

The Sarbanes-Oxley Act of 2002: Congress Jumps into the Corporate Fray

By STEVEN J. SNYDER

The recent wave of corporate and accounting fraud, and the resulting crisis in investor confidence, has been met with quick and decisive action from the United States Congress. The Sarbanes-Oxley Act of 2002 (the "Act") was passed by Congress on July 25, 2002, and signed into law by President George W. Bush on July 30. The Act's stated purpose is to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities law." The Act seeks to achieve this purpose through a comprehensive set of regulations aimed primarily at those groups in the best position to ensure or influence the accuracy of corporate disclosures - i.e., corporate officers and directors, outside auditors, and corporate attorneys. The Act creates myriad new duties, responsibilities, proscriptions, penalties and pitfalls for these regulated groups. What follows is an overview of some of the key provisions of the Act, along with an analysis of issues that are of interest to executives, attorneys and other groups affected by this new legislation.

Corporate Governance

The Audit Committee: Section 301 of the Act creates specific new requirements regarding the composition, responsibilities and procedures of a public corporation's audit committee. As an initial matter, each member of the audit committee must be an outside director who is "independent" of the corporation. In addition, the corporation's audit committee must:

(1) be directly responsible for the engagement and oversight of the corporation's auditors, including resolution of disagreements between management and auditors regarding financial reporting;

(2) establish procedures for receiving and dealing with complaints and confidential, anonymous submissions by employees regarding accounting, internal controls, or auditing matters;

(3) approve, in advance, all non-audit services (except certain "de minimus" services) provided by the corporation's independent auditors; and

(4) receive reports directly from the corporation's auditors on issues related to the audit, such as alternative treatments of financial information under GAAP that were discussed with management and the treatment preferred by the auditors.

Thus, the Act places a substantial burden on audit committee members to oversee the corporation's auditors, resolve conflicts between auditors and management, and deal with complaints or concerns about the

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Some Non-Frivolous Securities Claims Are Not Enough To Save Plaintiff from Sanctions: In a decision interpreting the mandatory sanctions provision of the Private Securities Litigation Reform Act of 1995, the United States Court of Appeals for the Second Circuit ruled that, even though a securities fraud complaint contained certain non-frivolous claims, the otherwise frivolous nature of the complaint warranted an award of sanctions against the plaintiff for the full amount of the defendants' costs and attorneys' fees in defending the suit. *Gurary v. Nu-Tech Bio-Med Inc.*

corporation's accounting practices. As a result, audit committee members—who often have a limited amount of time to devote to their responsibilities—need to reevaluate whether they can amply serve in their roles. Indeed, we should not be surprised to see many independent directors shun membership on their board's audit committees given the intense scrutiny corporate reporting will receive into the foreseeable future, and the likelihood of being sued for any errors in such reporting. In addition, directors are likely to insist upon greater, and more expensive, directors' and officers' liability insurance coverage, commensurate with their greater exposure to liability under the Act.

Corporate Responsibility for Financial Reports: Section 302 of the Act directs the Securities and Exchange Commission (the "SEC") to promulgate rules requiring both the chief executive officer (the "CEO") and chief financial officer (the "CFO") of a corporation to sign and certify in each 10-K and 10-Q report that:

- (1) the certifying officer has reviewed the report;
- (2) based on the certifying officer's knowledge, the report (a) does not contain any misstatement or omissions that render

it misleading, and (b) fairly presents the financial condition and performance of the corporation;

(3) the certifying officers (a) are responsible for designing and maintaining internal controls, (b) have recently evaluated the corporation's internal controls to ensure that material information relating to the corporation is made known to the officers, and (c) have presented in the report their conclusions about the effectiveness of internal controls;

(4) the certifying officers have disclosed to the corporation's auditors and audit committee (a) any weaknesses in internal controls, and (b) any fraud, whether or not material, by employees having a significant role in internal controls; and

(5) the certifying officers have disclosed whether there were any significant changes in internal controls subsequent to the date of their evaluation, including any corrective actions.

Similarly, Section 906 of the Act creates an additional, but slightly different, certification obligation for CEOs and CFOs. Under Section 906, each periodic report containing financial information filed with the SEC shall be accompanied by a written statement by the CEO and CFO certifying (1) that the report complies with the requirements of the Exchange Act, and (2) that the information contained in the report is accurate in all material respects. This provision became effective on July 30, 2002, and specifies harsh criminal penalties for knowing and willful violations.

Although the Act gives CEOs and CFOs defenses for unknowingly certifying false or erroneous financial reports, the Act's extensive certification requirements will make it more difficult for CEOs and CFOs to prevail on such defenses. Specifically, CEOs and CFOs will have difficulty asserting ignorance of accounting or reporting errors given the requirement that those officers certify (1) that they are responsible for designing and maintaining internal controls, and (2) that they have recently evaluated the effectiveness of such controls to ensure, among other things, that material

