

Tax-Exempt Bonds: Is Sarbanes-Oxley Relevant?

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In 2002, Congress passed the Sarbanes-Oxley Act (SOA or Act) in the wake of financial scandals involving for-profit corporations, such as Enron, Tyco, Xerox, WorldCom, and Adelphia Communications. The SOA, as implemented by the Securities and Exchange Commission (SEC), effectively requires that publicly-traded, for-profit corporations take steps to establish: (1) independent board audit committees; (2) management and auditor accountability for internal financial controls and financial reporting; (3) whistleblower protection; and (4) internal reporting structures and responsibilities for attorneys and accountants.¹ Importantly, because of the manner that not-for-profit corporations are treated under federal securities law, not-for-profit organizations were spared from the explicit corporate-governance mandates of SOA. The extent to which SOA will affect the tax-exempt bond market, however, and the extent to which SOA will *indirectly* alter not-for-profits' management, organization, and legal exposure, remains an open question.

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¹ SOA also establishes numerous other obligations for allied professionals and market participants, including accountants, lawyers, stock analysts, and fund managers. This article will not address the

As of the date of this article, it is clear that, in the wake of SOA, some attention is being directed at not-for-profits' corporate-governance structures and financial controls. Leading not-for-profit hospitals and health systems have voluntarily implemented certain provisions of SOA, and bond-rating agencies have begun to take note of not-for-profits' actions regarding corporate governance. Corporate-governance concerns, however, are currently impacting tax-exempt bond ratings, bond insurance, and bond pricing only marginally, if at all.

A few states are considering new legislation that would impose some reforms on the corporate-governance practices of not-for-profit corporations. In the absence of definitive action by government regulators to impose SOA-like obligations on not-for-profits, however, the changes effected by SOA will probably not become the focus of issuers, obligors,² or other bond-market participants unless and until a high-profile bond default occurs. In the aftermath of such a default, however, it is the view of the authors that the governance standards and internal controls of the defaulting obligor will likely be judged, in the context of a claim under Rule 10b-5 or a claim for breach of fiduciary duty, against the corporate-governance "best practices" that are currently developing under SOA. For this reason, board members, officers, allied professionals, and bond-market participants should familiarize themselves with the changes resulting from SOA on for-profit corporations, and they should consider whether similar changes are appropriate for particular tax-exempt bond obligors.

Aside from changes in the regulations directly affecting publicly-traded corporations, SOA does contain some provisions, including criminal law provisions, that also apply to not-for-profit board members, managers, and allied professionals. Although SOA's criminal provisions are directed at only the most egregious conduct, they are written broadly enough to apply to all individuals, not just those associated with publicly-traded or for-profit corporations.

features of the SOA addressing these allied professionals unless those features are likely to significantly affect tax-exempt bond issuers or obligors.

² Generally, tax-exempt bonds are limited liability obligations of the issuing financing authority or municipal government for the benefit of a not-for-profit entity such as a hospital, health system or school that is, in turn, obligated to repay the funds borrowed. Bond investors look to the recipient of the funds raised, or the "obligor," to repay the bonds.

I. THE MARKET ENVIRONMENT FOR TAX-EXEMPT BONDS

Tax-exempt bonds are a fundamental source of capital for not-for-profit healthcare institutions. In 2002, proceeds of tax-exempt bond issuances constituted 54% of the total capital raised by not-for-profit hospitals and health systems from all external sources.³ During 2003, not-for-profit healthcare entities received approximately \$28.5 billion through the issuance of municipal securities, primarily tax-exempt bonds.⁴ Although less than the \$32.3 billion in bonds issued for not-for-profit healthcare entities during 1993, funds raised in 2003 were slightly greater than the \$26.2 billion raised in 2002.⁵

According to hospital CFOs, this dependence on tax-exempt bonds to meet capital needs will continue. In a survey report released in May 2004, the Healthcare Financial Management Association (HFMA) found that tax-exempt bonds rank only behind cash from operations as current sources of capital funds for hospitals and health systems.⁶ The CFOs surveyed by HFMA also confirmed that they will continue to rely on tax-exempt bonds to meet future capital needs, again second only to cash from operations.⁷ Experts question, however, whether many not-for-profit hospitals and health systems will continue to have access to the tax-exempt markets as the gap between strong and weak performers seems to be widening.⁸

While the highest rated performers among not-for-profit hospitals and health systems seem to be benefiting from growing operating margins, slightly improved reimbursement rates, and their ongoing efforts to focus on core operations, many

³ Healthcare Financial Management Association, *Financing the Future Report 1: How Are Hospitals Financing the Future? Access to Capital in Health Care Today* at 4 (2003) [hereinafter HFMA 1].

