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# THE SARBANES-OXLEY ACT: FEDERALIZING NORMS FOR OFFICER, LAWYER, AND ACCOUNTANT BEHAVIOR

LARRY CATÁ BACKER†

## INTRODUCTION

In response to a number of corporate scandals, the federal government enacted the Sarbanes-Oxley Act of 2002 (the “Act”). The Act creates a framework of government oversight of the accounting profession and its practices, imposes a number of certification requirements on corporate officers, restricts a number of corporate practices involving trading of securities by and loans to corporate officers, imposes reporting duties on lawyers, and provides protection for employees who disclose violations of law perpetrated by corporate officers and directors. This Article explores some of the changes made by the Act in a practice context. The Article focuses on the manner in which the Act might affect corporate behavior in a number of common business situations involving: people considering the offer of a position as a corporate officer; accounting firms seeking to perform audit and other functions for a corporate client; officers seeking loans from their employer corporation, including advances of fees pursuant to indemnification agreements; corporations facing adoption of financial codes of ethics; lawyers seeking guidance on the situations in which they are now required to report evidence of corporate wrongdoing; implementing internal accounting and disclosure systems and disclosing wrongdoing; people seeking guidance on the protection

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afforded by the Act for reporting corporate wrongdoing; and officers facing criminal penalties for certain types of wrongdoing. The relationship of the Act to state corporate law and the Act's inconsistencies, traps for the unwary, and unanswered questions, are also explored.

The twenty-first century exploded onto the consciousness of the business community in a big way. Since the unification of Germany in 1989, and more vigorously since the collapse of the Soviet Union in 1991 and the entry of the People's Republic of China into the world marketplace thereafter, American methods of business have been held up to the world as the approach most worth emulating.<sup>1</sup> This was particularly the case with respect to the American public corporation. The American public corporation worked best because it was based on democratic principles of corporate governance, which mirrored and worked in synergy with the governing ideal of nation-states.<sup>2</sup> The American corporation was grounded in a regime of full disclosure of information about enterprises that sought to minimize transaction costs and market inefficiencies of corporate debt and equity.<sup>3</sup> Furthermore, it represented a form of enterprise in

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<sup>1</sup> See Suzanne Kapner, *S.E.C. Chief Promises to Cooperate With Europe*, N.Y. TIMES, Oct. 11, 2002, at W1; see also Carolyn Brancato & Michael Price, *The Institutional Investor's Goals For Corporate Law in the Twenty-First Century*, 25 DEL. J. CORP. L. 35, 46-47 (2000) (describing Delaware as a global model for corporate governance); Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 866 (1997).

With perhaps a bit of nostalgia, a high level American accounting policymaker best expressed both the old and emerging realities: "Traditionally, the argument from the United States has been that if we want to have an international set of rules, they ought to be U.S. rules, because we have the best system," said Robert H. Herz, the Chairman of the Financial Accounting Standards Board, in a recent interview. Referring to the Enron, WorldCom and other corporate scandals, Mr. Herz said, "The recent events have led people to question whether our system is that much superior, and it has increased receptivity toward international accounting standards." Kapner, *supra* note 1.

<sup>2</sup> See, e.g., Lee A. Travis, *Corporate Governance and the Global Social Void*, 35 VAND. J. TRANSNAT'L L. 487 (2002). For an example of the way in which the essentially political notion of democratic governance has seeped into discussion of organizing principles for enterprises and other sub-national communities, see Neil Weinstock Netanel, *Cyberspace Self-Governance: A Skeptical View from Liberal Democratic Theory*, 88 CAL. L. REV. 395 (2000).

<sup>3</sup> For a discussion of the basic notions underlying the regulation of transactions in corporate securities, see LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1 (2d ed. 1988); Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979). For a

which exit within highly liquid markets was favored<sup>4</sup> and shareholder interest given pride of place.<sup>5</sup> The checks and balances of highly developed principles of corporate fiduciary duty, outside auditing of financial statements, constant disclosure, severe rules against advantaged transactions in corporate securities, and an active shareholders and creditors bar provided a model fit for emulation worldwide.<sup>6</sup>

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discussion of state duties to disclose, see, for example, Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996). The functionaries of the SEC routinely reaffirm the underlying principle of disclosure as the basis of modern corporate and securities regulation. For example, on the eve of the current round of corporate scandals, the SEC Chairman explained that "[h]igh quality and timely information is the lifeblood of strong, vibrant markets. It is at the very core of investor confidence." Arthur Levitt, Chairman's Statement to Sec. & Exch. Comm'n on Regulation Fair Disclosure (Aug. 10, 2000), at <http://www.sec.gov/news/extra/seldisal.htm> [hereinafter Levitt]. For a more iconoclastic view of the current regime of disclosure as a means of regulating markets, see, for example, RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 15.8, at 444 (4th ed. 1992) (suggesting that the disclosure regime was based on erroneous lessons from the market crash of 1929); Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994).

<sup>4</sup> The germinal work of the economist Albert Hirschman provides a useful conceptual framework for understanding the modern focus of the development of capital market rules, especially for public companies. See ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY* (1970). The corporate law permits shareholders a limited right of participation by virtue of their right to elect the board of directors and to vote on fundamental corporate changes. The corporate and securities laws preserve a shareholder's power to liquidate her holdings in an enterprise and realize something approaching the fair value of her investment when participation or loyalty are not viable alternatives. See, e.g., *Austin v. Mich. Chamber of Commerce*, 494 U.S. 652, 687 (1990) (Scalia, J., dissenting) (noting that shareholders' only alternatives when they disagree with management are "(1) his ability to persuade a majority . . . of his fellow shareholders that the action should not be taken, and ultimately (2) his ability to sell his stock"); William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 895, 897 (1997) ("Primarily, corporate law affords common stock a right to vote . . . . The right of shareholders to sell their share interests . . . is fundamental as well as an economic source of constraint on the exercise of management discretion.")

<sup>5</sup> See, e.g., ALI'S PRINCIPLES OF CORPORATE GOVERNANCE § 2.01 (1994) ("[A] business corporation should have as its objective the conduct of such activities with a view to enhancing the corporation's profit and the gains of the corporation's owners, that is, the shareholders."); Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 32.

<sup>6</sup> See Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1147, 1153 (1999) (noting the convergence of major global systems with movement of non-U.S. systems to U.S. style shareholder model and movement of United States toward more global model); Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1147-48 (1998). But see, e.g., William W. Bratton & Joseph A.

In the year 2001, the world saw the disclosure of fraud and corruption at the highest levels of the American corporate hierarchy. One example is when the controlling family of the Adelphia Corporation used the public corporation as a personal banking service, thereby causing the corporation's collapse, and their criminal prosecution.<sup>7</sup> Another example is Worldcom, where outright fraud in the preparation and reporting of its financial condition resulted in the misstatement of its value in

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McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213 (1999). For a taste of the American academic literature on the subject, see generally Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411 (1996); Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498 (1997); Michael Gruson, *The Global Securities Market: Introductory Remarks*, 1987 COLUM. BUS. L. REV. 303; James R. Silkenat, *Overview of United States Securities Markets and Foreign Issuers*, 17 FORDHAM INT'L L.J. S4 (1994). Other institutions, notably the World Bank, have taken similar positions, seeing a connection between the American political and its corporate/securities model throughout the developing world. "[I]t is neither coincidental nor wholly unexpected that the World Bank and the U.S. Agency for International Development have been key supporters of studies that explore the relationship between economic liberalization and democracy." Shelley Feldman, *NGOS and Civil Society: (Un)Stated Contradictions*, 554 ANNALS AM. ACAD. POL. & SOC. SCI. 46, 58 (1997); see also *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). According to Milhaupt:

Of course, the flow of ideas has never been one sided. Approaches to corporate governance and securities regulation can flow into the U.S. as well. Japanese economic success has prompted a thorough re-examination of American governance mechanisms. Both Japan and, to a lesser extent, South Korea have been held up by American commentators as attractive alternative models of economic and social organization. At the same time, American economic successes, including most recently those associated with Silicon Valley, have prompted extensive soul searching in Japan and South Korea, leading to the importation of governance technologies perfected on this side of the Pacific.

Milhaupt, *supra*, at 1158-60.

<sup>7</sup> See Christopher Stern, *Members of Rigas Family Indicted; 3 Ex-Adelphia Officials Accused of Conspiracy*, WASH. POST, Sept. 24, 2002, at E1 (noting that the Rigases "[allegedly] used Adelphia funds to cover more than \$250 million in personal stock losses"); see also Bill Bergstrom, *Adelphia Boss Took in \$67 Million; Agents Document Hefty Advances from Cable Firm*, CHI. TRIB., July 29, 2002, at 6 (alleging that bills from family owned companies, including the Buffalo Sabres pro-hockey team, a furniture and interior design company, a car dealership, and a number of partnerships, were allegedly paid out of Adelphia bank accounts); Geraldine Fabrikant, *Indictments for Founder of Adelphia and Two Sons*, N.Y. TIMES, Sept. 24, 2002, at C1 (asserting that the three are charged with conspiracy, securities fraud, wire fraud and bank fraud in connection with their economic activities involving Adelphia).

excess of six billion dollars, causing its own collapse.<sup>8</sup> Enron Corporation collapsed under the weight of its own convoluted Ponzi schemes and now faces investigation for possibly criminal manipulation of markets.<sup>9</sup> It may have also contributed to the recent electrical crisis in California.<sup>10</sup> There were other collapses and scandals as well. Among the most spectacular collateral collapses was that of Arthur Andersen, once one of the most powerful and influential accounting and related-service firms in the world.<sup>11</sup> With its partners subject to criminal and civil

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<sup>8</sup> See, e.g., Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3 (explaining that WorldCom filed for bankruptcy protection after accumulating \$41 billion of debt due to, in part, misstating \$3.8 billion in expenses for five quarters); see also *The Lessons of WorldCom*, WASH. POST, July 23, 2002, at A16 ("WorldCom's accounts were spectacularly misleading: Nearly \$4 billion in expenses were misreported, creating a huge overrepresentation of the firm's profits."); Jon Van, *Ex-WorldCom Execs Charged with Fraud; 3 Others Likely to Plead Guilty*, CHI. TRIB., Aug. 29, 2002, at 1 (noting that WorldCom's accounting irregularities were reported as high as \$7.1 billion, nearly twice the amount originally disclosed).

<sup>9</sup> See, e.g., Daniel Fisher, *Shell Game; How Enron Concealed Losses, Inflated Earnings—and Hid Secret Deals. Are Criminal Charges Next?*, FORBES, Jan. 7, 2002, at 52 (stating Enron used a network of external partnerships to hide the declining value of its assets); see also Alexei Barrionuevo et al., *Enron's Fastow Charged with Fraud*, WALL ST. J., Oct. 3, 2002, at A3 (noting that Former Enron chief financial officer, Andrew Fastow, was charged with fraud, money laundering and conspiracy by federal prosecutors); Carrie Johnson & Peter Behr, *Charges Near in Probe of Enron Officer; Former CFO Fastow Is Task Force's Focus*, WASH. POST, Sept. 26, 2002, at E1 (stating that investigators from the Justice Department's Enron task force and the Securities and Exchange Commission attempted to prove that former executives knew, or should have known, that Enron was dependent on sham asset sales and inflated financial deals); Allan Sloan et al., *Who Killed Enron; It's the Scariest Type of Scandal: A Total System Failure*, NEWSWEEK, Jan. 21, 2002, at 18 ("[A] handful of executives and outsiders made millions by investing in off-balance-sheet deals with Enron that played a large role in destroying the company.").

<sup>10</sup> See, e.g., Kenneth Bredemeier, *Agency to Probe Energy Firms*, WASH. POST, Aug. 14, 2002, at E1 ("The Federal Energy Regulatory Commission yesterday ordered a formal investigation into allegations of manipulative electricity and natural gas trading by three Enron Corp. affiliates . . . at a time when consumers were handed huge utility price increases."); see also Scott Thurm et al., *Juice Squeeze: As California Starved for Energy, U.S. Businesses Had a Feast*, WALL ST. J., Sept. 16, 2002, at A1 ("A detailed examination of recently released internal memos by Enron Corp. lawyers, transcripts of trader conversations gathered by investigators, and scores of interviews with market participants and regulators yields a comprehensive look at how the U.S. energy industry cashed in on and contributed to California's energy crisis.").

<sup>11</sup> See, e.g., Allan Sloan et al., *No Accounting for It*, NEWSWEEK, Feb. 25, 2002, at 34 (noting that Andersen, Enron's outside accountants, was said to be responsible for shredding the energy company's documents during its audits); see also *Andersen*

investigation and its assets subject to a large number of civil suits by those who have suffered losses allegedly as a result of Andersen's provision of services, the company has been reduced to a shadow of its former self.<sup>12</sup> Large chunks of the business were sold or spun off.<sup>13</sup> The Andersen employees who could find other jobs took business with them.<sup>14</sup> Even the largest banking

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*Fades Away*, WASH. POST, Sept. 8, 2002, at H2 (stating Arthur Andersen officially surrendered its license to practice accounting in all 50 states and that "[t]he firm will wait at least a year to officially close its doors to help shield former partners and their new firms from lawsuits by shareholders of Enron, WorldCom and other now-bankrupt clients"); David S. Hilzenrath, *Financial Watchdog Became an Enabler*, WASH. POST, June 16, 2002, at A20 (stating that Andersen, one of the world's largest accounting firms, announced to the Securities Exchange Commission on August 31, 2002 that it would stop auditing companies listed on stock markets); Sheila McNulty & Gary Silverman, *Andersen the Fallout; Verdict Delivers Final Blow to Andersen Conviction*, FIN. TIMES, June 17, 2002, at P26 ("Even before the verdict, the firm . . . had become a pariah in the business community and fodder for television comedians poking fun at the rich and powerful."); E.A. Torriero & Robert Manor, *Jury Finds Andersen Guilty; Auditor Convicted of Obstructing U.S. Investigation of Enron Failure; Firm Says Verdict 'Effectively Ends' its Core Practice*, CHI. TRIB., June 16, 2002, at 1 (explaining that following Andersen's conviction for obstruction of justice, "the firm acknowledged that the conviction 'effectively ends' its auditing practice").

<sup>12</sup> See, e.g., Edmund Sanders & Jeff Leeds, *U.S. Indicts Enron Auditor Over Shredding; Inquiry: Andersen Faces an Obstruction of Justice Charge After Failing to Reach a Plea Agreement with Prosecutors*, L.A. TIMES, Mar. 15, 2002, at A1 (noting that federal prosecutors indicted Andersen for allegedly orchestrating the destruction of Enron documents); see also Delroy Alexander & Naftali Bendavid, *Andersen Dismisses 7,000 U.S. Employees; Ex-Enron Auditor Duncan Expected to Plead Guilty*, CHI. TRIB., Apr. 9, 2002, at N1 ("[T]he indictment has caused the legendary Chicago-based firm to fall apart quickly, with auditing clients, foreign affiliates and U.S. tax partners abandoning Andersen in recent weeks."); David S. Hilzenrath, *Doubts Grow That Andersen Can Survive*, WASH. POST, Apr. 20, 2002, at E1 ("Industry observers said they doubted that Andersen can stay in business."); Sheila McNulty & Peter Spiegel, *Enron Auditor to Plead Guilty and Co-operate*, FIN. TIMES, Apr. 10, 2002, at 28 (stating that David Duncan, the Andersen partner who headed the Enron audit, prepares to plead guilty to obstructing justice for destroying large amounts of Enron documents).

<sup>13</sup> See, e.g., Jerry Hirsch, *L.A. Andersen Partners Talking to Rival Firms*, L.A. TIMES, Apr. 20, 2002, at C1 (stating that Andersen partners negotiated to sell off parts of their business to rival accounting firms, such as KPMG and Deloitte & Touche); see also Delroy Alexander, *275 Andersen Employees Resign to Create Own Firm*, CHI. TRIB., May 22, 2002, at N1 (explaining that former Andersen employees form Huron Consulting Group while taking 75 clients with them); Thomas S. Mulligan, *Andersen Near Deal on Consulting Unit*, L.A. TIMES, May 1, 2002, at C3 (noting that Andersen nears deal to sell its consulting business to KPMG Consulting, Inc).

