Taxpayers as Investors: The Case for Applying Sarbanes-Oxley to Public Development Authorities

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I. INTRODUCTION ........................................................................................................ 857

II. BACKGROUND ......................................................................................................... 858
   A. River Park Square, the Spokane Downtown Foundation, and the City of Spokane ........................................................................................................ 858
   B. Public Development Authorities ........................................................................ 859
      1. Public Purpose .............................................................................................. 861
      2. The Benefits of Municipal Bonds ................................................................... 862
   C. The Sarbanes-Oxley Act of 2002 ....................................................................... 862
      1. Auditing ......................................................................................................... 864
      2. Corporate Responsibility ............................................................................... 864
      3. Enhanced Disclosures ................................................................................... 865

III. DISCUSSION AND ANALYSIS .................................................................................... 866
   A. SOX Best Practices ............................................................................................. 866
   B. PDAs, Nonprofits, and SOX ................................................................................ 867
   C. Taxpayer and Investor Protection ...................................................................... 869

IV. RECOMMENDATION ................................................................................................. 870
   A. SOX Best Practices Will Increase PDA Accountability ...................................... 871
   B. SOX Best Practices Will Increase Individual and Institutional Investor Confidence ........................................................................................................ 872
   C. SOX Best Practices Will Increase Confidence in PDAs ..................................... 872

V. CONCLUSION ........................................................................................................... 873

   I. INTRODUCTION

   Recent cases of investor fraud at publicly traded companies caused Congress to pass the American Competitiveness and Corporate Accountability Act of 2002, also known as Sarbanes-Oxley (SOX). While SOX technically only applies to publicly traded companies who are registered with the Securities and Exchange Commission (SEC) pursuant to the Securities Exchange Act of 1934,1 it has valid application in other corporate sectors. Given the recent financial and accounting scandals at Public Development Authorities (PDAs) in the state of Washington,2 this Note examines...

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2. See infra Part II.A (discussing Spokane’s parking PDA). For another example of a recent PDA scandal, see WASHINGTON STATE AUDITOR’S OFFICE, ACCOUNTABILITY AUDIT REPORT, GRAYS HARBOR
whether the application of the “best practices” provisions of SOX should be applied to PDAs. Part II sets forth the background related to Spokane’s River Park Square parking garage, the role of PDAs in Washington, the relevant provisions of SOX, as well as the results those provisions are designed to accomplish. Part III analyzes the relevance of SOX best practices for PDAs and also discusses the potential burdens that these organizations may face in complying with SOX. Part IV presents three reasons for applying SOX best practices to PDAs: increased PDA accountability, increased investor confidence, and increased municipal confidence. Given the tremendous impact financial mismanagement and fraud at PDAs can have on both investors and the general taxpaying public, it is clear that in order to fully accomplish SOX’s purpose of investor protection, state and local governments should extend the legislation’s provisions to these public corporate entities.

II. BACKGROUND

A. River Park Square, the Spokane Downtown Foundation, and the City of Spokane

In 1995, developers in Spokane, Washington, had a vision to expand the existing River Park Square Mall and renovate its parking garage, which are located in the city’s urban core. Because the developers, Lincoln Investment Co. and Citizens Realty, did not have the $80 million required for the project, they approached officials from the City of Spokane to discuss a potential public-private partnership. The Washington State Constitution severely limits the ability of state governments to lend or gift public funds; thus, the city could not back a loan for the developers, despite the potential public benefits in the form of increased property values and tax revenues that might accrue to Spokane and its citizens from a revitalized downtown. Thus, the city and the developers devised a complex plan that would essentially allow the city to finance a portion of the developer’s costs by chartering a special municipal corporation, known as a PDA. The nonprofit Spokane Downtown Foundation, in tandem with the PDA, would then issue municipal revenue bonds to purchase the renovated parking garage adjacent to the mall, which the PDA would operate. The bonds, like all municipal revenue bonds, would be repaid by project operating revenues. The city attempted to protect its operating revenues by chartering the PDA instead of undertaking the project on its own. However,
the city did agree to back the project by pledging revenues from its parking meter fund “for the sole purposes of supporting the Authority’s activities including paying operating and maintenance expenses and ground rent payments in connection with the [parking] Facility” in the event of a shortfall.9 This was held to encompass the payment of debt service.10

Due to various contingencies, including accusations of fraud and changes in the value of the garage, revenue estimates never reached projected levels and the PDA was unable to service the bond debt or cover its operating expenses.11 After a great deal of litigation, and a substantial lowering of the city’s credit rating,12 the City of Spokane was ordered to comply with its pledge to help repay the PDA’s bonds with its own parking meter funds.13 To understand why the city established a PDA to operate the parking garage, it is necessary to understand what PDAs are, what purposes they serve, and what benefits they enjoy.

B. Public Development Authorities

PDAs are “special purpose quasi-municipal corporations”14 intended “to improve the administration of authorized federal grants . . . to improve governmental efficiency . . . or to improve the general living conditions in the urban areas of the state.”15 Under the Revised Code of Washington (RCW), PDAs are subordinate municipal corporations that may perform “any lawful public purpose or public function.”16 They are “subject to general laws regulating local governments,”17 such as the Open Public Meetings Act18 and competitive bidding requirements for public works projects.19 PDAs are public corporations created by Washington state law. Many states provide for similar public