⁴ See Fitch Ratings, 2004 Nonprofit Hospitals and Health Care Systems Forecast at 6 (January 15, 2004) [hereinafter 2004 Nonprofit Hospitals]; Healthcare Financial Management Association, *Financing the Future Report 4: How Are Hospitals Financing the Future? Access to Capital in Health Care Today* at 8 (2004) [hereinafter HFMA 4]; The Bond Buyer, http://www.bondbuyer.com/msa_displayquickreport.html?prod=decade_bondvolume.

⁵ 2004 Nonprofit Hospitals, *supra* note 4 at 5-8.

⁶ HFMA 4, *supra* note 4 at 4.

⁷ HFMA 4 at 8; Cain Brothers, *Capital Growth Versus Capital Appreciation*, Strategies in Capital Finance at 10 (Winter 2004, Volume 42) [hereinafter Capital Growth].

⁸ See Unland, J. & Ponton, K., *Not-For-Profit Hospitals Face New Challenges Accessing Capital*, Hospitals & Health Systems Rx (Winter 2003, Volume 5, Issue 1) [hereinafter Challenges Accessing Capital]; Standard & Poor's, *U.S. Not-for-Profit Health Care: First Quarter 2004 Ratings Roundup Demonstrates Growing Sector Stability* (April 7, 2004) [hereinafter 2004 Ratings Roundup]; HFMA 4; Galloro, V. "Unequal Access," *Modern Healthcare* (May 10, 2004); 2004 Nonprofit Hospitals, *supra* note 4.

organizations face declining cash positions, continued operating losses, and increased competition and out-migration.⁹ These factors are separating not-for-profit hospitals and health systems into the “haves” and “have-nots” in terms of capital access.¹⁰ For many hospitals and health systems, these operating challenges will likely mean that it will be more difficult to access the tax-exempt market. For the true have-nots, these operating challenges will likely prevent access to the tax-exempt market on any terms.¹¹

Unfortunately, these challenges come at a time when capital spending by not-for-profit hospitals and health systems is projected to increase for the next five years at an annual rate of at least 14%.¹² This expectation is remarkable when compared to the 1% average annual increase in capital spending for the period between 1997 and 2001.¹³

Poor governance practices or an inability of the board to clearly define an appropriate, consistent mission for hospitals and health systems are factors that can result in credit downgrades.¹⁴ It is unlikely, however, that the existence of strong governance practices (including the existence of a truly independent audit committee, adequate internal controls, and financial statement certification) will lead to an upgrade or enhance an obligor’s ability to access the capital markets.¹⁵ But, as it becomes more and more difficult for many not-for-profit hospitals and health systems to readily access the tax-exempt market, it is likely that the existence of strong corporate-governance practices could enhance credit quality or access to capital for those who fall on a particular ratings, or interest rate, margin.

⁹ 2004 Ratings Roundup, *supra* note 8.

¹⁰ Challenges Accessing Capital, *supra* note 8; HFMA 4 at 2. Whether or not a hospital or facility with less than an investment grade credit rating will be able to access the bond market depends on a number of factors. For some facilities in some states, there is “pent up demand” to underwrite noninvestment-grade debt. New York seems to be such a state. During 2003, New York hospitals and health systems issued more debt than those in any other state even though approximately 44% of the rated hospitals in New York are considered to be noninvestment-grade. In part, this seems to be possible because of the number of New York investors seeking tax-exempt bonds. HFMA 4 at 9-10.

¹¹ HFMA 4.

¹² Healthcare Financial Management Association, *Financing the Future Report 3: How Are Hospitals Financing the Future? Access to Capital in Health Care Today* at 11 (2004).

¹³ *Id.*

¹⁴ 2004 Ratings Roundup *supra* note 8; Fitch Ratings, *Evaluating Corporate Governance: The Bondholders’ Perspective* (April 12, 2004) [hereinafter *Evaluating Corporate Governance*].

¹⁵ *Evaluating Corporate Governance* at 3-8; 2004 Nonprofit Hospitals, *supra* note 4 at 4; Fitch Ratings, *Sarbanes-Oxley Act: Voluntary Compliance Viewed as a Best Management Practice* (January 27, 2004);

II. INFLUENCE OF KEY MARKET PARTICIPANTS

Almost by definition, the three global rating agencies—Standard & Poor's, Moody's, and Fitch—are critical participants in the tax-exempt market and could, if they desired, effectively require issuers and obligors to adopt SOA-compliant policies and procedures. They have not done so. In a May 4, 2004 conference call and companion report, *Evaluating Corporate Governance: the Bondholders' Perspective*, Fitch made it clear that, while it is interested in corporate governance, only organizations that are true outliers in terms of poor governance practices should be concerned that such practices could lead to a downgrade of their tax-exempt bonds.¹⁶ Fitch has written that "companies that are found to have exceptionally weak corporate governance (or disclosure practices) could face a downgrade or other negative rating action, while those with very strong practices might warrant a special or favorable mention in the credit analysis."¹⁷

