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# Chapter 2

# The Sarbanes-Oxley Act: A Parent Corporation's Duty to Disclose Safety and Environmental Issues Related to Its Subsidiaries, and How the Internal Controls Necessary to Carry Out that Duty May Expose a Parent Corporation to Liability for the Torts of Its Subsidiaries

**Larry J. Rector**[1]
***Steptoe & Johnson PLLC***
**Clarksburg, West Virginia**

**Synopsis**



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## § 2.01. Introduction.

Signed into law in the wake of the Enron and WorldCom collapses,[2] the Sarbanes-Oxley Act (SOX)[3] has caused corporate executives and board members to reevaluate their compliance programs. With nearly the same degree of haste in which SOX was enacted, publicly held companies have rushed to the conclusion that Sarbanes-Oxley redefines the way that corporate America does business. Costs and consequences aside, SOX does little to change a publicly held company's disclosure obligations. However, from a liability standpoint, SOX could have an enormous impact on publicly held parent corporations. Because of the internal controls required under SOX, parent corporations must certify that they are exercising control over the flow of material information from their subsidiaries to them. As a result, Sarbanes-Oxley may force parent corporations into situations where they are required to control their subsidiaries in a manner that could subject them to liability for their subsidiaries' torts.

Even before SOX became law, publicly held corporations were required to provide the disclosures necessary to comply with SEC Regulation S-K and applicable accounting standards. Absent effective internal controls and thorough auditing, corporations could not have accurately assured their reporting compliance. And, therein is the catch. Prior to Sarbanes-Oxley ,

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2 On December 2, 2001, Enron, which held $63.4 billion in assets at the time, filed for what was then the largest bankruptcy in the history of the United States. On July 21, 2002, WorldCom, which held $107 billion in assets at the time, trumped Enron's monumental collapse by filing for what currently stands as the largest bankruptcy in the history of the United States.

3 President George W. Bush signed the Sarbanes-Oxley legislation on July 30, 2002, a mere five days after the Sarbanes-Oxley bill passed the Senate with a vote of 99-0 and the House of Representatives with a vote of 423-3.

corporate executives were not required to personally assure the accuracy and completeness of disclosures. As a result, WorldCom and Enron executives– none of whom were indicted under SOX–argued the defense of ignorance.[4] However, under SOX, a corporation, through its Chief Executive Officer (CEO) and Chief Financial Officer (CFO), is required to certify that it has complied with reporting requirements. In turn, a CEO and CFO of a publicly held corporation must also certify the effectiveness of its company's internal controls. As a result, the gray area of ignorance theoretically disappears, creating accountability stretching from the bottom to the top.

However, practically speaking, Sarbanes-Oxley may not have that effect. Indicted on 36 charges of fraud and conspiracy with regard to the $2.7 billion fraud at HealthSouth, Richard Scrushy, who is the founder and former CEO of HealthSouth, was the first CEO charged under Sarbanes-Oxley . Not unlike Ebbers (WorldCom), Lay (Enron), and Skilling (Enron), with the obvious exception being that Ebbers, Lay, and Skilling were not indicted under SOX, Scrushy maintained his innocence by contending that he was ignorant of the fraud that occurred at HealthSouth, asserting that other HealthSouth officers were responsible for the scandal. Acquitted after a four-month trial and three weeks of jury deliberations, Scrushy's case is proof that SOX may not be an airtight means of securing the conviction of corporate executives who preside over publicly held companies that fraudulently mislead investors. Therefore, Sarbanes-Oxley may not actually deter the next Enron, WorldCom, or HealthSouth. Instead, SOX may have an entirely different, and likely unintended, effect on corporate America. Though SOX was designed to promote corporate responsibility and restore

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4 During his closing argument in the criminal trial against Bernard Ebbers, the former CEO of WorldCom, Assistant United States Attorney William F. Johnson characterized Ebbers' defense of ignorance as an "Aw Shucks" defense. Ebbers, who was charged with one count of conspiracy, one count of securities fraud, and seven counts of false filing with the SEC, was ultimately convicted on all counts and sentenced to 25 years in prison. Similarly, a jury found Kenneth Lay, Enron's founder, guilty on one count of conspiracy, two counts of wire fraud, and three counts of securities fraud. During the same trial, Jeffrey Skilling, Enron's former CEO, was found guilty on one count of conspiracy, twelve counts of securities fraud, five counts of making false statements, and one count of insider trading. During their jury trials, both Lay and Skilling asserted an "I didn't know" defense.

investor confidence,[5] SOX may have the unforeseen potential of forcing a parent company to exercise the type of control over its subsidiaries that could result in the parent company's corporate veil being pierced.

In the context of a parent corporation's obligation to disclose safety and environmental issues experienced by its subsidiaries, SOX should not create a particularly overwhelming problem for a parent corporation that fulfilled its disclosure obligations before SOX took effect. Requisite safety and environmental disclosures have not changed since 2002; only corporate accountability has increased. To ensure corporate accountability at the highest level, SOX requires CEOs and CFOs of publicly held companies to certify the effectiveness of internal controls. For a parent corporation's internal controls to be effective, material information from the parent's subsidiaries must flow to the parent. Therefore, within the context of this topic, the CEO and CFO of a parent corporation would be responsible under SOX for certifying that material safety and environmental information regarding subsidiaries is known by the parent corporation. As a result, although a parent corporation's duty to disclose its subsidiaries' material safety and environmental information is the same now as it was prior to SOX, the internal control requirements established under SOX require a parent corporation to take an increased role in ensuring the dissemination of material information from its subsidiaries. Because of the increased role SOX requires parent corporations to undertake in ensuring that they are aware of their subsidiaries' material information, SOX could have the effect of exposing parent corporations to liability for the torts of their subsidiaries.

## § 2.02. A Parent Corporation's Duty to Disclose Safety and Environmental Issues Related to Its Subsidiaries.

### [1] — The Securities Exchange Commission and SOX.

The purpose of SOX is to promote investor confidence in the marketplace. Though Sarbanes-Oxley does not actually redefine SEC reporting

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5 Describing "[r]esponsibility to shareholders [as] the heart and soul of Sarbanes-Oxley, Representative Michael Oxley, co-sponsor of SOX, stated that SOX was created "to restore investor confidence by enhancing the reliability of financial statements."