9. Eugster v. City of Spokane, 76 P.3d 741, 747 (Wash. Ct. App. 2003) (quoting the authorizing resolution passed by the Spokane city council on November 25, 1996); see also Camden, City, Cowles Affiliates Team Up, supra note 4 (discussing basic background facts of the deal).
10. See Eugster, 76 P.3d at 757 (determining that “in context with the entire ordinance” the ordinance “does not preclude giving priority to debt service of the bonds”).
11. See id. at 750.
12. Oliver Staley, Spokane’s Bond Ratings Downgraded After Veto, THE SPOKESMAN-REVIEW (Spokane), Aug. 8, 2001 (discussing Moody’s downgrade of Spokane’s unlimited general obligation bonds from A1 to A2 as a result of the mayor’s decision to veto legislation to loan money from the city to the PDA per their interlocal agreement).
13. See Eugster, 76 P.3d at 746 (holding that writ of mandamus ordering the city to loan its parking meter funds for payment of debt service and operating costs of the garage was properly issued). Although the city was only ordered to “loan” funds to the PDA, the revenue situation at the garage provided little expectation of repayment. As discussed above, however, the Washington Constitution prohibits gifting public funds for such purposes, so terming the deal a loan was necessary.
16. Id. § 35.21.730(5).
17. Id. § 35.21.759.
18. WASH. REV. CODE § 42.30 (2003).
19. Id. §§ 39.04.010, 36.32.235–270.
corporate entities. PDAs are quasi-public corporations often chartered to manage economic development projects or public properties that are within the authority of the local government to control. Local governments have chartered PDAs to accomplish some of the “biggest and boldest” regional projects in Washington with increasing regularity over the last few decades. PDAs and similar municipal corporate entities have also been used to resolve fiscal difficulties in urban areas in need of redevelopment. Because PDAs undertake activities with independent revenue sources, such as donations and municipal revenue bonds, they provide urban governments with more flexibility in accomplishing needed economic development. As independent organizations, however, PDAs lack certain governmental powers like eminent domain.

While PDAs have their own boards of directors and operate independently from the local government authority responsible for their creation, they are generally subject to financial (and other) oversight by that local government. Despite the fact that PDAs are often chartered to accomplish a governmental purpose like public development, their formation cannot involve a direct loan or gift of public funds. However, section 35.21.730(1) of the RCW, the state law under which all Washington PDAs are chartered, does allow for the transfer of property or funds to a PDA with certain conditions.

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20. See, e.g., N.Y. GEN. CONSTR. LAW § 66(4) (McKinney 2003) (defining public benefit corporations as public corporations “organized to construct or operate [a] public improvement . . . [the] profits from which inure to [the] benefit of this or other states, or to [the] people thereof”); IOWA CODE § 419.2 (2003) (granting municipalities the authority to lease municipal land, buildings, or improvements to various third parties, such as nonprofit hospitals, research and development facilities, or sports facilities).


24. Reich et al., supra note 21; see also Out of Control, supra note 22.


26. Crenshaw-Lewis et al., supra note 25, at 5-6. Further, because PDAs are required to perform a “public purpose,” authorizing governments are often involved in any changes of organization mission or scope and may have the power to appoint one or more board members, depending on the provisions of any interlocal agreement between the PDA and the creating governmental authority. Id. at 13. See also WASH. REV. CODE § 35.21.745 (2002) (requiring that chartering governments “control and oversee [the PDA’s] operation and funds in order to . . . assure that the purposes of each program undertaken are reasonably accomplished”).

27. Nick Beermann, Legal Mechanisms of Public-Private Partnerships: Promoting Economic Development or Benefiting Corporate Welfare?, 23 SEATTLE U. L. REV. 175, 200 (1999) (discussing various mechanisms, including PDAs, used to finance public development and asserting that the public benefit of such projects are very often negligible when compared with the private gains).

28. Id; see also WASH. CONST. art. VIII, §§ 5, 7.

1. Public Purpose

PDAs are required to perform a “lawful public purpose or public function.” Any property transferred to a PDA from the municipal entity must contain a deed covenant that the property be used for a public purpose. Ostensibly, should the PDA change its mission to a nonpublic purpose, the property would revert back to the local government. In the case of the River Park Square parking garage, the public purpose of the Spokane parking PDA was to “create jobs, stimulate the economy, provide cultural opportunities, increase tax revenue, thwart the economic decline of the downtown area, and improve the quality of life.” In addition to the Spokane parking garage, other examples of Washington PDAs include Seattle’s Pacific Hospital Preservation and Development Authority, Skagit County’s Skagit Emergency Medical Service Commission, and Grays Harbor Public Development Authority, which oversees the redevelopment of a former (never-commissioned) nuclear plant site. Although hospital charity care, rural emergency medical services, and economic development have a more traditional public purpose than the operation of a parking garage adjacent to a shopping mall, Washington courts defer to the judgment of the legislature—in this case, the local government authority that establishes the PDA—when “it is debatable as to whether or not an expenditure is for a public purpose.” Thus, once a city or county council creates a PDA in good faith, the courts will assume that the organization has a public purpose sufficient to meet the requirements of section 35.21.730 of the RCW. Further, “[t]he fact that private ends are incidentally advanced is immaterial to determining whether legislation furthers a public purpose.” Lastly, one commentator has argued, “the channeling of funds through a public entity [such as a municipal corporation] yields a strong inference of public purpose which successfully avoids constitutional scrutiny by the court.” By having the Spokane parking PDA lease and operate the garage, the City of Spokane avoided Washington’s constitutional prohibitions on the gifting of public funds, and the garage was presumed to serve a public purpose.