Leading underwriting firms are also critical market participants that could require enhanced governance as a condition to tax-exempt issuances. Contrary to suggestions made by some commentators that underwriters would be among the first market participants to require SOA-like governance standards,¹⁸ recent conversations with leading firms indicate that underwriters are not likely to lead any effort to require SOA-compliant governance practices of issuers and obligors. Although these underwriting firms recognize the importance of and encourage sound governance practices, they will be satisfied if adequate, but not SOA-compliant, governance practices are in place. The investment bankers interviewed confirmed that other key participants in the tax-exempt market, including the rating agencies and bond insurances companies, are questioning obligors about their governance practices but are not yet imposing any additional requirements.

Given the historical importance of credit enhancements such as bond insurance or bank letters of credit, insurers are another key participant in the tax-exempt bond

Standard & Poor's, *Credit Policy Update: S&P Extends Review of Corporate Governance* (March 25, 2004).

¹⁶ *Id.*

¹⁷ *Id.*

market with the clout to require issuers and obligors to “voluntarily” comply with SOA. Rather than dictating any specific governance model, the bond insurance companies seem content at this time to rely on negotiated real estate and operating covenants, additional disclosure requirements (the delivery of financial statements quarterly, if not monthly, for example), and obligations that financial statements be certified by responsible officers of the obligor.¹⁹ If, however, bond insurance companies decide to return to the healthcare-related tax-exempt market at levels seen in past years, they seem to be a likely source of negotiated covenants requiring enhanced governance practices.

Until 1998, the percentage of tax-exempt healthcare bonds that were insured consistently exceeded the insured level of the general tax-exempt market.²⁰ For example, 46% of all healthcare bonds issued in 1991 were insured, compared to only 32% of all offerings made in the broader tax-exempt market.²¹ In 1998, approximately 60% of the tax-exempt bonds issued for the benefit of not-for-profit healthcare organizations were insured, but only 27% of such bonds were insured in 2000.²² This significant retreat from the market by bond insurers is attributed to the high-profile bankruptcy of Allegheny Health, Education and Research Foundation, and AHERF’s default on approximately \$500 million of tax-exempt bonds.²³ The bankruptcy of Harvard-Pilgrim Health Care of New England in 1999 likely exacerbated this decline in coverage.

Although the percentage of insured healthcare-related issuances has risen since 2000 (and reached 37% in 2002), the current rates remain below the level seen in 1998.²⁴ Due to the greater level of risk associated with healthcare issues, underwriting criteria used by insurers have become more stringent, and the cost of bond insurance is

¹⁸ Healthcare Trustees of New York State, *Sarbanes-Oxley, Implications for Governing Board Members of New York State’s Not-for-Profit Health Care Provider Institutions* (August 2003) [hereinafter *Sarbanes-Oxley Implications*].

¹⁹ *Sarbanes-Oxley Implications*; HFMA 1, *supra* note 3 at 12-14, 21; HFMA 4, *supra* note 4 at 9.

²⁰ *Id.*

²¹ 2004 Nonprofit Hospitals, *supra* note 4 at 3.

²² HFMA 1, *supra* note 3 at 17; 2004 Nonprofit Hospitals, *supra* note 4 at 3.

²³ 2004 Nonprofit Hospitals, *supra* note 4 at 15; *Challenges Accessing Capital*, *supra* note 8 at 18.

²⁴ HFMA 1, *supra* note 3 at 17; 2004 Nonprofit Hospitals, *supra* note 4 at 3.

believed to have doubled since 1998.²⁵ In addition, the major bond insurance companies seem to be generally unwilling to write insurance on healthcare obligors with less than an “A” credit rating.²⁶ Given this reluctance to move back into the healthcare bond market at levels seen in 1998, should insurers decide to assume the same level of industry risk seen prior to AHERF’s default, it seems likely that they will do so only after requiring bond obligors to accept “higher premiums, requirements for mortgages, and stricter business and financial covenants.”²⁷ The authors of this article believe that these stricter requirements may include covenants regarding SOA-type governance practices and financial controls.

