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Supreme Court to Rule on Constitutionality of SOX's Public Company Accounting Oversight Board: Free Enterprise Fund, et al. v. PCAOB, et al.

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On May 18, 2009, the United States Supreme Court granted certiorari in *Free Enterprise Fund and Beckstead and Watts, LLP v. Public Company Accounting Oversight Board, et al.*, 537 F.3d 667 (D.C. Cir. 2008). This case seeks to resolve the constitutionality of the Public Company Accounting Oversight Board ("PCAOB") created as part of the Sarbanes-Oxley Act of 2002 ("SOX"). *Free Enterprise Fund* raises two constitutional questions: (1) whether the provisions of SOX creating PCAOB violate the Constitution's separation of powers; and (2) whether it violates the Appointments Clause.

PCAOB is a private-sector, nonprofit corporation, created to oversee the auditors of publicly traded companies. Congress created PCAOB in the wake of the accounting scandals at Enron, Worldcom, and other companies that led to passage of SOX. Under SOX, PCAOB has regulatory and enforcement authority over all accounting firms that audit publicly traded companies. The five PCAOB members are appointed by a majority vote of the five Commissioners of the U.S. Securities and Exchange Commission ("SEC").

If the Supreme Court rules in favor of the Petitioners in finding that PCAOB is unconstitutional, this could mean the end of PCAOB (and possibly SOX since there is no severability provision in SOX). Such a ruling

would signal a victory for those who believe that, in enacting the PCAOB provisions of SOX, Congress overstepped its authority by purportedly removing the President's power and authority over PCAOB. Alternatively, if the Respondents prevail and the Supreme Court finds no constitutional infirmities, PCAOB and SOX will be left intact. Either way, the ruling could have a significant impact on both administrative and securities law.

Background of *Free Enterprise Fund*

In *Free Enterprise Fund*, the plaintiffs, a nonprofit public interest organization (Free Enterprise Fund) and a Nevada accounting firm (Beckstead and Watts, LLP), brought a lawsuit against PCAOB seeking declaratory and injunctive relief. The suit raised two questions regarding the constitutionality of PCAOB. First, the plaintiffs challenged PCAOB as a violation of the separation of powers doctrine. Second, the plaintiffs contended that Congress violated the Appointments Clause through SOX by vesting the power to appoint members of PCAOB in the SEC. The United States intervened to support the constitutionality of SOX. The district court denied PCAOB's motion to dismiss the complaint for lack of jurisdiction (on the basis that the plaintiffs did not pursue administrative remedies before filing its complaint), but granted both the

United States' and PCAOB's motions for summary judgment finding that the PCAOB was constitutional.

Plaintiffs appealed, and the D.C. Circuit upheld the constitutionality of PCAOB. In determining whether the PCAOB members were principal or inferior officers under the Appointments Clause, the D.C. Circuit concluded that, because the PCAOB's members' exercise of its powers under SOX are subject to "comprehensive control by the Commission" and that the members are both accountable to and removable by the SEC, the members are inferior officers not required to be appointed by the President. The D.C. Circuit also determined that the SEC is "Cabinet-like" because it has executive authority over government policy, and because the Commissioners as a group exercise the same authority vested in a single head of a department.

In response to the plaintiffs' separation of powers argument, the D.C. Circuit reasoned that, because independent agencies are constitutional and the SEC has comprehensive control over the Board, the statutory scheme does not restrict the President's power over the Board. In finding that the President is not stripped of his ability to remove Board members, the court noted that "[l]ike-minded Commissioners can be appointed by the President and they can be removed by the President for cause, and Board members can be appointed and removed for cause by the Commissioners." Accordingly, because the President has "broad-ranging authority" under the Act, the D.C. Circuit rejected plaintiffs' arguments.

Judge Kavanaugh, however, dissented. He found that PCAOB's structure violates both the Appointments Clause and the separation of powers doctrine, and characterized this case as "the most important separation-of-powers case regarding the President's appointment and removal powers to reach the courts in the last 20 years." He concluded that the PCAOB members are not inferior members because they

are not directed and supervised by the SEC. Kavanaugh discussed at length the history of the Appointments Clause and Supreme Court precedent regarding the President's removal power.

Following the D.C. Circuit's ruling, plaintiffs petitioned for writ of certiorari to the Supreme Court, and certiorari was granted on May 18, 2009.

The Issues on Appeal

The key issues for the Supreme Court to decide are (1) whether SOX violates the separation of powers doctrine by the manner in which members of PCAOB are selected and removed, and (2) whether SOX violates the Appointments Clause. Both sides have acknowledged that this is a case of first impression.

Petitioners frame the question for the Court as "whether a statute vesting an independent agency with power to review or supplant another agency's work product satisfies the Constitution's requirements for Presidential appointment and removal of executive officers." Attacking the statute, Petitioners argue that Congress deprived the President of any ability to influence, control, or supervise PCAOB through the SEC.

Assuming the PCAOB members are inferior officers, under the Constitution's Appointments Clause, Congress can vest the appointment of inferior officers in the President, the Courts of Law, or in the Heads of Departments. Although inferior officers can be selected by "Heads of Departments," the question is whether the SEC, an independent agency, is considered a "Department" under the Appointments Clause. The Supreme Court has not addressed whether a multi-member entity can constitutionally appoint officers of the United States. Specifically, the Court must address whether the five SEC Commissioners collectively qualify as the "Head" of the SEC and whether the SEC qualifies as a "Department" under the Appointments Clause.

Petitioners alternately contend that members of

PCAOB are principal officers under the Constitution who must be appointed by the President with the advice and consent of the Senate. Petitioners note that “the heads of every other independent agency exercising the executive function are appointed and removed by the President.” Petitioners further contend that the President currently has no authority to appoint or remove any of the members of PCAOB. Because of this lack of presidential supervisory power or authority over the PCAOB, the petitioners claim a violation of the separation of powers doctrine and the Appointments Clause.

Respondents, supported by the United States, argue that the Court lacks jurisdiction to hear this case because the petitioners did not seek review under the SEC’s statutory review scheme. In addition, Respondents argue that the Board members are inferior officers and that the SEC’s control over the Board precludes a separation of powers violation. Respondents assert that Congress borrowed from its experience with self-regulatory organizations in enacting SOX. Respondents contend that the PCAOB members are inferior officers under *Edmond v. United*

States, 520 U.S. 651 (1977), which held that inferior officers are those whose work is directed and supervised at some level by others who were appointed by the President. Respondents argue that, since the Board members are inferior officers under *Edmond*, there is no violation of the Appointments Clause.

Respondents oppose the petitioners’ separation of powers argument on the basis of the SEC’s “pervasive oversight and control” of PCAOB. Addressing the President’s power, Respondents reiterate the D.C. Circuit’s holding that SOX “preserves the President’s ability to ensure faithful execution of the laws because the SEC has pervasive control over the Board and the President has sufficient control over the SEC.” Thus, Respondents maintain that SOX does not, in any way, diminish presidential power.

Conclusion

Paul Hastings will closely follow this case. Oral arguments are scheduled for this fall in the 2009 Term. Paul Hastings will provide an update with analysis of the Supreme Court’s ruling once a decision is reached.



If you have any questions concerning these developing issues, please do not hesitate to contact the authors as follows below.

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