New York Law Journal

August 8, 2002 Thursday

CORPORATE RESPONSIBILITY LEGISLATION: CONFLICTS, UNCERTAINTIES

By Stanley S. Arkin

IN THE WAKE of highly publicized corporate scandals and their resulting politicization, Congress has reacted with legislation as redolent of populist anger as it is of well-intentioned and needed reforms.

With the list of major accounting and securities fraud investigations and indictments at public companies growing on almost a daily basis, even the most staunch opponents of corporate reform have quickly hopped on the speeding band wagon. In a mere two weeks, Congress all but unanimously passed broad corporate reform legislation called the Sarbanes-Oxley Act of 2002 (SOA or the act) that was signed into law by President George W. Bush on July 30, 2002.[1] The act seeks to address a deep-seated loss of investor confidence in the strength, reliability and transparency of corporate earnings.

While reformers have touted the act's enhancement of criminal penalties - such as doubling maximum sentences for certain securities crimes - it is dubious whether the prospect of greater punishment will deter potential corporate miscreants. Our criminal statutory scheme, coupled with the federal sentencing guidelines, already provide a seriously and arguably over-harsh inventory of sentencing penalties. In addition, powerful regulatory sanctions in the securities and banking domain provide a criminal and regulatory architecture that is enormously flexible and far reaching. Congress' haste to promote reform has resulted in legislation that in part may engender confusion, not clarity, and in the end be experienced as a kind of Rockefeller Drug Law version of securities enforcement - compromising the desired goals of curbing the corporate and accounting abuses that have shaken Wall Street.

Noteworthy Reforms

The SOA contains a number of noteworthy reforms designed to alter accounting, board-room and securities industry practices, including:

Creating an independent accounting oversight board to regulate the auditing of public companies and enacting prohibitions to curb auditor conflicts of interest.

Requiring public companies' chief executive officers and financial officers to certify the appropriateness of financial statements and imposing strict criminal penalties for making false certifications.

Significantly increasing the criminal penalties for obstruction of justice, securities, mail and wire fraud - imposing murder-level prison terms of up to 25 years in certain circumstances.

Directing the Securities and Exchange Commission (SEC or commission) to establish rules restricting securities analyst conflicts of interest.

Directing the SEC to establish rules imposing standards for the professional conduct of attorneys who practice before the commission.

Establishing broad new protections for corporate whistleblowers.

Lengthening the statute of limitations for shareholder securities fraud lawsuits.

In sum, the act creates statutory obligations that substantially increase the potential criminal and civil exposure for public companies, their employees, auditors, and attorneys. Of particular concern among the far-reaching provisions of the SOA, the provisions regarding attorney professional conduct and CEO and CFO certification of financial statements will likely cause significant discord, litigation, and uncertainty.

Professional Standards for Lawyers

One of the most significant, but least noticed, features of the SOA is a provision that requires the SEC to promulgate rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers.[2] This provision resulted from an amendment to the Senate bill that arose from a concern that corporate lawyers have forgotten that they work for the corporation and for the ordinary shareholders who own the corporation, and not the senior executives who are their managers.[3] In a recent letter to SEC Chairman Harvey Pitt, 40 law professors expressed a concern[ ] about the role of professionals in the Enron matter and other frauds on investors [and a] belie[f] that attention should [ ] be given to the role of lawyers in representing public corporations, and in particular to whether lawyers should inform a client corporation's directors about violations of the securities laws.[4] The federal proscription of attorney conduct mandated by the SOA is vague, in some ways untenable, and may create a conflict with applicable state ethics rules that currently govern lawyers' professional conduct.

