies filing financial reports with the SEC. While a few of the Act’s provisions are immediately effective, or become effective very soon, many of the critical details and implementation of the Act are left to the rule-making authority of the SEC over the next several months.

### New Officer and Director Regulations

Officer Certification of Annual and Quarterly Reports. Effective immediately, each periodic report filed by a public company must include a certification by the company’s chief executive officer (“CEO”) and chief financial officer (“CFO”) (or their equivalent) that the report fully complies with the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and that the information fairly presents, in all material respects, the company’s financial condition and result of operations.

The SEC will adopt rules requiring principal executive officers and principal financial officers (or persons performing similar functions) to certify each annual or quarterly report filed with the SEC. In general, the officer will be required to certify that: (i) the officer has reviewed the report; (ii) to the officer’s knowledge it does not contain a material misstatement or omission; (iii) to the officer’s knowledge the report fairly presents the company’s financial condition and results of operations in all material respects; (iv) the officer is responsible for designing, maintaining and evaluating the effectiveness of the controls and has described their effectiveness in the report; (v) the officers have disclosed to the auditors and audit committee any material weaknesses in the controls and any individual fraud that has occurred; and (vi) the officer has indicated whether there have been any significant changes in the internal controls since the filing of previous reports.

Code of Ethics for Senior Financial Officers. Within 180 days, the SEC will adopt rules requiring public companies to disclose whether or not (and if not, why not) the company has adopted a code of ethics for its senior financial officers. The new rules will require immediate public disclosure by a company of any change in or waiver of the code of ethics.

Certain Personal Loans to Executives Prohibited. A public company may not, directly or indirectly, make personal loans or otherwise extend credit to or for any director or executive officer, except for consumer lending transactions of the type and on the terms made available by the company to the public. It appears the term “executive officer” includes a company’s president, any vice president in charge of a principal business unit, and any other person who

performs a policy making function. Existing loans can continue if there is not a material modification in the terms or renewal of the loan.

SEC-Barred Persons Prohibited from Serving as Officers or Directors. Effective immediately, the SEC may bar persons from serving as officers or directors if they violate the general anti-fraud provisions of the federal securities laws and their conduct demonstrates “unfitness” to serve as an officer or director.

Improper Influence on Conduct of Audits. Within 270 days, the SEC will adopt rules to make it unlawful for an officer or director of a public company or a person acting under such person’s direction to fraudulently influence, coerce, manipulate or mislead an accounting firm in the performance of its audit. Presumably, the forthcoming rules will indicate more precisely to what extent an attorney may be held liable under this provision. The SEC will have exclusive authority to enforce this rule.

Responsibilities of Legal Counsel Practicing Before the SEC. The SEC will issue rules of professional conduct for both inside and outside counsel who represent public companies before the SEC. The rules will require that: (i) an attorney must report evidence of a material violation of the securities laws or a breach of fiduciary duty by the company or its agents to the chief legal counsel or the chief executive officer of the company; and (ii) if the chief legal counsel or chief executive officer does not respond appropriately, the attorney must report the evidence to the audit committee or other committee comprised solely of independent directors, or to the full board of directors.

## **New Insider Trading Regulations**

Reporting of Insider Stock Transactions. The Act amends Section 16(a) of the Exchange Act to require reports of changes in beneficial ownership (i.e., Form 4) to be filed with the SEC by the end of the second business day following any transaction by insiders.

No Insider Trading During Pension Fund Blackout Periods. Senior management is prohibited from any insider trading during pension fund blackout periods imposed on 50% or more of the participants in a defined contribution plan, such as a 401(k) plan, if a director or executive officer acquired such securities in connection with his service or employment as a director or executive officer. This provision is effective 180 days after the law’s enactment.

## **New Corporate Disclosure Regulations**

Increased Review of Periodic Filings by the SEC. Public companies can expect enhanced scrutiny of their routine filings where reviews to date have been minimal and generally coincided with registered offerings by the company. Now the SEC must systematically review, on a regular basis (at least every 3 years), disclosures made by public companies in periodic reports. For purposes of scheduling reviews, the SEC must consider the following factors: (i) companies that have issued material restatements of financial results; (ii) companies that have experienced significant volatility in their stock price; (iii) companies with the largest market capitalization; (iv) emerging companies with disparities in price to earnings ratios; (v) companies whose

operations significantly affect any material sector of the economy; and (vi) any other factors the SEC considers relevant.

Real Time Disclosures. Public companies must now disclose on a “rapid and current basis” such additional information concerning material changes in the company’s financial condition or operations, in plain English, as the SEC determines is necessary or useful to protect investors.

Financial Statements Must Reflect Material Correcting Adjustments. Each financial report that contains financial statements and is filed with the SEC must reflect all material correcting adjustments identified by the company’s accounting firm.

Disclosure of Off-Balance Sheet Transactions. Within 180 days, the SEC must adopt rules requiring the disclosure in each Form 10-K and Form 10-Q of all material off-balance sheet transactions and other relationships of the company with unconsolidated entities or other persons that may have a material current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

Pro Forma Financial Information. Within 180 days, the SEC must adopt rules requiring that pro forma financial information included in any report filed with the SEC (i) contain no untrue statement or omission of a material fact which would make the pro forma financial information misleading; and (ii) be consistent with the GAAP financial statements.

Management Assessment of Internal Controls. Each Form 10-K will contain an internal control report stating management’s responsibility for maintaining an adequate internal control structure, procedures for financial reporting and an assessment of the effectiveness of the internal control structure. The company’s accounting firm must attest to and report on this assessment.

