The current economic crisis, coming hard on the heels of the Enron, WorldCom, and Tyco scandals, has diminished public trust in both corporate executives and the business professionals—accountants and lawyers—who advise and serve them. At the same time there is a growing societal demand that corporations, and their agents, have a moral obligation to do no harm, which falls not solely on the corporation but, more specifically, on those who manage it.

Until recently, the regulatory environment—or lack thereof—was complicit in the unethical behavior of corporate officers and employees. Officers legally could claim ignorance, hide behind the corporate veil, and eschew personal responsibility for corporate misdeeds. Honesty, transparency, and responsibility all but disappeared in such an environment. An ensuing culture emerged in which employees were hesitant to speak the truth. Distrusting their bosses, employees feared retaliation, firing, or worse. Out of a perverse sense of loyalty, employees and managers of giant corporations tacitly agreed to a code of silence, even when facing glaring legal, ethical, and financial crises.

This culture of opaqueness, rather than transparency, contributed to the ethical scandals early in this millennium. The current regulatory environment attempts to address this culture of opacity by casting light on the inner-workings of corporations. As the result of recent actions by Congress, the Securities and Exchange Commission (SEC), and the United States Sentencing Commission (together, regulatory bodies) it is no longer legally permissible for an officer or director of a publicly held company to ignore fraud. This is an important and dramatic shift: the law is beginning to codify elements of ethical leadership, rewarding it when it’s present, and penalizing those who choose to ignore it.

Moreover, in the current regulatory environment it is safer for employees down the corporate ladder to point out looming troubles. Companies are now rewarded for encouraging legal compliance and ethical decision-making.
Rather than “no good deed goes unpunished,” good deeds now are rewarded. For example, if a company supports internal whistle blowing and then self-reports a violation to the Justice Department, the company’s financial penalty will be eliminated, or substantially reduced.

This chapter focuses on the post-Enron regulatory environment and—more specifically—the passage and implications of the Sarbanes-Oxley Act (hereafter SOX, but also called the “Public Company Accounting Reform and Investor Protection Act of 2002”). It addresses some tough questions facing post-Enron corporate officers, their lawyers, and accountants, such as: What is the precise duty owed by corporate officers (or business professionals) to prevent a company from harming others? Even if not legally obligated, does the law protect employees from retaliation by their peers if they choose to blow the whistle on corporate fraud? And, how has the law changed to encourage ethical leadership in publicly traded companies?

Sarbanes-Oxley and its Mandate for Ethical Leadership
Society’s mistrust of corporations is widely attributable to failures in the nation’s economic regulatory system and the lapsing ethical standards of the legal and accounting professions. That is why SOX focused on closing gaps in the legal environment that permitted the infamous, unethical conduct at corporations such as Enron, WorldCom, and Adelphia. While there is clear evidence that regulatory reform and improved professional ethics are essential to restoring public trust in business, we believe they are insufficient. While SOX was an appropriate legal response to the problems, we believe that regulatory bodies alone cannot create a wave of ethical leadership in corporate America. All the new laws and ethical training in the world will not, in and of themselves, lead to virtuous corporate behavior.

In the pages that follow, we argue that ethical leadership was the missing ingredient pre-Enron. We believe there will continue to be ethical lapses in corporate America until executives realize that, along with their financial and strategic responsibilities, one of their primary obligations is to create ethical organizational cultures. The good news is that, if for no other reason than the fear of retribution in the form of fines and possible jail time, executive behavior in this regard appears to be changing.

In response to the Enron/Arthur Andersen debacle, Congress held extensive hearings aimed at unearthing the root causes of the accounting scandals. It attempted to create a law that encouraged, and rewarded, legal and ethical compliance while simultaneously increasing executive and professional (lawyers and accountants) responsibilities and punishments absent compliance. In crafting SOX, Congress attempted to regulate corporate behavior in four ways: through increased professional reporting requirements, increased prison terms and amended federal sentencing guidelines for wrongdoers, enhanced corporate compliance programs, and stronger protections for internal whistle-blowers.
Increased Reporting Requirements
In legislating increased officer/director penalties for misleading the public, Congress ultimately focused on establishing *effective deterrents* for white-collar criminals. First, Congress successfully increased punishment with respect to securities fraud and insider trading. For example, SOX includes an “obstruction measure,” which criminalizes the destruction or alteration of documents when such actions impair federal agency investigations. It also directs the SEC to enact civil remedies—as opposed to criminal—so that injured parties themselves can sue corporate officers who break the law.