The SOA requires that any regulations passed by the SEC contain provisions requiring attorneys 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 senior lawyer or executive at the company and, if this person does not appropriately respond, requiring attorneys to report the evidence to the board of directors or a committee of the board that is comprised solely of independent directors.[5] Lawyers who violate the SOA minimum standards will be deemed to have violated the Securities Exchange Act of 1934 or the commission rules promulgated thereunder, and will be subject to penalties for such a violation.[6] This rule appears to restrict most state ethics rules governing lawyers, which provide attorneys with discretion in how to handle a client's fraud or other criminal wrongdoing as long as they are acting in the best interest of the company that they represent.[7]

One question that emerges immediately is whether federally imposed lawyer ethical standards (call them professional disclosure duties) will preempt traditional state ethical rules. In brief compass, among the additional difficult questions which arise under these provisions are:

What lawyers will be deemed to be covered by the professional standards? Pursuant to the extremely broad terms of the SOA, lawyers representing a public company, even if this engagement is not directly related to practice before the SEC, arguably may be sanctioned by the commission for failure to report evidence of corporate wrongdoing. These broad terms also raise the possibility that counsel retained by individual corporate officers or directors who are compensated by the company may be covered by the disclosure obligations of the SOA.

How much evidence of wrongdoing must exist before disclosure is required? The SOA seemingly requires lawyers to report evidence - regardless of the attorney's perceived significance of it, or its probity or how it was obtained - of an amazingly broad array of corporate misdeeds including, material violation of securities law or breach of fiduciary duty or similar violation. In addition, such misdeeds may have been committed by any agent of the company - a term that likely includes not only corporate employees, but auditors, consultants, investment bankers, insurers, lenders, etc. In this vein, it is noteworthy that the SOA requirement that attorneys disclose mere evidence of fraud appears to lower the standard set forth in ABA disciplinary rules, which currently provide that a lawyer must have information clearly establishing that his client's conduct is fraudulent prior to being able to take remedial action.[8]

An Appropriate Response

What is an appropriate response to an attorney's disclosure? Under the SOA, an attorney disclosing evidence of corporate misconduct to company executives or inside counsel only complies with minimum professional standards if that person makes an appropriate response. This notion of appropriateness is extremely vague and subjective - providing no guidance to practitioners or the SEC in addressing how to evaluate remedial action taken by company insiders.

Must the disclosed information come from the issuer? Given the breadth of the any agent term of the SOA, there is a significant question as to whether evidence of wrongdoing obtained by a lawyer in connection with the representation of an entity other than the issuer must be reported to officers or directors of the issuer if that lawyer also represents the issuer.

While the particularities of SEC regulation of lawyers will be a result of pending commission rule making, the minimum standards imposed by the SOA both increase a lawyers' duty to report information of potential criminal conduct and create myriad questions and uncertainties for lawyers who represent public companies and their agents.

Pursuant to the SOA, chief executive officers and chief financial officers must certify that their company's periodic financial reports are not materially misleading and fairly present in all material respects the financial condition and results of operations of the issuer, and will now be statutorily responsible for establishing and maintaining effective internal corporate controls.[9] Moreover, where CEOs or CFOs certify their company's financial statements knowing that their contents are misleading, they may be convicted of a criminal offense including penalties of up to $5 million and 20 years in prison.[10] Senate efforts to water down the usual criminal scienter requirement of knowing and willful to the level of reckless were, happily, defeated in Conference Committee.

While federal courts have properly burdened senior executives with responsibility for corporate financial reports (even if they were not personally involved in preparation of the filing),[11] the SOA certification provision is the first rule that holds particular corporate officials categorically responsible for the accuracy of periodic financial reports and the efficacy of internal control mechanisms.[12] Analogous provisions contained in the Securities Act of 1933 require corporate directors and senior officers to sign registration statements offering securities to the public[13] and provide a specific right of action against such signatories if it turns out that the registration statement was materially misleading.[14] These latter provisions, however, provide such executives an affirmative defense if they conducted a reasonable investigation to confirm the accuracy of the registration statement or reasonably relied on the authority of an expert in reaching this conclusion.