## **New Audit Committee Regulations**

Public Company Audit Committee Requirements to Maintain Exchange Listing. Within 270 days, the SEC will adopt a rule directing the national securities exchanges and national securities associations to prohibit the listing of any securities of a public company whose audit committee does not comply with the following requirements: (i) the audit committee must be directly responsible for the appointment, compensation and oversight of work by the accounting firm engaged by the company and the accounting firm must report directly to the audit committee; (ii) each member of the audit committee must be a member of the company’s board of directors and must be “independent” (i.e., may not accept any consulting, advisory or other compensatory fee from the company except in her capacity as a member of the committee or board and may not be an affiliate of the company); (iii) the audit committee must establish procedures for handling complaints on company accounting matters and the confidential anonymous submission by employees of concerns on accounting matters; (iv) the audit committee must have the authority to hire independent counsel and other advisors; and (v) the company must provide funds to pay the accounting firm and any advisors employed by the audit committee.

Disclosure of Audit Committee Financial Expert. Within 180 days, the SEC must adopt final rules to require each public company to disclose whether or not, and if not the reasons therefore, the audit committee has at least one member who is a “financial expert.” The Act sets forth standards for determining whether an individual qualifies as a “financial expert.”

Audit Committee Relationship with Auditors. An issuer’s audit committee (or, if none, the entire board) will have the authority to approve all audit and non-audit services to be provided by the issuer’s auditor, and approval of permitted non-audit services must be disclosed in the issuer’s periodic reports. Neither the lead audit partner nor the review partner who prepares an audit for a public company can perform an audit for the same company for more than five consecutive years. In addition, the Act commissions a study with respect to mandatory rotation of audit firms. Auditors will be required to make more frequent and thorough reports to audit committees, especially with respect to an issuer’s internal controls.

### **New Accounting Oversight Board and Auditor Independence**

Supervision and Regulation of Accounting Firms. The Act calls for the creation of a five-member independent Accounting Oversight Board (the “Board”) appointed by the SEC and subject to SEC oversight. Accounting firms that conduct audits of public companies will be required to register with the Board. The Board will establish auditing and attestation standards, as well as quality controls and ethics standards. The Board will review annually each accounting firm that conducts more than 100 audits a year; accounting firms conducting fewer audits are to be reviewed every three years. The Board can investigate potential violations of rules and impose sanctions. The Board’s power extends to domestic accounting firms as well as foreign public accounting firms that audit financial statements of companies under U.S. securities laws.

Auditor Independence. Under the Act, accounting firms are barred from providing several non-audit services to their audit clients. These include bookkeeping or other services related to accounting records or financial statements; financial information systems design, appraisal or valuation services; actuarial services; management functions or human resources; broker or dealer or investment adviser services; and legal services. The Act also prohibits public accounting firms from providing any audit services to a client if a CEO, controller, CFO or chief accounting officer of the client was employed by the accounting firm and participated in the client’s audit during the one-year period prior to the initiation of the current audit.

### **New Securities Analysts Regulations**

The SEC, or at its discretion, the NYSE or NASD, will adopt rules to limit conflicts of interest of securities analysts by enhancing the separation between investment bankers and research analysts. The Act suggests a number of rules, most of which are similar to those recently adopted by the NYSE and NASD. Among these rules is one imposing post-offering “blackout” periods during which brokerage firms that acted as underwriters in public offerings may not publish reports on the issuer.

## **New Enforcement Penalties and Liability**

Criminal Liability for Failure to Certify Periodic Reports. The Act also provides that each periodic report containing financial statements filed by a public company must include a certification by the company's CEO and CFO that the report fully complies with the requirements of the Exchange Act and that the information fairly presents, in all material respects, the company's financial condition and results of operations. A person who provides the required certification *knowing* that the report does not meet the requirements of the rule may be fined up to \$1 million or imprisoned for up to 10 years, or both, and a person who *willfully* provides a certification *knowing* that the report is inadequate may be fined up to \$5 million or imprisoned for up to 20 years, or both.

Forfeiture of Bonuses and Profits. If a company is required to restate its financial statements because of material noncompliance with SEC financial reporting requirements as a result of misconduct, the CEO and CFO are required to reimburse the company for (i) any bonus or other incentive-based or equity-based compensation received during the 12-month period following the public issuance or filing of the financial documents, and (ii) any profits realized from the sale of company securities during the 12-month period. The Act does not specify whose misconduct nor the level of misconduct that could give rise to CEO and CFO reimbursement.

Freezing of Assets. The SEC may, during an investigation, seek an order in federal court imposing a 45-day freeze on extraordinary payments to corporate executives by placing the payments in escrow to ensure that corporate assets are not improperly taken.

Statute of Limitations for Securities Fraud. The Act amends the statute of limitations for securities fraud claims which, under the Act, must be brought within two years of discovery of the facts constituting the violation or within five years after the violation.

Criminal Penalties for Defrauding Shareholders. The Act authorizes the imposition of criminal penalties, consisting of a fine or up to 25 years imprisonment, on persons who knowingly engage in securities fraud with respect to a public company.

White Collar Crime Penalty Enhancement Act of 2002. The Act amends the mail fraud provisions of the United States Code to make "attempt" and "conspiracy to commit" crimes punishable as mail fraud with jail sentences up to 20 years.

Document Destruction. The Act strengthens laws that criminalize obstruction of justice, such as document shredding or falsifying records, allowing for fines and up to 20 years imprisonment.

Whistleblower Protections. The Act creates criminal sanctions against those who retaliate against whistleblowers and includes both fines and up to 10 years imprisonment.

Bankruptcy Loopholes. The Act changes the bankruptcy code to make judgments and settlements based upon securities law violations non-dischargeable, preventing corporate wrongdoers from sheltering their assets under the umbrella of bankruptcy.