30. Id. § 35.21.730(5).
31. Id. § 35.21.747(1).
34. CLEAN, 947 P.2d at 1175 (quoting Anderson v. O’Brien, 524 P.2d 390, 394 (Wash. 1974)).
35. The same cannot be said, however, of the Internal Revenue Service (IRS) when it determines the tax-exempt status of PDA-affiliated bonds. Although the Spokane Downtown Foundation bonds were originally tax-exempt, the IRS later reversed that determination because the city’s eventual ownership of the garage (once the debt was retired), would not be free from private encumbrances (the city would still have to pay “ground rent” to the developer on the land) and was “not enough to make the garage a public project eligible for tax-free status under federal law.” Jim Camden, IRS Says Garage Bonds Not Tax-exempt, THE SPOKESMAN-REVIEW (Spokane), Sept. 15, 2001, available at http://www.spokesmanreview.com/breaking-news-story.asp?submitdate=2004326111613.
36. CLEAN, 947 P.2d at 1175.
37. See Beermann, supra note 27, at 195.
38. See id.
2. The Benefits of Municipal Bonds

One of the benefits of being a PDA is the ability to issue tax-exempt municipal revenue bonds to finance capital projects. Unlike general obligation municipal bonds supported by ad valorem property taxes, which can be issued by governments that have taxing authority, PDAs can issue municipal revenue bonds for specific projects. The debt service on these bonds is paid by project revenues. Although revenue bonds generally involve more risk than general obligation bonds, both investments are typically seen as a more stable alternative to the stock market and other riskier investment opportunities.

Because tax-exempt bonds are “the last genuine tax shelter available to the individual investor,” they are primarily bought by individuals because they stand to benefit from the tax exemption on interest payments. Thus, like illegal or quasi-legal financial practices among publicly traded companies that lead to stock devaluation, defaults in the municipal bond market caused by fraud or other corporate malfeasance can have a tremendous impact on the general public. While rating agencies, such as Moody’s Investors Service and Standard & Poor’s, Inc., grade the creditworthiness of bond issuers in an effort to aid investors, these agencies rely on accurate financial (cash flow and liquidity) information from issuers to provide the public with an informative credit rating. It is just this sort of information related to publicly traded companies that SOX was intended to regulate. For various reasons, however, SOX does not apply to the nonprofit sector or municipal corporations, despite the potential benefits.

C. The Sarbanes-Oxley Act of 2002

On July 30, 2002, Congress signed into law the American Competitiveness and Corporate Accountability Act of 2002, also known as Sarbanes-Oxley, in honor of its two principal sponsors. Congress rapidly passed SOX in the wake of major corporate accounting scandals at Enron, WorldCom, and Tyco, among others. The stated purpose of the Act is “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . .” as well as “to protect the interests of investors and further the public interest in the preparation of informative, accurate, and

39. Municipal bonds, which are assumed to serve a public purpose, are exempt from all federal taxes and some, but not all, state and local taxes. See GARY M. STRUMEYER, KEYS TO INVESTING IN MUNICIPAL BONDS 12 (1996); ANNETTE THAU, THE BOND BOOK: EVERYTHING YOU NEED TO KNOW ABOUT TREASURIES, MUNICIPALS, GNMS, CORPORATES, ZEROS, FUNDS, & MORE 99-100 (1992).
40. See Crenshaw-Lewis et al., supra note 25, at 5; THAU, supra note 39, at 100.
41. See Crenshaw-Lewis et al., supra note 25, at 5.
42. See THAU, supra note 39, at 100.
43. Id.
44. When bonds are exempt from state and local taxes, the benefit is double. Id.
45. See STRUMEREY, supra note 39, at 139.
46. Id. at 141.
47. See SOX, supra note 1.
49. SOX, supra note 1 (preamble).
Applying SOX to PDAs

independent audit reports for companies the securities of which are sold to, and held by
and for, public investors.” The Act makes substantial changes in U.S. securities laws,
namely by establishing or expanding requirements for auditor independence, corporate
responsibility, and financial disclosures of publicly traded American companies.
Other provisions of the Act establish penalties for altering or destroying documents
and create the Public Company Accounting Oversight Board (PCAOB), which sets
standards for “auditing, quality control, ethics, independence, and other standards related
to preparation of audit reports.”

Because SOX is designed to protect investors—both individual and institutional—from the consequences of corporate fraud and questionable accounting practices, its
purpose is as relevant to bond-issuing PDAs as to publicly traded companies. However,
SOX does not apply to nonprofit, municipal, or private corporations (collectively referred
to as the unregulated sectors), with minor exceptions.

The potential for investor and donor fraud in these corporate sectors has caused
some commentators and many governance associations to call for the unregulated sectors
to adopt various provisions of SOX on a voluntary, “best practices” basis. In fact, some
state officials, such as New York Attorney General Eliot Spitzer, have suggested that
state legislatures should pass bills requiring nonprofits to comply with various aspects of
SOX. Although there are valid reasons why SOX targets public companies and not the

50. Id. § 101(a).
51. Id. §§ 201-209.
52. Id. §§ 301-308.
53. Id. §§ 401-409.
54. SOX, supra note 1, §§ 801-807.
55. Id. §§ 101-109.
56. Id. § 101(c)(2).
57. Two aspects of SOX apply to all corporations no matter whether they are nonprofit, for-profit, public,
or private. One of these provisions makes it a crime to intentionally destroy documents involved in a federal
investigation. See id. § 802(a). The other provision creates penalties for retaliation against corporate fraud
whistleblowers. See id. § 1107; see also Boardsource, The Sarbanes-Oxley Act and Implications for Nonprofit
2006) (describing provisions of SOX that currently apply to nonprofits).
58. For the unregulated sectors, the importation of SOX corporate governance, disclosure, and auditing
provisions, although not mandated, represent what is expected of publicly traded companies. The legislation
was passed because of a perceived need for changes in these practices and the resulting regulations represent
“best” corporate practices. See, e.g., Justin G. Klimko, The Sarbanes-Oxley Act: Possible Impacts on Privately
Held Companies, Mich. B.J., May 2004, at 36 (discussing impacts of SOX on private companies); Joseph
Kubarek, Sarbanes-Oxley Raises the Bar for Private Companies, NACD DIRS. MONTHLY, June 2004, at 19
(discussing the likelihood that SOX reforms will affect private companies and encouraging them to create a
code of ethics, and “move toward” compliance with conflict of interest and audit committee provisions);
Szymanski, supra note 48, at 1305 (asserting that nonprofit board members who are also executives at
companies subject to SOX “will import some of [SOX’s] demands into the nonprofits on whose boards they sit,
either through direct action or merely through heightened expectations of governance standards”); Boardsource,
supra note 57 (discussing recommended changes that could be made at nonprofits in anticipation of future
SOX-style mandates); John W. Titus, Sarbanes-Oxley: What It Means for Private Companies (June 2, 2003),
available at http://www.bccb.com/Publications/detail.aspx?id=336e9af7-6d83-48ce-a8f9-b84d548a037f
(outlining the types of private companies that may face increased corporate governance standards and why).
59. See Press Release, Office of New York State Attorney General Eliot Spitzer, Attorney General
Spitzer’s Proposed Reforms to State Corporate Accountability Laws (Mar. 12, 2003), available at
http://www.oag.state.ny.us/press/2003/mar/mar12a_03.html (discussing Spitzer’s proposed reforms to New
unregulated sector, there is growing recognition that SOX does have a place in the governance of all corporate entities.\textsuperscript{60} The relevant aspects of SOX for nonprofit and public corporations generally fall under Titles II (Auditor Independence), III (Corporate Responsibility), and IV (Enhanced Financial Disclosures) of the Act.\textsuperscript{61} The drawbacks and benefits of applying these aspects of SOX to nonprofits generally, and PDAs in particular, are discussed in Part III.