Perhaps the most controversial directive of SOX is aimed at chief financial and executive officers. Section 906(a) addresses the “willful blindness problem” of such officers by specifically requiring them to review corporate records, and then to issue statements certifying that the information contained in their companies’ financial reports properly reflects the financial condition of those companies. Through SOX, the SEC requires chief financial and executive officers to certify the accuracy of quarterly and annual financial reports—something that until the passage of SOX they did not have to do. In sum, post-SOX, CEOs now are criminally responsible for misleading or fraudulent financial reports.

Now that CFOs and CEOs must investigate and certify the accuracy of financial statements given to the public, SOX calls for steep criminal penalties of ten to twenty years in prison if executives know that the financial statements do not fairly represent the financial condition of their companies. Since individuals and institutions invest money in companies based on published information, post-Enron, the investing public became reluctant to place their trust in corporate America. Pre-SOX, corporate officers who acted without knowledge of accounting irregularities were not held liable—which only encouraged the type of organizational opacity described above. Executives, like Enron’s Ken Lay, tried to stick their heads in the sand to avoid learning about financial malfeasance within their companies. In an attempt to restore public faith, SOX now requires such “hear no evil, see no evil” corporate officers to face substantial fines and possible jail time.

Congress also recognized that professionals—lawyers and accountants, both external and internal—were complicit in “window dressing” companies’ financial statements. Fearing retaliation if they spoke up or opposed such shenanigans, ancillary professionals became complicit in the bad actions of executives—and, in the process, violated their basic, professional ethical obligation to refuse to subordinate their judgment to that of a client or employer. Thus, SOX provisions reflect the hard-earned lessons from Enron: independent corporate lawyers and CPAs are essential to ethical behavior. Indeed, it is the lawyers and CPAs working on the ground floors of corporations who often are the first to see problems as they brew. In the worse cases, those professionals provide the “seal of approval” needed to successfully
due the public. Thus, SOX creates a framework of government oversight of the accounting profession and its practices, and imposes reporting duties on lawyers, as well.

In an attempt to restore trust, Congress hoped to improve the quality of the financial information that public companies report to investors by increasing transparency. To do so, SOX makes not only accountants, but also lawyers, gatekeepers for the public. The law now imposes significant limitations on the kinds of relationships that accounting firms can have with the companies they audit. For example, to avoid conflicts of interest, an accounting firm no longer can act as a consultant to the same company whose financial statements its accountants certify. Congress noted that Arthur Andersen may have had difficulty in saying no to Enron’s questionable accounting practices during their audit because the firm’s consulting revenue from Enron was scheduled to be $100 million, while their audit fee was only $4 million.

Congress also established the Public Company Accounting Oversight Board (PCAOB), which now oversees the audits of publicly traded companies. This oversight is designed to protect the interests of investors and the public interest by encouraging CPAs to prepare informative, fair, and independent audit reports.

For lawyers and accountants, SOX also sets minimum standards of professional conduct for those who appear and practice before the SEC. In the new regulatory environment, a violation of any SOX provisions now also constitutes a violation of the Securities Exchange Act of 1934. Such a violation can give rise not only to monetary penalties, but also to an order disbarring an attorney or accountant from practicing before the SEC. These SEC’s sanctions are not the only regulatory enforcement provisions in place. In addition, all states require that SEC-sanctioned attorneys and accountants report their federal violations to the state that has licensed them. Doing so will likely be followed by disciplinary proceedings before the relevant state authorities governing the conduct of attorneys and accountants, who then may impose the ultimate penalty: the loss of the professional’s license to practice.

