FLEXING THE COMMERCE CLAUSE MUSCLE AT THE TURN OF TWO CENTURIES: AN HISTORICAL PERSPECTIVE OF FEDERAL GOVERNMENT CONTROL OVER CORPORATE MORAL BEHAVIOR

Paul N. Iannone **PREFACE**

Corporate governance has been a dominant theme in the news media and corporate boardrooms in recent times. There has recently been a seemingly endless account of publicly traded corporations falsifying their financial statements, allegedly to inflate their stock prices. Much of this corporate malfeasance has been blamed on poor corporate governance standards. Some of the blame has been attributed simply to unethical or immoral corporate behavior. Besides corporate executives, fingers have been pointed at the accounting profession and the legal profession for abandoning their own "governance standards." Corporate governance is a broad term, but essentially it encompasses directing corporate activities and whether the procedures and safeguards are in place and followed to protect shareholders and the investing public at large.

The term "corporate governance" should also be inculcated in the business classroom lexicon. Business law and ethics courses offer a solid platform on which to introduce contemporary themes in corporate governing, such as the new roles for the board of directors, audit committees, the outside auditor, and corporate legal counsel under the Sarbanes-Oxley Act of 2002.[1]

A fitting way to introduce corporate governance (and "good" corporate behavior) is to examine the federal government's role in controlling corporate behavior, using its powers under the Commerce Clause of the United States Constitution. [2] Federal action at the beginning of our two most recent centuries provides an excellent illustration for students of our government challenging runaway corporate behavior. Enforcement of the Sherman Antitrust Act[3] against large corporate trusts and the enactment of the Sarbanes-Oxley Act were watershed moments in history, where corporate behavior was a prime issue and centerpiece of public attention. This essay is therefore offered as a possible introductory topic or lesson for students in the study of corporate governance, ethics and behavior. In dealing with extensive provisions of the Sarbanes-Oxley Act, the primary focus of this essay will be government's new controls and mandates over corporate executives, external auditors, and corporate legal counsel.

* Assistant Professor, College of Business, Sacred Heart University; Member, Connecticut Bar, 1998, and C.P.A. 1981; Quinnipiac University School of Law, J.D., 1998; University of New Haven, M.S.T., 1982, Central Connecticut State University, B.S., 1977.

1 Sarbanes—Oxley Act of 2002, Pub. L. No. 107-204,116 Stat. 745, § 302(a).

2 "The Congress shall have the Power to . . . regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST, art. I, §8.

3 15 U.S.C. § 1.

A Unique Historical Perspective

President Theodore Roosevelt would have been both disappointed and proud. He would have been disappointed that violations of the public trust by corporate executives and others, against which he fervently crusaded at the beginning of the twentieth century, continued at the beginning of the twenty-first century. President Roosevelt crusaded against the perceived damaging effects of large corporate trusts to the American economy and the American people. His efforts were noteworthy, as demonstrated by his pursuit in 1902 to dissolve the infamous Northern Securities Company under the relatively newly-minted authority of the Sherman Act. The extreme financial scandals at the commencement of the twenty-first century are strikingly reminiscent of the corporate manipulations of the antitrust laws at the start of the twentieth century. The modem twenty-first century scandals, in combination with the attacks of September 11, 2001, severely shook investor confidence and adversely affected the economy of the United States. Edmund Morris, author of the biography of Theodore Roosevelt, *Theodore Rex,* recently commented that February 19, 2002, "marks the centennial of the day in 1902 when Theodore Roosevelt launched his historic prosecution of the Northern Securities Company, the Enron of its time."[4]

Nonetheless, President Roosevelt would have been equally proud the 107th Congress and President George W. Bush reinvigorated his crusade and enacted the landmark Sarbanes-Oxley Act, a decisive and powerful response to the much- publicized corporate misbehavior of companies such as Enron and WorldCom.[5] It is an interesting historical note that both Roosevelt and Bush dramatically wielded the "commerce clause sword" of the United States Constitution at the beginning of a new century.

This essay will compare and parallel the federal government's use of its police power under the Commerce Clause in its judicial attack against the Northern Securities Company in 1902 and its legislative attack in 2002 against recent corporate governance violations. In both instances, the federal government's real target was corporate misbehavior. Part I will discuss the historical origins and purpose of the Commerce Clause. Part II will explore the federal government's prosecution of the Northern Securities Company and its outcome in the United States Supreme Court. Part III will discuss and analyze the federal government's exercise of its powers to regulate commerce (and corporate behavior) under Sarbanes-Oxley and its regulatory extension to corporate executives, accountants, and lawyers.

4 *All Things Considered,* National Public Radio broadcast, Feb. 19,2002, p. 13 of written transcript.

5 For additional information and background on the events leading to the enactment of the Sarbanes- Oxley Act of 2002, *see* HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE 1 -22 (2002); Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style,* 40 HOUS. L. REV. 1 (2003).