<sup>14</sup> See, e.g., Jerry Hirsch, *Company Fading From Big 5 Picture*, L.A. TIMES, June 17, 2002, at C1 (noting that Ernst & Young, Deloitte & Touche, KPMG, and PricewaterhouseCoopers all have benefited by picking up former Andersen clients).

enterprises have been affected. For example, Citigroup has been the subject of investigation with respect to its activities for several of these collapsed giants.<sup>15</sup> The practices of several broker dealers have been subject to review as well.<sup>16</sup> Corporate executives have had to give back large amounts of compensation awarded to them.<sup>17</sup> Lawyers have also been affected. Companies caught up in the financial scandals of their officers and directors have at times attempted to cast the net of liability widely enough to catch corporate general counsel.<sup>18</sup>

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Some firms have also acquired many former Andersen employees, such as Ernst & Young, who hired 200 former Andersen partners and approximately 1,000 staff members. *Id.*

<sup>15</sup> See, e.g., Gary Silverman, *Citigroup to Reform After Enron Scandal*, FIN. TIMES, Aug. 23, 2002, at 17 ("Congressional investigators have said Citigroup and JP Morgan Chase bankers helped Enron disguise the extent of its debts through complicated financial transactions."); see also Adrian Michaels & Gary Silverman, *Citigroup Faces Research Reform Hurdles*, FIN. TIMES, Sept. 30, 2002, at P25 (stating that Citigroup is under investigation by New York State Attorney General, Eliot Spitzer, with regards to conflicts of interest on the part of analysts at its Salomon Smith Barney investment banking unit).

<sup>16</sup> For example, Merrill Lynch & Co. analysts were under investigation by Eliot Spitzer, the New York State Attorney General, for allegedly recommending Internet stocks that they regarded as "junk." See, e.g., E. Scott Reckard, *Brokers May Face More Suits Amid Probe*, L.A. TIMES, Apr. 15, 2002, at C1 ("[A]nalytsts speak in depreciating—and at times obscene—terms about stocks that at the time sported the analysts' highest ratings."). Furthermore, Senate investigators cited sources in which Merrill Lynch aided Enron by raising the energy company's stock ratings. See, e.g., Carrie Johnson, *Merrill Ties to Enron at Issue in Probe; Senate Panel to Look at Firms' Relationship*, WASH. POST, July 30, 2002, at E1. In addition, the House Financial Services Committee sought details from Goldman Sachs Group, Inc. and Credit Suisse First Boston regarding their business dealings with various companies, including Enron and Global Crossing, Ltd. See, e.g., *House Widens IPO Probe to 2 More Banks*, L.A. TIMES, Sept. 5, 2002, at C1.

<sup>17</sup> For example, Jack Welch, the former chief executive officer of General Electric, received retirement benefits that included 24-hour access to a company-owned jet; a Mercedes-Benz; tickets to Wimbledon tennis matches, Boston Red Sox baseball games, and the Metropolitan Opera; free dry cleaning; and a fully-stocked, company-owned Manhattan apartment. See, e.g., Jonathan Finer, *Welch Cuts Back Perks; GE's Former CEO Cites 'Perception' of Retirement Package*, WASH. POST, Sept. 17, 2002, at E1. Welch and GE agreed to revise the retirement package, though he still is entitled to receive an office with administrative support and a nine million dollar annual pension. *Id.*

<sup>18</sup> See, e.g., Jonathan D. Glater, *Lawyer Caught in Tyco Tangle Leaves Friends Wondering*, N.Y. TIMES, Sept. 24, 2002, at C1 (stating that general counsel of Tyco accused of being part of conspiracy to loot the company). "Tyco's lawsuit paints Mr. Belnick as a part of a web of impropriety that allowed top executives to steal hundreds of millions of dollars and dole out money to other employees and perhaps even to a member of the board, thereby encouraging others to keep quiet." *Id.* The company seeks to compel Belnick to return all money paid to him while he served as



These corporate scandals also have had other wide-ranging effects. Among these were the large lay offs of employees, which have contributed both to individual suffering and to the already lackadaisical performance of the U.S. economy.<sup>19</sup> The scandals also contributed to continued weakness in the securities markets by reducing the value of the wealth of many people and, thus, potentially putting more strain on service sector spending by government.<sup>20</sup> The popular press and other influential organs of organized political activity clamored for governmental "action" of some type.<sup>21</sup> As a result, the federal government acted, and it acted in a big way. By passing the Sarbanes-Oxley Act,<sup>22</sup> the federal government has changed the business landscape in significant ways for four groups most intimately connected with

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general counsel. *Id.*

<sup>19</sup> See, e.g., Neil Irwin, *Jobless Report Shows Rebound Has Weakened; Unemployment Rate Swells to 5.9%*, WASH. POST, July 6, 2002, at E1 (asserting that joblessness rose to 5.9% in June 2002 due to the slumping stock market and corporate scandals).

<sup>20</sup> See, e.g., Steven Pearlstein, *Wild Day Leaves Dow Under 8000; Losses Raise Fear of Damage to Economy*, WASH. POST, July 23, 2002, at A1 (stating that the Dow Jones Industrial Average dropped nearly 3 percent after heavy trading on a single day). "Sunday's announcement by WorldCom Inc. of the biggest corporate bankruptcy filing in U.S. history no doubt contributed to yesterday's sour mood by reminding investors and traders that the fallout from accounting scandals is far from over, with more revelations, indictments and bankruptcies almost sure to follow." *Id.* "Investors also hammered the stocks of two of Wall Street's leading investment banks, Citigroup Inc. and J.P. Morgan Chase & Co., on the eve of Senate hearings into the firms' role in helping Enron Corp. hide its deteriorating financial conditions from investors and rating agencies." *Id.*

<sup>21</sup> See, e.g., *Post-Enron Progress*, WASH. POST, Feb. 19, 2002, at A14; see also Molly Irvins, *A Long Way to Go on Corporate Reform*, CHI. TRIB., Sept. 12, 2002, at N23; John Lewis, *Corporate Scandal: Cleanup Must Move Beyond Lip Service*, ATLANTA J. & CONST., July 11, 2002, at A14; *Make Businesses More Accountable*, ATLANTA J. & CONST., May 26, 2002, at F8; Felix G. Rohatyn, *An Agenda for Corporate Reform*, WALL ST. J., June 24, 2002, at A16.

<sup>22</sup> Pub. L. No. 107-204, 116 Stat. 745. The statute was enacted in response to the increase in restatements of corporate earnings, specifically from Enron, WorldCom, Global Crossing, and Xerox. See *The Accounting Reform and Investor Protection Act: Hearing Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. (2002) (statement of Paul Sarbanes, Member, Senate Comm. on Banking, Hous., and Urban Affairs). "I simply want to note that the problems leading to such dramatic lapses are widespread and seem to be built into the system of accounting and financial reporting. That is what this legislation seeks to address." *Id.* Prior to drafting the bill, the Senate Committee on Banking, Housing, and Public Affairs held ten hearings that heard from experts and interested parties. *Id.* In addition, the House Committee on Financial Services also held hearings regarding corporate and auditing accountability. The bill was signed by the President on July 30, 2002.

the governance of American public corporations—corporate managers and directors, accountants, and lawyers.

The purpose of this Article is to explore some of the ways in which the Sarbanes-Oxley Act might have affected general conduct norms in a number of situations common to most American publicly held enterprises, and the lawyers and accountants who form an integral part of the governance of those enterprises. The Article is organized along the lines of questions presented to the panel on the role of professionals after Enron.<sup>23</sup> Each of the questions focuses on the effects of the Act on the behavior of key groups of professionals: officers, directors, lawyers, and accountants.

1. *The Wall Street Journal recently had a story indicating that many CEOs and other executives are turning down new jobs since the publicity over corporate scandals,<sup>24</sup> due to fear of fear possible liability. If a candidate for a CEO position came to you, the lawyer, for advice, what would you advise him or her to do to protect him- or herself in deciding what corporation to join? Would your advice change if it were a manager much lower down the totem pole?*

The current reaction of top executives to the changes in the meshwork of legal obligation imposed by the federal government through the provisions of the Sarbanes-Oxley Act reminds me of the very similar reaction of officers and directors immediately after the publication of the Delaware Supreme Court's 1985 decision in *Smith v. Van Gorkum*.<sup>25</sup> At the time there were predictions that it would be impossible to hire competent directors, that insurance against director and officer liability

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<sup>23</sup> Symposium, *Enron and Its Aftermath*, St. John's University School of Law, Jamaica, New York (Sept. 20, 2002).

<sup>24</sup> See Jeffrey A. Sonnenfeld & Rakesh Khurana, *Fishing for CEOs in Your Own Backyard*, WALL ST. J., July 30, 2002, at B2 (noting that top CEO job openings are becoming harder to fill as Board of Directors turn to outsiders rather than insiders). Due to the fallout from the Enron and WorldCom scandals, "[t]op-tier stars are more nervous than they've ever been," the chairman of one of the largest executive search firms warned recently." *Id.* Being an insider of a firm is seen as a liability. As a result, fifty percent of CEOs in the top 200 firms are presently outside recruits (as compared to seven percent in 1980). *Id.* CEO tenure has shortened from eight to seven years, with dismissal being the reason for an early exit in one-third of the firms. *Id.*

<sup>25</sup> *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985).

would be impossible to acquire (and indeed for a time insurance became very costly and hard to acquire) and as a consequence, corporate governance would suffer. But that did not turn out to be the case.<sup>26</sup> Several things happened. First, states enacted new provisions that permitted corporations to shield their directors from liability for garden variety breaches of the duty of care;<sup>27</sup> the D&O insurance markets stabilized,<sup>28</sup> directors and officers changed their behavior to comport with the holding and dicta/advice contained in the *Van Gorkum* opinions,<sup>29</sup> and courts applied *Van Gorkum* more or less reasonably.<sup>30</sup>

Corporate officers and directors face a very similar situation today after the passage of the Act. But in a sense, corporate executives were lucky—the bulk of the changes inaugurated by the Act will affect accountants and lawyers more directly and significantly. Having said that, corporate executives and directors face a number of important new behavior modifying rules. Executive certification under sections 302<sup>31</sup> and 906<sup>32</sup> of

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<sup>26</sup> See, e.g., Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155 (1990). "By late 1987, the D & O insurance market was no longer in turmoil. Although premiums continued to rise, the rate of increase had slowed." *Id.* at 1156.

<sup>27</sup> See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). For discussion in the academic literature, see, for example, Jeffrey P. Weiss, *The Effect of Director Liability Statutes on Corporate Law and Policy*, 14 J. CORP. L. 637 (1989); see also Jonathan W. Groessl, *Delaware's New Section 102(b)(7): Boon or Bane for Corporate Directors?*, 37 DEPAUL L. REV. 411 (1987); Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239 (1987).

<sup>28</sup> See, e.g., Romano, *supra* note 26, at 1156.

<sup>29</sup> See, e.g., Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 449 (1993).

<sup>30</sup> For discussion of post-*Van Gorkum* judicial decisions, see, for example, Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579 (2002); see also William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002).

<sup>31</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777 (to be codified at 15 U.S.C. § 7241). Section 302 requires that executive officers certify all Form 10-K and Form 10-Q reports filed with the Securities and Exchange Commission. The certification must affirm that the signing officer reviewed the report and that it does not omit, or contain any untrue, statements of material fact. In addition, the officer must certify, to the best of her knowledge, that all financial statements contained in the report fairly present the financial conditions of the company. Lastly, the officer must affirm that she maintains and evaluates any internal control and report any deficiencies or fraud to the SEC, the company's auditors, and the audit committee.

the Act centralizes and expands the nature and extent of the reporting liabilities of directors and officers. Criminal penalties have been created with respect to certification where none had existed before,<sup>33</sup> and criminal penalties for existing crimes have been increased.<sup>34</sup> Directors and officers now face far more stringent reporting requirements for transactions in their company's securities,<sup>35</sup> and face loss of a potentially significant chunk of their compensation for violation of transaction rules.<sup>36</sup> It will now also be easier for the SEC to ban officers and directors from serving in like capacity in other enterprises for certain violations of the Securities Act of 1933 (the "Securities Act") and Securities Exchange Act of 1934 (the "Exchange Act").<sup>37</sup>

In a pre-Enron world, a CEO candidate was expected to conduct a certain amount of due diligence about a potential job

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<sup>32</sup> Sarbanes-Oxley Act § 906 (to be codified at 18 U.S.C. § 1350). Section 906 requires that the chief executive officer and chief financial officer draft a written statement to accompany all financial statements contained in periodic reports to the Securities and Exchange Commission. The statement must certify that the financial statements fully comply with sections 13(a) and 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"). Moreover, the certification must state that the information contained in the report fairly presents the financial conditions and results of the company's operations.

<sup>33</sup> For example, under section 906, if the certifying officer knows that the financial report does not comport with all of the section's requirements, then the officer may be fined up to \$1,000,000 and/or imprisoned for up to 10 years. *Id.* If the certifying officer willfully certifies the report knowing that it does not comport with the sections' requirements, then the officer may be fined up to \$5,000,000 and/or imprisoned for up to 20 years. *See id.*

<sup>34</sup> For example, pursuant to section 21(d)(3) of the Exchange Act, the Securities and Exchange Commission may bring a civil action against a violator of the securities laws. *See* 15 U.S.C. § 17u(3)(A) (2000). The limits for penalty against a violator range from a \$5,000 minimum to \$50,000. *See* 15 U.S.C. § 17(3)(B) (2000). Under the Act, these penalties have increased.

<sup>35</sup> *See id.* § 403 (to be codified at 15 U.S.C. § 78p(a)). Section 403 of the Act requires directors and officers to report to the SEC any transaction of personal holdings in the company within two business days after the transaction was executed.

<sup>36</sup> *See id.* § 304 (to be codified at 15 U.S.C. § 7243). If a company is required to prepare an accounting restatement because of a material non-compliance by the company, then the chief executive officer and chief financial officer must reimburse the company for any bonuses received or any profits realized from their personal sale of company stock.

<sup>37</sup> Sections 20(e) of the Securities Act (15 U.S.C. § 78t(e)) and 21(d)(2) of the Exchange Act (15 U.S.C. § 77u(d)(2)) are both amended by section 305, granting the federal judiciary the power to bar from service any officer or director whose conduct is determined to be "unfit." Previously, the conduct must have been deemed to be "substantially unfit."

opportunity—but much of that due diligence was directed at “fit” and corporate performance.<sup>38</sup> In our new post-Sarbanes-Oxley Act world of liability, a CEO candidate must exercise care and judgment, and must conduct her due diligence in some significantly new ways. That care and judgment should focus on: (1) internal corporate controls; (2) ethical rules in place; and (3) the composition and functioning of the board of directors, and principally the audit committee of the board.

Sensitivity to a corporation’s culture of internal controls is not something entirely new to publicly held corporations. Certainly since the 1996 decision of Chancellor Allen in *In re Caremark International Inc. Derivative Litigation*,<sup>39</sup> it has been clear that, at least under Delaware law, public corporations have had an affirmative duty to effectively monitor, or in the words of Chancellor Allen, the corporate board has a “responsibility to assure that appropriate information and reporting systems are established by management . . . .”<sup>40</sup> In a sense, this duty now

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<sup>38</sup> A taste of the approach can be gleaned from advice for companies seeking high level executives. See generally Ram Charan, *How to Lower the Risk in CEO Succession*, 17 LEADER TO LEADER 26, 26–32 (2002), reprinted at <http://drucker.org/leaderbooks/L2L/summer2000/charan.html>. New research suggests that the market for corporate executives is far less rational than might be assumed. See RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs (2002) (looking at the market for CEOs from the perspective of employers).

<sup>39</sup> 698 A.2d 959 (Del. Ch. 1996).

<sup>40</sup> *Id.* at 969–970. There are those within the academic community, reflecting perhaps the views of a certain segment of publicly traded company officers and directors, who would give *Caremark* short shrift. For a description of one of those arguments, see generally Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-governing Corporation*, 149 U. PA. L. REV. 1619, 1674–75 (2001) (explaining that “*Caremark* may not really be a duty of care case at all. It may be better understood as a case involving the duty to act lawfully, an area that traditionally has fallen outside of the business judgment rule. . . . As such, *Caremark* may be the corporate governance analog to the ‘public policy’ exception of the employment-at-will doctrine”). But see Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389 (2002); Harvey L. Pitt et al., *Director Duties to Uncover and Respond to Management Misconduct*, 11 INSIGHTS 5 (1997) (suggesting that there are ways to successfully deal with allegations of misconduct, but boards must play an active role in dealing with employees who breach company standards). It is possible to suggest that the practical effect of *Caremark* for most public companies was essentially hortatory, especially in light of the exculpations from many forms of liability for breach of the duty of care exemplified by provisions such as Delaware Corporate Code section 102(b)(7). However, whatever its “real” affect prior to 2002, I would argue that *Caremark* provides the post-Sarbanes-Oxley Act courts with a useful benchmark for

finds its way into the internal controls certification requirements of section 302 of the Act.<sup>41</sup> The historic sensitivity of a corporation to issues of internal control will provide a potential CEO with an indication of the likelihood of liability on this score. A corporation whose board and officers have been more, rather than less, aggressive about internal controls is an enterprise that is less likely to be the victim of fraud or illegal conduct. To that end, a potential CEO should try to familiarize herself with a corporation's system of internal controls. She should also obtain a sense of the nature and consequence of past improper conduct. A corporation that has been subject to multiple shareholder suits or governmental civil or criminal investigations suggests the culture of such an enterprise deserves some scrutiny before a candidate accepts a position there. None of this is hard to do, but it may require due diligence of the sort a CEO has been accustomed to perform in connection with corporate combinations.