To strengthen SOX’s impact, Congress imposed prison terms on the professional aiders and abettors of SEC violations—lawyers and accountants—to the same extent as corporate officers. For example, SOX now punishes both executives and the professionals who aid them in committing insider trading with the identical potential twenty-five year prison term. Before SOX, executives faced a ten-year term for insider trading, while lawyers and accountants faced a five-year term for aiding and abetting insider trading or any other SEC violation. SOX substantially increased all SEC-related prison terms for executives, and required that professionals face the same increased prison terms as executives.
Amended Sentencing Guidelines

Congress also passed a portion of SOX known as the “Corporate Fraud Accountability Act of 2002,” the goal of which was to create harsher prison terms when judges sentence executives who commit fraud. Congress enacted these new Federal Sentencing Guidelines in the belief that the strongest deterrent to executive malfeasance is the threat of a substantial loss of freedom. A conviction under SOX without such an enhanced criminal sentence would have vitiated the deterrent effect of the legislation, particularly given the fact that corporate officers (and their professional staffs) have the resources and ability to mount lengthy, rigorous, and often successful legal defenses. For example, Qwest’s (a Colorado-based company) former CEO Joe Nacchio’s 2007 criminal insider trading conviction resulted in a six-year prison term under the prior guidelines, but under the new guidelines that took effect after he committed insider trading, he would have faced several years more of imprisonment.

Congress also wanted to ensure that criminal sentencing guidelines relating to organizations would properly deter and punish their criminal misconduct. Thus, in 2004, the United States Sentencing Commission voted unanimously to amend the United States Federal Sentencing Guidelines, including substantial amendments to the section of the Guidelines regarding organizations. In the past, when executives broke the law, they faced individual fines and imprisonment; now, corporations themselves can be charged, convicted, and fined. This change reflects a shift from requiring mere legal compliance toward a broader requirement for organizations to create ethical cultures.

The new Organizational Guidelines encourage corporate boards to make concerted efforts to prevent wrongdoing by providing an incentive to establish good organizational practices and behavior. For example, if a corporation breaks the law, a judge (or a regulator through a settlement) is now empowered to impose reduced fines if the corporation can show that it had taken specific actions to prevent wrongdoing. The Organizational Guidelines provide an eight-point “culpability score” for organizations that sentencing judges must consider when imposing fines, four which may increase the ultimate punishment, and four that may mitigate it. The increasing factors are the involvement in, or tolerance of, criminal activity; the prior history of the organization; the violation of a court order; and obstruction of justice. The decreasing factors are self-reporting of a violation; cooperation with regulatory authorities; acceptance of responsibility; and the existence of an effective compliance and ethics program (ECEP).

In the post-Enron regulatory environment, corporate silence is no longer an option. Instead, cooperating with the government, accepting responsibility for a crime, promoting ethical compliance, and establishing an effective compliance program are now encouraged. SOX thus closes the pre-Enron legal
loophole that allowed a corporate board of directors to play absentee landlord which, in turn, allowed officers to turn a blind eye towards fraud, deception, and abuses of the public trust.

**Meaningful Compliance and Ethics Programs**

Although the application of the Organizational Guidelines by judges is not mandatory, many executives view them as the *de facto* standards for what constitute an effective compliance program. For example, the guidelines require companies to evaluate and measure the effectiveness of their compliance programs, and place greater responsibility on boards of directors and executives for oversight and management of ECEPs. While some companies have attempted to “window dress” such programs, SOX is clear that merely having an ECEP (and/or simply self-reporting a violation) is not sufficient to warrant a reduction in penalties for crimes committed. To promote and restore honesty, cooperation, and trust in corporate America, the new Organizational Guidelines expressly state that an organization will not be eligible to receive reduced penalties *if* the organization delays reporting an offense, or *if* individuals at certain levels of the organization turned a blind eye, tacitly approved, or participated in, the offense.