I. THE ORIGIN OF THE COMMERCE CLAUSE OF THE UNITED STATES CONSTITUTION

The debate whether governmental control over commercial activity should rest at the state or federal level of government continues today, as it has since the birth of our Nation. As we have witnessed with the passage of the Sarbanes-Oxley Act, there appears to be resurgence toward federal preemption of traditionally state- controlled commercial activity to protect the public against destructive business behavior. However, the issue of the proper balance and repose of authority over commercial activities among the states during the Constitutional Convention of 1787 was of a more immediate concern that would determine the survival of the newly formed Unites States of America. Using federal authority over interstate commerce to protect the public's interest would be vetted at another time in United States history.

Before the United States Constitution was ratified, the union of states was loosely held together by the Articles of Confederation (the "Articles"). The Articles, adopted in 1781, contained scant reference to commerce. The Articles allowed substantial state freedom to conduct trade and set policy. Specifically, the Articles provided,

> The better to secure and perpetuate mutual friendship and intercourse among the people of the different states in this union, the free inhabitants of each of these states, paupers, vagabonds and fugitives from Justice excepted, shall be entitled to all privileges and immunities of free citizens in the several states; and the people of each state shall have free ingress and regress to and from any other state, and shall enjoy therein all the privileges of trade and commerce, subject to the same duties, impositions and restrictions as the inhabitants thereof respectively... .[6]

The commercial freedom expounded under the Articles of Confederation resulted in inefficiencies and unwelcome trade competition among the states that over time would have devastated the nascent United States economy. "The poor condition of American commerce and the proliferating trade rivalries among the states were the immediate provocations for the calling the Constitutional Convention."[7] Further, Federalists, who sought a strong federal government, were pressing for a national commercial policy to override protectionist state laws that could eventually erode the unity of the Union.[8] These protectionist state laws enabled a state to adopt trade

[6] ARTICLES OF CONFEDERATION art rv.

[7] Gerald Gunther, Constitutional Law 93 (12th ed. 1991) (hereinafter *"Gunther")*.

[8] Michael Kammen (ed.), The Origins of the American Constitution xi-xii (1986) (hereinafter *"Kammen")*.

restrictions and taxing regimes to neutralize competition from other states. In effect, states were waging "economic warfare"[9] to maintain economic control.

The authors of *The Federalist*[10] and George Washington urged national or federal control over interstate commerce to prevent aggressions between states. Alexander Hamilton wrote prolifically in *The Federalist* of the negative effects of decentralized control over commerce:

> The competitions of commerce would be another fruitful source of contention. The States less favourably circumstanced would be desirous of escaping from the disadvantages of local situation, and of sharing in the advantages of their more fortunate neighbours. Each State, or separate confederacy, would pursue a system of commercial polity peculiar to itself. This would occasion distinctions, preference and exclusions, which would beget discontent. The habits of intercourse, on the basis if equal privileges, to which we have been accustomed from the earliest settlement of the country, would give a keener edge to those causes of discontent, than they would naturally have, independent of this circumstance."
>
> The interfering and unneighbourly regulations of some States contrary to the true spirit of the Union, have in different instances given just cause of umbrage and complaint to others; and it is to be feared that examples of this nature, if not restrained by a national controul, would be multiplied and extended till they became not less serious sources of animosity and discord, than injurious impediments to the intercourse between the different parts of the confederacy.[12]

Hamilton also emphasized that trade with foreign nations must be regulated under one authority, and not left to the whims of individual state legislatures.

> Under a vigorous national government, the natural strength and resources of the country, directed to a common interest, would baffle all the combinations of European jealousy to restrain our growth....
> We might defy the little arts of little politicians to controul, or vary, the irresistible and unchangeable course of nature.... But in a state of disunion these combinations might exist, and might operate with success. It would be in the power of the maritime nations,

[9] John E. Nowak & Ronald E. Rotunda, Constitutional Law 138 (5th ed. 1995) (hereinafter *"Nowak & Rotunda").*

[10] A series of articles published in New York newspapers to persuade the American populace to accept the yet unratified Constitution offered during the Constitutional Convention of 1787. *Id.* at xi. Alexander Hamilton and James Madison were two of the noted authors.

[11] The Federalist No. 7 (Alexander Hamilton).

[12] The Federalist NO 22 (Alexander Hamilton).