The Sarbanes-Oxley Act itself provides another important source of CEO due diligence in contemplating a job offer for a public company. Section 404 of the Act will require a report by management on the company's internal controls.<sup>42</sup> This report

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interpreting and applying the new provisions.

<sup>41</sup> See Sarbanes-Oxley Act § 302 (to be codified at 15 U.S.C. § 7241(a)(4)). The chief executive officer and chief financial officer, upon certifying the Form 10-K and Form 10-Q reports, must affirm that they have evaluated the effectiveness of the company's internal controls and report any deficiencies or material weaknesses in such controls. In this regard it may be useful to recall that as early as 1997, Harvey Pitt, the now departed Chairman of the SEC, argued strongly for the adoption of:

[A] mechanism to ensure that directors learn sooner (rather than later) about allegations of significant illegality by corporate officers or directors. Not every claim or complaint must, or should, be channeled immediately to the company's directors. There comes a point, however, at which a certain threshold of seriousness has been passed (such as, for example, when outside counsel has been retained to address the problem).

Pitt et al., *supra* note 40, at 6. Pitt looked to the *Caremark* case for a model of corporate internal controls. *Id.* at 6-7.

<sup>42</sup> See Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262). Section 404 of the Act requires the SEC to create rules requiring companies to include an "internal control report" in their Form 10-K reports. The internal control report must state the responsibility of management for establishing and maintaining an internal control structure and procedures for financial reporting and assess the effectiveness of the internal control structure. See *id.* The SEC recently proposed to amend Item 307 of Regulations S-K and S-B to reflect the requirements of sections 404(a). See Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66208, 66219 (proposed Oct. 22, 2002) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270 and 274). Furthermore, an accounting firm

must include an assessment of those controls<sup>43</sup> and must be reviewed by the company's auditors.<sup>44</sup> A close reading of those reports will likely form an important part of a potential CEO's examination of the company. The potential CEO should not necessarily be looking for a "clean slate"; indeed a set of clean slate reports might raise red flags because it is unlikely that systems of internal controls are perfect or function flawlessly. Rather, what one is looking for are indications of honesty and effort. A pattern of small problems and swift correction makes for more comfort than reports indicating few but significant

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providing services to the company must attest to and report on management's assessment of the internal controls. *See* Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262(b)). The SEC proposed to amend Regulation S-X to reflect the attestation and reporting requirement pursuant to section 404(b), but may delay its effectiveness until the Public Company Accounting Oversight Board is operational and has defined attestation standards. *See* Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra*, at 66208, 66220, 66224 (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270 and 274). Though the SEC would not require a company to provide such attestations or reports until its proposed rules become effective, a company who voluntarily provides an annual report on the effectiveness of its internal controls and procedures for financial reporting should follow up with existing accounting literature. *Id.* at 66224. Similarly, auditors who voluntarily provide attestations before the effectiveness of the proposed rules should "perform such attestations in conformity with existing accounting literature regarding attestation engagements, including Section 501 of the AICPA's Statement on Standards for Attestation Engagements." *Id.*

<sup>43</sup> *See* Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262(a)(2)). Lynn E. Turner, the Chief Accountant for the SEC from 1998 to 2001, argued that the CEO and CFO should be required by the audit committee to assess the company's internal controls. He said, "[T]he audit committee . . . should require the CEO and CFO to provide to the audit committee and investors a report by management that clearly states management's responsibility for establishing, maintaining and ensuring an effective system of internal control actually exists and is operating. . . . If the executives are nervous about signing such a report, I suggest investors should be nervous about the numbers." *See Hearing on Accounting Oversight: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs, 107th Cong. (2002)* (statement of Lynn E. Turner, Chief Accountant, Sec. Exch. Comm'n).

<sup>44</sup> *See* Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262(b)). This is not an entirely new requirement. The Private Securities Litigation Reform Act of 1995 required that a company's outside auditors develop systems capable of detecting potentially illegal corporate acts, report those acts to the appropriate officers, and to assess the response. The Act effectively increases the nature and character of the auditor's assessment, but now more directly imposes on management substantial responsibility for the development and maintenance of internal control systems under section 404. *See id.*

The views of Harvey Pitt on these earlier requirements have been known for some time. *See* Harvey L. Pitt & David B. Hardison, *For Outside Accountants, the New Obligations Imposed by the Securities Litigation Reform Act Go Way Beyond Classical GAAS*, NAT'L L.J., Mar. 25, 1996, at B4.

problems or no problems at all.

This last point raises the related matter of the general culture of ethics within a corporation. A potential CEO should be aware of the extent to which the corporation has maintained a culture of ethical conduct at all levels of the corporate organization. The Sarbanes-Oxley Act now requires the SEC to issue rules respecting company codes of ethics for senior financial officers.<sup>45</sup> The existence of these codes must be disclosed on Form 8-K, along with changes in or waivers from their provisions. Corporations without ethics codes must disclose the reasons for the failure to promulgate one. Potential CEOs should determine whether a corporation has such a code in place, what they provide, and the extent and manner to which they have been enforced. Corporations that have required their officers to certify, on a periodic basis, that they have read the code and are in compliance with its terms are probably less likely to run afoul of the new requirements of the Act than those that do not. Boards of directors that tend to waive their ethics codes for expediency or for other reasons<sup>46</sup> are potentially trouble in the making.

Much of the burden of the new requirements falls on the audit committee of the board of directors. The Sarbanes-Oxley Act requires the SEC to direct the national exchanges to restrict the listing of issuers who, by April 26, 2003, have not appointed audit committees composed of independent members of the

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<sup>45</sup> See Sarbanes-Oxley Act § 406 (to be codified at 15 U.S.C. § 7264). In the Senate Banking, Housing & Urban Affairs Committee hearing on Feb. 12, 2002, Senator Charles Hagel addressed concerns to former SEC chairmen that Enron suspended its ethics code in 1999 and questioned if the SEC required any reporting of that action. See *Hearing on Enron Accounting and Investor Issues: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs, 107th Cong. (2002)* (statement of Sen. Charles Hagel). SEC Chairman David Ruder responded, "I don't think, Senator, that there is any direct reporting requirement. . . . One of the things I said in my testimony was certainly that we should require—and this is something the Commission can do—to go out and require the filing of an 8-K in events like that where an ethics code is being suspended or certain types of conflicts are created." *Id.* (statement of David Ruder, SEC Chairman).

<sup>46</sup> Thus, for example, Max Hendrick III, a partner at Vinson & Elkins, L.L.P., Enron's outside law firm, asserted in a letter that the Enron board of directors waived the company's ethics code on at least two occasions in 1999 to permit Fastow (Enron's Exec. VP and CFO) to engage in certain financial transactions. See Letter from Max Hendrick III to James V. Derrick, Jr., Executive Vice President and General Counsel, Enron Corp. (Oct. 15, 2001), reproduced in 1325 *PLI/Corp.* 881, 915-18 (2002), available at <http://www.westlaw.com>.



board of directors.<sup>47</sup> The Act requires public accounting firms to report directly to the audit committee, which is now responsible for the appointment and oversight of the outside auditing firm.<sup>48</sup> The audit committee has limited authority to engage the corporation's public accounting firm for non-audit activities.<sup>49</sup> Audit committee membership is limited to members of the board of directors, and all of the members of the audit committee must be independent.<sup>50</sup> The audit committee must establish procedures to receive, retain, and treat complaints regarding accounting, internal controls, and auditing matters, including procedures to facilitate confidential and anonymous employee

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<sup>47</sup> See Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78f(m)). Section 301 of the Act requires the SEC to direct the national stock exchanges to restrict the listing of companies who have not formed "independent" audit committees by April 26, 2003. The audit committee is a subcommittee of the board of directors who is directly responsible for the appointment, compensation, and oversight of any work provided by an independent auditor. The idea for an audit committee was addressed before the Senate Governmental Affairs Committee on January 24, 2002 regarding the oversight of independent auditors. See *Hearing on Enron Collapse: Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. (2002). Lynn Turner, the former Chief Accountant for the SEC, said before the Senate Banking, Housing & Urban Affairs Committee, "[T]he exceptions provided for in the rules of the stock exchanges would still permit an audit committee member who is not independent, should be eliminated." See *Hearing on Accounting Oversight: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002). In addition, John Whitehead, former co-chairman of Goldman Sachs and Co., suggested before the Senate Banking, Housing, & Urban Affairs Committee that the audit committees of the board be composed of the most financially experienced people. See *Hearing on Post-Enron Accounting and Investor Protection Issues: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002).

<sup>48</sup> See Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j(k)); see also *id.* § 301 (to be codified at 15 U.S.C. § 78f(m)). The Senate Banking, Housing, & Urban Affairs Committee addressed the need for the audit committee to provide oversight to independent auditors. See *Hearing on Accounting Oversight: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002). Lynn Turner, the former Chief Accountant for the SEC, said before the Senate Banking, Housing, & Urban Affairs Committee, "[T]he audit committee should, as I mentioned previously, directly hire, evaluate and if necessary, fire the auditor." *Id.*

<sup>49</sup> See Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j(i)). For example, it was suggested in the Senate Governmental Affairs Committee hearing on January 24, 2002, that the audit committee should be responsible for pre-approving consulting contracts with an auditing firm. See *Hearing on Enron Collapse: Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. (2002).

<sup>50</sup> See Sarbanes-Oxley Act § 301(m)(3) (to be codified at 15 U.S.C. § 78j(m)); see also *Hearing on Accounting Oversight: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002) (suggesting that members of the audit committee be independent).

reports of questionable accounting or auditing matters.<sup>51</sup> The audit committee must have the authority to appoint independent counsel and to be funded sufficiently to comply with their duties.<sup>52</sup> A potential CEO ought to ensure that she is comfortable with the composition, historic practices, and current operations of the audit committee of the board.

In short, CEOs face the same sort of due diligence when contemplating a job offer. The difference now is that, to some extent, the consequences have become more important, and the cost of error greater. More important, perhaps, the nature of the due diligence inquiry has changed, in some substantial respects, after enactment of the.

2. *The Act prohibits the corporation from extending personal loans to any executive officer, except for consumer credit. Does this new provision affect the ability of corporations to help new executives with their relocations? Does that then limit the pool of potential executives by geography and based on their financial wherewithal?*

In drafting the provisions of the Act, Congress was especially sensitive to what it characterized as the gross abuses by corporate insiders who used corporate funds as personal piggy banks to finance their personal activities.<sup>53</sup> For example, Adelphia executives secured a number of loans from the company to finance personal ventures.<sup>54</sup> Tyco executives had very large loans forgiven through the payment of matching bonuses.<sup>55</sup>

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<sup>51</sup> See Sarbanes-Oxley Act § 301(m)(4) (to be codified at 15 U.S.C. § 78j(m)).

<sup>52</sup> See Sarbanes-Oxley Act § 301(m)(5) (to be codified at 15 U.S.C. § 78j(m)).

<sup>53</sup> For example, the House Financial Services Committee addressed concerns with companies providing loans to their officers and directors. See *Wrong Numbers: The Accounting Problems at Worldcom: Hearing Before the H.R. Comm. on Fin. Servs.*, 107th Cong. (2002). Congressman Jim Leach objected to loans from companies to officers when he said, “[T]o put it plainly, it is self-dealing for a corporate head to give himself a multi hundred million-dollar loan, and it is a dereliction of duty for a board to go along.” *Id.*

<sup>54</sup> David Lieberman, *Rigas Pleads Not Guilty; Adelphia Founder, 4 Others Deny charges*, USA TODAY, Oct. 3, 2002, at B3 (“The family also allegedly led Adelphia to guarantee more than \$3 billion in loans to a Rigas-owned partnership to build a golf course on family land and to supply company jets for personal use.”); see also Sen. Paul Sarbanes, Address to the U.S. Senate Regarding the Accounting Reform and Investor Protection Act (July 8, 2002).

<sup>55</sup> The popular press was full of stories about the investigation relating to a

The Sarbanes-Oxley Act's solution to the problem of abuse was to amend section 13 of the Exchange Act by adding subsection k, prohibiting the extension of credit by an issuer to executive officers and directors.<sup>56</sup> As a result of this provision, corporate loan programs of virtually every description will be prohibited.<sup>57</sup> Existing loans will be grandfathered, unless the loan terms are modified.<sup>58</sup> The provision raises a number of questions. Many of these revolve around the issue of the meaning of "credit" for purposes of the application of the statute. The statute could be read narrowly to limit the power of the company to extend credit only with respect to standard form loans to executives. As such, the only credit covered under the Act would be credit in forms otherwise available from third party lenders. Reading sections 78m(k)(1) and (2) together, it is possible to read the term "credit" in section (k)(1) to be limited to the sorts of extensions of credit identified in section (k)(2)—home loans, consumer credit, charge cards, and extensions of credit by brokers and dealers. This produces a symmetrical reading of the provision when read as a whole. There is legislative history to support this narrower, but balanced interpretation of the

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loan forgiveness program for Tyco executives. "More than 40 Tyco International Ltd. employees received loans from the company worth tens of millions of dollars that were later forgiven at former chief executive L. Dennis Kozlowski's direction, raising fresh questions about how money flowed so freely to favored workers without public disclosure." Ben White, *Tyco CEO Arranged Forgiving of Loans*, WASH. POST, Sept. 17, 2002, at E1.

<sup>56</sup> See Sarbanes-Oxley Act § 401 (to be codified at 15 U.S.C. § 78m(a)).  
According to the Act:

It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.

*Id.* § 402 (to be codified at § 78m(k)(1)).

<sup>57</sup> The Act provides a very small exception for home improvement and manufactured home loans, consumer credit, extensions of credit under an open end credit plan, charge cards, or extensions of credit by a registered broker or dealer, provided these extensions of credit are made in the ordinary course and available to the public. See *id.* § 402 (to be codified at 15 U.S.C. § 78m(k)(2)).

<sup>58</sup> See *id.* § 402 (to be codified at 15 U.S.C. § 78m(k)(1)). Furthermore:

An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

*Id.*

provision. For example, Congresswoman Mink expressed her understanding of the provision as “prohibit[ing] corporations from providing ‘sweetheart’ loans—that is, direct or indirect personal loans—to or for any director or executive officer.”<sup>59</sup> Senator Sarbanes also appeared to suggest the prohibitions of the Act were meant to target ‘sweetheart’ loans of the type at issue in the scandals surrounding companies such as Adelphia and Tyco and that the provisions of sections k(1) and (k)(2) ought to be read symmetrically. Section 402 of the Act “would still prohibit corporate executives from reaping millions of dollars in loans from their companies, but the new language also realizes that executives need to use things such as credit cards to conduct their business.”<sup>60</sup> Senator Feinstein also suggested that the prohibitions would apply only to sweetheart loans when she stated, “Company loans to executive officers are now prohibited, sharply limiting the types of ‘hidden’ compensation that can be offered to executives without being fully disclosed to shareholders.”<sup>61</sup>

A broader reading of the statute, however, is also possible. There is nothing in the Act or in the legislative history that compels symmetry between sections (k)(1) and (k)(2). None is necessary. Moreover, the broadest reading of “credit” might well be consonant with the overall remedial intent of the Act as a whole. Certainly, there is some legislative history that might support such a reading. Senator Feinstein, who introduced what became the loan preclusion section of the Sarbanes-Oxley Act, spoke broadly of an intent to “prohibit all loans by a corporation to its directors or executive officers.”<sup>62</sup> Senator Sarbanes described the provision as necessary to “keep executives from obtaining corporate loans that are not available to outsiders.”<sup>63</sup>

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<sup>59</sup> 148 CONG. REC. H5474 (daily ed. July 25, 2002) (statement of Rep. Mink).

<sup>60</sup> 148 CONG. REC. S7355 (daily ed. July 25, 2002) (statement of Sen. Enzi).

<sup>61</sup> 148 CONG. REC. S6762 (daily ed. July 15, 2002) (statement of Sen. Feinstein).

<sup>62</sup> *Id.* at S6760. Senator Feinstein elaborated her intent to propose a provision with very broad application:

I see no justification for providing loans to corporate directors or executive officers. The goal of the reforms that we are currently debating should be to create an environment in which outside directors and major corporate officers act in as pure and honest a manner as possible. They should not enter into any appearance of conflict, such as the conflict that occurs when the corporation that they serve extends them a personal loan.

