Legal Backgrounder

WLF Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
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Vol. 19 No. 29 September 17, 2004

IS SARBANES-OXLEY VULNERABLE TO CONSTITUTIONAL CHALLENGE?

by

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In July 2002, Congress passed significant legislation imposing new duties on public companies, their executives, directors, auditors, plan administrators, and attorneys. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "the Act") sought to restore the integrity of public companies' disclosure and accounting practices after corporate scandals such as Enron and Worldcom. Among other provisions designed to hold corporate officers and directors more accountable, Section 906 of the Act requires a registered company's CEO and CFO to certify that a periodic report containing a financial statement filed with the SEC "fully complies" with the requirements of the Securities Exchange Act of 1934 (the "1934 Act") and "fairly presents, in all material respects" the financial condition of the company.[1]

To enforce this new requirement, the Act created significant criminal penalties for false certifications. Section 906(c)(1) provides that a CEO or CFO who submits a Sarbanes-Oxley certification "knowing" that the periodic report does not either fully comply with the requirements of the 1934 Act or fairly present the company's financial condition can be imprisoned for up to ten years and fined up to $1,000,000. A CEO or CFO who "willfully certifies" the same report with the same knowledge can be imprisoned for up to twenty years and fined up to $5,000,000.[2]

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[1]Section 906(a) and (b) – codified at 18 U.S.C. § 1350(a)-(b) – provide:

(a) Certification of periodic financial reports. - Each periodic report containing financial statements filed by an issuer with the [SEC] pursuant to Section 13(a) or 15(d) of the [1934 Act] shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content. - The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of Section 13(a) or 15(d) of the [1934 Act] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

[2]Section 906(c) – codified at 18 U.S.C. § 1350(c)(1)-(c)(2) – provides:

(c) Criminal penalties. - Whoever –
(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report

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The Scrushy Indictment. In March 2003, William Owens and Weston Smith, two former executives of HealthSouth, Inc., pleaded guilty to various criminal offenses, including violations of Sarbanes-Oxley's certification provisions. Six month later, on October 23, 2003, a federal grand jury in the Northern District of Alabama charged Richard Scrushy, HealthSouth's founder and former CEO, with similar offenses related to his alleged manipulation of HealthSouth's financial statements. A significant portion of Scrushy's conduct was alleged to have occurred before Sarbanes-Oxley became law, and was charged as violations of the mail fraud, wire fraud, securities fraud or related criminal statutes. However, the indictment also charged Scrushy with three separate violations of Section 906(c)(2). Specifically, Count 48 charged that Scrushy "willfully certified" HealthSouth's false Form 10-Q for the second quarter 2002; Count 49 charged that Scrushy "caused" HealthSouth's then-CEO and its CFO to willfully certify the company's false Form 10-Q for the third quarter 2002; and Count 50 charged that in March 2003 Scrushy "attempted to cause" HealthSouth's CFO to willfully certify an amended false Form 10-Q for the third quarter 2002. All three counts charged that Scrushy knew that the periodic reports did not "fairly present, in all material respects," HealthSouth's financial condition because the reports "materially overstated HealthSouth's net income … and materially overstated the value of HealthSouth's assets."

Scrushy's Motion to Dismiss. Scrushy has moved to dismiss counts 48, 49 and 50 of the indictment, arguing, *inter alia,* that the Act's certification requirement or at least its punishment provisions are unconstitutionally vague. He argues that the term "willfully" is meaningless when used to modify the word "certifies" and does not give CEOs and CFOs fair notice of the conditions under which they can be punished by up to a twenty year sentence. He further argues that the term "fairly presents in all material respects" is unconstitutionally vague because it invites arbitrary prosecution. Taken together, Scrushy says, these flaws in the statute demand that Counts 48 through 50 of his indictment be dismissed.

The Void-for-Vagueness Doctrine. While Section 906 was drafted hastily and lacks precision in certain respects, Scrushy will have a difficult time prevailing on his claim that the statute is unconstitutionally vague. Although the void-for-vagueness doctrine has been justly criticized for being applied inconsistently by the courts, a criminal statute is unconstitutionally vague only if it: (1) fails to give fair notice of what conduct is forbidden; and (2) therefore, encourages arbitrary and discriminatory enforcement. *Kolender v. Lawson*, 461 U.S. 352, 357 (1983). Moreover, the Supreme Court has made clear that statutes which neither infringe upon constitutionally protected rights particularly the First Amendment nor sweep in potentially innocent conduct are much less vulnerable to a vagueness challenge. *See Village of Hoffman Estates v. Flipside,* 455 U.S. 489, 499 (1982) ("the most important factor affecting the clarity that the Constitution demands of a law is whether it threatens to inhibit the exercise of constitutionally protected rights. If, for example, the law interferes with the right of free speech or of association, a more stringent vagueness test should apply").