> availing themselves of our universal impotence, to prescribe the conditions of our political existence; and as they have a common interest in being our carriers, and more in preventing our being theirs, they would in all probability combine to embarrass our navigation in such a manner, as would in effect destroy it, and confine us to a passive commerce.[13]
>
> It is indeed evident, on the most superficial view, that there is no object, either as it respects the interests of trade or finance that more strongly demands a Federal superintendence. The want of it has already operated as a bar to the formation of beneficial treaties with foreign powers; and has given occasions of dissatisfaction between the States.[14]

George Washington, in writing to Marquis de Lafayette in 1788 concerning trade with France, was also concerned the separate acts of state legislatures would undermine effective foreign trade relations:

> One Assembly makes a system, another Assembly unmakes it.
> Virginia, in the very last session of her Legislature, was about to have passed some of the most extravagant and preposterous Edicts on the subject of trade, that ever stained the leaves of a Legislative Code. It is in vain to hope for a remedy of these and innumerable other evils, until a general Government shall be adopted.[15]

Not everyone agreed there should be federal control over commerce. The southern states were not in agreement. The economy of the South was predominately agricultural, in contrast to the industrial north. The southern states' fear was that the majority, which rested in the northern states, would intentionally undermine the southern states' ability to independently conduct trade and set prices for the commodities sold to the northern industrialists.[16]

Therefore, the Commerce Clause, which gave Congress the power to regulate interstate commerce and commerce with foreign nations, was bom out of commercial necessity. "The national commerce power, it was hoped, would put an end to hostile state restrictions, retaliatory trade regulations, [and] protective tariffs on imports from other states."[17] This new national power would serve to dilute state laws that affected national commerce, as well as establishing an independent national power.[18] The Commerce Clause power cannot be underestimated. The Federal

13 THE FEDERALIST NO. 11 (Alexander Hamilton).

14 THE FEDERALIST NO. 22 (Alexander Hamilton).

15 *Kammen, supra* note 8, at 107 (George Washington to Marquis de Lafayette, April 28,1788).

16 *Id.* at 257 (George Mason, "Objections to the Constitution of Government Formed by the Convention," Nov. 1787).

17 *Gunther*, *supra* note 7, at 93.

18 *Id.*

power.[18] The Commerce Clause power cannot be underestimated. The Federal Government has exercised its Commerce Clause authority to cure bad behavior amongst businessmen and women, and to promote morality and justice in such matters as civil rights.[19] The use of the Commerce Clause as a shield to protect American citizens against business moral transgressions is the subject of this essay.

II. 1902 - The Government Flexes its Muscle against a Monopolistic Trust: The Northern Securities Company Case

Not surprisingly, given the genesis of the Commerce Clause, the early focus of judicial review during the early to mid-nineteenth century was state violations of the federal power over interstate commerce.[20] In the famous, seminal case of *Gibbons* v. *Ogden,*[21] the Supreme Court in 1824 affirmed the authority of the federal commerce power over state laws that interfered with national commerce. Chief Justice Marshall, writing for the Court, noted the national commerce power is far reaching: "This power, like all others vested on Congress, is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution."[22] He stressed that the "commerce among the several states" should be interpreted broadly, and that "[cjommerce among the States, cannot stop at the external boundary line of each State, but may be introduced into the interior."[23] However, Marshall reflected that not all commerce is "among the several states." "It is not intended to say that these words comprehend that commerce, which is completely internal, which is carried on between man and man in a State, or between different parts of the same State, and which does not extend to or affect other States."[24] Further to this point, Marshall stated that "[t]he completely internal commerce of a State, then may be considered as reserved for the State itself."[25]

The industrialization of America and the advancement of rail transportation during the post-Civil War period brought increased Congressional regulation under

[18] *Id.*

[19] The Commerce Clause provided the federal authority used in the Civil Rights Act of 1964 to outlaw discrimination in places of public accommodation, such as restaurants, hotels, movie theatres, etc. *See* 42 U.S.C. §2000a.

[20] *See generally Nowak & Rotunda, supra* note 9, at 139-142. Early commerce clause cases dealing with potentially violative state laws included Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824) (holding that New York's grant of a steamboat monopoly violated the Commerce Clause) ; Brown v. Maryland, 25 U.S. (12 Wheat.) 419 (holding that a Maryland law imposing a licensing requirement, a license fee, and penalties for failure to have a license for importation of liquor into the State of Maryland violated the Commerce Clause); Willson v. Black-Bird Creek Marsh Co., 27 U.S. (2 Pet.) 245 (1829) (holding that a Delaware law authorizing the building of a dam across a creek that flowed into the Delaware River did not violate the Commerce Clause); Cooley v. Board of Wardens, 53 U.S. (12 How.) 299 (1851) (holding that a Pennsylvania law requiring the use of a Pennsylvania pilot to navigate ships through a harbor in Philadelphia did not violate the Commerce Clause).

[21] 22 U.S. (9 Wheat.) 1 (1824).

[22] *Id.* at 196.

[23] *Id.* at 194.

[24] *Id.*

[25] *Id.* at 195.

signed to regulate business activity.[26] The Interstate Commerce Act was enacted to regulate the railroads, in particular the pricing policies and structure of rail travel. The Sherman Act was enacted to thwart the rising threat against free competition posed by large monopolistic combinations, known as "trusts." It is the latter act and its enforcement potential that occupied the attention of President Theodore Roosevelt at the start of the twentieth century.