1. Auditing

Due to the pervasive auditing abuses in the practices of companies like Enron and WorldCom, as well as the related scandals that plagued the once-prominent auditing firm of Arthur Andersen, much of SOX is designed to regulate the conduct of auditors and audits generally.\textsuperscript{62} The Act establishes the PCAOB, which both registers public accounting firms involved in audit preparation and sets ethical and other standards for their preparation.\textsuperscript{63} Furthermore, the Act prohibits companies from retaining the same firm to perform auditing services and other consulting services, such as bookkeeping, human resources, or organizational development\textsuperscript{64} without preapproval from the PCAOB.\textsuperscript{65}

In an effort to ensure board engagement with financial matters, particularly annual audits, SOX requires that public companies establish audit committees, which report to the boards of directors. These committees are “directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that [company] . . . for the purpose of preparing or issuing an audit report.”\textsuperscript{66} Members of the audit committee, aside from having positions on the company’s board of directors, are required to be “otherwise . . . independent”\textsuperscript{67} of the company. The Act provides little in the way of definition for what it means to be “otherwise independent,” except to state that such person may not (1) be a compensated consultant or advisor to the company, or (2) “be an affiliated person” of the company or its subsidiaries.\textsuperscript{68} SOX is silent on what it means to “be an affiliated person.”

2. Corporate Responsibility

Another substantial focus of SOX is corporate responsibility. As such, the Act requires that both Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) (“or persons performing similar functions”) review and sign quarterly and annual reports filed pursuant to the Securities Exchange Act of 1934.\textsuperscript{69} More significantly, the signing

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York’s corporate accountability laws, including a proposal to apply various provisions of SOX to nonprofits).

\textsuperscript{60} See id.

\textsuperscript{61} See, e.g., Szymanski, supra note 48, at 1312 (asserting that the SOX reforms “most likely to migrate into the nonprofit area” are those related to disclosures, corporate governance, and auditing).

\textsuperscript{62} Id. at 1314.

\textsuperscript{63} SOX, supra note 1, § 101(c).

\textsuperscript{64} Id. § 201(a).

\textsuperscript{65} Id.

\textsuperscript{66} Id. § 301.

\textsuperscript{67} Id.

\textsuperscript{68} SOX, supra note 1, § 301.

\textsuperscript{69} Id. § 302(a).
Applying SOX to PDAs

2005

officers must certify that the reports do not misstate or fail to state material facts,\(^\text{70}\) and based on their knowledge, “fairly present in all material respects the financial condition and results of operations of the [company] as of, and for, the periods presented in the report.”\(^\text{71}\)

Lastly, SOX holds the signing officers responsible for the development and maintenance of internal controls that ensure that the officers are made aware of pertinent information relating to the company’s affairs.\(^\text{72}\) Because they are required to evaluate the effectiveness of the internal controls,\(^\text{73}\) the signing officers are also required to alert the audit committee and the company’s auditors to problems of design or operation of the controls that may impact the audit.\(^\text{74}\) If changes are made to improve internal controls, those changes and corrective actions must be indicated in the report.\(^\text{75}\)

Other corporate governance provisions prohibit officers, directors, or anyone working at their direction from taking action to “fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.”\(^\text{76}\) Misconduct in the form of “material noncompliance” that results in a restatement of a company’s financial report requires that the CEO and CFO reimburse the company for any bonuses and stock profits realized during the period covered by the report.\(^\text{77}\) SOX also prohibits companies from extending personal loans to executives and directors, unless such loan is “of a type that is generally made available by such issuer to the public.”\(^\text{78}\)

3. Enhanced Disclosures

Finally, SOX requires significantly enhanced disclosures of both financial and corporate governance information. Section 401(a) directs the SEC to develop final rules requiring disclosure of off-balance sheet transactions expected to have “a material current or future” impact on the company’s financial condition in annual reports.\(^\text{79}\) This provision is intended to improve the accuracy of the reports by requiring disclosure of transactions that, prior to SOX’s enactment, had been used to conceal large corporate losses by keeping debt off the balance sheet.\(^\text{80}\)

Two other disclosure provisions contained in SOX are ultimately designed to enhance corporate accountability.\(^\text{81}\) The Act requires that companies disclose whether at least one member of the audit committee is a “financial expert,” defined as someone who possesses “an understanding of generally accepted accounting principles and financial

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\(^{70}\) Id. § 302(a)(2).

