The Sarbanes-Oxley Act; Civil and Criminal Litigation under the Federal Securities Laws

The Sarbanes-Oxley Act of 2002:
What Alabama Attorneys Need To Know

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I. INTRODUCTION

Congress passed the "Public Company Accounting Reform and Investor Protection Act of 2002" (the "Sarbanes-Oxley Act" or the "SOA") in reaction to recent widely-publicized accounting scandals. The SOA is a lengthy statute containing numerous specific mandates and prohibitions that will significantly alter the regulatory environment for public companies and their management, boards of directors, auditors and securities counsel. It also imposes new criminal penalties and increased the penalties for various securities-related crimes. The following is an overview of the SOA and a discussion of potential issues that may arise in the context of securities class actions and other litigation.

II. OVERVIEW OF THE SOA

A. Accountants.

1. Public Company Accounting Oversight Board. SOA § 101 established a self-regulatory organization, the "Public Company Accounting Oversight Board," (the "Board") to regulate the accounting profession in a manner similar to the NASD's regulation of the brokerage industry. All accounting firms that prepare audit reports for public companies must register with the Board and maintain their registration. The SOA gives the Board rulemaking authority with respect to auditing, attestation, quality control and ethics standards for auditors and it authorizes and directs the Board to discipline accounting firms that violate professional standards.

The Board may impose sanctions ranging from requiring additional professional training to revocation of a firm's or associated person's accounting license, and may levy fines of up to $15,000,000 in the case of intentional misconduct by a firm.

2. Non-audit services. SOA § 201(a) limits the permissible non-audit services by an accounting firm for its audit clients. Accounting firms providing audit services to public companies are prohibited from providing bookkeeping services, financial information systems design and implementation services, appraisal or valuation services, fairness opinions, contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions, human resources services, broker or dealer, investment adviser, investment banking services, or legal services. 15 U.S.C. § 78j-1(g). Auditing firms are allowed to provide tax services. However, those services must be approved in advance by the audit committee and disclosed. *Id.* at § 78j-1(h).

3. Closing the "revolving door." SOA § 206 prohibits an accounting firm from auditing any public company whose chief executive officer, controller, chief financial officer, chief accounting officer, or "any person serving in an equivalent position" was, at any time in the past year, an employee of the accounting firm. 15 U.S.C. §

78j-1(l). SOA § 204 requires auditors to rotate the lead audit partner at least every five years. 15 U.S.C. § 78j-1(j). The Comptroller General is directed to study the potential effects of requiring mandatory rotation of auditors. SOA § 207.

4. Work Papers. SOA § 802 requires accountants who audit public companies to maintain their work papers for 5 years. SEC rules require that certain papers be retained for 7 years. *See* 68 Fed. Reg. 4862.

B. Officers

1. Code of Ethics. SOA § 406 requires the SEC to issue rules requiring each issuer to adopt a code of ethics for senior financial officers.

2. CEO/CFO Certifications: Annual and quarterly reports filed with the SEC must contain CEO & CFO certifications.

   a. Financials. CEO/CFO certifications must state that the CEO and CFO have reviewed the report and that, based on the officer's knowledge, the report does not contain any material misstatement or omission and that the financial statements fairly present in all material respects the financial condition and results of operations of the issuer. SOA § 302(a)(1)-(3).

b. Internal controls; establishment and maintenance. The officers must also certify that they are responsible for establishing and maintaining internal controls, that they have designed those controls to ensure that material information is made known, that they have evaluated the effectiveness of the issuer's internal controls within the past 90 days and that they have presented their conclusions about the effectiveness of internal controls in the report being filed. SOA §302(a)(4).

c. Internal controls; disclosure of deficiencies or fraud. CEOs and CFOs must also certify that they have disclosed to the company's auditors and to the audit committee all significant deficiencies in the design or operation of internal controls and that they have disclosed any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls. SOA §302(a)(5).

d. Internal controls; significant changes. Finally, CEOs and CFOs must certify that they have indicated in the report whether there were significant changes in internal controls that could significantly affect such controls subsequent to the date of their evaluation. SOA §302(a)(6).