The seemingly deficient pre-Roosevelt enforcement of the Sherman Act provided momentum and encouragement to create business trusts that conspired to control prices, the marketplace, and the stock market. In 1895, the Supreme Court weakened the thrust of the Sherman Act by reserving government regulation over manufacturing in a sugar monopoly case to the states, pursuant to the residual clause of Tenth Amendment.[27] In addition, further exacerbating the federal government's problems in reining in the menacing trusts, New Jersey adopted extremely business friendly incorporation laws. Its new incorporation laws allowed forming parent- subsidiary groups of corporations controlled by a holding company.[28] Holding companies became legal in New Jersey, thus allowing trusts to combine with other trusts to form large corporate structures that could operate in more than one state.[29] "[M]any of the goals of a trust were now illegal because of the Sherman Act, but the trust's mere existence was no longer in violation of state incorporation statutes."[30] From here, New Jersey became the breeding ground for large corporate formations in many industries including steel, oil, and railroads.

Toward the latter part of the 1890's, the attitude of the federal courts began to change. In 1899, the Supreme Court held for the government, in *Addyston Pipe & Steel Co.* v. *United States,*[31] that the Sherman Act could invalidate price fixing agreements by iron pipe manufacturers. With the *Addyston* case, the courts seemed poised to reassert the federal government's broad commerce powers.

Against this background, Theodore Roosevelt assumed the presidency on President McKinley's assassination in 1901. Roosevelt vigorously opposed creating large trusts that could manipulate prices, affect the stock market, and potentially control sectors of the economy. "Although he had promised to follow in McKinley's footsteps, he had no sympathy for speculators and financial manipulators, whom he was later to call 'malefactors of great wealth.'"[32] There was no doubt that ending the power of trusts and corporate power would become a moral conviction for Roosevelt. Although Roosevelt understood that large corporate enterprises would be bom

[26] *Gunther*, *supra* note 7, at 97.

[27] United States v. E.C. Knight Co., 156 U.S. 1 (1895). The Tenth Amendment states, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[28] ROGER SHERMAN, ANTITRUST POLICIES AND ISSUES 36 (1978).

[29] *Id.*

[30] *Id.*

[31] 175 U.S. 211 (1899).

[32] NATHAN MILLER, THEODORE ROOSEVELT, A LIFE, 365 (1992), quoting a Roosevelt speech given at Provincetown, Massachusetts on August 20,1907.

velt. Although Roosevelt understood that large corporate enterprises would be bom out of an expanding industrial economy, he believed that unregulated monopolistic trusts posed serious threats to a free market and to free competition:[33]

> In Roosevelt's view, certain trusts were bad not because they were trusts but because they were run by bad men with evil motives.
> Such combinations deserved and should expect to be chastened by government, and Roosevelt made it his goal to see that they were.[34]

Roosevelt's first public foray was toward a new corporate railroad combination, the Northern Securities Company, which was formed by some of the most powerful financiers of that time. The case against the Northern Securities Company was the proving ground for asserting federal government control over large business concerns and businessmen that presented what was considered then to be bad behavior.[35] The Northern Securities Company was formed in November 1901, as a large holding company that combined three large railroad companies, the Burlington, the Northern Pacific, and the Great Northern, to obtain control over the Northwest Territory by means of a route through Chicago.[36] Prior to its formation, two railroad titans, Edward Harriman and James Hill, and one financial titan, J.P. Morgan, fought each other in the financial arena to take control over the Burlington railroad, which held the vital link to the west from Chicago. In order to bring an end to the acrimony and behind-the-scenes masquerading to acquire control, the three joined forces and contributed their individual railroad holdings to a new holding company under the New Jersey holding company statute. The new holding company, named the Northern Securities Company, was capitalized in excess of $400 million. The size of this company was large enough to prevent future raiders from taking control.[37]

The formation of the Northern Securities Company immediately caught Roosevelt's attention. He sought advice from Attorney General Knox about possible violations of the Sherman Anti-trust Act. Knox opined the combination was in violation of the Sherman Act, and the merger was illegal. He believed that the stock was overvalued, and that only by extorting the public through high prices could the company bring home a fair profit for the stockholders.[38] The federal government announced, on February 19, 1902, that it intended to file suit against the Northern Securities Company for violations of the Sherman Act. The suit was filed on March 10, 1902. The government argued the holding company was formed for restraining trade and competition in the northwest sector of the country and therefore should be

[33] *Id.* at 366.

[34] H. W. BRANDS, T.R.: THE LAST ROMANTIC 438 (1997).

[35] R.W. Apple, Jr., *The Case of the Monopolistic Railroadmen, in* QUARRELS THAT HAVE SHAPED THE CONSTITUTION 166 (John A. Garraty, ed., 1964) (hereinafter *"Monopolistic Railroadmen").*

[36] NATHAN MILLER, THEODORE ROOSEVELT: A LIFE, 367-68 (1992).

