

U.S. Supreme Court Upholds Sarbanes-Oxley Act and Public Company Accounting Oversight Board, Severing Unconstitutional Removal Restrictions

On June 28, 2010, the last day of its 2009–2010 term, the Supreme Court of the United States rejected a broad constitutional challenge to the existence of the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) and to the legitimacy of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).¹ *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. ___, No. 08-861 (June 28, 2010).

In a 5-4 decision by Chief Justice Roberts, joined by Justices Alito, Kennedy, Scalia and Thomas, the Court narrowly held that Sarbanes-Oxley’s removal restrictions, or “tenure provisions,” for Board members violate the separation of powers requirements of the U.S. Constitution. Those tenure provisions permit removal of Board members only for “good cause” by the Securities and Exchange Commission (the “SEC”), whose members in turn, in the Court’s opinion, would be insulated from direct Presidential control by a second layer of good cause removal protection.

At the same time, the Court rejected a broader challenge to the power and authority of the Board and determined that the unconstitutional tenure provisions could be severed from the remainder of Sarbanes-Oxley. It also concluded that members of the Board were validly appointed under the Appointments Clause of the U.S. Constitution. The Court’s ruling thus effectively permits the Board to continue to operate and Sarbanes-Oxley to remain in force unchanged, except that the SEC will now have the ability to remove Board members at will.

In a dissenting opinion by Justice Breyer, the remaining Justices disagreed with the conclusion that the “dual for-cause” removal restrictions interfered with the President’s constitutional executive power. The dissenting opinion highlights the potential for the Court’s contrary holding to raise doubts regarding the job security and administrative actions of “hundreds, perhaps thousands of high level government officials” (and includes an appendix listing 573 government officials subject to “dual for-cause” protections).

¹ Pub. L. No. 107-204, 116 Stat. 745 (2002).

I. Background to *PCAOB*: Presidential Removal and Appointment Powers

As one of the chief financial reforms of Sarbanes-Oxley in the wake of Enron and Worldcom, the PCAOB was created almost a decade ago as a new governmental organization responsible for the regulation and oversight of public company auditors. The PCAOB was structured as a private nonprofit corporation, with five board members appointed by the SEC and removable by the SEC upon a showing of good cause.² Although the PCAOB's actions are subject to review by the SEC, the PCAOB has its own separate authority, enhanced by its financial independence, in the areas of standard-setting, inspection and enforcement over accounting firms that audit public companies.

The *PCAOB* case was brought in 2006 in the U.S. District Court for the District of Columbia (the "District Court") by a nonprofit taxpayer advocacy organization, Free Enterprise Fund, and a small Nevada-based accounting firm, Beckstead and Watts, LLP (together, the "plaintiffs"). Because the plaintiffs' allegations challenged the constitutional sufficiency of the PCAOB and Sarbanes-Oxley, the United States intervened as a defendant. The two allegations that survived review to the U.S. Supreme Court questioned the PCAOB's accountability to the President: first, whether the *removal* of Board members by the SEC only upon a showing of a good cause violates the separation of powers doctrine implicit in the U.S. Constitution, which vests executive power in the President,³ and second, whether the *appointment* of Board members by the SEC violates the Appointments Clause of the U.S. Constitution, either because the members are "Officers of the United States" who must be directly appointed by the President, or because they are "inferior officers" who must be appointed by a "Head of a Department."⁴ The District Court dismissed the plaintiffs' claims on summary judgment, a decision that was affirmed, in a divided 2-1 opinion, by the D.C. Circuit Court of Appeals (the "Court of Appeals").⁵ The U.S. Supreme Court granted certiorari and heard oral arguments on December 7, 2009, with Solicitor General—and later Supreme Court nominee—Elena Kagan arguing on behalf of the PCAOB.

² See 15 U.S.C. §§ 7211(a), 7211(e)(1), 7211(e)(4), 7211(e)(6).

³ "The executive Power shall be vested in a President of the United States of America." U.S. CONST. art. II, § 1, cl. 1.

⁴ "[The President] shall have Power . . . by and with Advice and Consent of the Senate, [to] appoint . . . all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." U.S. CONST. art. II, § 2, cl. 2.

⁵ 537 F.3d 667 (D.C. Cir. 2008).

II. The Court’s Decision

A. Removal Restrictions

The Court first addressed the plaintiffs’ removal argument, holding that “the dual for-cause limitations on the removal of Board members contravene the Constitution’s separation of powers.”⁶ The Court distinguished previous cases in which it had upheld good-cause tenure restrictions on the removal of governmental officials either because the agencies in question were not “purely executive” in nature or because the executive officials were insulated by “only one level of protected tenure,” allowing the President to remove the supervising officer at will and exert direct control over the removal decision.⁷ With the PCAOB, the Court reasoned that because Sarbanes-Oxley explicitly prohibited the SEC from removing Board members at will,⁸ and in fact provided “an unusually high standard that must be met before Board members may be removed,”⁹ the President could not hold the SEC sufficiently accountable for its removal decisions and exercise requisite control over the PCAOB, as a part of the Executive Branch. “Even if the President disagrees with [the SEC’s] determination, he is powerless to intervene—unless that determination is so unreasonable as to constitute ‘inefficiency, neglect of duty, or malfeasance in office,’”¹⁰ the removal standard that the Court applied to the SEC Commissioners.¹¹ The Court emphasized the “novel” and “unusual” structure of Sarbanes-Oxley “in committing substantial executive authority to officers protected by two layers of for-cause removal—including at one level a sharply circumscribed definition of what constitutes ‘good cause,’

⁶ See *Free Enter. Fund*, Slip Op. at 10.