3. Management assessment of internal controls. SOA § 404(a) instructs the SEC to prescribe rules requiring each annual report of each reporting company to include an "internal control report" which shall (1) "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting;" and (2) contain a management assessment, as of the end of each fiscal year of, "the effectiveness of the internal control structure and procedures of the issuer for financial reporting..." Auditors are required to "attest to" and "report on" the assessment made by management. SOA § 404(b).

4. "Real Time" disclosure. SOA § 409 requires reporting companies to make more current, "real time" disclosure of material changes in their financial condition and to report all material off-balance sheet transactions, arrangements, obligations and other relationships that might have a material effect on the current or future financial health of the company.

5. Loans to executives. SOA § 402 prohibits issuers from directly or indirectly extending credit in the form of a personal loan to any director or executive officer of the issuer. SOA does not prohibit

consumer credit loans made in the ordinary course of the issuer's business if made on terms that are comparable to the terms offered by the issuer to the general public.

6. Improper influence. SOA § 303 makes it unlawful for any officer or director of an issuer to "fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading." *See* 68 Fed. Reg. 312820.

7. Insider trades during fund blackout periods. SOA §306 amends § 101 of ERISA, 29 U.S.C. § 1021(h), by prohibiting directors and executive officers of issuers from trading securities issued by the issuer during a pension fund blackout period (when individual retirement accounts are barred from trading).

8. Stock transactions involving management and principal stockholders. Directors, officers and persons owning more than 10% of any class of equity securities must disclose transactions in their company's securities within two business days. SOA § 403.

C. Directors; Audit Committees.

1. Independent Members. Each public company board must establish an audit committee composed entirely of independent board

members who may not be an "affiliated person" of the company or any subsidiary, and may not "accept any consulting, advisory, or other compensatory fee from the issuer." SOA § 301, 15 U.S.C. §78f(m)(3).

2. Code of Ethics. Each audit committee must adopt a code of ethics. SOA § 406.

3. Financial Expert. And each audit committee must have at least one member who is a "financial expert." SOA § 407. The requirements to be a "financial expert" are fairly stringent. *See* 68 Fed. Reg. 5110, 5113-114. The audit committee's expert must have an understanding of GAAP and be able to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves. He or she must have experience preparing, auditing, analyzing or evaluating financial statements comparable to the issuer's financials. The expert must have an understanding of internal controls and procedures for financial reporting and an understanding of audit committee functions. 68 Fed. Reg. 5110, 5113.

4. Auditor Oversight. The audit committee must be directly responsible for appointment, compensation and oversight of the company's auditors. SOA § 301, 15 U.S.C. §78f(m)(2) and (m)(5).

The committee is also responsible for "resolution of disagreements between management and the auditor regarding financial reporting."

5. Non-audit services. If the firm that audits the company also provides any non-audit services (including tax services), the engagement of the firm to provide those services must be approved by the audit committee. SOA § 201; 15 U.S.C. § 78j-1(h). Approval of audit firm for non-audit services must be disclosed in SEC filings. SOA § 202; 15 U.S.C. § 78j-1(I)(2).

6. Internal controls. The Audit Committee will also receive -- and must address -- signed reports from the CEO and CFO detailing "all significant deficiencies in the design or operation of internal controls" and "any fraud, whether or not material, that involves ... employees who have a significant role in the issuer's internal controls" SOA § 302(a)(5).

7. Receipt and investigation of complaints. Audit committees are required to establish procedures for receiving, retaining and "treatment of complaints" received by the Company regarding accounting, internal controls and other auditing matters. SOA § 301, 15 U.S.C. §78f(m)(4). The audit committee must also establish procedures for receiving confidential, anonymous submissions by employees regarding questionable accounting or

auditing matters. *Id.* Employees who report questionable practices are protected by from retaliation. SOA § 806. Audit committees are expressly authorized to employee independent counsel and other advisors. SOA § 301, 15 U.S.C. § 78f(m)(4). The issuer must provide funding for any advisors employed by the audit committee. *Id. at* §78f(m)(5).

8. SEC rulemaking. The SEC has issued a final rule directing the NYSE and NASDAQ to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements of the SOA. *See* 68 Fed. Reg. 18788 (04-16-03).

D. Employees

1. Persons protected. SOA § 806 prohibits retaliation against the issuer's employees. The SOA also prohibits retaliation against the employees of any "contractor, subcontractor, or agent of such company..." *Id.* 18 U.S.C. § 1514A(a).