[37] *Monopolistic Railroadmen*, *supra* note 35, at 164. Apple presents a lively, anecdotal account of the events leading to the formation and eventual dissolution of the Northern Securities Company

[38] *Id.* at 166.

was much more than a mere technical battle over interpreting the Sherman Act; it was a battle for control over corporate behavior and morality:[40]

> It had to do with power: specifically, with the power of the government vis-à-vis business. Power is part substance and part symbol, and the Northern Securities decision was to become a symbol of the government's right to control the activities of business.[41]

Similarly, as will be discussed in Part III, one hundred years later, in a show of government restraint over corporate power, the Sarbanes-Oxley Act was enacted to curb corporate behavior and those individuals that contribute to and foster that behavior.

The Supreme Court of the United States heard the case against the Northern Securities Company on the defendant's appeal from the Circuit Court for the District of Minnesota. On March 14, 1904, the Supreme Court rendered its decision against the Northern Securities Company, holding the combination was in violation of the Sherman Act and should be enjoined from transacting further business.[42] Justice Harlan delivered the opinion, with a famous dissent by the preeminent jurist, Justice Holmes. The Court did not hold the Northern Securities Company in fact restrained trade and competition under the Sherman Act; rather, the Court maintained that, under its holding company structure, Northern Securities Company had the power and propensity to restrain trade. Justice Harlan stated:

> This combination is, within the meaning of the act a 'trust,' but if not, it is a combination in restraint of interstate and international commerce, and that is enough to bring it under the condemnation of the act. The mere existence of such a combination and the power acquired by the holding company as its trustee constitute a menace to, and a restraint upon, that freedom of commerce which Congress intended to recognize and protect, and which the public is entitled to have protected. If such combination be not destroyed, all the advantages that would naturally come to the public under the operation of the general laws of competition, as between the Great Northern and Northern Pacific Railway companies, will be lost, and the entire commerce of the immense territory in the northern part of the United States between the Great Lakes and the Pacific at Puget Sound will be at the mercy of a single holding corporation organized in a State distant from the people of that territory.[43]

[40] *Id.* at 175.
[41] *Id.*
[42] Northern Securities Co. v. United States, 193 U.S. 197 (1904).
[43] *Id.* at 327.

> corporation organized in a State distant from the people of that territory.[43]

Justice Harlan admonished the business community that the commerce powers under the Constitution enable the federal government to protect the public against corporate greed:

> But the interests of private persons and corporations cannot be made paramount to the interests of the general public. Under the Articles of Confederation, commerce among the original States was subject to vexatious and local regulations that took no account of the general welfare. But it was for the protection of the general interests, as involved in interstate and international commerce, that Congress, representing the whole country, was given by the Constitution full power to regulate commerce among the States .. ."[44]

It appears that the above reference by Harlan to "the interests of private persons and corporations" was directed personally to the owners of the Northern Securities Company and was tantamount to Harlan's moral indictment of their behavior. Perhaps Harlan's primary concern and motivation in issuing the opinion was grounded more in philosophical and moral foundations than the law. As discussed below, Justice Holmes seemed to agree.

The Northern Securities case was a major victory for President Roosevelt. It was clearly a successful show of governmental force over powerful corporate giants. It is arguable the real import of prosecuting the Northern Securities Company had more to do with the symbolic assertion of governmental control over business and less to do with establishing bedrock legal precedent under the Sherman Act. In his famous dissent, Justice Holmes stated: "Great cases, like hard cases, make bad law."[45] The dissents written by Justices White and Holmes are persuasive that the ultimate ruling in the case was possibly legally flawed. Justice White argued the Commerce Clause and the Sherman Act did not empower Congress to regulate stock ownership in state corporations.[46] Justice Holmes maintained the enforcement provisions of the Sherman Act are activated only on showing of some anticompetitive action by the combined companies. "[T]here is no attempt to monopolize . . . [and] no combination in restraint of trade, until something is done with the intent to exclude strangers to the combination from competing with it in some part of the business which it carries on."[47] In an indirect way, Holmes chastised Roosevelt. He concluded his remarks with an admonition that went to the heart of the real issue in this case. According to Holmes, the real issue was whether the government intended to

43 *Id.* at 327.
44 *Id.* at 352.
45 *Id* at 400.
46 *Id.* at 369.
47 *Id.* at 409.

