An Overview of the Sarbanes-Oxley Act and Its Implications for Attorneys

Jeffrey W. Stempel
University of Nevada, Las Vegas -- William S. Boyd School of Law

THE SARBANES - OXLEY ACT:

Lawyer Professional Responsibility, and a Heightened Role for

Business Lawyers

"The first thing we do let's kill all the lawyers."

--William Shakespeare
II Henry VI, IV:2

By Jeffrey W. Stempel

There is no nonsense so errant that it cannot be made the creed of the vast majority by adequate governmental action.
-- Bertrand Russell (1872 - 1970)

In the state of nature...all men are born equal, but they cannot continue in this equality. Society makes them lose it, and they recover it only by the protection of the law.
-- Charles de Montesquieu (1689 - 1755)

Introduction

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002, H.R. 3763, well-publicized in the press as a legislative response to the perceived excesses of corporate America: Enron; WorldCom; Tyco; Global Crossing, etc.

The Sarbanes-Oxley Act of 2002 contains an array of provisions affecting lawyers as professionals serving businesses and contains one provision that will clearly impact corporate counsel in the ethical discharge of their duties. Section 307 of the Act and the recently released Proposed Roles of the Securities Exchange Commission regarding lawyer duties and implementation of Section 307 require counsel to go "up the ladder," to the board of directors, if necessary, with information about serious wrongdoing. To a degree, this presumably pre-emptive federal law is in tension with the ABA Rules of Professional Conduct and the Nevada Supreme Court Rules of Professional Conduct, both of which provide for a discretionary rather than mandatory in-house "whistle blowing."

An earlier draft of the SEC Rule implementing Section 307 would have required attorneys to engage in the essential equivalent of external whistle blowing if the Board did not take "appropriate action" when faced with evidence of corporate wrongdoing. The SEC, responding to substantial criticism from the organized bar (and to some degree the bench), backed away from this "noisy withdrawal" trial balloon. This article briefly sketches the new law and its provisions regulating lawyer professional conduct.

The Act

In the main, however, Sarbanes-Oxley is a corporate governance bill and an accounting regulation bill rather than a lawyer regulation bill. The Act sets forth its title and table of contents, followed by a section defining key terms, and provides for rulemaking and enforcement by the Securities Exchange Commission.

Title I of the Act creates a Public Company Accounting Oversight Board (Section 101) that will be itself overseen by the SEC (Section 107). The Board is a nonprofit corporation rather than a government agency and is structured in a manner similar to the NASD. The Board is subject to oversight by the SEC. The Board does not have direct oversight or disciplinary authority over issuers of securities. For example, if subjects of the Board's information requests resist, the Board will need an enforcement subpoena from the SEC. The Board is composed of five members, at least two of whom must be Certified Public Accountants. The Board Members are appointed for staggered five-year terms and may be removed during office, but only for "good cause."

Section 102 obligates public accounting companies to register with the Board. This must be done within 180 days of the naming of the Board, which took place on Oct. 28, 2002, making the compliance date April 26, 2003. Section 102 states that the Board will establish enforceable standards of auditing, quality control, and independence (Section 108). However, accounting standards as a general matter are still the province of the Financial Accounting Standards Board. Firms may be inspected by the government (Section 105), including foreign accounting firms, although there may be some room for debate on that point. (Section 106). Inspections of public auditing firms will take place annually if the firm does more than 100 audits of public companies. Inspections will be held every three years for other firms. Section 109 establishes funding for the Oversight Board.

Title II of the Act contains a number of provisions that seek to strengthen the independence of auditors. Section 201 forbids accounting firms from performing other services for an audit client within 180 days of the audit. Section 202 requires that any auditor "comfort letters" or similar representations be approved by the audit committee of the board of directors for the company. Section 203 requires that the partner in charge of an audit for a firm client be rotated at least every five years (think term limits for the auditing partner). Section 207 establishes that the SEC will study the mandatory rotation provision. The auditor is expected to report directly to the audit committee of the company's board of directors rather than permitting company officials to present (and potentially sugarcoat) the report (Section 204). Section 206 makes it a conflict of interest for a public accounting firm to audit a company in which any former employee of the accounting firm is an officer or director. The SEC is given authority to enforce these provisions of the Act (Section 208). Section 209 adds the caution that state regulators should not assume that the standards established under the Act for registered public accounting firms are applicable for "small and medium sized non-registered public accounting firms."