III. THE LEGAL ENVIRONMENT FOR TAX-EXEMPT BONDS

Tax-exempt bonds are issued by municipalities or special governmental authorities in offerings exempt from the registration requirements of the Securities Act of 1933 (1933 Act), and virtually all of the reporting obligations of the Securities Exchange Act of 1934 (1934 Act).²⁸ Issuers and obligors of tax-exempt bond offerings are, however, subject to state and federal securities laws and regulations, including the anti-fraud provisions of the 1933 Act and 1934 Act, most notably Rule 10b-5.²⁹

Although subject to the anti-fraud provisions of federal and state securities acts, the fees and expenses typically associated with a registered offering and the significant, ongoing costs of complying with the 1934 Act are avoided by issuers and obligors of tax-exempt bonds. The ability to access the tax-exempt market in this manner is a valuable, relatively low-cost and efficient funding source for not-for-profit healthcare organizations,³⁰ and a funding advantage not available to for-profit healthcare entities.³¹

²⁵ Cain Brothers, *Is the Sky Falling? Capital Leaves Healthcare*, Strategies in Capital Finance (Spring 2000, Volume 29).

²⁶ HFMA 4, *supra* note 4 at 14.

²⁷ 2004 Nonprofit Hospitals, *supra* note 4 at 3.

²⁸ See Levine, R., & Short, J., *A New Day for Healthcare Organizations: Sarbanes-Oxley Certification Requirements, Compliance, and Exposures*, White Paper issued by the Sarbanes-Oxley Task Force of the American Health Lawyers Association at 13 (January 2004) [hereinafter AHLA White Paper].

²⁹ 15 U.S.C. § 78j (Section 10(b) of the Securities Exchange Act of 1934); 17 C.F.R. § 240.10b-5 (Rule 10b-5). See also, AHLA White Paper at 13; In the Matter of City of Miami, Florida, Securities Act Rel. No. 8213 (March 21, 2003); Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Rel. No. 7049, 1994 SEC LEXIS 700 (March 9, 1994).

³⁰ Blazewski, J., *Commentary, Industry Insights, Cain Brothers’ Newsletter for Health Care Professionals*, March 8, 2004.

Issuers and obligors of tax-exempt bonds are each required to meet only limited disclosure requirements. Rule 15c2-12 under the 1934 Act requires issuers to provide a “final official statement” to each purchaser of bonds and to file a copy of the final official statement with a national repository and, in a few cases, with state depositories.³² The final official statement must include “information concerning the terms of the proposed issue of securities” and “information, including financial information or operating data, concerning such issuers of municipal securities *and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the [o]ffering.*”³³ Issuers and obligors are also required by Rule 15c2-12 to file annual financial information,³⁴ and to file notices of significant, specified events.³⁵

Passage of SOA did not change Rule 15c2-12’s disclosure requirements. Because the scandals that led to SOA were centered around the equities markets, SOA amended the laws and regulations of for-profit stock issuers, along with the professionals associated with the equities markets—accountants, equities underwriters and their analysts, and securities lawyers—without concentrating on participants in the bond markets.³⁶

Beyond the specific filing requirements of Rule 15c2-12, issuers and obligors are often contractually obligated, as a condition of the issuance, to make additional, periodic disclosures of, and certifications regarding, their financial results and operations. Material misstatements or material omissions in these contractual disclosure obligations

³¹ *Id.*; Capital Growth, *supra* note 7.

³² See 17 C.F.R. § 240.15c2-12(b).

³³ 17 C.F.R. § 240.15c2-12(f)(9) (emphasis added). This section clearly requires adequate disclosure of operational and financial information about bond obligors.

³⁴ The term “annual financial information” means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to [the party obligated to repay the bonds]. 17 C.F.R. § 240.15c2-12(f)(9).

³⁵ The enumerated events are, if material, principal and interest payment delinquencies; nonpayment-related defaults; unscheduled draws on debt service reserves reflecting financial difficulties; unscheduled draws on credit enhancements reflecting financial difficulties; substitution of credit or liquidity providers, or their failure to perform; adverse tax opinions or events affecting the tax-exempt status of the security; modifications to rights of security holders; bond calls; defeasances; release, substitution, or sale of property securing repayment of the securities; rating changes; and any failure to provide required annual financial information, on or before the date it is due to be filed. 17 C.F.R. § 240.15c2-12(b)(5)(C).

³⁶ See, e.g., SOA Titles I, III, IV, V (specifically regulating accountants, publicly-traded issuers, investment banks, and securities attorneys).

can form the basis of a claim under Rule 10b-5.³⁷ As these legal and contractual disclosure obligations suggest, the credit quality and profile of the obligor, together with other facts regarding the use of proceeds, are critical elements of a risk analysis of tax-exempt bond issuances. A reasonable investor certainly desires to know and evaluate these facts when deciding whether to purchase a bond, making them material to the investment decision.

