

# The Legal Intelligencer

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ALM

## Revisiting Sarbanes-Oxley:

*How Has the Corporate and Legal Landscape Been Altered in Its Wake?*

*The Sarbanes-Oxley Act has been in place since July 30, 2002. Since that time, questions have been raised over whether the act has done what it was intended to do, what changes have occurred in the corporate and legal communities as a result of the act, and what the future holds. As a possible indicator, earlier this month William H. Donaldson, the chairman of the Securities and Exchange Commission, predicted that some modest changes to Sarbanes-Oxley might come into consideration in the future.*

*ALM, publisher of The Legal Intelligencer and the Pennsylvania Law Weekly, invited five practitioners to share their thoughts on the current state of Sarbanes-Oxley and what they believe the relevant questions are now that it has been in place for several years. The editors at The Legal and the Law Weekly selected the panelists, chose the questions and edited the transcript. Excerpts from the roundtable discussion follow:*

**ALM: One thing I do want to start with is the issue involving the statute of limitations and its application. What are the arguments for and against applying it retroactively?**

**Sitarchuk:** Actually, there's one appellate decision. ... The 2nd U.S. Circuit Court of Appeals on Dec. 4, in a case called *In re Enterprise Mortgage [Acceptance Co.]*, decided that it should not be applied retroactively. They used the same reasoning as Judge Anita Brody did in *L-3 Communications Corp. v. Clevenger*, which seems to be the

weight of authority. I don't understand that, because the statute seems to clearly make it retroactive. To me, the language is unambiguous as it can be. But most of the courts are saying that there's ambiguity there and therefore it's not retroactive. ...

**Gabinet:** Well, the general law is unless it's clear from the statutory language that it's intended to be applied retroactively, then it's not applied retroactively unless there's signs and signals in the law leading up to it that you should know that it's going to be — and *Chevron Oil Co. v. Huson* is the leading U.S. Supreme Court case on retroactivity. I guess I would agree with you that I thought that the language of the statute was pretty clear.

**ALM: What is the language...?**

**Sitarchuk:** It says that the new statute of limitations, which is five or two years after the discovery, as opposed to three and one, applies to cases filed after the effective date of Sarbanes-Oxley. So you would think that would end the issue. But then there's another provision that says that the new statute of limitations provision is not designed to create any new causes of action. So they stick that with the effective date provision, and they decide that makes it ambiguous. ... There are some district courts that go the other way. But the trend seems to be in favor of non-retroactivity. And now that the 2nd Circuit has spoken, they expect the other circuits to fall in line.

**Gabinet:** ... That depends. You might wind up with a different decision since it's a statute that is beneficial to shareholders. I can see the West Coast going outstretched, because the 9th Circuit is not always predictable.

**ALM: So do we anticipate this going to the Supreme Court?**

**Sitarchuk:** If there's a split that develops, yeah ...

**ALM: Can someone explain Section 404? What are the requirements, and what does it change for the corporations?**

**Gabinet:** Section 404 is a provision that requires companies to certify the adequacy of their internal accounting controls, among other things. And what is required ... is a comprehensive review and codification of internal controls practices for public companies. And then [there is] a certification by the executive officers that they have systems and internal controls that are in place to detect the language of the statute with respect to fraud, misconduct and ensure the accuracy of the financial report. ... People are taking it incredibly seriously, and it's a big undertaking to review and develop comprehensive internal controls.

**Sitarchuk:** How much work does the SEC expect that the chief executive officer and chief financial officer will do, as opposed to just getting their underlings to certify to them? Isn't there an effect of squeezing the certification down to a point where it loses its meaning?

**Gabinet:** If you're asking me as an enforcement lawyer what I expect, I look at these things the way I look at all enforcement cases. We don't regulate public companies the way we regulate registered entities. So we don't go in and conduct regulatory examinations of public companies or things like that.

But what you can expect to happen is that if there is an accounting problem at a company, one of the questions will be the certification question. It's a way of bringing home to the senior executives the importance of accuracy and forthrightness in their financial accounting and systems. How much work do we independently expect them to do is another way of saying, how bad does their conduct have to be before you'll bring a case? And the answer is, it's a fact of the circumstances. ... I'm not speaking on behalf of the SEC or the rest of the division of enforcement ... but, personally, I'm not that interested in CEOs who have tried but failed. And what I will look for is the extent to which the organization has set the appropriate tone from the top.