\(^{71}\) Id. § 302(a)(3).

\(^{72}\) Id. § 302(a)(4).

\(^{73}\) SOX, supra note 1, § 302(a)(4)(c).

\(^{74}\) Id. § 302(a)(5).

\(^{75}\) Id. § 302(a)(6).

\(^{76}\) Id. § 303(a).

\(^{77}\) Id. § 304(a).

\(^{78}\) SOX, supra note 1, § 402(a)(2).

\(^{79}\) Id. § 401(a); see also 17 C.F.R. § 229.303(a)(4) (2003) (relating to off-balance sheet transactions).

\(^{80}\) See BLOOMENTHAL, supra note 48, at 2-5.

\(^{81}\) Id. at 132-37.
statements,” as well as experience with preparing or auditing financial statements and internal auditing controls. If the audit committee lacks such an expert, the company is required to explain the reasons why it believes such expertise is unnecessary on the committee. Similarly, the Act directs the SEC to issue rules requiring companies to disclose whether or not their “senior financial officers” are bound by an adopted code of ethics. Such a code of ethics is meant to ensure compliance with applicable laws, acceptable treatment of conflicts of interest—actual or perceived—and accurate disclosures in required financial reports. As with audit committee member financial expertise, the lack of a code of ethics must be explained in the company’s required reports.

III. DISCUSSION AND ANALYSIS

Having explored the relevant background information, this Note now turns to a discussion of how and why certain provisions of SOX are applicable to PDAs and, by extension, similarly situated public corporations. Although the wholesale importation of SOX to the unregulated sectors is not without its pitfalls, as a piece of watershed legislation designed to increase corporate transparency and investor confidence, many governance associations and practitioners recognize that SOX is likely to be relevant to their organizations—either via mandate or voluntary best practices. In order to ensure that PDAs adhere to SOX in the best possible manner, an understanding of the burdens imposed and benefits realized in its application is essential.

A. SOX Best Practices

The following provisions of SOX can be seen as recommendations for best practices in all corporate bodies—public and private, regulated and unregulated—to the extent that such provisions are relevant to the entity: (1) audit committees that include a member with expertise in internal controls; (2) certification of financial reports as to accuracy by officers such as the CEO and CFO; (3) an adopted code of ethics; and (4) whistleblower protections for employees who report potential violations. For example, although the boards of directors of nonprofits and municipal corporations may not have a

82. SOX, supra note 1, § 407 (a)-(b).
83. Id.
84. Id. § 406(a). “Senior financial officers” are defined as the CFO, comptroller, principal accounting officer, or “persons performing similar functions.” Id.
85. Id. The rules as adopted require the code of ethics to be filed as an exhibit to the annual report, posted on the company’s website, or provided free of charge to anyone requesting a copy. BLOOMENTHAL, supra note 48, at 135-36 (citing 17 C.F.R. § 229.406(c)(2)-(3) (2004)).
86. See Szymanski, supra note 48, at 1315-20 (outlining four areas of concern in applying SOX to nonprofits).
87. See supra note 58 and sources cited therein.
88. See Szymanski, supra note 48, at 1305 (suggesting that SOX will put “pressure on nonprofit institutions to borrow some of the principles of good governance espoused by the Act”).
89. SOX, supra note 1, § 407.
90. Id. § 1350.
91. Id. § 406.
92. Id. § 1514A.
stand-alone audit committee, the weight that SOX places on the duties of such a committee in publicly traded companies emphasizes the benefits that Congress believes such a committee confers on the organization. Furthermore, although non-regulated entities are not required by the SEC to submit financial statements, SOX sends a clear message that executive directors and financial officers of all organizations should undertake to ensure the accuracy of financial reports. As such, it is worth examining the burdens and benefits that either voluntarily committing to such best practices or legislatively mandating the application of SOX to these unregulated corporate entities will have on their operations.

B. PDAs, Nonprofits, and SOX

Because PDAs operate more like nonprofits than publicly traded companies, an analysis that draws on the application of SOX to nonprofits is more informative than those that deal with regulated corporations. Wendy Szymanski cites three problems with applying SOX to nonprofits: (1) the legislation was not designed for nonprofits; (2) it will create difficulties in recruiting competent board members; and (3) nonprofits are not suited to bear the costs associated with SOX. Likewise, these three issues prove problematic to differing degrees in applying SOX to PDAs.

If SOX was not designed with nonprofits in mind, it certainly was not designed with less well-known public corporations such as PDAs in mind. It is also true that PDAs, unlike public companies, do not have an incentive to “record ever higher returns,” as with nonprofits. Because PDAs frequently rely on city or county funds or property to accomplish their mission, they face greater political pressure to stay solvent than many nonprofits. Local officials, who sit on the organization’s governing board and who are often responsible for appointing members of that board, have an incentive to maintain the organization’s financial appearances, lest they be blamed for the PDA’s mismanagement and lose their jobs. This political pressure to stay solvent is not as keenly felt in the nonprofit sector. Thus, there is marginally less incentive in that arena to misstate the organization’s financial picture. Because local officials may be slightly more interested in rosy but inaccurate financial scenarios in relation to PDAs, the emphasis that SOX would place on accountability and truthful disclosure is of greater relevance for PDAs, despite the fact that Congress was not directly targeting them when passing SOX.