According to Fitch, over the last two years, there has been a substantial improvement in disclosure by obligors of tax-exempt healthcare bonds.³⁸ “Now more than ever, hospitals are bound by covenants in legal documents providing quarterly and annual financial disclosure as well as operating statistics and material events.”³⁹ Also according to Fitch, “improvements in disclosure remain a major area of opportunity for hospitals and health care systems.”⁴⁰ Others share this view and believe that improved disclosure can also improve access to capital.⁴¹

As a result, enhanced financial disclosure and reporting is being undertaken not just when required, but is being made voluntarily by leading health systems. Many of these leading health systems are posting financial results on their websites or are using privately-operated online repositories.⁴² Still others have implemented formal investor relations programs designed to improve and speed communications and information flow to bondholders and analysts.⁴³ Liz Alhand, the CFO of Presbyterian Hospital in Albuquerque, New Mexico, told the American Federation of Management Accountants that communicating with bondholders through an effective investor relations program “is one of the most important things [a CFO] can do to improve our access to capital.”⁴⁴

While improving access to capital may result in increased expectations for heightened disclosure, any such increased expectations will likely result in greater potential liability for issuers and obligors. Under Rule 10b-5, material misstatements and, importantly, *material omissions*, in Rule 15c2-12 filings and contractual disclosures

³⁷ In the Matter of City of Miami, Florida, *supra* note 29; Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, *supra* note 29.

³⁸ 2004 Nonprofit Hospitals, *supra* note 4 at 4.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ HFMA 4, *supra* note 4 at 15.

⁴² *Id.*

⁴³ *Id.*

are actionable. Rule 10b-5 makes it unlawful, in connection with the purchase or sale of “any security,” to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.⁴⁵ To violate Rule 10b-5, an issuer or obligor must act with the “intent to deceive, manipulate, or defraud,”⁴⁶ but the existence of intent may be proven by circumstantial evidence.⁴⁷ Furthermore, proof of intent may be satisfied by showing either actual knowledge of the misrepresentation or by showing “reckless disregard of ordinary standards of care.”⁴⁸ Because Rule 10b-5’s “recklessness” standard is based upon the ordinary standard of care among similarly-situated organizations, it is the view of the authors that not-for-profit corporations, at least those that participate in the public markets, may be held to equivalent standards as for-profit corporations.

The application of Rule 10b-5 to tax-exempt bond disclosure will likely be made, of course, after a default has occurred and a loss has resulted. In this context, and in light of the attention currently being given to developing corporate governance best practices (including the need for and role of independent audit committees and adequate internal controls), a future plaintiff may allege that it would not have purchased the bonds at issue if the obligor had disclosed insufficient corporate-governance practices or inadequate internal financial controls. If such a claim arises, the issuer or obligor’s best defense would likely be that their disclosures and governance practices are consistent with those maintained by others in their industry, and that they are designed to detect and report any financial failures.⁴⁹

⁴⁴ *Id.*

⁴⁵ 17 C.F.R. § 240.10b-5.

⁴⁶ In the Matter of City of Miami, Florida, *supra* note 29; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976).

⁴⁷ *Id.*

⁴⁸ *E.g.*, Howard v. Everex Systems, Inc., 228 F.3d 1057, 1063 (9th Cir. 2000).

⁴⁹ See, *e.g.*, Malone v. Microdyne Corp., 26 F.3d 471, 478 (4th Cir. 1994); Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297, 1305 (C.D.Cal. 1996). Although the facts now may seem egregious, the Commission’s cease and desist order entered against Allegheny Health, Education and Research Foundation for violations of Section 10(b) and Rule 10-5 may be instructive. In the Matter of Allegheny Health, Education and Research Foundation, Exchange Act Rel. No. 34-42992 (June 30, 2000). AHERF, through certain of its senior officers, materially overstated the net income of a group of its subsidiaries and “hid its true financial condition from the public through its misleading disclosures and omissions.” AHERF, through its officers, also improperly certified the accuracy of its financial statements to its bond trustees pursuant to requirements of its bond indentures.

The remarks made by Martha Mahan Haines, the SEC's Chief of the Office of Municipal Securities and an Assistant Director in the Division of Market Regulation, to the 2003 Annual Conference of The Bond Market Association, anticipate such claims.⁵⁰ In these remarks, which were intended to address the relevance of SOA to the municipal securities market, she urged "[i]ssuers and conduit borrowers of municipal bonds, especially complex entities that frequently access the market, [to] consider formally establishing internal disclosure controls and procedures to ensure that those preparing official statements and other disclosure documents have been provided with all information necessary to make full disclosure to investors."⁵¹ She also cautioned those bond professionals in attendance to "tell the whole truth" and "[t]o be safe, when in doubt, disclose."⁵² Perhaps the most cautionary advice that she gave, however, was to remember that "[w]hen investors have been deceived, you can be sure that neither the courts nor the Commission appreciate technical excuses."⁵³

