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Life After Sarbanes-Oxley

They Got Tougher

New criminal penalties for fraud and obstruction affect all companies.

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The Sarbanes-Oxley Act of 2002 is, most obviously, a significant addition to federal securities law. But it does not end there. Sarbanes-Oxley sets forth strict criminal provisions with the power to reach everybody in American business. As Assistant Attorney General Michael Chertoff told the Senate Judiciary Committee: "The act increases the white collar penalties, including measures to ensure that prison sentences—substantial ones—will be the rule, rather than the exception, in significant criminal cases."

Sarbanes-Oxley raises the penalties for violations of a number of existing laws attacking fraud and contains sweeping new provisions against obstruction of justice by document destruction. It also directs the U.S. Sentencing Commission to revise the federal sentencing guidelines to reflect this new get-tougher approach.

ANTI-FAILURE, ANTI-FRAUD

Because the relevant deadlines arrived so quickly, one criminal offense created by Sarbanes-Oxley received a lot of early publicity: the new Section 906 criminal penalties for certification of false financial reports by corporate officers. The CEO and the CFO of an issuing entity must now certify that financial statements comply with Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information "fairly presents" the financial condition and results of business operations. Knowing false certification is punishable by a fine of up to $1 million and imprisonment of up to 10 years. Willful false certification is punishable by a fine of up to $5 million and imprisonment of up to 20 years.

This provision, single-handedly, may reshape the structure of American corporations. The criminal penalties are stifling, and their real effect is yet to be felt as public companies scramble to assess their current system for preparing financial reports. Companies, both large and small, must now devise systems that will allow the officers who must sign the financial reports to rely absolutely on the process and people by which the information for the reports was generated. Even more daunting is the prospect of this provision stretching beyond the bounds of financial reports to cover other reporting mechanisms that relay information to multiple federal agencies.

Mail and wire fraud receive similarly strong treatment in Sarbanes-Oxley. Section 900 drastically elevates the criminal penalties for these crimes. The maximum prison sentence has been increased to up to 20 years (except for fraud affecting a financial institution, which still earns the wrongdoer up to 30 years behind bars).

In addition, penalties for conspiracies to commit these fraudulent practices have been revised. Previously, conspiracy to violate the substantive federal fraud offenses was punishable by a maximum of five years' imprisonment. Section 902 of Sarbanes-Oxley states that attempts and conspiracies to commit the substantive fraud offenses—mail, wire, bank, health, and now securities—will have the same maximum punishment as the substantive crime. In addition, the section explicitly provides that the attempt to commit any of these frauds is now a distinct federal crime.

SENTENCING LANDSCAPE

More broadly, Section 905 directs the U.S. Sentencing Commission to review the landscape of all white collar crimes and to revise the sentencing guidelines to implement the provisions of Sarbanes-Oxley. The commission must act to promulgate the appropriate guidelines or amendments within 180 days.

Section 805 also directs the Sentencing Commission to review whether the sentencing guidelines sufficiently address obstruction-of-justice crimes. For new offenses, the commission is charged with ensuring that the guidelines provide sufficient deterrence and punishment. This includes providing a specific sentence enhancement for a fraud offense that endangers the solvency or financial security of a substantial number of victims.

Congress gave the Sentencing Commission emergency authority to meet its 180-day deadline. Since amendments must be presented to Congress by Jan. 25, 2003, normal procedures are being expedited, and the notice-and-comment period is on an abbreviated track.

Following a review, the commission will likely vote to promulgate issues and items for comment during its Nov. 19-20 meeting. There will be a shortened public comment period (perhaps 30 days), and the commission will likely vote to promulgate any new amendments at its Jan. 7-8, 2003, session. Amendments promulgated under emergency authority will be promulgated again on May 1, 2003, as part of the commission's regular cycle.

Paper Misdeeds

No doubt in light of the trouble that engulfed Arthur Andersen over its Enron work, Sarbanes-Oxley creates a more comprehensive and far-reaching regime imposing criminal liability for obstruction of justice by document destruction. The new provisions are crafted in the broadest possible language, and companies of all sizes, whether private or public, should review document retention policies to avoid potential criminal liability.