Measured against these standards, Section 906 will likely survive Scrushy's void-for-vagueness challenge.

The Proscribed Conduct Is Neither Constitutionally Protected Nor Potentially Innocent. Scrushy must concede that the certification requirement does not inhibit the exercise of a constitutionally protected right. He also has a hard time explaining how a CEO or CFO would be convicted and punished for innocently certifying a periodic report. Contrary to Scrushy's argument, "certifying" that the report fairly presented the company's financial condition is not an innocent act under either Section 901(c)(1) or (c)(2); both sections require the government to prove that the CEO or CFO *knew* that the periodic report did not fairly present, in all material respects, the company's financial condition. And Scrushy incorrectly argues

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> accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or
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> **(2)** willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

Before Sarbanes-Oxley, any person who knowingly and willfully filed a false periodic report with the SEC could be fined up to $1,000,000 or imprisoned up to ten years, or both. *See* 15 U.S.C. § 78ff (2002). Sarbanes-Oxley stiffened the penalties for violation of this statute, as well.

that the statute gives CEOs and CFOs no choice but to certify periodic reports. If a CEO knows the report does not fairly present the company's financial condition, he or she need not file the report until it *does* fairly present the company's financial condition. The delay in filing the report may have adverse consequences in the marketplace for the company, but the securities laws punish such delay merely by fining the issuer $100 a day. 15 U.S.C. § 78ff(b). Thus, it is unlikely a court will be convinced that the certification provision will be used to punish the innocent CEO or CFO.

The Statute Gives Fair Warning of the Forbidden Conduct. Scrushy's primary argument is that the phrase "willfully certifies" defies definition. Of course, the term "willfully" appears throughout the federal criminal code as a modifier for the word "violates" and is often defined to require proof that the defendant acted with specific intent to do something the law forbids. Scrushy argues, however, that the term "willfully" makes no sense when it modifies the word "certifies," which, as discussed above, he incorrectly claims is a potentially innocent act when applied to false periodic reports. Scrushy is particularly bothered by the fact that Section 901(c)(1) sets a potential ten year maximum penalty for "certifying" a periodic report knowing that it does not fairly present the financial condition of the company, but that Section 901(c)(2) increases the potential penalty to twenty years when "willfully certifying" the same report. He claims this is a distinction without a difference; that the act of certifying that a periodic report fairly presents the company's financial condition when the CEO or CFO knows otherwise is always a willful act. Put another way, because "certifying" with criminal knowledge and "willfully certifying" with criminal knowledge are the same, the statute fails to give constitutionally required fair notice of when a CEO or CFO can be prosecuted for a ten year offense versus a twenty year offense. Thus, he concludes, the statute is void-for-vagueness.

While the statute's language is somewhat inartful, the government argues that by distinguishing between non-willful and willful false certifications, the statute gives more than sufficient notice of the circumstances under which a defendant can be subject to differing criminal sanctions. They are probably correct. Under Section 906(c)(1), the government need only prove that a CEO or CFO certified the periodic report "knowing" that it did not, in fact, fairly present the financial condition of the company. To convict Scrushy under Section 906(c)(2), however, the government acknowledges that it must prove that when Scrushy signed (or caused others to sign) the certifications, he also knew that his conduct was prohibited by statute, *i.e.,* that he had the specific intent to do something the law forbids. *See Cheek v. United States,* 498 U.S. 192, 201 (1991) (to show willful violation of criminal tax statute, government must prove that the law imposed a duty, that the defendant knew of this duty and that he voluntarily and intentionally violated that duty)*; Ratzlaf v. United States,* 510 U.S. 135, 141-142 (1994) (to willfully violate the anti-structuring statute, government must prove that the defendant acted with knowledge that his structuring was illegal). Thus, the insertion of the word "*willfully*" fairly warns CEOs and CFOs of the heightened state of mind that must be proven in order to subject a defendant to the maximum punishment.

Scrushy also argues that the phrases "fairly presents" and "in all material respects" are both highly subjective terms, which fail to provide meaningful notice to a certifying CEO or CFO. While the government's response to Scrushy's argument is weak, a court is likely to find that these terms also have sufficient meaning to satisfy the fair warning concern of the void-for-vagueness doctrine.[3] Legislation such as Sarbanes-Oxley need give fair warning only to those potentially subject to it, not all "ordinary people." *See Connally v. General Constr. Co.,* 269 U.S. 385, 391 (1926) (discussing decisions of the court that have upheld statutes as not vague which include those "rested upon the conclusion that the employed words or phrases [have] a technical or other special meaning, well enough known to enable those within their reach to correctly apply them").[4] Because Section 906 is addressed to CEOs and CFOs of public companies filing periodic reports with the SEC, the statute will be deemed to give fair notice if the key terms have a meaning well enough defined to enable a certifying CEO or CFO to discern their meaning and apply them correctly.