Ms. Haines' comments to the Bond Market Association highlight the fact that, while there may be only slight current market benefits to enhancing a not-for-profits' corporate governance structures, and the SOA does not contain specific mandates for not-for-profit entities, existing statutory filing requirements and contractual disclosure requirements already expose not-for-profit entities, their boards, and management to potential liability. For that reason, not-for-profit corporations engaged in the tax-exempt market should examine the changes imposed on for-profit corporations by SOA and seriously consider whether any changes in their own corporate-governance practices would be appropriate and advisable.⁵⁴

⁵⁰ Remarks of Martha Mahan Haines to The Bond Market Association 2003 Annual Conference, available at <http://www.bondmarkets.com/news/Haines2003.shtml>.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ In the event that a large bond default occurs, not-for-profit board members should be aware that they may face personal exposure for the default. While some states give not-for-profit board members full immunity, or at least heightened protection from suit, for their board participation, board members may nonetheless, depending on the applicable law, face a claim for breach of fiduciary duty by defaulted bondholders. See, e.g., N.Y. Stat. N-PCL § 720 (2004)(providing only limited immunity for not-for-profit directors); Vernon's Tex. Rev. Civ. Stat. § 1396-2.26 (2004)(permitting claims against not-for-profit board members by State Attorney General); Fla. Stat. § 617.0834 (permitting suit against for not-for-profit board members while establishing certain limiting standards). See also, *In re Boston Regional Medical Ctr.*,

IV. APPLYING SOA-COMPLIANT GOVERNANCE PRACTICES TO NOT-FOR-PROFIT CORPORATIONS

SOA addresses a wide range of practices and perceived abuses among public corporations and other participants in the equities markets. Specifically, SOA establishes new legal strictures for publicly-traded corporations and their allied professionals: accountants, securities lawyers, investment banks, and investment analysts.⁵⁵ Although the requirements and implications of SOA do not apply directly to not-for-profit corporations, familiarity with SOA's most pertinent provisions may nevertheless be beneficial for not-for-profit corporations and their allied professionals.

A. Board of Directors

The most important corporate-governance change resulting from SOA is its requirement that a publicly-traded corporation's board of directors establish an audit committee composed of independent directors. To be "independent," a board member must not, with certain exceptions, be a paid consultant or advisor to the corporation, or receive any fee as compensation for non-board work from the corporation.⁵⁶ In addition, the audit committee must, as a general rule, have at least one "financial expert," defined by SOA as a person who: (1) understands generally accepted accounting principles and financial statements; (2) has experience in the preparation of financial statements of comparable corporations; (3) has experience with internal accounting controls; and (4) understands the proper function of audit committees.⁵⁷

A primary purpose of the establishment of independent audit committees is to clarify the responsibility of the board—separately from management—to hire and

Inc., 328 F.Supp.2d 130 (D. Mass. 2004)(directors shielded by State law); *Herman v. Health Care Delivery Serv., Inc.*, 9 Andrews Pen. Fund Lit.7 (CD CA 1998)(breach-of-fiduciary duty claim pending); *S.H. and Helen R. Scheuer Family Foundation, Inc. v. 61 Associates*, 179 A.D.2d 65, 582 N.Y.S.2d 662 (N.Y. App. Div. 1992)(permitting claim); *Blocker v. Texas*, 718 S.W.2d 409 (Tex. Ct. App. 1986)(permitting suit by Attorney General).

⁵⁵ SOA has many provisions that are ancillary to the activities of for-profit corporations, including the creation of the Public Company Accounting Oversight Board, provisions regarding equities issuers and their attorneys and accountants, and regulations affected stock underwriters and analysts, etc. In addition, SOA contains many provisions that provide funding, mandates, and guidance to governmental agencies, including the SEC, the Internal Revenue Service, and the United States Sentencing Commission. Except where relevant to the concerns of not-for-profit obligors, these parts of SOA will not be discussed in this article.

⁵⁶ SOA Section 301 (amending 15 U.S.C. § 78f (Section 10A of the Securities Exchange Act of 1934)).

⁵⁷ SOA Section 407.

oversee the work of the corporation's auditors.⁵⁸ SOA requires that the audit committee receive certain reports, made mandatory by the Act, from the company's auditors regarding the company's internal financial controls.⁵⁹ The audit committee also provides an established conduit for the corporation's employees, accountants, and attorneys to alert the board of potential problems.⁶⁰

Each not-for-profit corporation's situation varies and should be evaluated individually, but not-for-profit boards may find the creation of independent audit committees to be a valuable instrument for assuring the integrity of the corporation's accounting systems and financial reports. Insistence upon the presence of at least one financial expert on the audit committee may similarly be beneficial, and the institution of a clear, independent conduit for employees, accountants, and attorneys to alert the board of any serious concern may provide greater protection for the corporation, while relieving the entire board of the obligation to examine individual complaints.