> disintegrate society so far as it could into individual atoms. If that were its intent, I should regard calling such a law a regulation of commerce as a mere pretense. It would be an attempt to reconstruct society. I am not concerned with the wisdom of such an attempt, but I believe that Congress was not entrusted by the Constitution with the power to make it, and I am deeply persuaded that it has not tried.[48]

One historian summed up the importance of the Northern Securities Company case: "But by creating a moral climate in which government could effectively control the power of business, the decision helped to work a permanent change in American life."[49]

III. 2002 - The Government Flexes its Muscle Against Corporate Governance Violations and Financial Fraud

Fast-forwarding 100 years to 2002 is not meant to dilute the importance of one hundred years worth of significant Commerce Clause judicial decisions or significant legislation (such as the Securities Act of 1933[50] and the Securities Exchange Act of 1934[51]). It is intended to recognize that building a framework for corporate moral behavior is a work in progress and is within the reach of the federal government under its Commerce Clause authority. Prosecuting the Northern Securities Company marked a milestone in 1902; the Sarbanes-Oxley Act marked a similar milestone in 2002.

In early 2002, the United States was still reeling from the aftermath of the September 11, 2001 attack. It was also reeling from the shock to the financial markets on the almost daily revelations of allegations of financial statement misrepresentation. Federal government action was clearly justified under the federal securities laws. Investigations by the Securities and Exchange Commission (SEC) of the alleged improprieties were underway; however, a congressional legislative response was unavoidable. The legislative response, the Sarbanes-Oxley Act[52] (the Act), was signed into law on July 30, 2002. It is an extensive and, some may think, intrusive piece of legislation, designed to prevent financial statement misrepresentation, to provide harsh penalties, and ultimately to protect the investing public. The Act set up new regulations for corporate executives of publicly held corporations, accountants that audit publicly held corporations, lawyers that represent publicly- held corporations (both internal and external lawyers), audit committees, and investment analysts. This essay will center on those provisions of the Act that serve to moderate and control corporate moral behavior.

[48] *Id.* at 411.

[49] *Monopolistic Railroadmen, supra* note 35, at 175.

[50] 15 U.S.C. § 77(a)

[51] 15 U.S.C. § 78(a).

[52] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204,116 Stat. 745, § 302(a).

vestment analysts. This essay will center on those provisions of the Act that serve to moderate and control corporate moral behavior.

There was minimal Congressional debate whether the Act was within the Commerce Clause. The House of Representatives Committee Report cited its Constitutional authority to enact this legislation under both Article 1, section 8, clause 1 (general welfare of the United States) and Article 1, section 8, clause 3 (power to regulate interstate commerce).[53] However, Republican Congressman Ronald Paul of Texas did express some interesting dissenting views to passage of this legislation and questioned the need for severe governmental intervention.[54] His comments were emblematic of the political differences between those who argue for less government control and those who believe that government has a duty to protect its citizens. Congressman Paul's comments offer a provocative record of a discussion about potential limits of federal authority to pass such legislation. Congressman Paul opened his remarks by stating:

> Seldom in history have supporters of increased state power failed to take advantage of a real or perceived crisis to increase government interference in our economic and/or personal lives. Therefore, we should not be surprised that the events surrounding the Enron bankruptcy are being used to justify the expansion of federal regulatory power .. ,[55]

With respect to constitutional authority, he stated:

> Finally, Congress should contemplate whether we actually have any constitutional authorization to impose these new regulations, instead of simply stretching the Commerce Clause to justify the program de jour.[56]
>
> Furthermore, this legislation exceeds the constitutional limits on federal power, interfering in matters the 10th amendment reserves to state and local enforcement. I therefore urge my colleagues to reject this bill. Instead, Congress should focus on ending corporate welfare programs which provide taxpayer dollars to large politically connected companies, and ending the misguided regulatory and monetary policies that helped create the Enron debacle.[57]

Congressman Paul was correct in noting the Act created new federal regulatory power over commercial activities that have traditionally been regulated by the states.

[53] H.R. Rep. No. 414,107 Cong., 2d Sess., at 35 (2002). There was no reference to the Commerce Clause in the Senate Report.

[54] *Id.* at 49.

[55] *Id.*

[56] *Id.*

[57] *Id.*

The following discussion will highlight those sections of the Act that seek to regulate corporate moral behavior and improve corporate governance among accountants, lawyers, corporate executives, and members of corporate boards. There is a clear message that corporations and those that serve corporations must establish and adhere to a set of ethical guidelines. This discussion is not intended to cover the entire Act; it is intended to draw out those provisions that signal federal mandates for ethical behavior. It is also noteworthy that there are extensive criminal penalties for violations of the Act. (The penalty provisions will not be discussed in this essay[58]).