Prior to Sarbanes-Oxley, prosecutors relied on 18 U.S.C. §§1503, 1505, and 1512 to prosecute document destruction cases. Although these provisions provided some powerful tools, loopholes in the scheme required prosecutors to craft indictments with care. For instance, the government could prosecute an individual directly engaged in the destruction of documents under Sections 1503 and 1505, but not Section 1512. Defendants under Section 1512 were limited to those who "corruptly persuade" another to destroy documents.

As to the scope of liability, prosecutions under Sections 1503 and 1505 were limited to circumstances in which a proceeding or investigation was actually under way at the time of the obstructive conduct. By comparison, Section 1512 allowed prosecution for destruction in advance of an "official proceeding," but the case law reflected considerable disagreement over how far in advance it could have been. Decisions ranged from the narrow view that an official proceeding had to have begun or been scheduled to begin at the time of the obstruction, to a very broad reading under which evidence that the defendant may have foreseen an official proceeding at some time in the future sufficed. And some courts preferred to evaluate the reach of the statute on a case-by-case basis, which gave little guidance to prosecutors or the public.

Beyond Loopholes

Sarbanes-Oxley has closed these loopholes and replaced uncertainty about the reach of the law with the broadest standard of liability for document destruction. First, the act amends Section 1512 by adding a new provision allowing prosecutors to charge the "individual shredder" as well as the "corrupt persuader" for obstruction. 18 U.S.C. §1512 (c).

More importantly, the act includes a new provision, 18 U.S.C. §1519, which broadens both the subject matter and the circumstances in which liability can attach for document destruction in advance of a federal proceeding. Section 1519 provides: "Whoever knowingly alters, destroys . . . 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 in relation to or contemplation of any such matter or case*, shall be . . . imprisoned not more than 20 years." (Emphasis added.)

The phrase "any matter within the jurisdiction of any department or agency of the United States" tracks, in part, the language of the federal false statement statute, 18 U.S.C. §1001. The courts have consistently interpreted "any matter" under Section 1001 as including almost every conceivable area of interest for any federal agency. Looking forward, the new Section 1519, read with Section 1001, may also apply to matters only indirectly within the jurisdiction of the United States, such as where state and local governments, and even private contractors, receive substantial federal funding or carry out delegated federal duties.

Moreover, by explicitly making document destruction "in relation to or contemplation of any such matter or case" subject to criminal sanction, Sarbanes-Oxley substantially enlarges the scope of liability for document destruction in advance of federal activity. The provision sweeps aside prior disputes about the timing of the destruction and codifies the broadest standard for determining when criminal liability attaches. The Justice Department has taken note of this broad power in its Sarbanes-Oxley field guidance, stating that Section 1519 "explicitly reaches activities by an individual 'in relation to or contemplation of' any matters," and suggesting that the amended Section 1512 should be read in conjunction with the new Section 1519. Obviously, prosecutors will be on the alert for opportunities to test this new authority.

The Idiot E-mail

Section 1519 leaves open the question of when a matter or case is "contemplated," and thereby presents a potential danger for companies. For instance, if an employee sends an e-mail message to his co-workers about a corporate matter and states, "If the feds ever get wind of this, they'll be all over us like a . . . ," and if the subject matter of the e-mail is in fact something that is properly within the jurisdiction of a federal agency, has a "matter" now been "contemplated" by the company under Sarbanes-Oxley? If the company fails to suspend the application of its document retention policy as to these materials, and they are purged in due course, is the company exposed to criminal liability?

Although this is probably the outer edge of circumstances that would give rise to prosecution under Section 1519, it is by no means an unusual circumstance. The government's case against Arthur Andersen shows that a document retention policy, if not handled properly, can be a sword for the government rather than a shield for the defendant.

In sum, new penalties and provisions for white collar crimes contained in Sarbanes-Oxley reach beyond public companies to all corporations, regardless of size, structure, or line of business, and to their executives. The Sentencing Commission's new directive may yield yet more revisions to the current guidelines and policy statements. And the document destruction provisions of Sarbanes-Oxley place a premium on developing a document management policy that reflects new potential liabilities. Although Sarbanes-Oxley was passed in response to recent corporate and accounting scandals, its criminal provisions are something that all white collar practitioners should know.

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