B. Management

Under SOA, CEOs and CFOs are obligated to assure the integrity of their companies' accounting procedures and financial disclosures. In particular, each CEO and CFO must certify the accuracy of the company's financial disclosures filed with the SEC and certify that the company's internal financial controls are adequate.⁶¹ The Act also requires that corporations disclose whether they have established ethics standards for the corporation's CFO and other senior financial officers.⁶² While SOA's standards for executives do not directly apply to CEOs or CFOs at tax-exempt-bond obligors,⁶³ the Act's certification requirements and standards of conduct underscore the expectation that upper management take personal responsibility for the corporation's financial disclosures and that they evaluate and assure the integrity of the company's internal financial controls. Not-for-profit corporations may want to weigh the costs and benefits of adopting a similar set of requirements and standards.

⁵⁸ SOA Section 301.

⁵⁹ SOA Section 204 (amending 15 U.S.C. § 78j-1 (Section 10A of the Securities Exchange Act of 1934)).

⁶⁰ SOA Section 307.

⁶¹ SOA Section 302.

⁶² SOA Section 203 (amending 15 U.S.C. § 78j-1 (Section 10A of the Securities Exchange Act of 1934)).

C. Accountants

A large percentage of SOA's provisions are directed at the accounting profession. The Act establishes the Public Company Accounting Oversight Board.⁶⁴ It requires that audit partners oversee the audit of a publicly-traded corporation for no more than five consecutive years,⁶⁵ and the Act requires that the company's auditors certify the adequacy of the company's internal financial controls to the board's audit committee at least annually.⁶⁶ SOA also prohibits certain conflicts of interest between accounting firms and the corporations that they audit, including a limitation on the services that an accounting firm can provide to a corporation that it audits.⁶⁷

SOA's regulation of the accounting profession has received significant vocal objection.⁶⁸ Nonetheless, not-for-profit corporations may conclude that periodic rotation of accounting partners, or even of accounting firms,⁶⁹ may reduce the possibility of auditor complacency or other problems. Likewise, certification of a company's internal financial controls by an auditor may reduce the likelihood of internal fraud by a single or small group, of employees, and attention to potential business conflicts between an accounting firm's audit unit and its other business units may increase the likelihood that any financial irregularities are discovered and reported.

It is too early to examine, much less empirically determine, whether SOA's heightened regulation of auditors will reduce or eliminate financial scandals in publicly-traded corporations; the directors or management of not-for-profit corporations, however, may deem the cost of some of these measures to be minimal, particularly in comparison to the potential exposure of the corporation to loss or liability.

D. Attorneys

SOA establishes a mandatory reporting process for instances of certain possible legal improprieties by attorneys who "practice before the Securities Exchange

⁶³ See SOA Section 302 (limiting the mandates of CEOs and CFOs to firms that are required to file registrations with the SEC pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934).

⁶⁴ SOA Title I, Section 101 et seq.

⁶⁵ SOA Section 203 (amending 15 U.S.C. § 78j-1 (Section 10A of the Securities Exchange Act of 1934)).

⁶⁶ SOA Section 204 (amending 15 U.S.C. § 78j-1 (Section 10A of the Securities Exchange Act of 1934)).

⁶⁷ SOA Section 201.

⁶⁸ See, e.g., Laura Rich, "Sarbanes-Oxley Draws Renewed Criticism," *Inc. Magazine*, January 13, 2005.

⁶⁹ Although Congress stopped short of requiring mandatory periodic rotation of audit firms, it ordered a study of the costs and benefits of such a requirement. Cf. SOA Section 207.

Commission in any way in the representation of issuers.”⁷⁰ In the event that an attorney is concerned that the financial disclosures of a publicly-traded company represented by the attorney are misleading, SOA requires that the attorney report his or her concern to the General Counsel (or other chief legal officer) of the corporation.⁷¹ In the event that the General Counsel “does not appropriately respond to the evidence [of an impropriety],” the attorney must report the concern to the audit committee, or some other board committee, that has been specifically established to receive such information.⁷²

While SOA’s specific provisions regarding attorney reporting do not apply to not-for-profit corporations, board members or executives may deem the establishment of a method for attorneys to report their concerns to those governing the organization to be in the organization’s best interest.

V. CRIMINAL-LAW PROVISIONS IN SOA

Congress limited most of the civil provisions of SOA to publicly-traded corporations. Most of the criminal law provisions of the Act, however, also apply to individuals at not-for-profit corporations. While SOA’s criminal law provisions address only the most egregious conduct, SOA’s criminal provisions underscore the seriousness of corporate responsibility for all corporations that are involved in the public markets, not just publicly-traded, for-profit corporations.