2. Protected activities. The SOA protects employees who lawfully provide information to governmental authorities regarding conduct they reasonably suspect to constitute mail, wire, or securities fraud, violations of any rule or regulation issued by the Securities and Exchange Commission, or violations of any other Federal law relating to fraud against shareholders. 18 U.S.C. § 1514A(a).

3. Prohibitions. The SOA provides that an employer may not "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against" an employee for providing information regarding potential shareholder fraud to law enforcement agencies, any member of Congress, a person with supervisor authority over the employee, or to "such other person working for the employer who has the authority to investigate, discover or terminate misconduct." SOA § 806(a), 18 U.S.C. § 1514A(a)(1). The SOA also protects employees who file, cause to be filed, testify, participate in, or otherwise assist in a lawsuit alleging corporate fraud covered by the SOA or any SEC rule or regulation. Protected conduct includes assisting in a lawsuit that is "about to be filed" if the employer has knowledge of the impending proceeding. *Id.*; 18 U.S.C. § 1514A(a)(2).

E. Attorneys

1. Rules of Professional Responsibility. SOA § 307 requires the SEC to prescribe "minimum standards of professional conduct for attorneys" who practice before the SEC. The SEC's rules must require issuer's counsel "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company" to the company's CLO or to its CEO. If those

officers fail to take appropriate action, the attorney must report the evidence to the company's audit committee, to its independent directors, or to the board of directors as a whole.

2. SEC regulations: 17 C.F.R. § 205.1, *et seq.* If an attorney who represents the issuer before the SEC becomes aware of a material violation, the attorney shall report that evidence to the issuer's CLO or to its CLO and its CEO. 17 C.F.R. § 205.3(b)(1). The CLO must investigate the reported potential violation. Unless the CLO determines that no material violation has or is likely to occur, he or she take all reasonable steps to cause the issuers to adopt an appropriate response. *Id.* at § 205.3(b)(2). In lieu of making an inquiry, a CLO may refer a report of evidence of a material violation to a qualified legal compliance committee that was duly established prior to the report. *Id.*

F. Analysts. SOA § 501 requires the SEC to promulgate rules governing the independence and objectivity of securities analysts and protecting analysts from retaliation by their firms because of negative research or ratings.

G. Disclosure of off-balance sheet transactions. SOA § 401 requires the SEC to issue rules requiring financial reports filed with the SEC to disclose all material off-balance sheet transactions and other relationships of the issuer with other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. *See* 68 Fed. Reg. 5982.

III. EMPLOYEE WHISTLEBLOWER SUITS

A. Persons protected. SOA § 806 prohibits retaliation against the issuer's employees. The SOA also prohibits retaliation against the employees of any "contractor, subcontractor, or agent of such company..." *Id.*

B. Protected activities. The SOA protects employees who lawfully provide information to governmental authorities regarding conduct they reasonably suspect to constitute mail, wire, or securities fraud, violations of any rule or regulation issued by the Securities and Exchange Commission, or violations of any other Federal law relating to fraud against shareholders.

C. Prohibitions. The SOA provides that an employer may not "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against" an employee for providing information regarding potential shareholder fraud to law enforcement agencies, any member of Congress, a person with supervisor authority over the employee, or to "such other person working for the employer who has the authority to investigate, discover or terminate misconduct." SOA § 806(a), 18 U.S.C. § 1514A(a)(1). The SOA also protects employees who file, cause to be filed, testify, participate in, or otherwise assist in a lawsuit alleging corporate fraud covered by the Act or any SEC rule or regulation. Protected conduct includes assisting in a lawsuit that is "about to be filed" if the employer has knowledge of the impending proceeding. *Id.*; 18 U.S.C. § 1514A(a)(2).

D. Claims procedure. An employee who claims to have been discharged or otherwise retaliated against in violation of the SOA must file a complaint with the Secretary of Labor (the "Secretary") within 90 days of the alleged violation. §806(b), 18 U.S.C. §1514A(b)(1).[1] If the Secretary finds reasonable cause to believe that discriminatory behavior has occurred, the Secretary must issue a preliminary order providing appropriate relief. The company and the employee have 30 days to request a hearing before an administrative law judge ("ALJ"). The parties have 60 days to appeal the ALJ's decision to a U.S. District Court. *See* 68 FR 31860, 31861. If the Secretary fails to issue a final decision within 180 days of the filing of the complaint, absent a showing that the delay was due to the claimant's bad faith, the employee may bring an action for *de novo* review in the appropriate U.S. District Court. SOA § 806(b)(1)(B), 18 U.S.C. § 1514A(b)(1)(b).