*Id.*

<sup>63</sup> 148 CONG. REC. S7360 (daily ed. July 25, 2002) (statement of Sen. Sarbanes).

My sense is that Congress did not really consider what it meant by the terms of the provision they enacted, other than that Congress wanted to prohibit the sort of loans at the heart of the corporate scandals being covered in the press. In light of this fairly concrete and memorialized Congressional intent—to change corporate behavior deemed harmful without otherwise effecting changes in the corporate law or corporate operation—the narrower rather than the broader reading of the meaning of the term “credit” is appropriate.

The determination of the meaning of “credit” for purposes of the loan prohibition provisions will have significant effect. A broad understanding of the meaning of “credit” would sweep within its definition a number of what had been unproblematic transactions between executives and the company. These include cash advances against future bonuses and amounts advanced to executives under corporate indemnification plans to cover expenses incurred in connection with the defense of a potentially indemnifiable action.<sup>64</sup> The narrower definition might not. Corporations will have to look for alternatives to attract and retain executives. The most straightforward alternative is to substitute direct payments for loans or by increasing salaries. Of course, that poses a problem for many publicly held corporations which face increasing press, governmental, and shareholder scrutiny of salary and compensation structures.

Prohibition of advances of potentially indemnifiable expenses under a broad reading of the provisions of section (k)(1) would affect significant change on current corporate practice. A strong argument can be made, however, that whatever meaning it is given, the advancement of expenses connected to an indemnifiable action against an officer or director permitted

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<sup>64</sup> See, e.g., DEL. CODE ANN. tit. 8, § 145 (2002); N.Y. BUS. CORP. LAW §§ 723, 725 (McKinney 2002). For a discussion of the attorney fee advancement provisions of indemnification agreements under state corporate law, see, for example, Robert P. McKinney, *Protecting Corporate Directors and Officers: Indemnification*, 40 VAND. L. REV. 737, 752–55 (1987); Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 581–82 (1996); E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987). For cases discussing the advancement of attorneys fees under company indemnification rules, see, for example, *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 823 (Del. 1992); *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339 (Del. 1983).

under state corporate law ought not to come within the meaning of “credit” extensions prohibited under new section 78m(k)(1). First, such advances are not true loans, that is an extension of credit where both parties understand that repayment will be required. Indemnification advances are more aptly considered a conditional obligation. Only those executives who are *not* entitled to indemnification will be required to repay the advances.<sup>65</sup> Moreover, advances for expenses were not the sort of transaction between the corporation and its officers or directors that Congress had in mind when it enacted this provision.<sup>66</sup> More important, it is unlikely that Congress would preempt such an integral part of state corporate law and practice in such an offhanded manner. If Congress had intended to preempt this portion of the state laws of indemnification, Congress would have done so explicitly rather than by implication.

Applicability of new section 78m(k) to state indemnification laws permitting advances of expenses raises a more general point. To some extent, the new provision evidences the growing importance of federal preemption of corporate law, at least with respect to publicly traded companies. New section 78m(k) effectively makes provisions typically found in state corporate law that permit loans to employees and officers unavailable to publicly traded corporations but not to other corporations.<sup>67</sup> The Sarbanes-Oxley Act, in this respect, constitutes another step in the piecemeal creation of a federal corporate law applicable to publicly traded companies.

3. *The Sarbanes-Oxley Act prohibits registered accounting firms from performing audits for an issuer if they are also performing certain nonaudit services, unless pre-approved by the firm’s audit committee. The Senate Committee report on Enron blamed Enron’s problems on the accountants’ role in providing audit and nonaudit services. Would a bright-line*

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<sup>65</sup> See, e.g., DEL. CODE ANN. tit. 8, § 145(e) (2002) (stating that repayment is required “if it shall ultimately be determined that *such person* is not entitled to be indemnified by the corporation”).

<sup>66</sup> See discussion of legislative history *supra* notes 62–63.

<sup>67</sup> See, e.g., DEL. CODE ANN. tit. 8, § 143 (2002). The standard for approving those loans is generally fairly low—usually loans may be made when in the judgment of the board, such loan might reasonably be expected to benefit the corporation. *Id.*

*test barring accounting firms from providing audit and nonaudit services have been more efficacious in preventing any future malpractice by accountants?*

The Sarbanes-Oxley Act sets forth a fairly rigid bright line, essentially prohibiting the provision of non-auditing services by a registered auditing firm during the time that firm performs auditing services.<sup>68</sup> However, the registered auditing firm may perform both audit and non-audit services upon approval by the company's audit committee,<sup>69</sup> if approval is obtained in the manner specified in the Act.<sup>70</sup> The approval process is meant to provide a closer connection between audit committee action and the trading price of the company's securities.<sup>71</sup> The expectation

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<sup>68</sup> See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201(a), 116 Stat. 745, 771 (to be codified at 15 U.S.C. § 78j-1(g), (h)). This section also prohibits registered auditing firms from providing the auditing client, "contemporaneously with the audit, an non-auditing service." *Id.* (to be codified as amended at 15 U.S.C. § 78j-1(g)).

<sup>69</sup> 15 U.S.C. § 78j-1(h) provides that "[a] registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer." See Sarbanes-Oxley Act § 202 (to be codified at 15 U.S.C. § 78j-1(h)). The Senate Committee Report indicated that though the Committee had "considered adopting a complete prohibition on non-audit services by accounting firms for their audit clients, . . . [they] instead decided on a somewhat more flexible approach." S. REP. NO. 107-205, at 16 (2002).

<sup>70</sup> New 15 U.S.C. § 78j-1(i)(1)(A) (2002) requires audit committee pre-approval of such activities, and public disclosure to investors in periodic reports required by section 13(a). See Sarbanes-Oxley Act § 202 (to be codified at 78j-1(i)(2)). Pre-approval responsibilities can be delegated "to 1 or more designated members of the audit committee who are independent directors of the board of directors . . ." *Id.* (to be codified at § 78j-1(i)(3)).

<sup>71</sup> The Sarbanes-Oxley Act provides a de minimus exception to the pre-approval disclosure rules for non-auditing services if:

- (i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the nonaudit services are provided;
- (ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and
- (iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

*Id.* § 202 (to be codified at 15 U.S.C. § 78j-1(i)(1)(B)). The Senate Committee described this provision as available only in the "atypical circumstance where an auditor is providing to the issuer a service that was anticipated to be an audit

is that disclosure will affect the market price of shares. To that extent, a market reaction to attempts to avoid more rigid separations between audit and non-audit functions performed by the same entity might be the most effective regulator of that relationship between accountants and issuer. Even before the passage of the Act, auditing firms had begun adjusting their behavior in light of perceived governmental and market pressures. Some of these firms had announced programs of voluntary decoupling of audit and non-audit functions in the wake of the post-2000 business and accounting scandals

Having posited this market and disclosure oriented approach to the regulation of the relationship between issuer and outside auditor, I should concede that the Sarbanes-Oxley Act appears, to some extent, to be an admission that the market-disclosure model, a model that has been the foundation of the regulation of publicly held companies for most of the twentieth century, has not worked as well as it should have.

In the future, the new regulatory, investigatory, and disciplinary functions of the Public Company Accounting Oversight Board (the "Board") might prove to be a more significant deterrent to accountant misconduct.<sup>72</sup> In addition to fines,<sup>73</sup> the Board can temporarily or permanently bar

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service within the scope of the engagement, but is later discovered to be a non-audit service." S. REP. NO. 107-205, at 20 (2002).

<sup>72</sup> Section 105 of the Act provides that the Board is authorized to conduct investigations of accounting firms who allegedly violated the securities law, SEC rules, Board rules, or professional standards. *See* Sarbanes-Oxley Act § 105(b)(1) (to be codified at 15 U.S.C. § 7215(a)). During an investigation, the Board is also authorized to hear relevant or material testimony from members of the firm and compel the production of relevant or material documents. *See id.* § 105(b)(2)(A)(B)(C) (to be codified at 15 U.S.C. § 7215(b)). The Senate Banking, Housing, & Urban Affairs Committee addressed the creation of an independent auditing board on March 19, 2002. *See Hearing on Post-Enron Accounting and Investor Protection Issues: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002) (testimony of Charles Bowsher). The Committee discussed creating an accounting standards board by statute under the control of the SEC. *Id.* (testimony of Charles Bowsher and Aulana Peters). Moreover, they discussed the framework of the board and how it would differ from the independent oversight offered by groups, such as FASB. *Id.* (testimony of Charles Bowsher).

<sup>73</sup> *See* Sarbanes-Oxley Act § 105(c)(4)(D) (to be codified at 15 U.S.C. § 7215(c)(4)(D)). This section of the Act provides the Board the ability to impose civil monetary penalties against violators of the securities law, the Board rules, SEC rules, or professional standards. In general, a natural person may be fined no more than \$100,000 and no more than \$2,000,000 for other persons such as corporations and partnerships. *See id.* § 105(c)(4)(D)(i) (to be codified at 15 U.S.C. §



accounting firms from the market for public company audit work.<sup>74</sup>

4. *The Sarbanes-Oxley Act requires that each corporation establish a code of ethics for senior financial officers. What sort of things would you advise be placed in that code? Does having a code expose these officers to any additional liability?*

Section 406 of the Sarbanes-Oxley Act compels the SEC to issue rules by January 26, 2003, requiring a public company to disclose whether it has adopted an ethics code "for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions."<sup>75</sup> The Act defines a code of ethics to mean:

[S]uch standards as are reasonably necessary to promote—(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and (3) compliance with applicable governmental rules and regulations.<sup>76</sup>

There are a number of sources from which ethics rules can be drawn. I might start with the ethics rules of the professional organizations most closely tied to financial affairs and financial reporting—accounting and law. Very influential will be the ethical standards that the Board is required to establish under

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7215(c)(4)(D)(i). However, if the conduct is found to be intentional, knowing, reckless, or repeatedly negligent, then a natural person may be fined up to \$750,000 and no more than \$15,000,000 for other persons. *See id.* § 105(c)(4)(D)(ii) (to be codified at 15 U.S.C. § 7215(c)(4)(D)(ii)).

<sup>74</sup> *See id.* § 105(c) (to be codified at 15 U.S.C. § 7215(c)). With regards to intentional, knowing, reckless, or repeatedly negligent conduct that violates the securities laws, the Board rules, SEC rules, or professional standards, the Board has the ability to temporarily revoke registration with the Board, suspend a person from practice with a firm, and limit a person's activities. *Id.* The Board may also invoke the penalties on a permanent basis. *Id.*

<sup>75</sup> *Id.* § 406(a) (to be codified at 15 U.S.C. § 7264).

<sup>76</sup> *Id.* § 406(c) (to be codified at 15 U.S.C. § 7264(c)); *see also Hearing on Enron Accounting and Investor Issues: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002) (testimony of Arthur Levitt) (discussing the need for new legislation in the face of an increasing corporate willingness to breach ethical duties).

section 103 of the Act.<sup>77</sup> These standards are to be developed after consultation with professional accounting and advisory groups.<sup>78</sup> The views and ethical standards of these professional and advisory groups will also be influential.<sup>79</sup> Corporate law might contribute as well. For example, the conflicting interest transaction approach of Sub Chapter F of the Revised Model Business Corporation Act (RMBCA) might provide a basis for approaching the issue of conflicts of interest identification.<sup>80</sup>

The greatest value of any code would lie in its efficiency—its power to affect behavior in a positive way, and its effectiveness in revealing potential areas of ethical concern in a timely manner. The danger of any Code writing is the temptation to use the Code as a means of expressing the loftiest notions in the most hortatory terms, but providing little in the way of implementing language or sanctions for violation of the ethics rules. Rules that reflect the reality of the law and the conduct of the business, that are easy to understand and easy to apply, and that include well-understood consequences, provide the foundation for a successful code of ethics. Providing the board of directors with the mechanics for tempering the application or consequences of the rules in appropriate cases, with or without a shareholder approval feature, would make the ethics code fair. The most well implemented code, of course, is the one internalized by the relevant work force, that is, one that seems part of a natural order of things. The provisions of the Sarbanes-Oxley Act do not seem to add much to this project. The economics of disclosure will result in the adoption of at least pro

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<sup>77</sup> Sarbanes-Oxley Act § 103(a)(1) (to be codified at 15 U.S.C. § 7213). The Board must require accounting firms to maintain work papers and other documents for at least seven years, have all of its audit reports reviewed by an independent auditor (either within or without the firm), and report on its internal control reviews. *See id.* § 103(a)(2)(A)(i) (to be codified at 15 U.S.C. § 7213(a)(2)(A)(i)).

<sup>78</sup> *See id.* § 103(a)(1) (to be codified at 15 U.S.C. § 7213(a)(1)). The groups likely to participate include organizations like FASB and AICPA. *See Hearing on Post-Enron Accounting and Investor Protection Issues: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs, 107th Cong. (2002).*

<sup>79</sup> The American Institute of Certified Public Accountants Code of Conduct, for example, serves as a basis for state regulation of the accounting profession. *See Paul B. W. Miller, Financial Accounting Regulations and Organizations, in 1 ACCOUNTANTS' HANDBOOK § 2.4, at 2-31 (D.R. Carmichael et al. eds., 9th ed. 1999).* For an overview of the ethical standards developed by some of these groups, see, for example, AICPA CODE OF PROFESSIONAL CONDUCT, available at <http://www.aicpa.org/about/code/index.htm> (last visited Oct. 11, 2002).

<sup>80</sup> *See* MODEL BUS. CORP. ACT § 8.60(1) (2002).

forma codes of ethics in virtually every reporting corporation. It may also serve as an additional black-letter source of liability for lawsuits, and in this manner provide a focal point for coercive behavior modification. But we should keep in mind that it is the conduct and not the code that ought to be the focus of any ethical enterprise.

5. *If you are an attorney representing a company and you become suspicious that the company is misrepresenting its financial statements, what should the attorney do? Does it matter whether the attorney is in-house or in a firm? Are there different risks for them? What potential liability does the attorney possibly incur if he or she fails to act in a responsible manner?*

Section 307 of the Act<sup>81</sup> has introduced a very controversial provision affecting lawyers. The Act compels the SEC to adopt new rules of professional conduct applicable to attorneys practicing before it in any way in the representation of issuers. These rules are to include:

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.<sup>82</sup>

The SEC is also given the authority to censure any persons appearing before it.<sup>83</sup> The rule would apply both to corporate in-

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<sup>81</sup> See Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245).

<sup>82</sup> *Id.* § 307(1)(2).

<sup>83</sup> Section 602 of the Sarbanes-Oxley Act, adding section 4C to the Exchange Act, provides the SEC with the authority to "censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission" (for, among other reasons, willful violation or willful aiding and abetting the violation of the securities law or the rules and regulations issued

house attorneys and outside counsel.

These rules have potentially far reaching effects. Though the section has worried various legal observers because it is thought to put the attorney-client confidentiality relationship into question, the plain language of the statute appears to indicate an intention to preserve the confidential relationship between attorneys and their corporate clients. Recall that under section 1.13 of the ABA Model Rules of Professional Conduct (the "Model Rules") attorneys represent the corporation rather than the constituents or agents of the corporation.<sup>84</sup> In that light, the requirement to report first to inside counsel or the CEO, and then to members of the board of directors, might be characterized as merely expressing in specific context the otherwise ordinary duty of the attorney to zealously represent the corporate client under the Model Rules.<sup>85</sup>

Moreover, section 307 of the Act is applicable to a subset of legal violations—"material violation of securities law or breach of fiduciary duty or similar violation"—covered by section 1.13 of the Model Rules. With respect to these violations, the threshold standard of knowledge of violation is reduced from knowledge of a violation of legal obligation or law in the Model Rules to "evidence of a material violation" in the Act.

On the other hand, the options for action by attorneys discovering material violation of law or fiduciary duty are limited. While the Model Rules provide for significant flexibility and build in a system of proportionality (e.g., "the lawyer shall proceed as is reasonably necessary in the best interest of the organization"),<sup>86</sup> the Act requires presentation of the evidence of

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thereunder). *See id.* § 602 (to be codified at 15 U.S.C. § 78d-3).

<sup>84</sup> *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2002) ("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.").

<sup>85</sup> Thus, it is possible to argue that the new reporting rules of section 307 of the Act mirror the requirements under the Model Rules. Section 1.13(b) of the Model Rules requires an attorney, who knows that any person associated with the company will act or refuse to act in a manner that might be construed as a violation of law imputable to the corporation, to act. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(b). The actions the attorney can take include seeking reconsideration, advising that a separate legal opinion is necessary, or seeking referral of the matter to higher authority in the organization, including, if appropriate, the board of directors. *Id.* at R. 1.13(b)(1). Section 1.13(c) permits a lawyer to resign in the event the highest authority of the company insists on action "that is clearly a violation of law." *Id.* at R. 1.13(c).