SOA’s criminal provisions affect three basic areas of federal criminal law: securities fraud, destruction of documents, and retaliation against whistleblowers. SOA creates three new criminal fraud offenses: a new securities fraud offense, attempt or conspiracy to commit criminal fraud, and the knowing failure to certify accurate financial reports for publicly-traded corporations (applicable to certain corporate officers).⁷³ SOA also dramatically increases the potential penalties for one existing securities fraud offense (15 U.S.C. § 78ff(a)), and it increases the penalties for mail fraud, wire fraud,

⁷⁰ SOA Section 307.

⁷¹ *Id.*

⁷² *Id.*

⁷³ 18 U.S.C. §§ 1348, 1349, 1350 (2004).

and certain ERISA (Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, et seq.) violations.⁷⁴

With regard to document destruction, SOA creates three new federal offenses: destruction of documents intended for use in an official proceeding, destruction of documents intended for use in a governmental investigation, and destruction of audit records by auditors.⁷⁵ Finally, SOA criminalizes “any action harmful to any person, including interference with the lawful employment or livelihood of any person” that provides truthful information “to a law enforcement officer.” Of SOA’s eleven criminal law enhancements, eight apply to actions that could be taken by individuals at not-for-profit corporations.⁷⁶

Law enforcement officers take a particularly dim view of the destruction of documents while a regulatory or criminal investigation is ongoing. Of the equities market scandals that prompted SOA, the destruction or altering of documents was at the heart of many of the government’s prosecutions. Frank Quattrone at Credit Suisse First Boston, the accounting firm Arthur Andersen (based on the actions of an in-house attorney), and Martha Stewart of Martha Stewart/Living Omnimedia, were each indicted for alleged obstruction of justice for their roles in the destruction or altering of business records after receiving notice of a government investigation. Stewart and Arthur Andersen have been convicted, and Quattrone’s first trial ended in a one-juror-holdout mistrial. Significantly, as alleged in the indictments, Quattrone and Arthur Andersen’s in-house attorney each used their firms’ “document retention” policies to actually obstruct justice. After receiving notice that government investigations were under way—even that subpoenas had been issued—Quattrone and Arthur Andersen’s in-house attorney allegedly directed that others “clean up their files” or “pay attention to the document-retention policy.” The indictments alleged that those actions had the intended and foreseeable effect that documents relevant to the government’s investigation would be destroyed. In light of SOA’s new document destruction offenses, actions similar to that

⁷⁴ 15 U.S.C. § 78ff(a) (2004); 18 U.S.C. §§ 1341, 1343 (2004); 29 U.S.C. § 1131 (2004).

⁷⁵ 18 U.S.C. §§ 1512, 1519, 1520 (2004).

⁷⁶ Specifically, making a false securities filing, mail fraud, wire fraud, attempt or conspiracy, destruction of records for official use, destruction of records for investigatory use, retaliation against informants, and intentional violation of certain ERISA provisions.

of Quattrone and Arthur Andersen now will likely result in more-certain prosecution, with a greater likelihood of conviction.

Finally, one cautionary note concerning SOA's whistleblower protection features is applicable to not-for-profit corporations. SOA's new criminal offense for taking "any action [including any adverse employment action] harmful" to a person who provides truthful information "to a law enforcement officer" encompasses a broad range of actions, but it protects only whistleblowers who report their concerns to law enforcement officers—not whistleblowers who only report their concerns to internal corporate personnel. SOA's civil provisions, however, induce publicly-traded corporations to establish internal mechanisms for in-house attorneys and accountants to raise serious concerns of impropriety "up the chain of command" and, ultimately, to the board. In this way, SOA's criminal law provisions provide greater protection to whistleblowers, at all corporations, who *first* report their concerns to law enforcement officers rather than to internal personnel. It is too early to tell how this apparent incongruity in SOA's regulatory thrust will alter whistleblower behavior, but corporate boards and officers should be particularly cautious in dealing with internal whistleblowers in light of SOA's establishment of this new "whistleblower retaliation" federal criminal offense.

VI. CONCLUSION

Aside from SOA's criminal provisions, noted above, tax-exempt-bond issuers and obligors have avoided increased governmental regulation of their activities, and bond-market participants currently are not requiring that bond issuers or obligors change their corporate-governance practices. As SOA alters the corporate-governance expectations for publicly-traded corporations, however, market incentives or civil liability concerns may induce changes in not-for-profit corporations' corporate-governance structures, or in the conduct expected of their managers, accountants, and attorneys. All individuals affiliated with tax-exempt bond issuers and obligors would be prudent to examine the changes currently taking place in publicly-traded corporations after SOA and consider whether comparable changes are advisable in their situation.

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