[1]*See* Occupational Safety and Health Administration of the Department of Labor (OSHA) Interim Final Rule for the handling of discrimination complaints under § 806, 68 Fed. Reg. 3080 (1-22-03), 29 CFR Part 1980.

IV. PENALTIES

A. Civil.

1. Forfeiture of bonuses and stock sale profits. SOA § 304(a)(1) provides that the issuer is required to restate its financials due to the issuer's material non-compliance with the securities laws, the CEO and CFO must reimburse the issuer for:

   a. Bonuses and other incentive-based compensation received during the past 12 months; and

   b. Any profits realized from the sale of securities of the issuer during the past 12 months.

2. Equitable Relief for investors in SEC actions. Section 21(d) of the 1934 Act, which authorizes the SEC to bring enforcement actions, was amended by SOA § 305(b) to grant the SEC authority to seek equitable relief for the benefit of investors. 15 U.S.C.A. § 78u(d)(5).

3. Funds For Investors. If the SEC obtains disgorgement or civil penalties for violations of the securities laws, SOA § 308 authorizes the SEC to pay the funds into a disgorgement fund for the benefit of victims of the violations.

4. Trading During Pension Fund Blackout Periods. SOA § 306 authorizes the issuer to sue in order to recover profits realized in

violation of the prohibiting on trading during blackout periods. SOA § 306(a)(2). If the issuer does not sue, a shareholder may sue without making the demand upon the board that is usually required in a conventional derivative suit. SOA § 306(a)(3). *See* 68 Fed. Reg. 3729 (Dept. Of Labor final rules implementing civil penalties for violations).

5. Bankruptcy. The SOA also amended the bankruptcy code to make debts resulting from securities fraud claims under the 1934 Act or common law fraud non-dischargeable. SOA § 803.

B. Criminal.

1. CEO/CFO Certifications. SOA § 906 contains certification provisions similar to § 302. False certifications can result in fines up to $5 million and 20 year sentences. 18 U.S.C. § 1350.

2. Enhancement of Fraud and Obstruction of Justice Sentences. *See* SOA § 905 and § 1104. *See also* 68 Fed.. Reg. 3080.

3. Securities Fraud. SOA § 807 provides that persons who commit securities fraud in connection with the securities of a public company are subject to fines and imprisonment for up to 25 years. 18 U.S.C. § 1348.

4. Document destruction. SOA § 802 provides that any person who destroys documents in an attempt to impede a federal investigation

may be fined or imprisoned for up to 20 years. 18 U.S.C. § 1519.

5. Audit record destruction. SOA § 802 requires accountants who audit public companies to maintain their work papers for 5 years. SEC rules require that certain papers be retained for 7 years. *See* 68 Fed. Reg. 4862. Accountants who fail to maintain their work papers pertaining to an audit can be imprisoned for up to ten years. SOA § 802. 18 U.S.C. § 1520.

6. Whistleblowers. Retaliation against whistleblowers can result in imprisonment for up to 10 years. SOA §1107.

7. White-collar penalty enhancements. The maximum penalty for mail and wire fraud was increased from 5 years to 20 years and penalties for ERISA violations increased. SOA §903.

8. False statements. The maximum penalty for false statements made to the SEC was increased from $1 million and 10 years to $5 million and 20 years for individual violators, and increased from $2.5 million to $25 million for entity violators. SOA §1106.

9. Temporary Freezes. SOA § 1103 authorizes the SEC to apply for a temporary freeze of payments to officers, directors or employees by an issuer under investigation.

V. ARE SOA VIOLATIONS ACTIONABLE UNDER THE 1934 ACT?

SOA § 3(b) contains a broad, general enforcement provision,[2] which states:

> A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

Violations of the 1934 Act are actionable pursuant to § 10(b) of the 1934 Act, 15 U.S.C. §78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5,[3] which prohibit, in

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[2]Two SOA sections containing language specifically precluding private rights of action. SOA § 303, which prohibits improperly influencing an auditor, grants the SEC exclusive enforcement authority. Similarly, SOA § 804, which extends the statute of limitations for a securities fraud action under the 1934 Securities Act, states that "nothing in this section shall create a new, private right of action."