<sup>86</sup> *Id.* at R. 1.13(b).

material violation to “the chief legal counsel or the chief executive officer of the company (or the equivalent thereof).”<sup>87</sup> In addition, the Act requires the lawyer to present the issue to the audit committee of the board of directors or other appropriate committee of outside directors “if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation).”<sup>88</sup> No safe harbor provision is provided in the event of eventual inappropriate action by the board of directors. It is possible that at this point Rule 1.13(c) of the Model Rules would apply and permit the lawyer to resign. In this sense, it is possible to view the section 307 requirements as part of a package of institutional requirements to correct failures in the market for gatekeeping services.<sup>89</sup> With respect to lawyers, at least, the failure is rectified through a focused fortification of a lawyer’s representation of corporate clients, but in keeping with the spirit of the Model Rules. This sentiment appears to have been expressed by the now departed SEC Chairman Harvey Pitt in a speech delivered at the ABA 2002 Annual Meeting.<sup>90</sup>

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<sup>87</sup> Sarbanes-Oxley Act § 307(1) (to be codified at 15 U.S.C. 7245(1)).

<sup>88</sup> *Id.* § 307(2) (to be codified at 15 U.S.C. 7245(2)).

<sup>89</sup> John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1404–05 (2002). Thus, Professor John Coffee suggests that underlying the extent of the market reaction to the corporate scandals from Enron:

lies the market’s discovery that it cannot rely upon the professional gatekeepers—auditors, analysts, and others—whom the market has long trusted to filter, verify and assess complicated financial information. Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

*Id.*

<sup>90</sup> Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association’s Business Law Section (Aug. 12, 2002), available at <http://www.sec.gov/news/speech/spch579.htm>. Chairman Pitt said:

We’ve been directed to ensure that appropriate standards of ethics and competency are established, implemented and enforced. The profession should examine itself and provide guidance about how its members should behave that is broader than technical legality, and truly in the public interest. The Report produced by Jim Cheek’s Task Force is in the best tradition of this kind of private sector self-examination. It reiterates that “the *organization* is the lawyer’s client and that the lawyer owes that client an obligation of protection from harm,” and embodies the idea in Sarbanes-Oxley that lawyers should fulfill their responsibilities to their ultimate client . . . . While there will be details that we must consider as we develop rules for attorney conduct, the underlying principle of Sarbanes-Oxley is unassailable—attorneys must be vigilant in protecting the interests of

The SEC recently proposed rule 205 to reflect the requirements of § 307 of Act.<sup>91</sup> The proposed rule suggests that the SEC will interpret its authority under section 307 quite broadly.<sup>92</sup> The proposed rule “incorporates several corollary provisions that are not explicitly required by section 307.”<sup>93</sup> Section 205.3(b) of proposed Part 205 codifies the “up the ladder” reporting system for attorneys who practice or appear before the SEC.<sup>94</sup> According to the proposed rule, an attorney’s duty to report is triggered when she “becomes aware of information that would lead a reasonable attorney to believe a *material* violation [of securities law or breach of fiduciary duty or similar violation by the company or agent thereof] has occurred, is occurring, or is about to occur.”<sup>95</sup> Once the duty to report is triggered, the attorney is required to report the material violation to the issuer’s chief legal officer or chief executive officer.<sup>96</sup> Subsequently, the CLO or CEO is obligated to determine whether the report has any merit, and if it does, to remedy the situation.<sup>97</sup> If the CLO or CEO find that the report does not have merit, then they must report their findings to the attorney.<sup>98</sup> An attorney only fulfills her obligations once she “receives an appropriate response within a reasonable time and has taken reasonable steps to document his or her report and the response to it has satisfied his or her obligations under the rule.”<sup>99</sup> An attorney who does not receive an appropriate response, or if she believes that reporting the violation to the CLO or CEO is futile, must report the violation to the issuer’s audit committee or a subcommittee of the board of directors containing independent directors or to the full board.<sup>100</sup> The

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their true clients.

*Id.* (internal citations omitted).

<sup>91</sup> Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71673 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205).

<sup>92</sup> The proposed regulations are introduced as an expression of the Commission’s “intention to implement a robust system” in response to the mandate represented by section 307. *See id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 71674.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

attorney is also required to document the response, or absence thereof, of her report as it travels "up the ladder."<sup>101</sup> The SEC indicates that the attorney's record should "typically include the date, time, location, manner, and substance of the report and the response and the identity of witnesses to either."<sup>102</sup>

Proposed rule 205.3(d) outlines the obligations of both outside and in-house attorneys who report material violations and do not receive an appropriate response.<sup>103</sup> An outside attorney who does not receive an appropriate response to her report is required to withdraw from her representation, notify the SEC of her withdrawal on the basis of "professional considerations," and disaffirm any submission to the SEC that they have participated in that may be tainted by the violation.<sup>104</sup> The SEC notes that the outside attorney's withdrawal is consistent with the Model Rule 1.16.<sup>105</sup> An in-house attorney who does not receive an appropriate response is required to disaffirm any submissions she participated in that may be tainted by the material violation, but she is not required to resign.<sup>106</sup> Furthermore, pursuant to proposed rule 205.3(d)(4), the SEC provides protection to an attorney, whether outside or in-house, who reasonably believes was discharged because she fulfilled her reporting obligations.<sup>107</sup> Under the proposed protection provision, the attorney may report her discharge to the SEC without violating the attorney-client privilege, presumably based on the whistleblower protections provided by § 806 of the Act.<sup>108</sup>

Under certain circumstances an attorney may submit confidential information to the SEC without breaching the attorney-client privilege. Pursuant to proposed rule 205.3(e), an attorney may use documents she prepared to defend against allegations of attorney misconduct.<sup>109</sup> Moreover, proposed rule 205.3(e)(2) permits an attorney to reveal confidential information to prevent the commission of an illegal act that the attorney

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<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 71684.

<sup>103</sup> *Id.* at 71674.

<sup>104</sup> *Id.* at 71674, 71683

<sup>105</sup> *Id.* at 71684.

<sup>106</sup> *Id.* at 71674.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

reasonably believes “will result either in perpetration of a fraud upon the Commission or in substantial injury to the financial or property interests of the issuer or investors.”<sup>110</sup> The SEC indicated that Model Rule 3.4 is in accordance with this provision.<sup>111</sup>

Despite the length and breadth of the proposed rules, the provision itself still suffers from a number of ambiguities. Among those areas of ambiguity are the quantum of evidence sufficient to give rise to the obligation to bring a matter to company senior counsel or the CEO;<sup>112</sup> the amount of time between the discovery of evidence and its disclosure;<sup>113</sup> the characteristics of appropriate and inappropriate responses to this disclosure by the CEO or senior company counsel;<sup>114</sup> and the

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<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at 71684.

<sup>112</sup> The proposed rule defines evidence of a material violation as “information that would lead an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur.” *Id.* at 71678. The comments to this proposed rule provide that the objective standard created by this definition does not require an attorney to believe the information. Thus, even if an attorney subjectively does not believe the information she has learned or obtained, she must determine whether the information would lead an attorney, acting reasonably, to believe that the material violation” requires reporting. *Id.* However, the standard “is intended to preclude reports based on mere suspicion of a material violation while providing flexibility to the attorneys when evaluating their reporting obligations.” *Id.*

The SEC, however, has indicated in the proposed rule that the standard for making a required report of material violation under section 307 “is not comparable to a judicial determination that a material violation actually occurred. There must, however, be some factual basis that would lead an attorney to reasonably believe that a material violation has occurred, is occurring, or is about to occur.” *Id.*

<sup>113</sup> The comments in the proposed rule suggests a non-unitary approach:

[W]hen an attorney “becomes aware” of information that would lead an attorney reasonably to believe in the existence of a material violation would turn, at least in part, on the attorney’s training, experience, position and seniority. Attorneys are not necessarily expected to identify issues they are not equipped to see. What the reasonable, experienced securities lawyer might regard as a clear violation of the law may appear different—or not appear at all—to an unseasoned attorney with a different level of expertise.

*Id.*

<sup>114</sup> The proposed rule suggests that the SEC will measure the appropriateness of a response “against an objective reasonableness standard.” *Id.* at 71676. Yet, it seems that the SEC will flesh this standard out in prosecutions under the rule. “The Commission’s intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an ‘appropriate response’ is objectively reasonable.” *Id.* The comments to the proposed rule do, however, provide some examples of what could comfortably be considered



amount of time between disclosure to the appropriate official and a response.<sup>115</sup>

There are a host of other problems, many of which are highlighted in the proposed rules themselves.<sup>116</sup> A significant problem for the SEC revolves around the scope of the applicability of section 307. The SEC has taken a very broad view of who comes within the definition of "attorneys appearing and practicing before the Commission" under section 307.<sup>117</sup> Included in the definition are lawyers preparing or participating in the preparation of any writing the lawyer has reason to believe will be filed with or incorporated into a document submitted to the SEC.<sup>118</sup> Under this definition, it may be possible to sweep within the ambit of section 307 virtually every lawyer doing any sort of legal work for a publicly traded company. Indeed, the SEC meant to sweep with a very broad brush—including within the definition even foreign attorneys employed by foreign issuers in foreign jurisdictions.<sup>119</sup> Moreover, the term "attorney" is defined to include "persons who hold themselves out as attorneys, even if they are not, in fact, admitted, licensed, or otherwise qualified to practice law."<sup>120</sup> Combined with the applicability of the rules to foreign

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appropriate and inappropriate responses under very basic and extreme fact circumstances. *See id.* at 71676-77.

<sup>115</sup> Proposed Rule 205.3(b)(4), 67 Fed. Reg. 71686, provides for a response within a reasonable time. The SEC has solicited comments on the reasonable time standard, and specifically on setting specific deadlines or deadlines linked to the complexity of the issues presented in the report. *Id.* at 205.2(b)(5).

<sup>116</sup> For example, the SEC solicited comments to its proposals relating to the treatment of subordinate attorneys as set forth in proposed rule 205.5. 67 Fed. Reg. 71696. Currently, the proposed rule requires a subordinate attorney to end run his supervising attorney where the subordinate is dissatisfied with the supervisor's response to her report, and permits the subordinate to make a noisy withdrawal under the circumstances in which such withdrawals are generally permitted. *See id.*

<sup>117</sup> The definition in the proposed rule is based on Rule 102(f) and, according to the SEC, "is consistent with the position the Commission has taken as *amicus curiae* in cases involving liability under section 10(b) of the Exchange Act." 67 Fed. Reg. 71676. That itself represents an aggressive posture which will likely be tested in the courts.

<sup>118</sup> *Id.* at 71675. Also included are lawyers advising that any such writing need not be submitted to the SEC or that an issuer is not required to make any submission to the SEC. *Id.*

<sup>119</sup> *See id.* at 71676. The SEC, aware of the breadth of its definition, sought comments about the value of applying the reporting requirements of section 307 to foreign lawyers and other affected foreign professionals. *See id.* at 71676-78.

<sup>120</sup> *Id.* at 71677.

practitioners, the proposed rule would include within its ambit foreign notaries and others who, in civil and other non-common law systems, perform work traditionally characterized as legal work in the United States. It is not clear that Congress meant to bring these actors within the requirements of the Act. On the other hand, to the extent that the Act was meant to compel people performing work characterized as “lawyer’s work” in the United States, and to the extent that Congress expected the Act to have broad extra-territorial effect, then including civil law notaries and other such professionals within the reporting requirements of section 307 might be consistent with the broadest outlines of the Act. Whatever the resolution of these ambiguities and problems in the regulations, the statutory commands under section 307 itself presents a number of traps for the unwary. An interesting potential trap for the unwary is found in the definition section of the Sarbanes-Oxley Act. The securities laws are now defined to include the provisions of the Sarbanes-Oxley Act.<sup>121</sup> As such, among those activities that lawyers must bring to the attention of the company are failures by company lawyers to comply with their reporting obligations under section 307. Lawyers now have both a duty to report, if they fall within the ambit of section 307, and must report “material evidence” of the violation of the reporting obligations under section 307 of other lawyers.

Additionally, neither the statute nor the proposed rules consider the extent to which knowledge can be imputed within law firms. It is possible for courts reasonably to take the position that law firms, especially law firms with securities practices, are responsible as a whole, for the obligations of its employees—whether partners or employees.<sup>122</sup> If that is the case, then law firms might now be well advised to put in place systems of internal control and information sharing mechanisms that have had to be developed by public companies after *In re*

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<sup>121</sup> See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2(b), 116 Stat. 745, 749 (to be codified at 15 U.S.C. § 78c(a)(47)).

<sup>122</sup> The Federal Rules of Civil Procedure provide for sanctions assessment against lawyers and their law firms jointly, absent exceptional circumstances. See FED. R. CIV. P. 11(c)(1)(A). On the other hand, section 307, unlike the civil procedure rules, do not explicitly provide for firm wide joint responsibility. On that basis, liability may be limited to the individuals who are found to have committed the violation. *Cf. Pavelic & LeFlore v. Marvel Entm’t Group*, 493 U.S. 120 (1989) (1983 form of Rule 11 did not permit firm sanctions for individual misconduct).

*Caremark*, and implemented now in light of the certification requirements of section 302 of the Act.<sup>123</sup> Moreover, it is unclear the extent to which the reporting rules under section 307 impact the rules in many states which provide a mechanism under which corporate fiduciaries can avoid liability for garden variety breaches of the duty of care—for example, under the provisions of Delaware Code section 102(b)(7).<sup>124</sup> The proposed rule does not clarify the matter. Section 205.2(d) defines breach of fiduciary duty as a “breach of fiduciary duty recognized at common law” but is silent with respect to the effects, if any, of state exculpatory rules.<sup>125</sup>

It is possible that the failure to make appropriate efforts to discover and report under the new standards, or to correctly determine whether the initial response by corporate counsel or the CEO was appropriate, might lead to civil liability for the lawyer with the section 307 obligation. Three sources of liability come to mind: (1) malpractice; (2) violation of state professional responsibility rules; and (3) civil liability with respect to the quality of section 307 reporting itself.

It is important to mention the possibilities for state law professional discipline even though I would concede that the likelihood of discipline, even under the theory I propose here, is unlikely at best. The failure to comply with the reporting requirements of section 307 might constitute an act of malpractice. Let me suggest one basis—lack of legal competence. The duty to report imposed by section 307 may imply a certain level of legal competence. The idea that the basic skills of lawyers representing corporations ought to include some

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<sup>123</sup> Some in the legal academy suggest that any such project will be difficult for law firms. See Coffee, *supra* note 89, at 1418 (“Whatever the control problems with accounting firms, law firms have nothing even remotely approaching the substantial system of internal controls employed by audit firms.”).

<sup>124</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2002). This provision, similar to provisions in most other states, permits a corporation to amend its articles of incorporation to eliminate or limit the personal liability of directors for most forms of breaches of the duty of care. While the exact extent of the power to eliminate liability in this regard varies from state to state, the provisions permit a fairly broad exculpation clause to be built into the basic governance structure of any corporation. No such provision permits eliminating liability for breaches of the duty of loyalty. See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

<sup>125</sup> Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71678 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205) (commenting on proposed Rule 205.2(d)).

minimum level of familiarity with the accounting field has been renewed with some force after the Enron scandals.<sup>126</sup> A lawyer without sufficient skills to reasonably identify “material violation of securities law or breach of fiduciary duty or similar violation” under section 307 might be deemed to act with sufficient recklessness that malpractice liability might attach,<sup>127</sup> even under the normally protective rules of malpractice law.<sup>128</sup>

In addition, to the extent that failure to comply with the new section 307 reporting rules will in the future constitute violation of state professional responsibility rules, the lawyer will face additional problems. Failure to comply with the section 307 reporting requirement might constitute grounds for lawyer discipline. State discipline would complement the new power of the SEC to censure under section 602 of the Act. Indeed, censure or other action against a lawyer by the SEC could well serve as evidence creating a presumption of the commission of an act subjecting the lawyer to discipline.

But compliance might also generate problems for lawyers subject to section 307. The fear of malpractice liability might encourage conduct that, itself, will create the potential for lawyer civil liability. Both the lower evidentiary standard triggering reporting (“evidence of material violation”) and the post-facto determination by the SEC of violation might make lawyers cautious about their approach to reporting. Lawyers might then tend to over-report rather than under-report “evidence.” They might also tend to deem a lower rather than a higher quantum of “evidence” sufficient to meet the reporting

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<sup>126</sup> See Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1449–54 (2002).