With increased regulation comes increased responsibility for the organization. The more rules with which there are to comply, particularly if there are significant penalties for non-compliance, the greater the burden to the individuals responsible for ensuring such compliance, i.e., the board members. At present, there are few laws mandating corporate accountability in the nonprofit sector, despite the complexity of the demands facing nonprofit boards. Szymanski cites greater board member exposure to liability

93. Like nonprofits, PDAs are prohibited from private inurement in that they must provide a “public purpose.” See supra Part II.B.
94. Szymanski, supra note 48.
95. Id. at 1316-20.
96. Id. at 1316.
regarding financial matters as increasing the difficulty nonprofits face in recruiting board members. Because nonprofit board members are not compensated for their services, their willingness to assume personal financial liability for these organizations is likely to decrease. While this is certainly a relevant concern for uncompensated PDA boards, one factor potentially reduces this risk for PDAs. That is, as corporations with the backing and direct involvement of local governmental officials and a mission to accomplish a legitimate public purpose, PDAs may have an easier time attracting board members than small nonprofits. The potential for community and political prominence-by-association that serving on a PDA board offers may offset the accompanying drawbacks associated with exposure to personal liability. Given the magnitude of the potential liability, the complexity of the job performed by PDA board members, and the lack of compensation for their services, applying SOX standards to PDAs may certainly inhibit recruitment of competent members. Prior to imposing SOX-like provisions on public corporations, officials will want to pay attention to the experience of small companies and nonprofits in any early adopting states.

Lastly, Szymanski argues that, unlike public companies, applying SOX to nonprofits with revenues in excess of $250,000 (as proposed by Spitzer) will impose too great a cost burden on smaller nonprofits. Although definitive information is presently unavailable, given the value of the properties that PDAs manage, such as large urban convention centers, historic tourist attractions, ski areas, large public housing projects, and hospitals, it is likely that many of their operating revenues are higher than the proposed $250,000 threshold. Like nonprofits, the increased costs of complying with SOX will be passed on to customers—in this case taxpayers—in the form of reduced services. However, due to governmental backing of PDAs, both direct and indirect, increased costs to operate these organizations will also impact taxpayers more generally through increases in taxes and fees. While the costs to any one individual are likely to be small, legislators will want to be aware of the potential to marginally increase the overall municipal tax burden by imposing SOX-like provisions on PDAs. Given the magnitude of PDA revenues, the organizational costs of compliance are likely to be

98. See Szymanski, supra note 48, at 1316 (citing Peter Swords, An Examination of Nonprofit Board Members’ Exposures to Liability, C479 A.L.I.–A.B.A. 165 (1990)).
99. Id.
100. See Goldschmid, supra note 97, at 632 (asserting that “the roles of directors of nonprofit institutions are more demanding and complex than those of their for-profit peers” despite the fact that they “provide less oversight, less effective participation in decision-making, and in general, less effective governance”).
101. New York, for example, could be an early adopting state if Attorney General Spitzer’s proposed reforms go forward. See Press Release, Office of New York State Attorney General Eliot Spitzer, supra note 59.
102. See Szymanski, supra note 48, at 1317-18 (drawing an analogy between the impact on small nonprofits and the substantial rise in the auditing costs faced by small public companies).
103. For example, even the Spokane parking PDA had first-year revenues of nearly $1.8 million—far above the threshold. It is worth noting, however, that original estimates predicted $4 million in annual revenues. Jim Camden, City Gets Lofty Projections, Analysis Should Have Shown Garage Wouldn’t Work, Attorney Says, THE SPOKESMAN-REVIEW (Spokane), Mar. 29, 2004, at A1.
104. Government backing comes from guarantees on bonds and/or gifts of publicly owned property as well as direct financial support.
105. See Szymanski, supra note 48, at 1317-19 (discussing the proportionally large impact to small nonprofits). Assuming that the $10,000 cost Szymanski cites is accurate, the burden to PDAs should be relatively small as a percentage of annual revenues. Id.
outweighed by the increase in accountability and organizational transparency that SOX provisions are designed to bring about.

C. Taxpayer and Investor Protection

As discussed above, Congress’s main purpose in passing SOX was to protect investors by improving the reliability of disclosures.  

Although Congress directed SOX toward publicly traded corporations, the stocks of which are purchased by individual and institutional investors, not all investors are protected—even theoretically—without extending SOX disclosures, audit provisions, and corporate governance principles to other sectors. PDAs are a prime example because PDAs are able to issue tax-exempt debt. Therefore, they attract a wide range of investors, many of whom are attracted both to the potential for a return on their investment and the tax shelter that such investments provide. Accurate bond ratings, a primary source of information regarding the credit risk a given entity presents, are dependent upon financial audits, current budgets, and other economic and operational data. It follows that the more accurate the financial information, the more accurate the rating, and the better investors are able to evaluate the risk of their investment. Assuming that applying SOX provisions to PDAs will result in better financial information, the purpose of the Act—the protection of investors—will thereby be furthered.

However, there is an additional dimension to the investor protections that the application of SOX to PDAs has the potential to realize. As taxpayers are all indirect investors in the PDAs whose debt is backed by their municipality, they benefit when the bond issuance of the PDA is successful. Not only does the public benefit from the purpose served by the PDA, but the benefit is accomplished, for the most part, without the direct use of public tax dollars.

When things go wrong, as they did in Spokane, however, the municipality—and by extension its taxpayers—bear the financial burden. Given the public benefit that PDAs provide, this is not the same bitter pill swallowed by Enron investors, who could hardly take comfort in personal losses that enabled the private gains of its highly compensated executives. Regardless, with the recent financial difficulties faced by local governments in Washington and around the nation, having to reduce core municipal services to bail out an ostensibly self-supporting project, even one with public benefits, is far from harmless. In fact, these projects are often undertaken by PDAs because the chartering municipality has specifically chosen not to fund its activities at the expense of core services. This was specifically the choice made by Spokane officials.