[3]Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b), states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--To use or employ, in connection with the purchase or sale of any security ...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

connection with the purchase or sale of any security, the making of any untrue statement of a material fact or the omission of a material fact that would render statements made not misleading. Although § 10(b) does not contain an express cause of action, the courts have recognized an implied private cause of action for 1934 Act violations.[4] To state a claim a plaintiff must show: (1) a misrepresentation or material omission (2) in connection with the purchase or sale of a security (3) reliance, (4) causation, (5) damages and (6) "scienter." *See, e.g., Basic, Inc. v. Levinson,* 485 U.S. 224 (1988). The following is a discussion of just a few of the many potential impacts of the SOA on 10b-5 claims. Given the numerous new requirements of the SOA and the broad language of SOA § 3, it is safe to assume that the SOA will provide class action plaintiffs with a variety of new arguments. The following is a discussion of a few of the potential issues.

A. <u>The CEO/CFO certifications.</u> Under pre-SOA law, CEOs and CFOs signed SEC filings. Therefore, they were already subject to potential liability for false financial reports. See, e.g., *Howard v. Everex Systems,*

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[4] *See,* e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 730 (1975).

Inc., 228 F.3d 1057, 1061-65 (9th Cir. 2000). The SOA mandates CEO signatures each quarter, rather than yearly. The SOA also imposes an obligation on CEOs and CFOs to make a new series of affirmative statements about the efficacy of disclosure controls and internal controls of the issuer. If a company is required to restate its financials, plaintiffs might be able to allege that the CEO/CFO statements about disclosure controls and internal controls were false and misleading. For example, a plaintiff might allege that the internal controls and procedures for financial reporting were not capable of providing reasonable assurance that the financials conformed to GAAP. Thus, the SOA certification may expand the array of statements for which individuals are likely to be sued.

B. <u>"Rapid and Current" Disclosure</u>. SOA § 409, requires public companies to disclose the public on a "rapid and current basis" any additional information concerning material changes in its financial condition or operations, could give rise to a new type of securities fraud claim alleging that disclosures were not sufficiently "rapid and current." SOA § 409 suggests SEC rule-making regarding what is "necessary and useful for the protection of investors. Unlike other sections of the SOA, §409 does not contain a specific deadline for rule-making.

C. <u>Audit Committee Members</u>. When plaintiffs' counsel attempt to sue peripheral defendants, such as outside directors, accounting firms or lawyers, they face a series of hurdles. A plaintiff must plead and prove "scienter."– essentially that the defendant acted with intent or severe recklessness.[5] The Supreme Court has done away with "aiding and abetting" liability. *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164 (1994). Also, Private Securities Litigation Reform Act ("PSLRA"),[6] imposed more stringent pleading requirements.[7] To satisfy the PSLRA's pleading requirements, 10b-5 plaintiffs must plead "with particularity facts giving rise to a strong inference" that defendants acted with scienter.[8] These requirements have made it more difficult to sue outside directors.[9] Plaintiffs' counsel sometimes attempt to demonstrate

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[5]See *Ziemba v. Cascade Intern., Inc.* , 256 F.3d 1194 , 1202 (11th Cir. 2001) ("'Severe recklessness,' such as will satisfy scienter required in order to state claim for securities fraud claim under Rule 10b-5, is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from standards of ordinary care, and that present danger of misleading buyers or sellers which is either known to defendant or so obvious that defendant must have been aware of it."); *See also*, McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir.1989).

[6]Pub.L. 104-67, Dec. 22, 1995, 109 Stat. 737.

[7]For a discussion of the PSLRA, *see Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir. 2002). In 1998 Congress realized that many litigants were making an "end run" around the PSLRA by filing in state courts. Congress responded by passing a statute federalizing all securities fraud class actions. *See* Pub.L. No. 105-353.

[8]*See, e.g., Rosenzweig v. Azurix Corp.*, 2003 WL 21242319 (5th Cir. 06-13-03); *Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820 (8th Cir. 2003); *Eminence Capital, LLC v. Aspeon, Inc*, 316 F.3d 1048 (9th Cir. 2003).