Sarbanes-Oxley Provisions Affecting the Behavior of Corporate Executives and Directors

The principal executive officer (CEO) and the principal financial officer (CFO) must certify in each annual or quarterly financial report filed with the SEC that they have reviewed the report, and that the report does not contain any untrue statement of a material fact or omission of a material fact.[59] The certifying officers are also responsible for internal control systems and must disclose to the company's auditors and the audit committee of the board of directors any significant deficiencies of the internal controls.[60] Further, the certifying officers must disclose any fraud (no matter how insignificant) that involves management or employees involved in internal control.[61] Officers or directors (or persons under their direction) will be found to have acted unlawfully if they "take action 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."[62]

The Act prohibits officers and directors from trading in the stock of the company while there is a "blackout period" in effect.[63] A blackout period exists when employees and participants in pension plans are temporarily suspended from transferring company stock (for example, during a change of a plan fiduciary).[64] This provision is intended to prevent profiteering by trading in company stock during blackout periods by officers and directors while rank-and-file employees are frozen out from trading in their individual pension accounts.

One very interesting provision may reach the outer limits of the Commerce Clause. The provision compels the CEO and CFO to forfeit, and to reimburse the company for, any bonus or other incentive-based or equity-based compensation received during a twelve-month period following the issuance of financial statements that require an accounting restatement resulting from misconduct and noncompli-

58 The penalty provisions are found in Title VIII, IX, and X of the Act, Act §§ 801 through 1107.

59 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204,116 Stat. 745, § 302(a).

60 §302(aX5XA).

61 §302(aX5)(B).

62 §303(a).

63 §306(a).

64 §306(aX4)(A).

received during a twelve-month period following the issuance of financial statements that require an accounting restatement resulting from misconduct and noncompli- ance.[6:>] Any profits earned from the sale of securities of the company during this twelve-month period must also be returned to the company.[66]

Also, in response to publicized abuses, a companion provision to §304 that limits enrichment of company executives and may also stretch the bounds of the Commerce Clause is the prohibition against personal loans to company officials.[67] It may be argued company lending to an employee does not impact interstate commerce.[68] Section 402(a) provides that it is unlawful for the company to make personal loans to any executive officer or director. The company may not extend credit, maintain credit, or arrange for credit, for executive officers or directors.[69] Such loans can inherently lead to conflicts of interest. For example, a company that has extended credit to an officer or director would have an interest in the officer or director's financial ability to repay the loan.

Section 406, "Code of Ethics for Senior Financial Officer," strikes at the core of the philosophical underpinnings of the Sarbanes-Oxley Act. The legislative history of Section 406 reveals the Congress's motives in forcing public companies to stress ethics among its executives:

> The problems surrounding Enron Corp. and other public companies raise concerns about the ethical standards of corporations and their senior financial managers. The Committee believes that investors have a legitimate interest in knowing whether a public company holds its financial officers to certain ethical standards in their financial dealings. The bill requires issuers to disclose whether or not they have adopted a code of ethics for senior financial officers and, if not, why not. This section was recommended by Senator Corzine.[70]

This provision provides the SEC will require companies to issue reports to disclose whether or not the company has adopted a code of ethics for senior financial officers, including the CFO, principal accounting officer or other persons performing similar duties.[71] The term "code of ethics" is defined as a set of standards

> necessary to promote -

[65] §304(a)(l).

66 §304 (a)(2).

[67] §402(a).

[68] In addition, query whether if a State enacted similar legislation, there might be a violation of the Contracts Clause of the Constitution: "No State . . . may pass any Law impairing the Obligation of Contracts." U.S. Constitution, art. I, §10.

[69] *Id.*

[70] S. Rep. No. 205,107 Cong., 2d Sess., at 54.

[71] §406(a).

> (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer [company], and
> (3) compliance with applicable governmental rules and regulations.[72]

Provisions Affecting the Behavior of Accountants

Under the broad umbrella of the Commerce Clause, the Sarbanes-Oxley Act has introduced new federal governance over accountants (and lawyers, discussed below) that provide audit opinions on financial statements for publicly held corporations. Before its enactment, the states had regulatory prominence over the accounting profession, either through a specially designated state board of accountancy or under the auspices of a consumer protection agency. The accounting profession has also been in some respects a self-regulating body, through professional societies, such as the American Institute of Certified Public Accountants and similar State professional societies. Under Sarbanes-Oxley, the federal government has virtually "preemptively" taken control over, or at least monitors, auditing standards and ethical standards for public accounting firms that represent and issue financial opinions for publicly traded companies.

The Act establishes the Public Company Accounting Oversight Board (the Board) to carry out its mandate to oversee the audits of publicly traded companies.[73] The Board is not an agency of the United States Government; it is organized as a nonprofit corporation under the District of Columbia Nonprofit Act.[74] Although the Board is an independent rule-making organization, its rules are to be reviewed and approved by the SEC.[75] Further, the Board is empowered to conduct investigations of public accounting firms may recommend disciplinary action and penalties against an accounting firm to the SEC.[76] The SEC also will appoint the initial Board members.[77] Public accounting firms that prepare, issue, or participate in the preparation or issuance of audit reports of publicly traded companies are required to register with the Board.[78] Therefore, the Board substantively has powers and authority similar to a governmental agency, or at the least as a sub-agency or unit of the SEC.