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106. SOX, supra note 1 (preamble).
107. See THAU, supra note 39, at 100.
108. See STANDARD & POOR’S PUBLIC FINANCE CRITERIA 2 (1999) (stating that while bond ratings are “not a general-purpose evaluation of an issuer,” they are determinative of credit risk).
109. See THAU, supra note 39, at 106 (highlighting the documentation requirements for parking revenue bonds—the type issued by the Spokane Downtown Foundation).
110. This is true because the municipality must either service the PDA’s guaranteed debt or resume control over PDA assets that were once the property of the municipality and granted to the PDA under section 35.21.730(1) of the RCW.
111. See Eugster v. City of Spokane, 76 P.3d 741, 756-59 (Wash. Ct. App. 2003) (detailing the city’s preliminary discussions regarding financing the garage project).
Local taxpayers also feel the hit in a less direct manner. When PDAs default on their bonds, especially when it is due to a failure of the chartering municipality to honor its agreement with the PDA, as was the case in Spokane, credit rating agencies may choose to downgrade the municipality’s unlimited general obligation bond rating.\textsuperscript{112} This can have tremendous long-term impacts for community projects. A lowered municipal bond rating means higher interest rates on bonds due to the perceived risk to investors. This, in turn, raises the cost of the city’s capital projects, which are ultimately financed by local taxpayers. Lower bond ratings mean higher taxes and/or fewer capital projects for the citizens.

In Spokane, for example, the city’s overall credit rating, which was initially grade “A+” according to Standard & Poor’s,\textsuperscript{113} was, over the course of several months, downgraded to “BBB.” Such a substantial downgrade can have enormous ramifications for city finances. Not only are the city’s general obligation bonds seen as riskier investments, requiring issuers to charge the city a higher interest rate, but such a low rating may mean that the city’s bonds are not fully subscribed. Furthermore, the higher cost of credit applies to all debt issuances, which means that all of Spokane’s public projects that were dependent on debt financing were substantially more expensive as a direct result of the downgrade. These costs are in addition to over $30 million that the city ultimately had to pay to the Spokane Downtown Foundation to service the bond debt on the garage. Had the city honored its obligations in the first place, they would have lessened the impact on the taxpayers by keeping the cost of public projects low. Although it is impossible to say whether more thorough audits, enhanced financial disclosures, or better corporate governance could have prevented the River Park Square parking garage debacle, there is reason to believe that these provisions, if applied to PDAs, will lead to better investment outcomes for municipalities, individual investors, and taxpayers.

IV. RECOMMENDATION

Because the application of SOX best practices to PDAs, discussed in Part III.A, will (1) increase PDA accountability; (2) increase individual and institutional investor confidence; and (3) increase municipal confidence in PDAs, this Note recommends that state legislatures\textsuperscript{114} enact laws requiring PDAs to follow the best practices provisions of SOX, subject to the precautions discussed in Part III.B. In the absence of state legislative action, city and county councils should require that their PDAs adopt SOX on a best practices basis.\textsuperscript{115} However, should neither state nor local governments require PDAs to

\textsuperscript{112} See Staley, \textit{supra} note 12 (describing the circumstances leading to a second credit rating downgrade for Spokane due to River Park Square parking garage issues).

\textsuperscript{113} Standard and Poor’s ratings run a continuum from “AAA,” which indicates that “[t]he obligor’s capacity to meet its financial commitment on the obligation is extremely strong” to “C,” which indicates that the obligation is “highly vulnerable to nonpayment.” Obligations rated “D” are in default. \textsc{Standard & Poor’s Public Finance Criteria, supra} note 108, at 3-4.

\textsuperscript{114} The U.S. Constitution prohibits the federal government from extending SOX to state-created entities such as PDAs. U.S. Const. amend. X. SOX is currently applicable only to publicly traded companies registered with the federal SEC. \textsc{SOX, supra} note 1, § 101.

\textsuperscript{115} For an example of local government provisions governing the formation and operation of PDAs, see \textsc{Seattle, Wash., Mun. Code ch. 3.110-3.590 (2005), available at http://clerk.ci.seattle.wa.us/~public/code1.htm}.
comply with applicable provisions of SOX, PDAs should undertake to do so voluntarily. 

PDA compliance with SOX, although complicated and demanding, will best serve their respective constituencies, as well as the local taxpayers.

A. SOX Best Practices Will Increase PDA Accountability

The emphasis that SOX places on responsible corporate governance, enhanced disclosures, and better auditing serves to increase organizational accountability for the practices and policies that lead to the organization’s success or failure. By requiring boards to form audit committees, the organization is guaranteed to bring some focus to the issues. Furthermore, by requiring at least one of the audit committee members to possess financial expertise, the likelihood that financial inaccuracies will be spotted and questioned increases. The fact that the board—individually or as a whole—may be subjected to liability for perpetrating materially false information in annual financial statements may provide the needed incentive to bring organizational focus to these issues. Similarly, because PDA executive directors and financial officers would be required to certify financial statements and audits for their accuracy, as well as develop policies for internal financial controls, it is likely that their attention to (and knowledge of) financial matters will increase. Had board members of the Spokane Downtown Foundation and parking PDA paid closer attention to financials, they may have been in a better position to discover and alert the city council to the inaccurate financial information either while the organizations were still in a position to take remedial action or, better yet, prior to the issuance of bonds.

The same is true with regard to the code of ethics that is required for senior executives. Not only would the code bind these executives to the stated ethical norms of the organization, but the development of the code would also serve to focus organizational attention on ethical issues. Because the Act is non-specific as to the substantive requirements of such a code, developing a code imposes a relatively light burden on organizations. Rather, it seems to require only that an organization pay attention to ethical issues—even if to merely explain why they find a code of ethics unnecessary. However, once developed, such a code would bind the PDA to an ethical yardstick against which the PDA’s chartering governmental authority, its constituency, and the general public could measure its performance.

A study discussed by Harold Bloomenthal in his book Sarbanes-Oxley Act in Perspective notes several findings related to companies that were found to have engaged in financial fraud, chiefly that “senior executives were frequently involved” and the

116. Section 406 of SOX merely defines a code of ethics to mean “such standards as are reasonably necessary to promote . . . honest and ethical conduct.” SOX, supra note 1, § 406(c)(1).