[9]*See, e.g., In re Livent,* 148 F. Supp. 2d 331 (S.D.N.Y. 2001); *In re Ratheon Securities Litigation*, 157 F. Supp.2d 131 (D. Mass. 2001); *In re Aetna, Inc. Securities Litigation*, 34 F.

scienter by claiming that the defendant disregarded obvious "red flags" regarding fraudulent conduct.[10] The SOA may make audit committee members more likely targets in securities fraud class actions because it forces them to become more actively involved in the company's audits. The SEC declined requests to provide a safe harbor for audit committee experts. 68 Fed. Reg. 5110, 5116. It also made it clear that other audit committee members could not escape liability by reliance on the expert.[11]

D. Possible protection from liability. The SOA may have provided audit committee members with a vehicle to protect themselves from potential securities fraud claims by virtue of the "complaint" provisions of §301 The SOA requires audit committees to establish procedures for the "receipt, retention and treatment" of complaints received by the company and it mandates the implementation of procedures for employees to anonymously raise their concerns regarding questionable accounting or auditing matters. The Act expressly authorizes audit committees to engage independent

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Supp. 2d 935 (E.D. Pa. 1999).

[10] *See, e.g., Hart v. Internet Wire, Inc*, 50 Fed. Appx. 464, 466 (2nd Cir. 2002); *Peltz v. Polyphase Corp*, 36 Fed. Appx. 316, 319 (9th Cir. 2002); *Ziemba v. Cascade Intern., Inc.* , 256 F.3d 1194 , 1202 (11th Cir. 2001); *In re Comshare Inc. Securities Litigation,* 183 F.3d 542, 552 (6th Cir. 1999).

[11] A person who is determined to be an audit committee financial expert will not be deemed an "expert" for any other purpose, including without limitation for purposes of Section 11 of the 1934 Act. *Id. at* 5116-5117.

counsel and other advisers to carry out those duties and it requires issuers to "provide for appropriate funding" to finance the employment of outside advisors. §301. If audit committees take appropriate steps to receive complaints and if they retain outside counsel to investigate reports of questionable conduct, they may be in a better position to prove that they did not ignore "red flags."

E. Lawyers. The good news for lawyers called upon by § 307 to report possible violations is that the SEC's rule provides a safe harbor from private civil actions. Section 205.7 states that the SEC's rules shall not create a private cause of action against a lawyer, a law firm or an issuer.[12] Possible implications for the recipients of the reports are less clear-cut. Knowledge frequently equates to scienter. If a reported violation is a prelude to a financial meltdown, the CLO, CEO or director who failed to take appropriate action will be hard-pressed to claim that he or she had no knowledge of the problem.

F. Does SOA Prohibit Advancement of Litigation Expenses? Several of the pre-SOA corporate scandals involved sweetheart loans to corporate

[12]Lawyers are, of course, subject to sanctions and discipline by the SEC. 17 C.F.R. § 205.6.

officers.[13] In response to those scandals, Congress included §402 of the Act, which provides that it shall be unlawful for any issuer, "directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer." While intended to curb perceived abuses of power by corporate executives, §402 could have unanticipated consequences. From a literal reading of the statute it arguably prohibits the advancement of litigation expenses to officers and directors for indemnification purposes. Delaware and most other states allow companies to advance litigation costs to officers and directors, subject to a repayment if certain conditions are met. Most public companies have indemnification arrangements that typically provide for the advancement of litigation expenses, including attorneys' fees.

G. The Statute of Limitations.

The SOA increased the limitations period for 1934 Act claims to 2 years from discovery of the facts giving rise to the action or 5 years from the violation. Section 804(b) states:

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[13] *See* Jerry Markon & Robert Frank, Five Adelphia Officials Arrested on Fraud Charges, Wall Street Journal, July 25, 2002, at A3.; Andrew Ross Sorkin, Tyco is Said to Consider Renomination of Two Directors, N.Y. Times, Nov. 6, 2002, at C2; see also Floyd Norris, Tyco's Small Changes Leave Big Questions, N.Y. Times, Oct. 25, 2002, at C1.

> a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of... years after the discovery of the facts constituting the violation; or...5 years after such violation.

This new statute of limitations is applicable to actions commenced after SOA was enacted (June 30, 2002). *See* § 804(b).