<sup>127</sup> In this sense, even good faith defenses might be insufficient to protect a lawyer who seeks to excuse her breach of any section 307 obligation on the grounds that she was unaware that particular events are somehow “material evidence” subject to reporting under section 307. Essentially, section 307 might be a vehicle for the heightening of the standard for liability under state professional responsibility rules. Professor Cunningham suggests that the threat of malpractice in this area generally has posed little threat to lawyers and relies instead on ethical and prudential arguments. See *id.* at 1452 (“Failure to master accounting matters, even in the intersection of law and accounting, is less likely to result in successful malpractice claims. For these, a good defense would be the hardy ‘mere error of judgment’ doctrine, strong so long as a lawyer can show good faith.”). Section 307 obligations might make a good faith showing harder to sustain.

<sup>128</sup> For other suggestions of liability for malpractice under the Act, see, for example, Martha Neil, *Rule on Reporting Wrongs Stirs Debate*, 37 A.B.A. J. E-Report 8 (Sept. 27, 2002), available at WL 37 ABAJERE 8.

requirements of section 307.<sup>129</sup> But overzealousness, and the resulting overreporting, might itself lead to liability where such reporting, if ultimately determined not to reveal any breach, causes loss to the company. The comments to the proposed rules, however, emphasize the SEC's understanding that section 307, standing alone, does not create a "private right of action against an attorney."<sup>130</sup> This last potential basis of civil liability suggests another basis of exposure. This source of liability would be based on the way in which the reporting requirements of sections 307 and 404 might work together to produce liability for both lawyers and accountants.<sup>131</sup> The Act does not explain the relationship between the reporting system created under section 307 and the requirement of section 404 for the preparation, testing, and disclosure of management's internal control report. Under rules to be created by the SEC, section 404 will impose on companies the obligation to create and report on their internal control structure and procedures for financial reporting. Reporting companies will also have to assess the effectiveness of the internal control structure, while accounting firms providing services to the company will have to attest to and report on management's assessment of the internal controls.<sup>132</sup> In effect, it might be possible for both management and auditors, in the course of preparing, reviewing, and certifying a section 404 report, to review and pass on the quality and sufficiency of a lawyer's reporting obligations under section 307. In this context, the company and its auditors might have to, in order to meet their obligations, provide the evidence necessary to establish grounds for liability on the part of lawyers

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<sup>129</sup> Whether or not section 307 reports are subject to analysis and disclosure by management and a company's outside auditors under the requirements of section 404 of the Act, the disclosure requirements of Regulation S-K may require, or at least strongly counsel for, disclosure of section 307 reports when the company reasonably concludes that a government investigation is likely. *See* 17 C.F.R. § 229.103 (2002).

<sup>130</sup> Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71697 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205) (commenting on proposed Rule 205.6). The comment cites to statements made by Senator Edwards, 148 Cong. Rec. S6552, and Senator Enzi, *id.* at S6555, in support of its understanding.

<sup>131</sup> *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (to be codified at 15 U.S.C. § 7262(b)).

<sup>132</sup> Stephen J. Crimmins et al., *Sweeping Securities Law Reform Affects Issuers, Officers, and Directors*, 169 N.J.L.J. 729 (2002).

to third parties affected by the section 307 disclosures.

There is another wrinkle: the Act is not clear about the relationship between the section 307 requirements and the protections afforded under the section 806 whistleblower provisions, discussed in greater detail in the section that follows.<sup>133</sup> Section 806 extends protection to employees of a company against retaliation under certain specified circumstances. Only certain named parties, however, are subject to the prohibitions of new section 806, including employers and their agents.<sup>134</sup> As such, whistleblower protection may not extend to actions commenced by a third party, unrelated to the employer or its agents, for acts undertaken as an employee. The encouragement of reporting under section 307 should not be read as encouragement of reckless or negligent over-reporting which results in damage to the company. Consequently, statutes that protect employees reporting wrongdoing should not protect the wrongdoing of the reporting employees as against third parties—particularly shareholders, and perhaps even the creditors of the corporation. On the other hand, a broader reading of the whistleblower provisions might lead to a different result. If the purpose of the protection is to encourage reporting, then employee liability based on that reporting would seem to create disincentives to robust reporting under section 307. Since the disclosure of section 307 reporting may be a function of a company's obligations under section 404, as overseen by the company's outside auditors, it would be plausible that any damage alleged was not caused by the reporting employee, but rather by the reporting company and its auditors. As such, the employee should escape liability to third parties, at least in circumstances in which the section 307 reporting might be covered by the whistleblower protections of section 806 with respect to employer action.<sup>135</sup>

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<sup>133</sup> For a more detailed discussion of the new section 806, see *infra* section 6.

<sup>134</sup> The entities subject to the prohibitions of the whistleblower provisions include any "company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company." Sarbanes-Oxley Act § 806 (to be codified at 18 U.S.C. § 1514A(a)).

<sup>135</sup> Of course, the circumstances under which this may occur may be quite limited, given the potential narrowness of the application of the protection of the whistleblower provision. See discussion *infra* section 7.

Section 307 of the Act thus presents any number of uncertainties. Perhaps the greatest long term uncertainty of the reporting requirement itself is its relationship to state rules of professional conduct.<sup>136</sup> To some extent, the Act represents the first, if limited, attempt by the federal government to regulate lawyers. The federalism and comity implications of this sort of regulation have yet to be worked out. On one hand, this may represent a targeted intervention; on the other hand, it may represent the first step toward the creation of a federal or national bar and the bifurcation of the bar between state and federal practitioners. The SEC itself, in promulgating the proposed rules implementing standards of professional conduct for attorneys, announced that it might "at some future date supplement or amend this rule to expand its scope and address additional ethical issues that are relevant to practice before the Commission."<sup>137</sup> This echoes a strain of argument that has been gathering force within the country for a number of years urging at least a partial federalization of attorney regulation and practice.<sup>138</sup> Though the SEC goes to some lengths to deny that it will "propose to create an 'SEC Bar' with admission requirements, of which attorneys must be members to appear or practice before the Commission,"<sup>139</sup> the SEC embraces its authority to "police the behavior of practitioners appearing before it."<sup>140</sup> I am not sure that the distinction the SEC makes has any practical difference in effect on those who must practice before it. Moreover, the SEC speaks only of not supplanting state ethics laws "unnecessarily, particularly in areas (e.g., safeguarding of client assets, escrow procedures, advertising) where the Commission lacks expertise."<sup>141</sup> The SEC has

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<sup>136</sup> See *supra* note 84 and accompanying discussion.

<sup>137</sup> See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71674-71675, 71696-71698 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205).

<sup>138</sup> See, e.g., Fred C. Zacharias, *Federalizing Legal Ethics*, 73 TEX. L. REV. 335 (1994) (considering creation of federal code of legal ethics for the regulation of lawyers). Some have suggested the creation of a federal bar. See, e.g., Stephen B. Burbank, *State Ethical Codes and Federal Practice: Emerging Conflicts and Suggestions for Reform*, 19 FORDHAM URB. L.J. 969, 974 (1992).

<sup>139</sup> Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71675.

<sup>140</sup> *Id.* (quoting *Polydoroff v. ICC*, 773 F.2d 372, 374 (D.C. Cir. 1985)). For the SEC, section 307 of the Act confirms this regulatory authority. *Id.*

<sup>141</sup> *Id.* at 71673.

reserved for itself, however, the right to consider “whether Congress intended for the agency’s rule to ‘occupy the field’ on this issue [the up-the-ladder-reporting-system], and whether part 205 would preempt any state rules governing the reporting of evidence of a material violation by attorneys representing issuers before the Commission.”<sup>142</sup>

Whatever the SEC will call its intervention in the regulation of lawyer ethics, the result might well be another step toward the creation of a bifurcated bar, as traditionally understood, with elite lawyers licensed or regulated under federal law and others the subject of more parochial state regulation. The SEC has made its own pro-federalization view clear enough on this score: “Commission preemption of any state ethical rules as topics covered by Part 205 would have the salutary benefit of creating a single uniform standard which attorneys in all jurisdictions must satisfy; and it would also resolve the dilemma faced by attorneys who practice in multiple jurisdictions.”<sup>143</sup> It is ironic that this process appears to have gained some impetus at the time when the sitting president and the political party controlling the House of Representatives have both characterized their political philosophy as favoring devolution of federal power to the states.<sup>144</sup>

6. *What if the person who is suspicious of the senior management is an officer, what should he or she do? Does reporting the possible illegality protect them? Does it matter what level employee reports, e.g., officer versus stock room clerk?*

The Sarbanes-Oxley Act provides enhanced protection for whistleblowers.<sup>145</sup> The new section 806 provides protection for

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<sup>142</sup> *Id.* at 71697.

<sup>143</sup> *Id.* For arguments supporting the creation of a federal securities bar, see Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies*, 22 DEL. J. CORP. L. 537, 578–585 (1997).

<sup>144</sup> The Republican Party, in particular, has taken a position in favor of devolution of authority to states and the private sector as a matter of party policy at least since before the 1994 congressional elections. For a discussion of the Republican position on federalism and states rights, see, for example, REPUBLICAN NATIONAL COMMITTEE, *CONTRACT WITH AMERICA: THE BOLD PLAN BY REP. NEWT GINGRICH, REP. DICK ARMEY, AND THE HOUSE REPUBLICANS TO CHANGE THE NATION* (Ed Gillespie & Bob Schellhas eds., 1994).

<sup>145</sup> Section 806 of the Act adds 18 U.S.C. § 1514A.



employees who act as whistleblowers in a corporation subject to federal securities laws reporting requirements.<sup>146</sup> The new section prohibits a corporation "or any officer, employee, contractor, subcontractor, or agent of such company," from discharging, demoting, suspending, harassing, or discriminating against any employee for whistleblowing.<sup>147</sup> Any action by a whistleblower must "be commenced not later than 90 days after the date on which the violation occurs" by filing a complaint with the Secretary of Labor.<sup>148</sup> An officer, as an employee of the issuer, should be protected like any other employee under the whistleblowing provisions. This would be consistent with the approach of modern corporate statutes, such as the RMBCA, which distinguishes between directors and officers in part because of the employee status of officers, but imposes similar fiduciary duties on both.<sup>149</sup> Because officers are burdened, however, with fiduciary duties to corporations substantially similar to those of directors, as a result of officers not being "ordinary" employees, an argument could be made that the whistleblowing protections ought not to extend to them. This argument, however, defies the intent of whistleblowing provisions to encourage disclosure.

The more interesting question involves the directors. Whistleblowing provisions do not cover non-employee directors.

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<sup>146</sup> 18 U.S.C. § 1514A applies only to companies with a class of securities registered under section 12 of the Exchange Act or companies required to file reports under section 15(d) of the Exchange Act. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 806(a), 116 Stat. 745, 802-03 (to be codified at 18 U.S.C. § 1514A(a)).

<sup>147</sup> *Id.* § 806 (to be codified at 18 U.S.C. § 1514A). Acts constituting protected whistleblowing are described in section 806(a)(1). In order to be protected the employee must have a reasonable belief that the information she provides, or causes to be provided, constitutes a violation of federal shareholder anti-fraud laws and the information is provided only to the classes of individuals identified in the statute. Failure to meet any of these requirements results in a loss of protection under this provision. The courts are likely to have to clarify the standards used to assess an employee's reasonable belief as well as the circumstances under which the provision of information is delivered to the statutorily designated individuals. *Id.*

<sup>148</sup> See *id.* (to be codified at 18 U.S.C. § 1514A(b)(1)(A)) (a person seeking protection under the whistleblower provisions must file a complaint with the Secretary of Labor); *id.* § 806(b)(2)(D) (to be codified at 18 U.S.C. § 1514A(b)(2)(D)) (stating that action must be commenced within 90 days of the date on which the violation occurs).

<sup>149</sup> See MODEL BUS. CORP. ACT § 8.42 (Comm. on Corp. Law of the section of Bus. Law of the A.B.A. 1994) (official comment) ("[E]very corporate officer or agent owes duties of fidelity, honesty, good faith, and fair dealing to the corporation.").

Yet, the Sarbanes-Oxley Act appears to impose greater regulation on the specifics of behavior deemed minimally necessary to comply with directors' duties of care. It is not clear, however, that the Act has substantially altered the substance of director fiduciary duties in general, except to the extent of adding detail (and thus limiting discretion) with respect to certain conduct. The core of the new requirements with respect to certification and reporting apply to officers, not directors.<sup>150</sup> But the same cannot be said with respect to the duties and obligations of those members of the board of directors that form the audit committee. Indeed, the greatest level of change applies to audit committee directors.<sup>151</sup> Among the most important new roles for the audit committees of a corporation whose shares trade on national stock exchanges are the creation and maintenance of procedures for receiving, retaining, and investigating complaints regarding accounting, internal controls, and auditing matters.<sup>152</sup> This provision requires the national

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<sup>150</sup> The principal new certifications with respect to a company's reports and internal controls under section 302 of the Act apply only to the designated corporate officers, and not to the board of directors as a body. The same is true of the periodic certifications of financial reports under section 906. *See supra* notes 33–45 (discussing the new certification and reporting requirements).

<sup>151</sup> The members of the audit committee are now subject to a number of duties. They include the obligation to review action deemed inappropriate in the context of section 307 reports of material violations of the securities laws. *See* Sarbanes-Oxley Act § 307(2) (to be codified at 18 U.S.C. § 7245) (requiring report to the audit committee, or another committee composed solely of independent directors or the entire board of directors). In addition, the audit committee is responsible for determining the propriety of approving the provision of certain non-audit services by the corporation's auditors. *See id.* § 201(a) (to be codified at 15 U.S.C. § 78j-1(a)) (amending section 10A of the Exchange Act). The audit committee is now also specifically charged with the management of the corporation's external auditors. *See id.* § 204 (to be codified at 15 U.S.C. § 78j-1) (amending section 10A of the Exchange Act by adding new section (k) requiring the auditor to report to the audit committee all critical accounting policies and practices to be used, all alternative treatments of financial information that have been discussed with management, and all other material written communications with management). The Exchange Act is also amended by defining a corporation's audit committee as the committee charged with oversight of the corporation's accounting and financial reporting processes or the entire board of directors if no such committee is constituted. *Id.* § 205 (to be codified at 15 U.S.C. § 78c) (amending section 3(a) of the Exchange Act by adding new subsection (a)(58)).

<sup>152</sup> *See id.* § 301 (to be codified at 15 U.S.C. § 78j-1) (amending section 10A of the Exchange Act by adding new section (m)(4)). The audit committee must establish procedures for the receipt, retention and treatment of complaints received by the company with respect to accounting, internal accounting controls or auditing matters and must provide for "the confidential and anonymous submission by

exchanges to adopt rules prohibiting the listing of any securities of an issuer that does not constitute an audit committee with the authority over audit and financial affairs specified in that section.<sup>153</sup> Moreover, corporations subject to the audit committee rules of section 301 (all companies whose securities trade on national securities or otherwise traded by national securities associations) may not appoint inside directors to the audit committee,<sup>154</sup> and must provide "appropriate funding, as determined by the audit committee," for payment to outside auditors and the advisors hired by the audit committee.<sup>155</sup> Corporations are also given substantial incentives to appoint at least one member to the audit committee who is a financial expert.<sup>156</sup>

The Sarbanes-Oxley Act has potentially far reaching effects on state corporate law. In particular, the new rules, to the extent they create federal civil and criminal rules of fiduciary duty of care, seem to override state corporate law provisions permitting corporations to opt out of liability for duty of care violations committed by directors—for example, Delaware Code section 102(b)(7).<sup>157</sup> At its narrowest, it has certainly created an exception to the applicability of the exculpatory rules by effectively doing away with them for public corporations to the extent specified in the Act. Moreover, the Act seems to open the door to the creation of additional sources of duty on the part of corporate managers. Section 307 of the Act speaks of a duty to report material violations of the securities laws, fiduciary duty

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employees of concerns regarding questionable accounting or auditing matters." *Id.*

<sup>153</sup> *Id.* § 301 (to be codified at 15 U.S.C. § 78j-1) (amending section 10A of the Exchange Act by adding new section (m)(1)(A)). The duties and obligations of the audit committee are specified in subsections (m)(2) through (m)(6). In addition to the obligations described *supra*, note 151, these duties include responsibility for the appointment, compensation and oversight of the outside auditor, and the authority to engage outside advisors.

<sup>154</sup> Sarbanes-Oxley Act § 301(m)(3) (to be codified at 15 U.S.C. § 78j-1).

<sup>155</sup> *Id.* § 301(m)(6).