We believe the amended Organizational Guidelines have succeeded in creating a dramatic shift from mere compliance towards creating a true ethical environment in some corporations. The effect of SOX has been to establish legal compliance as a *minimum* threshold rather than the ultimate standard for ethical behavior. Where that has occurred, SOX has succeeded in its effort to foster the kind of ethical decision-making that is less likely to result in compliance failure.

Moreover, the burden of setting the “ethical tone” for a company now falls squarely on the shoulders of those at the top. The Organizational Guidelines are clear that directors and executives must now take an active role in establishing the content and implementation of an ECEP. In addition, they must attempt to prevent and detect criminal conduct themselves, and they must promote a culture that encourages ethical conduct and compliance with the law throughout the organization.

The new legislation attempts to shatter the “silence is golden” mode of corporate conduct. Effective compliance and ethics training is now a requirement for *all* employees within the context of an ECEP. Additionally, an organization’s compliance and ethics officers must be given adequate authority and resources to carry out their duties. This includes reporting directly, and having access to, top executives and the Board of Directors (usually through the Audit Committee).

Moreover, the amended Organizational Guidelines expressly provide—as an essential component of the design, implementation, and modification of an effective compliance program—that all companies must periodically assess
the risk that criminal conduct will occur in their organizations. In other words, good business now dictates that companies identify risk areas where criminal violations may occur, and be proactive in preventing them. Organizations also must demonstrate the use of auditing and monitoring systems to detect criminal conduct, and undertake periodic evaluations of the effectiveness of their compliance programs.

The Organizational Guidelines focus on individual responsibility for corporate behavior regardless of one’s position, knowledge, or stature within an organization. To this end, they define seven minimum requirements for an effective compliance program:

1. Prevention and Detection Procedures: Standards and procedures are established to prevent and detect criminal conduct;

2. High-Level Oversight: High-level personnel are assigned overall responsibility to oversee compliance, and provided adequate resources and authority to carry out such responsibility;

3. Due Care: Reasonable efforts are made to exclude high-level individuals who engage in illegal activities or other improper conduct;

4. Training and Communication: Effective compliance and ethics training is effectively required for all employees and agents, including those in upper levels, and this obligation is ongoing, with required periodic updates;

5. Monitoring: Reasonable steps are taken to achieve compliance by detecting criminal conduct, and providing systems to anonymously report (and seek guidance) regarding potential or actual criminal conduct;

6. Consistent Enforcement: Compliance is enforced and encouraged through disciplinary measures and appropriate incentives; and

7. Response and Prevention: Reasonable steps are taken to prevent criminal conduct.

While we recognize that many organizations have yet to reach these standards, we believe that, through them, SOX has begun to incrementally change the tide towards more ethical behavior.
Enhanced Internal Whistle-Blowing Protection

In enacting SOX, Congress wanted to change the corporate environment “from the inside out” in order to prevent wrongdoing from occurring in the first instance. When Enron’s Sherron Watkins attempted to call attention to the fraud at Enron, she was ignored. Yet, in so doing, she ultimately proved that the best way to prevent corporate fraud was to encourage those witnessing it to speak up. Unfortunately, in most companies, lower management employees are encouraged to fix, rather than report, such problems. Top executives do not want to hear bad news; what they want is for their employees to deliver on the projected financial figures they promised to Wall Street. This internal pressure leads to the potential for compromised decision-making in which urgent short-term actions replace a long-term, ethical, perspective. As the pressure on managers to perform mounts, their tendency to ignore ethical ramifications of their actions grows.

In this environment, whistle blowers, who often serve as the lone voice of organizational morality, are under tremendous pressure, and usually fare poorly at the hands of their company: They may be denied promotions, fired, or even blackballed within their industry. Thus, those who consider making a firm’s wrongdoings public are aware of the high likelihood that they will be condemned for their efforts by others in the organization. Because the consequences for whistle blowers are often so disastrous, such actions are not to be taken lightly. That is why SOX increases protection for employees who witness, and report, accounting misstatements, fraud, and other wrongdoing. Although SOX does not require employees of publicly traded companies to whistle blow externally to the SEC, the Act encourages them to do so because it requires the board of directors of publicly traded companies to create anonymous reporting procedures to protect the identity of whistle blowers.

