Reshuffle in the field of legal advice

Sebastian Korts, lawyer, tax lawyer, Master of Business Administration
Petra Korts, lawyer, tax lawyer, Master of Business Administration
www.korts.de

Hard times have begun for management boards, supervisory boards and managers of German companies which are listed on U.S. stock exchanges as well as for subsidiaries of such companies. At the end of August 2002 the U.S. Securities and Exchange Commission (SEC) decided that there were no exceptions for foreign companies from the Sarbane-Oxley Act 2002 signed by President George W. Bush. With the Sarbane-Oxley Act amongst other things new complex tasks and responsibilities of the management of companies listed on the US stock exchange have been created, which also must be observed by the German companies affected.

For instance, the issuer's CEO and CFO have to declare in writing for the annual or quarterly business reports that these report do not contain any untrue facts and that the annual accounts as well as other financial information on the whole present the company's financial and profit situation correctly. The scope of the financial information required under U.S. law exceeds by far the extent stipulated by section 264 subsection 1 HGB (Commercial Code). Such reporting must cover risks, as well, which may result from the subsidiary. A penal sanction is attached to this duty of confirmation. If the submitted declaration was incorrect and if the relevant director was aware of that, it will be punishable by fines of up to 1 million U.S. dollars or a sentence of up to 10 years' imprisonment or both. If the declaration was submitted incorrectly even on purpose, the maximum fine will be up to 5 million U.S. dollars and the possible imprisonment up to 20 years.

Closely connected to this new duty of confirmation is the likewise new obligation to establish an internal control system, which is to make sure that the essential information about the issuer and its consolidated subsidiaries will be placed at the disposal of the signing directors. The directors themselves are responsible for the establishment and efficiency of this control system and have to present and assess the efficiency of this control system in the reports to be signed.

This yields liability under civil law of the director concerned apart from the penal sanction in the case of an incorrect confirmation. The new statutory regulation provides for a kind of reversal of the burden of proof by assuming right from the start that the declaring director has committed a corresponding breach of duty by submitting the incorrect declaration. It is up to the respective director to prove his or her lack of knowledge of the incorrectness of the submitted declaration. However, since the director is responsible for the internal control system he or she will only seldom succeed in proving this. If he or she succeeds, the question of the director's liability for a breach of his or her duties within the scope of the internal check will be raised. A vicious circle, which appears hopeless to the management concerned for liability will have to be accepted when an incorrect confirmation has been submitted – knowledge or not.

Little imagination is necessary to be able to imagine how the central management of a group will involve the bodies of its subsidiary into these duties.

If the annual accounts have to be corrected considerably, both the variable remunerations and the proceeds from the sale of the issuer's shares, which CEO and CFO have received within one year after the disclosure of the statements to be corrected, will have to be paid back to the issuer in future. This also affects German directors of companies listed on U.S. stock exchanges.

Besides, management boards and members of the supervisory board are obliged to inform the SEC if they hold shares of the issuer. A change in ownership of these documents has to be announced as well. Omitted or insufficient advice may also have consequences under criminal law for the respective directors, namely fines or even imprisonment.

Special protection is granted to those employees of companies listed on U.S. stock exchanges who inform the responsible authorities of violations of the law committed by the issuer. By the possibility of an appeal they are to be protected against dismissals, suspensions or other discrimination which happen to them as a result of the reporting of violations of the law. If such employees are prevented from disclosing violations of the law, this will be punishable by a fine or up to 10 years' imprisonment.

Manipulations and destruction of business documents and fraudulent deception of auditors will be punished with considerable prison sentences of up to 25 years in future – in the case of securities fraud of even up to 25 years.

In order to ensure the management's independence direct and indirect loans of the issuer or its subsidiaries to members of the management are prohibited (with special regulations for already existing loans, for usual consumer credits or for credits of U.S. banks which are secured by the U.S. Federal Deposit Insurance Corporation).

Another reform, which has to be observed by the management of companies listed on the U.S. stock exchange or their subsidiaries, is that the auditing company of the issuer or its subsidiaries is no longer allowed to give legal advice which is not connected with the audit of the annual accounts. It is to be expected that soon also the tax consultants of the auditing company will be affected by this.
A newly to be created U.S. authority, the Public Company Accounting Oversight Board, will strictly see to it that this prohibition is observed. The companies are forced to charge external, independent advisors with the legal and possibly also the tax advice. This may result in major reshuffles within the advisory market. After a transition period, which is to make sure that current projects can be concluded, this regulation will be applicable without exception. This means that already now new projects can be carried out by external legal advisers only. It remains to be seen whether this is only playing "musical chairs" or whether independent legal advice will actually be established in the companies. In Germany legal advice will always be understood also as advice on fiscal issues. Thus it may be the case that advice given by auditing companies will soon not only have to stand up to the official audit but also to legal aspects even from the point of view of investor protection.

Given the tightening up of the U.S. legal position voices in Germany are also being raised demanding similar changes in the German capital market law. Thus the "Finanzmarktförderungsplan 2002 bis 2006" (Financial Market Promotion Plan 2002 to 2006) of the federal government announced in case of a re-election provides for personal liability of managers for incorrect ad hoc reports as well as the establishment of "accounting police".

German managers now have to cope with two problems: on the one hand they have to answer for the direct obligations of the Sarbane-Oxley Act and on the other hand, more or less as an indirect consequence of this, they have to comply with the regulations of the German laws getting more stringent. One can only hope that these two sets of rules and regulations will not cause any conflict of interests within these two range of duties.