**Dodds:** I think what you're going to end up seeing ... is going to depend on the size of the company that's involved. If it's a multi-national company with thousands of employees and lots of subsidiaries, as a practical matter the CFO or the CEO simply can't certify ... that they know, from their own personal knowledge, that everything in there is correct.

I think what you're going to see, in companies of that size, is sort of sub-certification. They're going to break up the reporting process into its constituent parts and push the certification requirement down on the people responsible for each of those parts. Do some due diligence to make sure that their certifications are accurate, and then certify, ultimately, based upon all of the those sub-certifications. As a practical matter, there's probably no other way to do it. ... In the smaller company, where the CEO can be expected to have more intimate knowledge of the company's operations, then the requirement would probably be viewed differently.

**Schenck:** The criminal penalties have an interesting distinction, because they refer to a knowingly false certification as having a 10-year maximum sentence,

and a willful violation being a 20-year maximum sentence. So they make a distinction between knowing that the certification is false, and one assumes that willful means they're actually involved in falsifying.

**Gabinet:** As prosecutors, or former prosecutors, how different do you guys think Enron or WorldCom would be if there was a certification requirement?

**Schenck:** I think it would have been exactly the same ...

**Donato:** ... I'm sure it would have been exactly the same. I think the faulty premise of this statute is that things like Enron happened merely because of corporate greed, and I don't think that's the way it happened.

I don't represent multi-national corporations, but I do have some clients who are CEO's of smaller publicly held corporations. What occurs there is their belief in themselves makes them do certain things, accounting-wise, that they believe are stopgap measures, and they're going to be able to keep everybody employed and keep their product in the market if only these off-balance sheet items come true.

I don't think it's merely because the penalty for mail fraud before Sarbanes-Oxley was five years per count. Now you raise it to 10 years per count as though somehow that's going to change things. Because if you take a corporate CEO and you say, "If you do this thing you could go to jail for five years," well, five years to him is like life to other people. So it's not a matter of deterring his conduct by making the penalties more severe. And, to me, that's the faulty premise on which this statute is built. ... I don't think that's what motivates businessmen. ...

**Gabinet:** With the prosecution of guys like [former Enron CEO and COO Jeffrey K.] Skilling or [former HealthSouth CEO Richard] Scrushy, would it be easier if they had signed a certification?

**Sitarchuk:** Maybe a little bit, but not much. Basically, the fraud standard is going to be the same, and you're looking as to whether they knew about the illegal activity and allowed it to continue. Whether they sign a certification or not doesn't make a heck of a lot of difference in my mind.

The kind of conduct we're talking about has always been illegal. Raising statutory maximums probably makes the politicians feel good and be able to say to their constituents that they've done something, but what really gets the attention of business is enforcement activity. If they think that government resources [are] dedicated to ... ferreting out accounting irregularities that rise to a level of fraud, that's going to have a real deterrent effect.

**Dodds:** I think what gets their attention is civil enforcement activity. I think criminal enforcement activity gets their fear ... and they have to devote a lot of money to defense lawyers, and that's good for three of us at the table, but as a practical matter I think if you instill fear that's not going to have the effect you want. ...

If you want to punish a corporation, the best way to do that is to fine them ... hit them where it hurts. ...

**Sitarchuk:** I think certifications do make people balk at a certain level. With a lot of these corporate frauds, the way they end up being disclosed is somebody below the corrupt control group said, "I'm just not willing to do this." For that level of people, I think certification sometimes has an impact and makes them stop and say, "Wait a second, I'm not going to put myself in jeopardy for these guys."

**Dodds:** ... If you really look at it, this statute is a reaction to very drastic corporate scandals.

If you think of all of the companies that do business every day, [the scandals are] less than a speck of dust in the entire universe of corporate activity. You have Enron and WorldCom and Tyco, and you had things that were just completely over the top. And as a result of the actions of a few companies, you now have a statute that essentially kills an ant with an elephant gun. It imposes obligations on companies that were doing things right in the first place and now have additional levels of bureaucracy and requirements that they have to deal with. ... To that extent, I think it is more political than anything. ...

**Gabinet:** ... It's not an exaggeration to say killing an ant with an elephant gun. ... But part of what the statute tries to do is to work on the environment in which misbehavior occurs. So for issues

like auditing firms with conflicts of interest, lack of internal controls for companies, whistleblower protection, attorney reporting of misconduct and things like that, we had systemic problems that were represented by some of these cases, and they were very egregious cases. ... So, part of what Sarbanes-Oxley does is to try to address some of the structural issues surrounding public company accounting and reporting.