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Third Circuit Allows Pre-Certification Settlement with Named Class Representative Only: In a decision which adds a very powerful tool to a defense lawyer's litigation arsenal, the United States Court of Appeals for the Third Circuit has dismissed a putative class action as moot when the defendant had offered judgment in full to the named class representative. In a class action for violations of the Fair Debt Collection Practices Act ("FDCPA"), prior to the time that the plaintiff had moved for class certification, the defendant served an Offer of Judgment on the named plaintiff for the maximum relief which he could obtain if he were successful on the merits. In response, the plaintiff moved for class certification and then to strike the Offer of Judgment. Finding that the offer of complete relief mooted the litigation as far as the named plaintiff was concerned, the Third Circuit found that there was no longer a "case or controversy" under Article III of the U.S. Constitution as no motion for class certification had yet been made, and dismissed the case. The court also brushed aside the plaintiff's concern that the defendant could "pick off" putative class representatives, as the court felt to do so would be more expensive than going to trial under the FDCPA, which limits the defendant's liability to the members of the putative class. A hearing before the full panel of the Third Circuit has been requested. *Colbert v. Dymacol, Inc.*

information reaches them. This appears to be somewhat of a reversal of policy for Congress, which passed the Private Securities Litigation Reform Act (the “PSLRA”) less than seven years ago in an attempt to rein in securities fraud actions.

Attorneys

The Act also creates regulations affecting the professional responsibilities of attorneys. Specifically, Section 307 of the Act directs the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of corporations that are subject to the federal securities law. The SEC rules must include provisions (1) requiring attorneys to report evidence of material violations of securities law, breaches of fiduciary duty, or similar violations by the corporation, or any agent thereof, to the chief legal counsel or the CEO of the company; and (2) requiring the attorney to report the evidence to the audit committee (or to another committee of independent board members or to the entire board) if the chief legal counsel or CEO does not “appropriately respond to the evidence” by adopting remedial measures or sanctions.

This provision has generated controversy because of its breadth and vagueness. For instance, it is not clear what kind or amount of evidence will trigger an attorney’s disclosure obligation. Nor is it clear how an attorney will determine whether or not the chief legal counsel or the CEO has appropriately responded to the evidence. The provision has also generated concern because it has the potential to create conflicting obligations for attorneys under federal law and state codes of ethics. The rules ultimately adopted by the SEC should resolve these issues; however, one thing is clear: attorneys cannot sit idly by if they believe that corporate wrongdoing has taken place.

Private Securities Litigation

Section 804 of the Act lengthens the statute of limitations for private securities

fraud actions filed after July 30, 2002. The Act increases the limitations period to the earlier of two years after the discovery of the facts constituting the violation, or five years after the violation occurred. The old limitations period was either one year after discovery or three years after the violation, whichever was earlier. This provision, like the CEO and CFO certification requirements in Sections 302 & 906, appears to reflect a reversal of Congress’ policy, as reflected by the PSLRA, to curb the number of securities fraud actions.

Employee “Whistleblower” Protection

Section 806 of the Act creates a civil action for employees who are discriminated against for providing information to, or assisting in, an investigation by (1) a federal agency, (2) a member or committee of Congress, or (3) a person with supervisory authority over the employee. To fall within the protections of this section, the employee providing information or assistance must reasonably believe his or her employer has violated a law, rule or regulation relating to accounting misconduct or securities fraud. Employees are also protected from discrimination for filing, assisting in, or participating in actions or proceedings against their employer for the violation of securities laws or regulations.

Thus, employers considering whether to discipline an employee who erroneously accuses the company of fraud or misconduct—in some cases causing substantial short-term damage to the company’s reputation and stock price—will now have to make difficult decisions regarding whether or not an employee’s belief was “reasonable.” In addition, employers will have to carefully consider terminating or taking any disciplinary action against an employee who recently and erroneously reported suspected accounting misconduct to his or her supervisor, even though the contemplated termination or disciplinary action is unrelated to the employee’s accusations.

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Understanding and ensuring compliance with the Act will be a major challenge for corporations, accounting firms and their legal advisors in the months and years to come.

Conclusion

The Sarbanes-Oxley Act of 2002 Act creates a vast array of new regulations for the key players in the financial reporting game. In addition, many provisions of the Act vest the SEC and the new Public Company Accounting Oversight Board with broad authority to issue rules and

regulations to carry out the purposes of the Act. Thus, understanding and ensuring compliance with the Act, and the regulations promulgated thereunder, will be a major challenge for corporations, accounting firms and their legal advisors in the months and years to come. ■



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AKO corner

notable decisions

Motion for Temporary Restraining Order Involving Non-Competition Agreement Denied:

AKO successfully opposed a motion for a temporary restraining order brought against its clients, Exhomde, LLC ("Exhomde") and its principal, by ProActive Sales, Inc. ("ProActive"). Exhomde provides nationwide sales and service support in Home Depot stores to numerous hardware and consumer products manufacturers. In a lawsuit commenced in August 2002, ProActive, one of Exhomde's competitors, alleged, among other things, that Exhomde hired a former ProActive employee in violation of his non-competition agreement with ProActive and, through this employee, misappropriated certain of ProActive's trade secrets and other confidential information. ProActive sought a temporary restraining order prohibiting Exhomde from, among other things, soliciting ProActive's clients and employees, using or disclosing any of ProActive's trade secrets or other confidential information allegedly revealed by the former employee, and prohibiting the former employee from working for Exhomde.

At a hearing held in late August, 2002, Judge William H. Walls of the United States District Court for the District of New Jersey denied ProActive's motion for a temporary restraining order. Mark Weyman and Joel Tennenberg of AKO successfully represented Exhomde and its principal. *ProActive Sales, Inc. v. Kreutzer, et al.*

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