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BUSINESS CRIMES UPDATE

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New Federal Law Targets Corporate Misconduct

It is said that Congress is very good at doing two things: (1) nothing, and (2) overreacting. Whether the recent passage of expansive federal legislation aimed at stamping out financial fraud will prove to be an overreaction to the so-called "corporate crime wave" remains to be seen. What is clear is that most provisions of the new law, many of which would have been highly controversial in a different environment but were enacted with little debate or serious dissension, will have a dramatic impact on corporate America and cannot be ignored.

Specifically, on July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, P.L. 107-204 (the "Act"), an extensive patchwork of reforms addressing a variety of corporate governance, accounting and fraud issues. The principal areas addressed by the bill are: (1) reform of independent audits of public companies, (2) improved corporate governance, and (3) new civil and criminal provisions aimed at punishing corporate misconduct. The latter category in particular is the focus of several remarkable new laws that bear close consideration.

CEO's On The Hook

Nothing focuses the mind like a hanging. A corollary to this principle is that nothing gets a company's attention like putting the boss's head in a noose. Accordingly, the Act requires that CEO's and CFO's certify, under threat of severe criminal penalties, the truthfulness of certain publicly-filed financial reports. Enactment of this requirement followed closely on the heels of similar action by the SEC in June, when it ordered the heads of nearly one thousand of the largest U.S. corporations to certify that financial reports previously filed with the Commission were accurate. Adding to the confusion, the Act contains two separate certification requirements — one of which is an addition to the federal criminal code and is explicitly criminal in nature — which are to some extent inconsistent.

Section 302 of the Act, entitled "Corporate Responsibility for Financial Reports," requires the principal executive and financial officers of public companies to certify that annual, quarterly and other reports "based on the officer's knowledge" do not "contain any untrue statement of a material fact" or omit any material facts, and "fairly present in all material respects the financial condition and results of operations" of the company. The officers must also certify that that company has internal controls adequate to ensure accurate reporting, and that they have disclosed to the company's auditors and audit committee (1) "all significant deficiencies in the design or operation" of the internal controls, and (2) "any fraud . . . that involves management or other employees who have a significant role in the issuer's internal controls . . . ." The SEC must enact rules within 30 days of passage of the Act (i.e., by August 29, 2002) implementing these requirements.

Section 906 of the Act creates a new § 1349 in the federal criminal code entitled "Failure of corporate officers to certify financial reports." This provision also requires CEO's and CFO's to certify that periodic reports to the SEC "fairly present[], in all material respects, the financial condition and results of operations of" the company. Signing such a certification with knowledge that the subject report does not comport with the stated requirements is punishable with a fine of up to $1,000,000 or 10 years in jail, or both. If such a violation is committed "willfully," the offender can be fined up to $5,000,000 or imprisoned for up to 20 years, or both.

Unlike § 302 of the Act, § 906 is apparently effective immediately, which begs the question: Are certifications required prior to issuance of the SEC rules, and, if so, what standards apply in the interim?

New Obstruction Provisions

Presumably in response to the rampant document shredding for which Arthur Andersen was effectively sentenced to death, the Act also contains two provisions aimed at such conduct.

Section 1102 of the Act amends 18 U.S.C. § 1512 by adding the following new subsection:

> (c) Whoever corruptly —
>
> (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or
>
> (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so,
>
> shall be fined under this title or imprisoned not more than 20 years, or both.

Of course, it is a lawyer's job to "influence" official proceedings. As with other federal obstruction statutes, the line between lawful and unlawful conduct depends on the word "corruptly."

Perhaps even more alarming is Section 802 of the Act, which creates an entirely new federal crime at 18 U.S.C. § 1519:

> Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

Note that this provision omits the crucial term "corruptly," although it does require proof of specific intent. In addition, the phrase "in relation to or contemplation of any such matter or case" is extraordinarily broad and is likely to be subject to dispute.