117. Bloomenthal, supra note 48, at 71. This has also been true in financial fraud cases involving the directors of nonprofit and public corporations, such as William Aramony of the United Way and Russell Harding of the New York City Housing Development Corporation. For a discussion of the United Way scandal, see Goldschmid, supra note 97, at 633-35. For a discussion of Russell Harding and the New York City Housing Development Corporation (NYCHDC), see Tom Robbins, Harding’s Hustle: Bonuses, Bargains, and Strip Clubs at the Housing Development Corporation, THE VILLAGE VOICE, May 8-14, 2002, available at http://www.villagevoice.com/issues/0219/robbins.php (describing former NYCHDC executive director Harding’s misuse of public funds, close relationship to then-mayor Rudolph Giuliani, and lack of effective board oversight).
company’s audit committee, if they had one at all, met only once a year.\textsuperscript{118} Bloomenthal concludes that these findings “suggest Sarbanes-Oxley and vigorous enforcement may make a difference.”\textsuperscript{119} Given the United Way and New York City Housing Development Corporation experiences,\textsuperscript{120} there is little reason to believe that similar enforcement would not make a difference for public and nonprofit corporations.\textsuperscript{121}

\textbf{B. SOX Best Practices Will Increase Individual and Institutional Investor Confidence}

As discussed above, because bond rating agencies will be provided with more accurate financial information related to PDAs, investors can have greater confidence in the agency’s evaluation of the credit risk that the PDA’s bond issuance represents. Likewise, the improved financial information will also serve to increase the confidence of municipal guarantors, who will be better prepared to evaluate the risk posed to their own finances and/or credit rating by backing the debt of the PDA. If SOX accomplishes its purpose and the duties it imposes result in more accurate information, knowledgeable investors will look to whether an organization is compliant with SOX (or SOX best practices) as one step of their evaluation of the risk that the organization poses to their investment. Because SOX is designed to remedy the problems that led to massive individual investment losses, organizations that are compliant with its provisions will be perceived as less of a risk.

Again, had SOX compliance been a possibility prior to the Spokane Downtown Foundation’s issuance of municipal bonds, it could be expected that more rigorous financial evaluations might have occurred prior to the signing of the agreement with the city. Once the project passed that test, however, investors could be more comfortable purchasing the bonds. Likewise, the City of Spokane would have been more secure in the knowledge that the project would be adequately monitored and audited, thus posing less of a risk to its own credit rating.

\textbf{C. SOX Best Practices Will Increase Confidence in PDAs}

Because PDAs generally undertake those needed activities too risky for government and not profitable enough for the private sector, it is important that they continue to maintain the confidence of the public—the true investors in PDAs. Implementing SOX best practices at PDAs will lead to the recruitment of more competent and financially-aware board members, greater disclosure of financial information, and better corporate governance practices. As a result, the public can have greater confidence that PDAs are accomplishing their public purpose in the most efficient and transparent manner.

Had SOX best practices been in place at the time the Spokane City Council was overseeing the Spokane parking PDA and making decisions regarding its continued operation, there is reason to believe that the project might have avoided financial impacts to taxpayers. Likewise, the issuance of the revenue bonds may have been scuttled by a

\begin{footnotesize}
\begin{enumerate}
\item[118.] See Bloomenthal, supra note 48, at 71.
\item[119.] Id.
\item[120.] See supra note 117.
\item[121.] This does, however, beg the question of enforcement. Municipalities willing to impose SOX duties on PDAs will need to provide for a certain level of monitoring and enforcement. See Goldschmid, supra note 97, for a discussion of the impediments to enforcement in the nonprofit sector.
\end{enumerate}
\end{footnotesize}
Applying SOX to PDAs

2005]

low rating, which would have caused the project to go back to the drawing board. Adding requirements to PDAs that result in a more engaged and financially competent board, transparency of finances to the public (and rating agencies), and more rigorous financial audits would have all cut against proceeding with the project. As it happened, the city council, developers, bond counsel, and rating agencies were all able to ignore the project’s dubious financials and pretend that it made financial sense.\(^{122}\) The mandatory disclosures and reporting duties that SOX requires would have brought financial problems to light earlier in the process. This is potentially true for two reasons: (1) the PDA board would have been subject to a duty to report the financial problems they discovered to the city council (assuming their annual financial reports are filed with them)\(^{123}\) and (2) the credit rating agencies would have given the PDA’s bonds a lower rating on the basis that the PDA was not SOX-compliant.

V. CONCLUSION

Knowing that a PDA is performing a public purpose and being as transparent as possible with its financial information will serve the purpose of making both elected officials and the taxpayers who elect them more comfortable with their decision to charter and oversee the work of a PDA. Because PDAs perform valuable services that are not economically feasible for the local government to undertake, especially in times of economic downturn, their continued viability is a desirable goal. The application of SOX best practices in accounting, disclosures, and corporate governance will help PDAs achieve a greater level of investor confidence, thereby facilitating their continued survival. However, the need for effective enforcement cannot be emphasized enough. State and local governments considering requiring PDAs to comply with SOX need to make sure that the regulations have teeth, lest these organizations treat its valuable tools as another set of bureaucratic hoops through which they have to jump. Although the cost of complying with SOX is not insubstantial, especially to public organizations where resources are scarce, the costs avoided are significant. Just ask the people of Spokane.


\(^{123}\) This is currently the case with Seattle PDAs. See SEATTLE, WASH., MUN. CODE ch. 3.110.400 (2005), available at http://clerk.ci.seattle.wa.us/~public/code1.htm (requiring PDAs to file an audited annual report with the city clerk as well as provide copies to the mayor and city council members). It is worth noting, however, that these required filings are not currently required to comply with SOX.