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[3]The government's brief claims that ordinary people can understand the phrase "fairly presents" because the phrase is used in jury instructions describing evidence submitted in a trial. Similarly, the government says that "material" is well-defined in criminal jury instructions. The use of these terms in jury instructions is beside the point, as Scrushy points out in his reply.

[4]*See also Hoffman Estates, supra,* 455 U.S. at 502 (holding that the business co-operator's admission that he sold "roach clips," commonly associated with cannabis consumption, belied his argument that he had no notice of what constituted drug paraphernalia outlawed by municipal ordinance).

Both "fairly presents" and "in all material respects" are comprehensible to public company CEOs and CFOs. Scrushy is correct to complain that these terms extend the duties of company management, which previously had been limited to ensuring that the financial information was presented in conformance with Generally Accepted Accounting Principles ("GAAP"), including its definition of materiality. *See* SEC Staff Accounting Bulletin 99, 64 Fed. Reg. 45/52 (August 19, 1999). According to the SEC, Sarbanes-Oxley's provision that the financial information is "fairly presented in all material respects" was intended by Congress to be "broader than financial reporting requirements under [GAAP]." SEC Release Nos. 33-8124, 34-46427, IC 25122 (Aug. 30, 2002) (final rule implementing certification requirement directed by Sarbanes-Oxley Section 302). Thus, as Scrushy properly points out, a CEO or CFO can theoretically be held criminally liable even if the financial information in a periodic report complies with GAAP. However, while the definitions can be criticized as being overly subjective, they are capable of being applied by accountants and by certifying CEOs and CFOs. In management representations to auditors, for example, CEOs and CFOs normally acknowledge that the "financial statements are *fairly presented* in conformity with" GAAP. *See* Dan M. Guy, *Practitioner's Guide to GAAS 2003* 218-220 (emphasis added). Thus, every CEO and CFO filing reports with the SEC is familiar with the meaning of "fairly presents," at least as indicating that the statements comply with GAAP. Similarly, "materiality" is a term of art under GAAP that has been defined by the SEC Staff and by the Financial Accounting Standards Board. There can be little doubt that the CEO and CFO of a publicly-traded company can reasonably understand those terms.

The Statute Does Not Invite Arbitrary and Discriminatory Enforcement. Scrushy also argues that because the statute's key terms are ambiguous, they provide prosecutors unbridled discretion in deciding what conduct constitutes a violation of Section 906(c), thereby encouraging arbitrary enforcement. While Scrushy correctly argues that the term "*fairly presents*" gives prosecutors a significant degree of latitude in making charging decisions anytime a company's financial statements are determined not to conform with GAAP, it is unlikely that a court will find the statutory terms so indefinite as to be "wholly lacking in terms susceptible of objective measurement." *Keyishian v. Bd. of Regents,* 385 U.S. 589, 604 (1967) (citations and internal quotations omitted). Indeed, the allegedly offensive language is as definite as the language of other statutes subjecting CEOs and CFOs to liability, such as Section 10b of the 1934 Act and Rule 10b-5 promulgated thereunder, which makes it unlawful, *inter alia,* for any person in connection with the sale of any security to "omit to state a material fact necessary in order to make the statement made … not misleading" *See* 17 C.F.R. § 240.10b-5 (2004). As the Second Circuit reasoned in ruling that Rule 10b-5 was not void-for-vagueness, "while perhaps falling short of the standards of immutability followed by the laws of the Medes and the Persians, [the words of Rule 10b-5] are definite enough according to the canons of Anglo-American law." *United States v. Persky,* 520 F.2d 283, 287 (2nd Cir. 1975).

Similarly, while Scrushy complains that "*willfully certifies*" is meaningless and thereby allows prosecutors to arbitrarily prosecute a violation of either 901(c)(1) and 901(c)(2) for the same conduct, the Supreme Court does not appear to be sympathetic to arguments focused on this type of prosecutorial discretion. In *United States v. Batchelder*, 442 U.S. 114, 123-125 (1979), for instance, the Court unanimously upheld against various constitutional challenges to a sentencing scheme which provided for alternate punishments of either two or five years for the same conduct. While in *Batchelder* the Court was considering punishment under two separate statutes, the Court remarked that there would be no vagueness if a single statute permitted alternate punishments for the same conduct. *Id.* at 123. Thus, even assuming Scrushy was correct that "certify" and "willfully certify" is the same conduct, his arbitrary prosecution challenge would likely fail.

Conclusion. Richard Scrushy's motion raises serious questions about the vagueness of one of Sarbanes-Oxley's key provisions. Given the deference the Supreme Court's void-for-vagueness doctrine provides Congressional drafting, however, his motion to dismiss the Sarbanes-Oxley based charges is unlikely to succeed.

  ISBN 1056 3059