**Sitarchuk:** I think the real question as to whether that's going to be effective or not is, how the enforcement authorities deal with institutions that end up having financial irregularity problems but made a good-faith effort to put these procedures into place. Because you see too many situations in which one bad apple creates a significant problem within an institution.

**Gabinet:** ... The fact that the company finds it and reports it is only one element that you consider. If you have a bunch of people who commit a fraud, and the fraud was at the top, you'd have a different situation than if you'd had people at the top that said, "We have this horrible thing going on, we need to clean it up." And I totally agree with you ... the SEC should be coming out with commendations for the companies that self-police and self-report, as long as they do it all right. Because we have a lot of work to do that doesn't involve kicking the people who are already down.

**Dodds:** One thing that we probably should talk about a little bit is whether there has been any sort of cultural change within companies? As much as I think the statute was political, it has had effects that I think are good. For example, it has the attention of members of boards of directors. ... If the statute has had any good effect, I think that it has board members and audit committee members refocused on their fiduciary obligations to the shareholders. It's caused them to detach themselves from management a little bit more. ...

**Donato:** ... As criminal defense lawyers, we tend to be cynical. But overall, I've seen ... a much greater willingness than there was in the past to commit significant resources to internal compliance.

**Schenck:** I think there's been a real change in criminal investigations, in the cooperation from the corporations as a result of the attention. The department's put a lot of emphasis on this. The corporations have cooperated with the investigation and made their internal investigations available, waived attorney-client privilege, and those are crucial considerations in deciding whether a corporation is going to be charged criminally or whether the individuals alone who created the problem will be charged.

**Donato:** I agree with that. I think it has had a cultural difference that's beneficial. But, I guess in the spirit of keeping in mind the other side, to what extent does this keep qualified people from agreeing to be on a board of directors? ... I think they might say, "I don't need that kind of aggravation. I don't need to be looking over my shoulder."

So the climate has changed for the better, but I wonder if it's one of those things that's keeping qualified people out of the very positions that we need them to be in in order to protect shareholders?

**Gabinet:** But they have to do so much more work. They have to really pay attention. But, at the same time, we complain about the directors being compensated for the work that they do. And they're not going to want to do that, to be put on the line, devote the time and energy ... maybe this is a place for retired executives to go. ...

**Dodds:** Pete, one point you made a few minutes ago about the change that has occurred sort of in the investigative phase of this criminal investigation, in corporations being more willing to cooperate. ... From my perspective, corporations have always been willing to cooperate for a lot of reasons ... especially if they're in a heavily regulated industry.

The difference now is that the government routinely expects disclosure of what otherwise would be privilege communications, the internal investigation. ... And it really has put corporate counsel in a position of becoming or being perceived as de facto investigators for

the government. In a short-term sense, I can understand why the government would think that's beneficial. ... In the long run, I think it's going to be a terrible mistake.

**Sitarchuk:** I think it deters companies from doing rigorous internal investigations. Because even if the government will ... take into account the waiver of the attorney-client privilege, there's no plaintiffs attorney worth their salt that's going to care less about any waiver. They're going to turn outside counsel into witnesses against their clients, and it is a nightmare.

**Gabinet:** Aren't there some developments in the case law on this, about discoverability of internal investigation?

**Schenck:** It's not good in Pennsylvania.

**Gabinet:** There's a policy question there too. Should there be a governmental immunity privilege if you do an internal investigation and you turn the results over to the government? There are a lot of hard questions about that.

**Schenck:** ... And I think we try to be sensitive to that. It's a difficult question ... assuming that the corporation has committed horrible misconduct that affects its shareholders, is it appropriate for the government to say, "Give it to us but you don't have to give it to any of these plaintiffs?"

**Dodds:** At least under the current case law, the government can make whatever commitments it wants. But the state of the law now is you have to proceed on the assumption that there's no such thing as a little bit of a waiver. When you end up in litigation against the private class action bar, I think ... you're going to end up giving it all over. ...

**Gabinet:** ... An interesting question arises, though ... and that is the difference between terrorizing executives and terrorizing companies. Because there are those in my organization who feel that penalties for public issuers puts the burden in the wrong place — the shareholder winds up paying the price. And one theory is that you really want the executives to be the ones who pay the price, because they've already harmed the company. ... •