SOX also requires company attorneys to pay attention to their intuition when they see something is awry—and does not allow them to hide behind the privilege of attorney/client confidentiality. In other words, attorneys must now blow the whistle on corporate fraud. In addition, SOX compels the SEC to adopt new rules of professional conduct applicable to attorneys practicing before the agency. These rules require an attorney to report evidence of legal violations by any agent of the company to the company’s legal counsel and audit committee, and this applies to both corporate in-house attorneys and to outside counsel. These rules have potentially far reaching effects because, in the past, the assumption has been that what one says to one’s lawyer stays with one’s lawyer. SOX changes this rule. If there is evidence of legal violations, any attorney retained by a publicly traded corporation must now report those facts to the company’s audit committee. It should be noted that an attorney is not required to report to the SEC if the company then fails to fix the problem; however, the American Bar Association now permits an attorney under these circumstances to whistle blow externally without violating confidentiality concerns.
Whistle-blowing accountants are subject to protection by the rules of professional conduct and ethics promulgated by the state boards of accountancy where they practice, and by the American Institute of Certified Public Accountants (AICPA). Yet, many internal CPAs are nonetheless reluctant to whistle blow both internally and externally to the SEC, fearing retaliation by their employers. Congress was particularly sensitive to the fact that Enron’s Sherron Watkins was effectively demoted after her whistle-blowing meeting with Ken Lay. Consequently, it granted all whistle blowers, including accountants, sweeping protections under SOX, which enhances existing state protections such as the right of the terminated whistle blower to sue under the tort of wrongful discharge under the public policy exception. Specifically, SOX provides whistle-blower-protection for internal accountants for any disclosures to a supervisor or regulatory body.

This protection is multi-layered. First, the Department of Labor requires an employer to reinstate fired whistle blowers to their prior positions if their terminations are deemed illegitimate. Although, the Department of Labor has not been very successful in compelling employers to do this, the law is at least on the books. Second, SOX provides a full spectrum of damages for an employee who is wrongfully fired for blowing the whistle in good faith. Third, it requires prosecution and imprisonment for up to ten years for any company supervisor who retaliates against an employee for truthful whistle blowing to law enforcement agencies, such as the FBI and Department of Justice. This last provision punishes executives who pressure their lawyers and accountants to “subordinate their judgment” and accept management’s perspective on the treatment of questionable accounting practices. Finally, SOX requires companies to have an independent audit committee that establishes, maintains and oversees whistle-blowing procedures.

In all, there is now a real opportunity for companies to adopt clear and effective whistle-blowing procedures. We believe corporate boards should consider requiring employees to whistle blow internally first, before going to the SEC or Congress. This would allow a company to properly and timely correct or mitigate the problem or damage, as well as to report any legal violations under the Organizational Guidelines. Corporate boards also should consider requiring in-house accountants to whistle blow internally when there is material departure from Generally Accepted Accounting Principles (GAAP) in the presentation of financial statements. While some states require in-house accountants to whistle blow internally, most states do not expressly require it.

Conclusion
Corporate America cannot run on ignorance and mistrust, and SOX has made great strides in fostering ethical behavior among corporate executives, their
attorneys, and their accountants. While SOX does not ensure ethical leadership, without doubt it encourages and rewards it. Moreover, while SOX does not solve all of the ethical problems brought to light by Enron, WorldCom, and those involved in the recent financial industry meltdown, it does demonstrate the regulatory environment’s ability to act swiftly in an attempt to steer the ship back on course. But, in the final analysis, public trust in corporations will continue to depend on business leaders who earn it through virtuous and ethical behavior. Laws can do only so much. While taking the cue from the new regulatory environment, executives nonetheless must choose the path of ethical leadership. If they do so, their employees will follow them and act in the best interests of the company. When leaders choose this path, they will see enhanced profitability and sustainability over the long term.