A close look at the Sarbanes-Oxley Act makes it abundantly clear that Congress was concerned with proper ethical behavior of public accounting firms:

> The legislation envisions that such an organization [public regulatory organization] will enforce compliance by accountants with professional ethics and competency standards applicable to audits

[72] §406(c).
[73] § 101.
[74] §101(b).
[75] § 107(b).
[76] §105.
[77] §101 (e)(4).
[78] § 102(a).

> The legislation envisions that such an organization [public regulatory organization] will enforce compliance by accountants with professional ethics and competency standards applicable to audits of such financial statements and establish such rules as are deemed necessary to provide for their review and enforcement, and provides for the oversight of such organizations by the Commission [SEC].[79]

The following provisions of the Act illustrate this observation:

1. The Board is mandated to establish quality control standards and ethical standards to be followed by public accounting firms. These standards will be adopted from proposals made by accounting professional advisory groups.[80] The quality control standards are to include requirements that every registered accounting firm must monitor professional ethics and independence from firms it audits.[81]
2. The Board must conduct investigations of public accounting firms to test and "evaluate the sufficiency of the quality control system of the firm. . ."[82]
3. The Board is authorized to conduct investigations of public accounting firms that may have violated the Act. The Board is also authorized to impose sanctions and other disciplinary measures including monetary fines and penalties.[83]
4. To help insure auditor independence and avoid conflicts of interest, the Act prohibits public accounting firms from performing certain enumerated nonaudit services "contemporaneously with the audit."[84] Such services as bookkeeping, financial systems design, valuation services, actuarial services, internal auditing, investment services, are legal services are prohibited.[85] In addition, other non-audit services that are not listed in §201, such as tax services, required pre-approval of the audit committee of the board of directors of the audited company.[86]
5. The Act requires lead audit partner rotation every five years.[87]
6. The public accounting firm conducting the audit must report to the audit committee of the board of directors all accounting policies and practices to be used, alternative methods of financial treatment of any item that was dis-

79. H.R. Rep. No. 414,107 Cong., 2d Sess., at 16.
80. §103(aXl).
81. §103(a)(2XB)(i).
82. §104(dX2).
83. §105.
84. §201 (a).
85. §201 (a).
86. 202.
87. §203.

positions. The Act provides that it is unlawful for a public accounting firm to perform an audit "if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer [company] was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."[89]

Act Provision Affecting Behavior of Lawyers

The legal profession was not immune to the reach of the Sarbanes-Oxley Act. As for the accounting profession, state bar authorities typically set professional standards. In addition the American Bar Association has played a key role in promulgating rules for attorney conduct. For attorneys who represent clients before the SEC, the Act provides the SEC will issue rules that will establish "minimum standards of professional conduct."[90] The Act requires that SEC rules provide that an attorney must report material violations of any securities law to the chief legal officer or chief executive officer of the company.[91] Further, if there is an inappropriate response from either officer, the attorney must report its evidence to the audit committee of the board of directors.[92] To carry out the mandate of the statute, the SEC has issued detailed and extensive final regulations in early 2003 under §307.93. In essence, Sarbanes-Oxley places both outside and inside counsel in the position of watchdog over ethical missteps by management and the public accounting firm conducting the audit. Section 307 may present new practical challenges for law firms in addressing issues of attomey-client privilege and the duty of loyalty to the client.[94]

[89] §206.

[90] §307.

[91] §307(1).

[92] §307(2).

[93] Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. Part 205 (2003). These regulations require the attorney to report violations to management, then to the board of directors, and are therefore sometimes colloquially referred to as the "Up the Ladder" regulations. At this writing, the SEC has yet to issue final regulations governing what is known as a "noisy withdrawal." "Noisy withdrawal" refers to the manner in which an attorney reports to the SEC withdrawing representation of a client.

[94] For additional information and insight relating to practicing law under the Sarbanes-Oxley Act of 2002, see Thomas M. Skove, *Lawyering After Enron,* 50 FED. Law. 32 (2003); Kenneth B. Winer & Gregory S. Bruch, *The SEC Standards of Professional Conduct: Practicing Law Under the New Regime,*
35 SEC. REG. & L. REP. 391 (2003).

CONCLUSION

Corporate misbehavior and fraudulent corporate governance are not a uniquely twenty-first century phenomenon. As we have seen, corporate ethical misbehavior was a serious issue at the commencement of the previous century, almost exactly 100 hundred years ago. As expected, the United States government, using its Commerce Clause authority and prerogative, stepped in to challenge and offer corrective measures. The government's attack on the antitrust abuses of companies such as the Northern Securities Company and the visceral reaction of Congress in enacting the landmark Sarbanes-Oxley Act were watershed events in the battle to protect the American public from corporate fraud. It is important that business students familiarize themselves with historical moments in business history and that they understand the government's retort and solutions. In this way they may become responsible business leaders with a strong sense of moral duty.