Title III sets forth measures designed to increase "corporate responsibility." Public company audit committees must comply with the Act in order to remain publicly traded (Section 301). Corporate officials must sign and certify annual and quarterly reports and may expressly may be held legally accountable for the content of the financial reports (Section 302). Under Sarbanes-Oxley, this requirement applies to all publicly traded companies, not only large companies. Company officials may not seek to improperly influence the outcome of an audit (Section 303). If an officer obtains a bonus or profits from stock options based on inaccurate data and the officer knew or should have known of its inaccuracy, the bonus or profits earned within 12 months of any such misconduct can be forfeited (Section 304). Officers or directors involved with corporate fraud may be barred from such positions in the future and may be fined (Section 305). Section 308 provides that penalties obtained by the SEC may be added to any disgorgement fund used to compensate victims of company misconduct. Of greatest interest to lawyers is Section 307 of the Act, which is the only segment of the law directly aimed at lawyers. Section 307 is discussed in greater detail in Section B below.

Title IV of the Act provides for "enhanced financial disclosures" by public companies, made in public periodic reports (Section 401). Section 402 establishes conflict of interest limitations on corporate officers, in particular on the benefits that a company may bestow on an officer. Transactions between the company's management and principal stockholders must be disclosed (Section 403). Company management is required to assess the internal controls of the company on financial data accuracy (Sections 404 & 405). Section 406 requires the SEC to promulgate a Code of Ethics for senior financial officers. Section 407 empowers the SEC to determine if an audit committee has a designated financial expert. Issuers of company securities are to review the periodic disclosures of the company for consistency (Section 408) and to make disclosures in real time (Section 409).

Title V seeks to reduce or compensate for the conflicts of interest among stock analysts (Section 501). Title VI relates to SEC resources and authority. This section of the Act authorizes additional funding for the SEC (Section 601), grants federal court authority to impose bars on the sale of "penny stock" (Section 603), regulates the qualifications of persons working with stock brokers and dealers ("associated persons") (Section 604), and establishes of Commission authority to regulate the appearance and practice of lawyers before the SEC (Section 602).

Title VII commissions a GAO study regarding the effect of consolidation among the accounting firms (Section 701) as well as requiring a study of credit rating agencies (Section 702) and a study to report violations of the Act (Section 703), as well as a study of enforcement actions (Section 704) and investment banks (Section 705).

Title VII of Sarbanes-Oxley provides criminal penalties for altering documents (Section 802; states that corporate debt will not be dischargeable in bankruptcy if the debt was incurred in violation of the securities laws (Section 803) and establishes a longer statute of limitations for securities law violations -- two years from the date of discovery or five years from the date of the violation, whichever is earlier (Section 804). Section 806

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provides job and other protections to whistleblowers ("employees of publicly traded companies who provide evidence of fraud"). Under Section 807 of the Act, companies and individuals who defraud shareholders are now subject to criminal penalties.

The whistle blower provisions of the Act are quite significant in that they cast a wide net. Not only employees, but also contractors, subcontractors, and other "agents" of a public company are subject to the protection of the Act. A company may not discharge, demote, suspend, threaten, or harass an agent for raising concerns about violation of any federal law relating to fraud against shareholders, so long as the protected person had a "reasonable belief" that there was a possible violation of the law. The protected person may be incorrect but is still protected against retaliation if his or her belief was reasonable. The protected person is permitted to complain to his or her supervisor, a federal agency, or to Congress. The remedies are broad and include reinstatement, back pay, compensatory damages, counsel fees and costs - but not punitive damages. However, the whistle blower provisions of Sarbanes-Oxley do not preempt other causes of action the protected person may have under state or federal law.

Title IX, "White-Collar Crime Enhancements," contains a number of significant provisions. It outlaws "attempts and conspiracies to commit criminal fraud offenses" (Section 902). It increases the penalties for mail and wire fraud from a maximum imprisonment of five years to a whopping 20-year maximum (Section 903). It also establishes penalties for violations of ERISA (the Employee Retirement Income Security Act), the 1974 statute that was supposed to prevent vanishing pension funds and other economic disaster for workers. The maximum fines have increased five and 20-fold and maximum imprisonment has increased from one year to 10 years (Section 904). The U.S. criminal sentencing guidelines are amended to provide for greater chance that white-collar criminals will be incarcerated or seriously fined rather than given probation (Section 905). In addition, CEOs must certify the accuracy of financial reports and will be held responsible for the content of their financial reports, including potential fines of up to $5 million and imprisonment of 20 years for willfully false certification (Section 906).

Title XI of the Act deals with "Corporate Fraud and Accountability." This section makes it illegal to tamper with company records or "otherwise impede" a government proceeding involving the company (Section 1102). Section 1103 gives the SEC authority to temporarily freeze corporate assets. Section 1104 amends the federal Sentencing Guidelines to provide for more severe sentences for obstruction of justice-type offences. Section 1105 provides the SEC with the authority to prohibit a person from serving as an officer or director of a public company. Section 1106 increases the criminal penalties for violations of the Securities Exchange Act of 1934. Section 1107 prohibits companies from retaliation against informants.