<sup>156</sup> *Id.* § 407 (to be codified at 15 U.S.C. § 7265). This provision empowers the SEC to require corporations to disclose whether or not the audit committee includes a financial expert, and if not, the reasons why no such expert is a member of the audit committee. Clearly, the intent is to create incentives through disclosure, for corporations to appoint such experts and avoid the potential embarrassment of having to offer an excuse for a failure to appoint such an expert other than a temporary vacancy.

<sup>157</sup> See *supra* note 124.

“or similar violation by the company or any agent thereof.”<sup>158</sup> At its broadest, however, the Act may represent a profound change in the willingness of the federal government to intrude on state prerogatives with respect to the fundamentals of corporate governance. Here is an example of how the federal securities laws continue to eat away at the scope and effectiveness of state corporate law, at least with respect to publicly held companies. Can federal corporate law be far behind?

The actual protections afforded to whistleblowers under the Act are tricky and present several traps for the unwary. Under the terms of that provision, no public company subject to its provisions or its agents may “discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee” of a company for whistleblowing.<sup>159</sup> There are a number of interesting parts to this protection. The protection is limited to certain broadly defined conduct related to investigations of fraudulent conduct against shareholders,<sup>160</sup> and by a reasonable belief standard.<sup>161</sup> Moreover the conduct is protected only if the information is provided to the employee’s supervisors, federal officials, or members of Congress.<sup>162</sup>

These provisions raise a number of issues. Perhaps the courts will rely on judicial interpretation of and developments in connection with other whistleblower provisions.<sup>163</sup> Among the

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<sup>158</sup> Sarbanes-Oxley Act § 307(1). The proposed rule does little to elaborate on this new category of violation. All the comment suggests is that “it appears from the context in which it is used in section 307, that the term is intended to extend beyond a breach of fiduciary duty or a violation of the securities laws.” Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71679 (proposed Nov. 21, 2002) (comment to proposed Rule 205.2(i)). It is likely that the Congress meant to express an intention to sweep broadly when it inserted this phrase. But statutes are not the best place in which to make a gesture. *This* gesture in particular will have to be given concrete effect in law. A likely candidate for inclusion in such a category of “other” are violations of anti-discrimination laws applicable to corporations. See *Holley v. Crank*, 258 F.3d 1127 (9th Cir. 2001), *cert. granted sub nom. Meyer v. Holley*, 122 S. Ct. 1959 (2002) (direct liability of corporate shareholder for corporate violation of federal Fair Housing Act).

<sup>159</sup> Sarbanes-Oxley Act § 806(a) (to be codified at 18 U.S.C. § 1514A(a)).

<sup>160</sup> *Id.* § 806(a)(1) (to be codified at 18 U.S.C. § 1514A(a)(1)) (“to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation . . .”).

<sup>161</sup> See *id.*

<sup>162</sup> *Id.* § 806(a)(1), (2) (to be codified at 18 U.S.C. § 1514A(a)(1), (2)).

<sup>163</sup> Many states, as well as the federal government, have enacted statutes designed to protect against retaliatory discharge in a whistleblower context. Federal

issues that await resolution, perhaps one of the most important is the character of the reasonable belief standard. The Act does not make clear whether a subjective or objective standard is to be used. Given the embrace of objective standards throughout the SEC's proposed rule under section 307, however,<sup>164</sup> it is likely that an objective standard, and perhaps one tied more or less strongly to context, will emerge.

Moreover, the statute creates some traps for the unwary employee. For example, an employee that conveys the information to the press or inferior employees may not be subject to the protection of the Act, since these groups are not included within the class of persons to which information may be conveyed. If the information conveyed is not connected to the violations referenced in the Act, the conveyance of that information, including perhaps otherwise confidential business information which might, after the fact, not be deemed to constitute information relating to a covered violation, would not be protected by the Act. Moreover, the affected employee must file a complaint with the Secretary of Labor within "90 days after the date on which the violation occurs."<sup>165</sup> Failure to meet this requirement, like similar failures in the context of race and sex discrimination, may have jurisdictional, and therefore preclusive, effect.<sup>166</sup> One can speculate that this very short

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statutes contain a number of provisions for protection of employees who disclose employer wrongdoing. See Toxic Substances Control Act § 23, 15 U.S.C. § 2622 (2000); Federal Water Pollution Control Act Amendments of 1972 §507, 33 U.S.C. § 1367; Safe Drinking Water Act §1450(i), 42 U.S.C. § 300j-9(i) (2000); Energy Reorganization Act of 1977 §211, 42 U.S.C. § 5851; Solid Waste Disposal Act § 1002, 42 U.S.C. § 6901 (2000); Clean Air Act § 322(a), 42 U.S.C. § 7622(a) (2000); Comprehensive Drug Abuse Prevention and Control Act of 1970 § 110, 42 U.S.C. § 9610. For state law provisions, see, for example, CONN. GEN. STAT. ANN. § 31-51m (West 2002) (protection of employee who discloses employer's illegal activities or unethical practices); N.J. Conscientious Employee Protection Act, N.J. STAT. ANN. § 34:19-1 (West 2002) (protection in disclosure of corrupt, illegal, fraudulent, or harmful activity); N.Y. LAB. LAW § 740(2)(a) (McKinney & Supp. 1986) (prohibiting retaliatory personnel action by employers). See generally Trystan Phifer O'Leary, Note, *Silencing the Whistleblower: The Gap Between Federal and State Retaliatory Discharge Laws*, 85 IOWA L. REV. 663 (2000).

<sup>164</sup> See *supra* notes 81-144 and accompanying text.

<sup>165</sup> Sarbanes-Oxley Act § 806(b)(2)(D) (to be codified at 18 U.S.C. § 1514A(b)(2)(D)).

<sup>166</sup> It has long been held that the complaint filing requirements have a jurisdictional effect. See, e.g., *Love v. Pullman Co.*, 404 U.S. 522, 523 (1972); *Evans v. Techs. Applications & Serv. Co.*, 80 F.3d 954, 962-63 (4th Cir. 1996); *Lowe v. City of Monrovia*, 775 F.2d 998, 1003 (9th Cir. 1986); cf. *Charles C. Jackson & John H.*

statute of limitations will operate as a fairly effective trap for the unwary. Many employees otherwise entitled to protection will find themselves unable to rely on the protection of the Sarbanes-Oxley Act for waiting too long to assert their rights.

In the case of the marginal employee—the employee in danger of dismissal for other reasons on the eve of a protected disclosure—, however, the rules may have a temporary positive effect. I suspect that the disclosure will temper any decision to dismiss the employee immediately, but where companies will be able to prove that the primary motivation in dismissal was unsatisfactory performance occurring prior to the protected activity, the company may still be able to successfully dismiss the employee. I also suspect that discrimination and whistleblower jurisprudence in other acts will have a substantial impact on the way this provision in the Sarbanes-Oxley Act is interpreted.

There is one caveat: It is not clear whether section 806's whistleblower provisions protect employees other than those of the reporting company.<sup>167</sup> It is clear from the provision's text that in-house lawyers and financial staff are covered. Nonetheless, outside law firm partners and associates, even those with reporting obligations under section 307, or partners and subordinate members of an audit team, even those with evaluation obligations under section 404, who provide information of the type contemplated by section 806 of the Act, do not appear to be covered under the terms of the Act. Indeed, the SEC, in proposing its rules under section 307 of the Act, solicited comments with respect to the need to extend application of the whistleblower provisions of section 806 at least to attorneys required to disclose information to the Commission

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Matheson, *The Continuing Violation Theory and the Concept of Jurisdiction in Title VII Suits*, 67 GEO. L.J. 811, 811 (1979) (concluding "that the Title VII filing requirement is not a jurisdictional absolute, but should instead be treated like a statute of limitations").

<sup>167</sup> The provision clearly covers employees of the publicly traded companies subject to the act—that is, companies with a class of securities registered under section 12 of the Exchange Act, or that are required to file reports under section 15(d) of the Exchange Act. The provision makes it clear that the agents and subcontractors of the company may not retaliate against the whistleblowing employee of the issuer, but appears to mention no equivalent protection for employees of the subcontractor or other third party. See Sarbanes-Oxley Act § 806(a) (to be codified at 18 U.S.C. § 1514A(a)).

under the proposed rule.<sup>168</sup> In the absence of direct statutory coverage, all such employees will have to rely on other statutory protections under federal or state law<sup>169</sup> to the extent those protections may be available.<sup>170</sup> There is some legislative history supporting this result.<sup>171</sup>

Despite the argument from the black letter of the provision, it may be possible to interpret the provision more broadly to cover non-issuer employees. First, it is possible to read the provision as requiring coverage of all employees of the issuer and its agents. The statute prohibits Exchange Act companies, or reporting companies under section 15(d) of the Exchange Act, "or any officer, employee, contractor, subcontractor, or agent of such company," to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee . . ."<sup>172</sup> If employees of the issuer were to be covered exclusively, the statute would have had to be written to provide that the prohibition applies to employees *of the company*. But it does not. It follows that the word "employee" must refer to employees of the company *and* employees of the contractors, subcontractors, or agents of the company.

Second, a strong argument can be made on the basis of policy and the need to interpret the provision in line with Congress's intent in enacting the provision. The Act institutes a fairly integrated system of disclosure centered on accounting and financial matter, including mandatory disclosure and analysis of

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<sup>168</sup> 67 Fed. Reg. 71693. Proposed Rule 205.3(e), 67 Fed. Reg. 71692, would permit disclosure of client information under certain circumstances.

<sup>169</sup> See *supra* note 163. The coverage of these statutes is uneven at best. See, e.g., O'Leary, *supra* note 163, at 663. For a discussion of general whistleblower provisions in federal and state law, see, for example, Elletta Sangrey Callahan & Terry Morehead Dworkin, *The State of State Whistleblower Protection*, 38 AM. BUS. L.J. 99 (2000); Michael Kane, *Whistleblowers: Are They Protected?*, 20 OHIO N.U. L. REV. 1007 (1994).

<sup>170</sup> Section 806(d) provides that "[n]othing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement." Sarbanes-Oxley Act § 806(d) (to be codified at 18 U.S.C. § 1514A(d)).

<sup>171</sup> For example, Senator Snowe stated, "[T]he Leahy Amendment grants important whistleblower protections to company employees—like Enron's Sherron Watkins—who bravely report wrongdoing occurring within their own corporation." 148 CONG. REC. S6734, S6761 (2002) (statement of Sen. Snowe). Senator Boxer noted that the provision "protects whistleblowers who reveal unethical acts by the companies for which they work." 148 CONG. REC. S6734, S6759 (2002) (statement by Sen. Boxer).

<sup>172</sup> Sarbanes-Oxley Act § 806(a) (to be codified at 18 U.S.C. § 1514A(a)).

internal systems of disclosure on the part of an issuer's outside auditors and lawyers. Therefore, it could be argued that the term "employee," as used in 18 U.S.C. § 1514A, includes the employees of the agents and sub-contractors of the issuer to the extent they are performing work for the benefit of the issuer (and issuer's security holders). Such a construction would not be unreasonable and comports with the broad remedial purposes of the Sarbanes-Oxley Act.

7. *The Act seems to be internally inconsistent with respect to the length of time that the auditors are supposed to retain work papers. In one part of the Act it says five years and in another seven? What would you advise auditors to do?*

There are a number of inconsistencies in the Sarbanes-Oxley Act. Section 103(a)(2)(A)(i) provides that the Board require registered public accounting firms to prepare and maintain audit work papers and other documents related to any audit report for at least seven years.<sup>173</sup> In contrast, the Corporate Criminal Fraud Accountability Act of 2002, section 802 of the Sarbanes-Oxley Act,<sup>174</sup> requires that "[a]ny accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies, shall maintain all audit or review work papers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded."<sup>175</sup> The easy answer here is for auditing firms to maintain the appropriate work papers for the longer of the two periods. The Act provisions contemplate this result.<sup>176</sup>

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<sup>173</sup> See *id.* § 103(a)(2)(A)(i) (to be codified at 15 U.S.C. § 7213(a)(2)(A)(i)) ("prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report . . ."). Section 105 of the Act provides the Board with authority to sanction violations of this retention rule. *Id.* § 105(c)(4) (to be codified at 18 U.S.C. § 7215(c)(4)). The sanctions include suspension or revocation of registration, temporary or permanent bar of any person from associating with a registered auditing firm, limitations on the activities of such person or firm, monetary fines, censure, and required professional training. *Id.*

<sup>174</sup> *Id.* § 802 (to be codified at 18 U.S.C. § 1501).

<sup>175</sup> *Id.* § 802(a)(1) (to be codified at 18 U.S.C. § 1520(a)(1)). Knowing and willful violation of this provision can result in fines or imprisonment for no more than ten years. *Id.* § 802(b).

<sup>176</sup> Thus, section 802(c) provides that the five year retention provisions of the Corporate and Criminal Fraud Accountability Act of 2002 do not "diminish or relieve any person of any other duty or obligation imposed by Federal or State law . . ." In this case, the requirements of a seven-year retention period fall within



There are other silences in the Act as well. For example, it is not clear that the provisions of sections 103(a)(2)(A)(i) or 802 apply to management internal review practices which accountants must review pursuant to section 404 of the Act.<sup>177</sup> Section 404 requires "each registered public accounting firm that prepares or issues" an issuer's audit report to "attest to, and report on, the assessment made by the management of the issuer" with respect to the issuer's internal control structure and procedures for financial reporting, as well as the effectiveness of these systems.<sup>178</sup> Reading the Act requirements broadly and with its remedial intent in mind, it would be reasonable to conclude that an auditor's internal control evaluation and reporting might well constitute "audit work papers and other documents related to any audit report" subject to the seven year retention rule of section 103(a)(2)(A)(i). The auditor's section 404 work might also constitute "audit or review work papers" within the meaning of section 802, and thus subject both to the five-year retention rule and its criminal penalties. It is likely that the work product produced by the auditors is meant to be covered under either or both. The better course for the client seeking practical advice, for the moment at least, is to err on the side of preservation.

8. *The Act provides criminal penalties for certain wrongdoing by senior management and others. The wrongful conduct ranges deal with financial statement certification and document destruction. Each of the provisions requires knowledge or intentional violation. Are these penalties likely to deter wrongful behavior? Do these penalties (and the other provisions of this Act) get us to the point where we are treating white-collar crime as similar to other crimes? Do we have a different standard of morality for white-collar crime than we do for street crime?*

Discussions about criminalizing conduct, especially conduct

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the obligations of registered auditing firms to the Board, while the five-year retention rules are general requirements applicable to any accountant and overseen by the SEC.

<sup>177</sup> For a discussion of section 404, see *supra* notes 42-44 and accompanying text.

<sup>178</sup> Sarbanes-Oxley Act § 404(b) (to be codified at 15 U.S.C. § 7262(b)).

related to economic activity, tends to progress along fairly well worn lines.<sup>179</sup> What has been new in the area is the explicit recognition of class, status, race, and ethnicity issues in connection with the punishment of crime.<sup>180</sup> The criminal provisions in the Sarbanes-Oxley Act again raise the core policy issues of the utility of criminalization to deter behavior deemed obnoxious (or worse), and the tension between equal treatment of criminals and proportionality of punishment. On the one hand, there is a logic and a sense of fairness in the notion that a criminal from the lowest socio-economic rung or, from racial or ethnic groups traditionally marginalized in this country, ought to be treated no differently than those from the highest reaches of the socio-economic elite.<sup>181</sup> The former controlling members of Adelphia, John Rigas and his sons, should face the same type of punishment as an impoverished bank teller for crimes of similar magnitude. The problem, of course, remains the meaning of "similar." While some argue that similar in this context means "the same effect"—equal prison terms and equal treatment in all other respects,<sup>182</sup> others suggest that where the positions of the

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<sup>179</sup> Kip Schlegel et al., *Are White-Collar Crimes Overcriminalized? Some Evidence on the Use of Criminal Sanctions Against Securities Violators*, 28 W. ST. U. L. REV. 117, 117–18 (2000–2001) (much of the relevant literature is cited in notes 1–4). As the authors of a recent empirical study of the effects of the criminalization of securities laws violations so well put it:

Since Edwin H. Sutherland first coined the term "white-collar crime" to describe those harmful business behaviors that, in his estimation, were not being punished either criminally or severely enough, there have been countless discussions and diatribes regarding the merits of defining such behaviors as criminal, how to define the concept, and how such behavior should be socially controlled.

*Id.* (internal citations omitted).