In a similar vein, Section 303 of the Act makes it unlawful "to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of . . . financial statements . . . for the purpose of rendering such financial statements materially misleading." Unlike the new obstruction offenses described above,this provision is not part of the federal criminal code, and its enforcement is left to the SEC.

Protection of Whistleblowers

The Act creates new protections for corporate whistleblowers, both in the form of criminal penalties and a private right of action.

Section 806 of the Act creates a new § 1514A in Title 18, prohibiting retaliation against any employee who provides information or otherwise assists in the investigation by a federal law enforcement agency or Congress of any conduct the employee reasonably believes to be in violation of federal anti-fraud laws. Victims of such discriminatory treatment are entitled to "all relief necessary to make the employee whole."

An even more powerful incentive to treat whistleblowers with kid gloves is contained in § 1107 of the Act, which amends 18 U.S.C. § 1513 as follows:

> (e) Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

The application to "any Federal offense" obviously extends far beyond securities fraud violations, and the definition of "law enforcement officer" is broad as well. *See* 18 U.S.C. § 115(c).

Attorney Obligations to Report Wrongdoing

Section 307 of the Act creates an affirmative obligation on the part of attorneys to report "evidence of a material violation of securities laws or breach of fiduciary duty or similar violation" to the CEO or general counsel of the company. Further, if the executive to whom the report is made "does not appropriately respond to the evidence," the attorney must report the information to the audit committee, a similar committee composed of independent directors, or the board of directors itself. This is a much more rigid requirement than currently exists under the typical rules of professional conduct. *See* ABA Model Rule 1.13(b). The new requirement must be included in new SEC regulations governing attorney conduct, and would apply to "attorneys appearing and practicing before the Commission in any way in the representation of issuers" of public securities.

Dramatically Enhanced Penalties

Most criminal justice scholars have concluded that the chances of getting caught, rather than the severity of the penalty, is the prime influence on an individual's decision to risk violating white collar criminal laws. The problem is that beefing up enforcement costs a lot more than enacting draconian penalties, making the decision for a tax-fearing politician easy.

True to form, substantial increases in the fines and jail time applicable to securities fraud and related violations have been touted as a centerpiece of the Act. Specifically:

- Penalties for mail and wire fraud are increased from 5 years imprisonment to 20 years;

- Violations of ERISA are punishable by 10 years in prison rather than 1;
- A new securities fraud provision carries a penalty of 25 years in prison;
- Penalties for existing securities fraud offenses are increased from 10 years in prison to 20, and fines are substantially increased; and
- Attempts and conspiracies to commit mail and wire fraud are subject to the same punishment as the actual commission.

The Act also requires the U.S. Sentencing Commission "as soon as practicable" to review, and enhance where necessary, penalties applicable to obstruction of justice, extensive criminal fraud, and other federal white collar offenses.

On the bright side, Congress has not yet enacted the death penalty for such infractions.

Other Provisions

There are many other key provisions of the Act, which are beyond the scope of this article. These include provisions designed to:

- Improve the reliability of independent audits by establishing an Accounting Oversight Board with broad powers to register, impose standards and rules upon, inspect, investigate, and discipline firms engaged in auditing of public companies;
- Ensure the independence of auditors by prohibiting the provision of certain non-audit services and requiring the rotation of responsible audit partners every five years;
- Improve the objectivity and reliability of investment research information by minimizing securities analyst conflicts-of-interest;
- Eliminate loans to executive officers and directors and accelerate the deadline for disclosure of insider transactions;
- Enhance the role of audit comittees by imposing specific requirements concerning their composition and responsibilities;
- Increase the transparency of financial disclosures by imposing requirements concerning off-balance sheet transactions, pro forma financial information, and material correcting adjustments;
- Improve the accuracy of public information about a company by requiring "rapid and current" disclosure of material changes in financial condition or operations; and
- Encourage public companies to adopt codes of ethics for senior financial officers.