Corporate Counsel's Duties Under Sarbanes-Oxley

As noted above, Section 307 of the Act deals directly with attorney conduct and requires counsel to bring arguable misbehavior to the board of directors. Section 307 provides:

Not later than 180 days after the date of enactment of this Act, the [Securities Exchange] Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and *practicing before the Commission in any way in the representation of issuers*, including a rule --

(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

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agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel of 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 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. (emphasis added)

Who are the Lawyers Covered by this Provision of Act?

The text of Section 307 is broad in that it refers to attorneys "appearing and practicing" before the Commission "in any way" in the representation of issuers. This can be read as suggesting that any lawyer doing work for a public company subject to SEC regulation is also subject to Section 307. The SEC Regulations implementing this provision of Sarbanes-Oxley suggest that the Commission will give Section 307 a broad interpretation. Commentators seem to believe that any lawyer doing work for a publicly traded company will most likely be deemed subject to Section 307 if the issue is fully litigated. Of course, the Section 307 definition "appearing and practicing before the Commission" can also be read more narrowly to suggest that Section 307 will not apply to attorneys unless they actually make formal appearances before the SEC or at least make formal submissions to the SEC. Nevertheless, how many business lawyers want to take that risk?

Comparing Sarbanes-Oxley to the ABA Model Rules and the ALI Restatement

ABA Model Rule 1.13, first enacted in the 1983 adoption of the Model Rules (which replaced the 1970 ABA Code of Professional Responsibility and is the basis of Nevada SCR 163) differs from Section 307 in that under the SCR and Model Rule, a lawyer may - but need not - engage in "up-the-ladder" internal reporting of corporate wrongdoing. Also, the ABA Rule appears to envision that the lawyer will take such action only when aware of a constituent of the organization (e.g., the chief financial officer) acting or refusing to act "in a matter related to the representation *that is a violation of a legal obligation to the organization, or a violation of law, which reasonably might be imputed to the organization*, **and** *is likely to result in substantial injury to the organization*, the lawyer shall proceed as is reasonably necessary *in the best interest of the organization*." (emphasis added). This is clearly a narrower rule than that provided for under Sarbanes-Oxley, setting up the possibility of conflict between state and federal law in this regard.

Further, in determining how to proceed under the ABA Rule and Nevada SCR, the lawyer "shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant consideration. Any *measures taken shall be designed to minimize disruption of the organization* and the *risk of revealing information* relating to the representation *to persons outside the organization*." (emphasis added). Measures may include asking reconsideration of the matter, advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization, and referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law. Again, the ABA Rule provides for less aggressive and more discretionary up-ladder reporting than Sarbanes-Oxley.

But, like Section 307 as written and the new, de-fanged SEC Rule, Rule 1.13 and SCR 163 do not mandate - or even encourage - attorney whistle-blowing

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outside the organization. The Rule provides that "[i]f despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, *that is **clearly** a violation of law and is likely to result in substantial injury to the organization*, the lawyer may resign in accordance with Rule 1.16."

In addition to the ABA Model Rules, the American Law Institute's *Restatement (Third) of Law Governing Lawyers* (2000) is an influential authority for legal ethics, although not binding on the states. Sections 94-96 of the Restatement deal with the issues addressed in ABA Rule 1.13 and Section 307 of the Sarbanes-Oxley Act. The *Restatement* view tends to tract the ABA Rule and thus presents a body of authority in tension with Sarbanes-Oxley.

A Tempest in a Teapot -- or the Road to Preemption

Sarbanes-Oxley is substantial, even momentous, legislation - but is Section 307 all that significant for lawyers? An examination of Sarbanes-Oxley Section 307 suggests it stops considerably short of a true whistle-blowing statute. However, it requires attorney action that arguably is inconsistent with the ABA Rules and the Nevada SCRs, which law controls. Within its sphere of authority, Sarbanes-Oxley probably controls by benefit of federal pre-emption doctrine. Consequently, attorneys working for publicly traded companies will probably need to conform their conduct to Section 307 of the Act rather than treating Nevada SCR 163 as a safe harbor in such situations.

Overall, however, Section 307 is quite consistent with Model Rule 1.13 in principle but will impose more duties on counsel in practice. A lawyer confronted with corporate wrongdoing should attempt to get the problem fixed internally, going over the head of a difficult employee if necessary. This is a natural corollary to the axiom that the attorney's client is the corporation, not any particular employee, especially if the employee is acting in a self-serving manner. In addition, under ABA Model Rule 1.6 and Nevada SCR 156, an attorney knowing of future planned client conduct involving the lawyer's services in crime or fraud - or likely to result fairly directly in death or serious bodily injury to another - is not bound to keep silent. Future financial fraud, however, generally does not provide attorneys with grounds to disclose ethically protected client information. NL

Jeffrey W. Stempel is a Professor of Law at the William S. Boyd School of Law, University of Nevada, Las Vegas.