⁷ See *id.* at 10–14.

⁸ 15 U.S.C. §§ 7211(e)(6), 7217(d)(3). These provisions require that the SEC remove Board members only “for good cause shown,” providing a finding on the record of one of several specific reasons for removal as well as notice and opportunity for a hearing.

⁹ See *Free Enter. Fund*, Slip Op. at 22.

¹⁰ *Id.* at 15. The dissent argues that it is largely irrelevant if Board members are only removable by the SEC for cause because, as the majority assumes, the SEC Commissioners are themselves only removable for cause. If, for example, the President and certain SEC Commissioners disagree on whether to remove a Board member, the President cannot force the SEC to remove the Board member without finding good cause to remove the disobedient SEC Commissioners. Significantly, the dissent did not deem multiple layers of for-cause removal constitutionally problematic. See *id.* at 12–13 (Breyer, J., dissenting).

¹¹ See *id.* at 5. The dissent disagrees with the Court’s conclusion that the SEC Commissioners are subject to a for-cause removal restriction, noting the lack of any statutory requirement that SEC Commissioners be removed for cause and the fact that the SEC was established before *Humphrey’s Executor v. United States*, 295 U.S. 602 (1935), in which the Court recognized the validity of for-cause removal restrictions on certain executive officers. See *id.* at 33–36 (Breyer, J., dissenting).

and rigorous procedures that must be followed prior to removal.”¹² Although the Court struck down the PCAOB removal procedures as unconstitutionally “depriv[ing] the President of adequate control over the Board,” the Court merely altered the way in which Board members could be removed: “Concluding that the removal restrictions are invalid *leaves the Board removable by the Commission at will* and leaves the President separated from Board members by only a single level of good-cause tenure.”¹³

B. Appointment

The Court quickly dispensed with the plaintiffs’ challenge to the Board members’ appointment. Holding that Board members are “inferior officers” and that the SEC is a “Department” within the meaning of the Appointments Clause, the Court considered only whether the Board members, as “inferior officers,” were validly appointed by the “Head” of a “Department”—that is, whether the SEC Commissioners were, collectively, the “Head” of the SEC. Finding that the SEC’s powers “are generally vested in the Commissioners jointly” and that there were no constitutional restrictions on collective appointments, the Court held that the Board members were validly appointed.

C. Severability

Notably, although Sarbanes-Oxley does not contain a “savings clause” which would clearly permit any unconstitutional provision to be removed, or “severed,” from the rest of a law to preserve that law’s general constitutionality, the Court in *PCAOB* nevertheless allowed the unconstitutional removal restrictions to be severed from the rest of Sarbanes-Oxley, leaving it “‘fully operative as a law’ with these tenure restrictions excised.”¹⁴ The Court acknowledged that Congress could amend Sarbanes-Oxley to correct the constitutional violation, but by severing the unconstitutional tenure provisions, the Court maintained the constitutionality of the PCAOB and Sarbanes-Oxley in all respects except for the manner of the Board members’ removal.

D. Remand and Declaratory Relief

Having affirmed the Court of Appeals’ judgment in part and reversed in part, the Court remanded the case for further proceedings consistent with its opinion. While the Court noted that the plaintiffs “are entitled to declaratory relief sufficient to ensure that the reporting requirements and auditing standards to which they are subject will be enforced

¹² See *id.* at 24–25.

¹³ See *id.* at 28 (emphasis added).

¹⁴ See *id.*

only by a constitutional agency accountable to the Executive, ”¹⁵ it specifically declined to enjoin the PCAOB’s operations.¹⁶

III. The Future of Accounting Oversight

The *PCAOB* decision does not appear likely to have any meaningful practical impact on the operation of the PCAOB or Sarbanes-Oxley more generally, except that the SEC may now remove Board members at will. Indeed, in response to the decision, SEC Chairman Schapiro stated, “I am pleased that the Court has determined that the Board’s operations may continue and the Sarbanes-Oxley Act, with the Board’s tenure restrictions excised, remains fully in effect.”

IV. Implications for Constitutional and Administrative Law

As noted in Justice Breyer’s dissent, the Court’s ruling on “dual for-cause” removal restrictions could yield far-reaching implications for a host of administrative agencies if it is interpreted to invalidate any for-cause tenure provisions for government officials who are themselves supervised by officers removable only by the President for cause. While the Court’s ruling avoids disruption to the PCAOB, the opinion might invite challenges to or cause uncertainty in the operations of other existing or future governmental agencies, particularly those that are structured, intentionally or not, with relatively greater independence from Presidential authority.

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¹⁵ See *id.* at 33.

¹⁶ See *id.*

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