Under its certification and internal controls provisions, the SOA creates a catch-22 in which, in the event of a restatement, corporate senior executives who have previously certified the accuracy of financial statements may be investigated for criminal wrongdoing to determine whether they knew that the financial statements were misleading and, if they did not know, may be civilly liable to the SEC for failing to create a system of internal controls sufficient to detect the applicable misstatements. In either event, if the restatement of earnings is a result of any misconduct (even if not the misconduct of the CEO and/or CFO), the CEO and CFO must pay back to the company any bonus or other incentive compensation that they received during the year prior to the misstatement and must disgorge to the company any profits that they received from sales of securities of the issuer during this period.[15] In light of the recent extraordinary magnitude of executive compensation, having this kind of sanction might be viewed as old-fashioned justice. However, where senior executives provide the required certification because they relied on the company's auditors and internal controls and it turns out that such checks were undermined by more junior miscreants, automatic divestment of bonus compensation and stock sale proceeds is an overly harsh result.

It is difficult to say just how much in actuality a CEO or CFO's responsibilities have been broadened by the SOA because CEOs and CFOs have fundamental obligations to insure fair and accurate financial reporting under existing regulatory measures. Nevertheless, it is clear that the potential civil and criminal penalties attendant to the SOA certification provisions significantly increase the personal risks faced by CEOs and CFOs of public companies. This is particularly true in large public companies where CEOs and CFOs will necessarily have to rely on the honesty and integrity of numerous employees and the companies' auditors in order to provide the necessary certification. The serious repercussions faced by CEOs and CFOs in the event of a restatement of earnings involving any misconduct in a positive sense will likely result in these officials implementing a review of corporate internal control systems and may result in companies taking serious measures in an effort to forfend against the possibility of restatements. The significant personal risks placed on these executives, however, may have the unintended result of dissuading competent individuals from serving in these positions - possibly resulting in a crisis akin to that faced in the mid-1980s when many corporate directors and officers were unable to obtain insurance and/or indemnification due to a perceived increased likelihood of being held liable for money damages.

Conclusion

The recent passage of the SOA is unambiguous in its desire to respond to the recent spate of corporate and accounting improprieties at public companies and, more specifically, to overwhelming public opinion blaming corporate officials for these problems. While this motivation is surely sound, in its haste to respond to the voting populace, Congress and the President have passed legislation that needs a lot more thought.

1. Pub. L. No. 107-204, 107th Cong., 2d Sess., 116 Stat. 745 (2002).

2. SOA 307.

3. The Ethical Responsibility of Lawyers After Enron, 148 Cong. Rec. 55652-02 (June 18, 2002) (statement of Sen. John Edwards).

4. March 27, 2002 Letter to Harvey Pitt (text available at http://www.fed-soc.org/Publications/practicegroupnewsletters/PGLinks/pittletter.htm).

5. SOA 304.

6. Id. 3(b)(1).

7. See ABA Model Rules of Professional Responsibility, Model Rule 1.13(b) (If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action ... related to the representation that is a ... violation of law which reasonably might be imputed to the organization ... the lawyer shall proceed as is reasonably necessary in the best interest of the organization.).

8. See ABA Model Code of Professional Responsibility, Disciplinary Rule 102(B)(1).

9. SOA 302.

10. Id. 906.

11. See Howard v. Everex Sys., Inc., 228 F.3d 1057, 1064-65 (9th Cir. 2000) (holding that a CEO who, acting with scienter, signs a corporate SEC filing that contains material misrepresentations, is liable as a primary violator of section 10(b) despite CEO's contention that he was not personally involved in the preparation of the filing); but see, e.g., Jacobs v. Coopers & Lybrand, L.L.P., No. 97 CIV. 3374 (RPP), 1999 WL 101772, at *16 (S.D.N.Y. March 1, 1999) (dismissing securities fraud claim against outside director and audit committee member who signed company's 10-K because plaintiffs failed to cite red flags that should have made the director aware of potential material misstatements).

12. It is noteworthy that SEC regulations require Form 10-Ks to be signed on behalf of the issuer by the registrant's principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least a majority of the board of directors or persons performing similar functions. See Amendments to Annual Report Form, Securities Act Release No. 6231, Exchange Act Release No. 17,114, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 72,301, at 62,812 (Sept. 2, 1980).

13. See Securities Act of 1933 6(a), 15 U.S.C. 77f(a) (2002).

14. See id. 77k(a).

15. See SOA 303.