<sup>180</sup> See, e.g., William J. Stuntz, *Race, Class and Drugs*, 98 COLUM. L. REV. 1795 (1998) (discussing the "racial tilts" resulting from drug enforcement strategies focusing on poor urban neighborhoods); Floyd D. Weatherspoon, *The Devastating Impact of the Justice System on the Status of African-American Males: An Overview Perspective*, 23 CAP. U. L. REV. 23, 26 (1994) (discussing the "correlation between the plight of African-American males and their treatment by our justice system"); Laura A. Wytsma, Comment, *Punishment for "Just Us"—A Constitutional Analysis of the Crack Cocaine Sentencing Statutes*, 3 GEO. MASON INDEP. L. REV. 473, 474 (1995) (analyzing "the development of the racially biased crack sentencing laws").

<sup>181</sup> See, e.g., Paul Butler, *Racially Based Jury Nullification: Black Power in the Criminal Justice System*, 105 YALE L.J. 677, 679 (1995) (arguing that the race of a black defendant is sometimes an appropriate factor for jurors to consider).

<sup>182</sup> Compare Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1316–24 (2001) (arguing that the punishment of street criminals ought to be grounded on the same principles

criminals are different, imposing punishment equal in outward form results in the imposition of disproportionate punishment. People taking the latter position tend to view proportionality as the touchstone for equivalence.<sup>183</sup> For them, imposing proportionally equal sentences furthers justice. If a person with no social or economic status loses, jail may be appropriate. The equivalent punishment for a member of a socio-economic elite might be the permanent prospective denial of elite status by effectively taking away the status and wealth of the person to be punished. Thus, for example, forcing the Rigas family to assume positions as part of the lower middle class and requiring them to work hourly jobs for their livelihood might be equivalent to the imposition of a jail sentence on the penniless thief.

But, putting questions of the philosophy of criminal law aside, a close examination reveals that the Sarbanes-Oxley Act added little in the way of criminal liability. True enough, section 906 carries criminal liability in cases of egregious violation<sup>184</sup> and other existing criminal penalties have been expanded,<sup>185</sup> however, on the whole, relatively little has changed. In this respect, the trend to federalize criminal provisions continues.<sup>186</sup>

If that is the case, then perhaps the importance of the criminal provisions of the Sarbanes-Oxley Act lie elsewhere. A clue can be gleaned from the prior discussion. The focus on white-collar criminality in this context tends to be parochial, and

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and forms of prosecutorial conduct as are applied to the punishment of white collar criminals), with Kyron Huigens, *Street Crime, Corporate Crime, and Theories of Punishment: A Response to Brown*, 37 WAKE FOREST L. REV. 1 (2002) (proposing alternatively a "virtue-ethics" theory of punishment).

<sup>183</sup> See, e.g., Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 366 (1999) (discussing shaming as an alternative to short terms of imprisonment for white collar criminals).

<sup>184</sup> See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 906(c), 116 Stat. 745, 806 (to be codified at 18 U.S.C. § 1350). If the certifying officer knows that the financial report "does not comport with all of the [section's] requirements," then he may be fined up to \$1,000,000 and/or imprisoned for up to 10 years. See *id.* § 906(c)(1). If the certifying officer "willfully certifies" the report knowing that it "does not comport with" the section's requirements, then he may be fined up to \$5,000,000 and/or imprisoned for up to 20 years. See *id.* § 906(c)(2).

<sup>185</sup> See *id.* § 1106 (to be codified at 15 U.S.C. 78ff(a)) ((1) changing the \$1,000,000 fine to \$5,000,000 and raising the 10 years imprisonment term to 20 years and (2) increasing the \$2,500,000 fine to \$25,000,000).

<sup>186</sup> See, e.g., Thomas J. Maroney, *Fifty Years of Federalization of Criminal Law: Sounding the Alarm or "Crying Wolf"?*, 50 SYRACUSE L. REV. 1317, 1318 (2000) (discussing the acceleration of the federalization trend in the past 20 to 30 years).

perhaps necessarily so. The concentration will be on the pool of potential perpetrators, their victims, and other pools of criminals potentially similarly situated. But I suggest that much of the thrust of the criminal provisions not be directed toward either the criminal or her victims. Instead, I would posit a much broader perspective within which to view the utility of the criminal provisions of the Act. Seemingly, the criminal provisions of the Act were directed at three primary and two secondary communities. The political benefits of the Act, both to the business and political communities in the United States, might be significantly greater, in the long term, than the benefits gained through the application of the criminal provisions to selected members of the American business classes.

The first is the domestic political community. The integrity of the public securities markets was compromised by the scandals. These scandals reached right to the top of the political elite.<sup>187</sup> The American financial system is based on an acceptance of the “facts” of transparent and liquid markets in which all traders are engaged in the market with equal information and the information fairly represents the relative condition of all market issuers.<sup>188</sup> The principles were nicely summarized by Justice Ginsburg in *United States v. O’Hagan*,<sup>189</sup> where she identified “an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”<sup>190</sup> There was a fear that confidence in the

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<sup>187</sup> Both Vice President Richard Cheney and the former Chair of the Securities Exchange Commission, Harvey Pitt, were well acquainted with many of the corporate villains who emerged in 2000–2002, and they were rumored to have some peripheral involvement with the scandals. See, e.g., Kathleen Day, *Harvey Pitt Raises A Promotion Commotion*, WASH. POST, July 25, 2002, at E1; James Grimaldi, *Asbestos Claims Hurt Halliburton Insurance Spinoff; Lawyers Ask Whether Parent Company Hid Information During Cheney’s Watch*, WASH. POST, Aug. 18, 2002, at A7.

<sup>188</sup> In his opening statement before the Senate Committee on Banking, Housing and Urban Affairs, Senator Sarbanes stated his understanding that “[a]s investors make the financial decisions that significantly shape their lives and assure their families’ well-being, they must be able to rely on information available to them as being complete, accurate, timely and comprehensible.” *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight Hearing Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 107th Cong. (2002) (opening statement of Paul S. Sarbanes, Chairman, Senate Comm. on Banking, Hous., and Urban Affairs).

<sup>189</sup> 521 U.S. 642 (1997).

<sup>190</sup> *Id.* at 658 (citing 45 Fed. Reg. 60412 (1980) and stating that trading on misappropriated information “undermines the integrity of, and investor confidence

existence of this sort of market was growing.<sup>191</sup> Viewed in this context, the provision of criminal sanctions that extended the reach of criminal law may only marginally have a therapeutic effect on the political community. Created for internal consumption in the United States, the criminal provisions represent both an attempt to assure the investing public that something grand is being done, while at the same time protecting the business elite from a serious erosion of their position or status. Sure, some members of the elite will have to be sacrificed—partners at Arthur Andersen,<sup>192</sup> certain “livin’ large” corporate officers and executives,<sup>193</sup> and perhaps, even some lawyers.<sup>194</sup> Of course, there will also be a number of ruined middle-class lives as well; principally the host of key assistants whose testimony will be necessary to paint a legally plausible morality tale writ almost larger than life about the excesses of these sacrificial elite actors.<sup>195</sup> The bulk of business people,

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in, the securities markets”).

<sup>191</sup> See, e.g., Jerry Markon & Richard B. Schmitt, *Q&A: The In's and Out's of Insider Trading*, WALL ST. J., Oct. 4, 2002, at C1.

<sup>192</sup> Arthur Andersen LLP was charged and convicted for obstruction of justice. See Carrie Johnson & Peter Behr, *Andersen Guilty Of Obstruction; Accounting Firm Will End Audit Work*, WASH. POST, June 16, 2002, at A1.

<sup>193</sup> In addition to the Rigas family from Adelphia, the following have also been indicted or convicted on criminal charges: Former Enron CFO, David Fastow and former Enron employee Michael Kopper; Former Tyco CEO, L. Dennis Kozlowski, and Former Tyco CFO, Mark H. Swartz; Former WorldCom CFO, Scott D. Sullivan, Former WorldCom Controller, David F. Myers, and other WorldCom officials, including: Buford Yates Jr., Betty L. Vinson, and Troy M. Normand. See Andrew Backover, *2 More Ex-Worldcom Players to Plead Guilty*, USA TODAY, Oct. 10, 2002, at 6B; Peter J. Howe, *Adelphia Executives Indicted; Charges Against 3 Rigases and Their Associates Include Securities Fraud*, BOSTON GLOBE, Sept. 24, 2002, at D1; *The Fall of Enron*, HOUSTON CHRONICLE, Oct. 20, 2002, at A26; Nicholas Varchaver, *Fall From Grace; Mark Belnick's Indictment in the Tyco Scandal Has Left Friends in Shock and Colleagues Bewildered. What Went Wrong?*, FORTUNE, Oct. 28, 2002, at 112.

<sup>194</sup> For example, Tyco's general counsel, Mark A. Belnick. See Varchaver, *supra* note 193.

<sup>195</sup> In conformity with a pattern of prosecutorial behavior learned from years participating in the courtroom campaigns of the “war” against drugs, state and federal prosecutors have targeted lower level employees who are less able, because of their inferior social and economic status, to resist the full force of the coercive power of government. These targets of prosecution then are permitted to negotiate a plea agreement in return for testimony against their superiors. One can clearly see the pattern at work in the slow government campaign against the senior officials at WorldCom. By October 11, 2002, four mid-level WorldCom accounting employees were targeted by government prosecutors and pleaded guilty in exchange for lighter sentences and testimony against higher-level executives. See *WorldCom Ex-*

however, will be left alone, with positions and status intact.<sup>196</sup>

The second is the global institutional trade community. The world business community is increasingly interlinked.<sup>197</sup> American participation in regional trade associations, principally NAFTA,<sup>198</sup> created a regional trade association between the United States, Canada, and Mexico. The World Trade Organization<sup>199</sup> requires the maintenance of the reputation of American business, as well as some stability and predictability with respect to American business conduct norms. To some extent, the American scandals damaged that reputation, as well as the standing of American business within the world community.<sup>200</sup> That loss of reputation could hurt world financial markets.<sup>201</sup> It could also hurt American authority in the

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*Accountant Vinson Pleads Guilty to Fraud*, AFX Eur. Focus, Oct. 11, 2002, available at LEXIS, News Group File. These include Betty Vinson, former accounting department employee, Troy Normand, former director of legal entity accounting, Buford Yates, former chief accounting officer, and David Myers, former comptroller of WorldCom. *Id.* "Lawyers said Vinson, Yates, Myers and Normand are likely to provide evidence against former top WorldCom executives, possibly including ex-CEO Bernie Ebbers and former chief financial officer Scott Sullivan, in exchange for lenient sentencing in the case." *Id.* For a critical discussion of such governmental behavior, see, for example, Ellen S. Podgor, *White-Collar Cooperators: The Government in Employer-Employee Relationships*, 23 CARDOZO L. REV. 795 (2002).

<sup>196</sup> It is interesting that the Act has little to say directly about director and officer compensation issues. Only section 304(a)(1) discusses forfeiture of bonuses or other incentive based compensation by officers, and even this clause is limited to chief executive and financial officers. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304(a)(1), 116 Stat. 745, 778 (to be codified at 15 U.S.C. § 7243(a)(1)).

<sup>197</sup> See, e.g., Michael Gruson, *The Global Securities Market: Introductory Remarks*, 1987 COLUM. BUS. L. REV. 303; cf. Michael Mussa, *Factors Driving Global Economic Integration* (2000), at <http://www.imf.org/external/np/speeches/2000/082500.htm>.

<sup>198</sup> North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 605.

<sup>199</sup> The World Trade Organization serves as the institutional framework through which the General Agreement on Tariffs and Trade is implemented. General Agreement on Tariffs & Trade, Oct. 30, 1947, 61 Stat. A-3, 55 U.N.T.S. 188. Much negotiation with respect to commercial issues on a global scale now occurs within the WTO framework.

<sup>200</sup> "What happened inside Enron, WorldCom, Xerox and perhaps many other corporations made a nonsense of the integrity of the US accounting system and exposed American corporate policy as, at worst, the domain of the criminal." *A World Plundered By Greed and Double Standards*, SUNDAY HERALD, June 30, 2002, at 10, available at LEXIS, News Group File; see also Aude Genet, *EU Seeks Corporate Action Plan to Avoid US-Style Scandals*, AGENCE FRANCE-PRESSE, Oct. 1, 2002, available at LEXIS, News Group File.

<sup>201</sup> See Silvia Ascarelli et al., *Stocks Sink on Effect of U.S. Corporate Scandals*, WALL ST. J., June 27, 2002, at C13 (noting world stock exchanges industrial averages dropped in light of U.S. corporate scandals); see also *Scandals Shake Faith*

continuing negotiations relating to issues of global trade.<sup>202</sup> The global business community, just like the American public, had to be assured that something was being done to correct the situation. In a large sense, the Sarbanes-Oxley Act, along with a new more formally cooperative attitude on the part of American officials, was meant to satisfy that need.<sup>203</sup>

The third set of actors to whom the Sarbanes-Oxley Act provisions were directed consists of countries that are said to be in transition to free market economies and democratic political institutions. These are the communities of nations that have been subject to intense lobbying with respect to their economies—from Russified kleptocracies<sup>204</sup> to states riddled with corruption.<sup>205</sup> With respect to these states, the American model of corporate governance has been raised as an ideal.<sup>206</sup> The

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in *U.S. Model*, WALL ST. J. EUR., June 28, 2002, at A1.

<sup>202</sup> Indeed, the recent European trip of Harvey Pitt emphasized the weaker position of the United States vis-a-vis its major global trading partners in the area of regulatory reform. "Responding to criticism that the United States practices a kind of economic imperialism by requiring some foreign companies to comply with a new corporate oversight law [the Act], Mr. Pitt told a gathering of European accounting professionals today, 'We seek to usher in a new regulatory regime in concert with you, not impose our solutions on you.'" Suzanne Kapner, *S.E.C. Chief Promises to Cooperate With Europe*, NY TIMES, Oct. 11, 2002, at W1.

<sup>203</sup> After the passage of the Act, the popular press reported positive reactions across the industrialized world. See, e.g., Lydia Adetunji & Andrew Hill, *New Law Turns the Spotlight on the Laggards*, FIN. TIMES, Aug. 16, 2002, at 24; *Corporate Law Must Be Tackled*, AUSTRALIAN FIN. REV., Aug. 5, 2002, at 54.

<sup>204</sup> A kleptocracy can be loosely defined as a nation suffering from regimes of institutionalized corruption. Many of the countries emerging out of the Soviet Union have been described in terms of wide-ranging institutionalized corruption in which an apparatus of the state is used to steal the nation's wealth for the benefit of the ruler's family and confidants. Russia, especially before the Presidency of Vladimir Putin, was sometimes held up as a paramount example of this form of governance. See, e.g., Steven Solnick, *Russia Over the Edge*, 7 E. EUR. CONST. REV. 126 (1998); MARTHA BRILL OLCOTT, *KAZAKHSTAN: UNFULFILLED PROMISE* (2002). See generally SUSAN ROSE-ACKERMAN, *CORRUPTION AND GOVERNMENT: CAUSES, CONSEQUENCES, AND REFORM* (1999).

<sup>205</sup> For a discussion of the kleptocracies of Africa and Asia, see, for example, THOMAS L. FRIEDMAN, *THE LEXUS AND THE OLIVE TREE* 146-151 (1999); Okechukwu Oko, *Subverting the Scourge of Corruption in Nigeria: A Reform Prospectus*, 34 N.Y.U. J. INT'L L. & POL. 397 (2002) (detailing the various causes of corruption in Nigerian business, politics, and military); cf. Ndiva Kofele-Kale, *The Right to a Corruption-Free Society as an Individual and Collective Human Right: Elevating Official Corruption to a Crime Under International Law*, 34 INT'L LAW. 149 (2000) (discussing the extent of corruption in various countries, legislative attempts to deal with the problem, and barriers to enforcement).

<sup>206</sup> See, e.g., Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1801 (2000); Jacques

scandals of 2000–2002 significantly tarnished the image of American business that this country projects. They raised the possibility of cynicism and a sense of a double standard by the emerging country elites are to be denied what apparently passes for acceptable conduct in the United States. The Sarbanes-Oxley Act's criminal provisions serve as damage control. They also serve as a model for behavior: when the United States is beset by examples of corruption in business, the government institutions act swiftly to identify and curb that behavior. Emerging states will be urged to do the same.<sup>207</sup>

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deLisle, *Lex Americana?: United States Legal Assistance, American Legal Models, and Legal Change in the Post-Communist World and Beyond*, 20 U. PA. J. INT'L ECON. L. 179 (1999).

<sup>207</sup> See generally *Security Threats to Americans Overseas: Hearing Before the Subcomm. On Nat'l Sec., Veterans Affairs, and Int'l Relations of the House Comm. on Governmental Reform*, 106th Cong. (2001) (testimony of John M. McCarthy, Dir. of Corp. Sec., Texaco, Inc.); *Safeguarding Macroeconomic Stability at Low Inflation*, WORLD ECON. OUTLOOK, Oct. 1, 1999, at 92.



