Contractors and Sureties Beware! Sarbanes-Oxley Will Affect You, Too

by Daniel E. Toomey and Tamara M. McNulty

"One of the concerns expressed is that there 'will be a number of unintended consequences—from rampant litigation to increased bureaucracy—most of which have the potential to inflict more harm than good.'"

On July 30, 2002, the president signed the largely bipartisan Sarbanes-Oxley Act of 2002.[1] This legislation was a response to the enormous corporate and accounting scandals, such as those involving Enron, Arthur Anderson and WorldCom, which had plunged the stock market into a near recession.[2] The legislation, called "the most far-reaching federal crackdown on corporate fraud since the Great Depression,"[3] spurred CCH, Inc., to immediately publish a 235-page monograph explaining it.[4] We will try to point out what this 130-page law may have in store for the construction industry and sureties.

Implementing Regulations are not Yet Written.

Because agencies are required to issue implementing regulations, most of which have not yet been written, much of what we say is predictive. One of the concerns expressed is that there "will be a number of unintended consequences—from rampant litigation to increased bureaucracy—most of which have the potential to inflict more harm than good."[5]

Most in the Construction Industry are not Aware of Implications.

Most people in the construction industry have not studied this new law's language on the erroneous assumption that it is narrowly drawn and not likely to affect them. The legislation is designed to correct perceived abuses by corporate executives and accountants of publicly traded companies. The best known provision requires high corporate officials (CFOs and CEOs) to certify, under the threat of enhanced potential criminal and civil responsibility, the accuracy of their company's financial statements.

Despite Senator Sarbanes statement that the law "applies exclusively to public companies . . . . It is not applicable to private companies,"[6] parts of the legislation will have a much wider impact.

Sarbanes-Oxley's Major Provisions

The major provisions of the law, many of which do not affect the construction industry, are:

- Creation of an Accounting Oversight Board, overseeing accounting firms for public companies, to set auditing standards and investigate auditing transgressions.

- Limitations on non-auditing work that accountants can perform for auditing clients.

- Increased direct responsibility of corporate officers and directors for public company financial disclosures that, if later deemed to contain material inaccuracies, would require these officers to return all bonuses, stock or stock option compensation earned in the period.

- A requirement that members of a public corporation's audit committee contain at least one financial expert, that they be independent and that their sole com-

pensation is limited to their service as independent members of the board.

- Disclosure of all off-balance-sheet transactions and conflicts of interest,[7] with the requirement that officers, directors and shareholders owning 10% or more of the company's stock report insider transactions no later than the second day after a covered transaction.

- A requirement that stock analysts disclose potential conflicts, including how much stock the analyst owns in any recommended company. Analysts are protected from retaliation from companies for their unfavorable reports.

- "Whistleblower" protection for persons who report violations of this law.[8]

- Requirement that attorneys who represent public companies report material misdeeds to either the chief legal officer or the chief executive officer of the company.

- Prohibition against insider trades by directors and officers in company stock during blackout-periods for employee-owners of the stock in their 401(k) plans, who must receive written notice at least 30 days in advance of any blackout period.

- Enhanced criminal penalties of up to 25 years and criminal and civil fines of up to $25 million.[9]

Impact on the Construction Industry and Sureties

Engineering News Record (*ENR*) noted, initially, "Executives and experts downplayed the impact on an industry as conservative and steady as construction. 'We're not as vulnerable.'"[10] There are not that many publicly traded construction or design-professional organizations. Sureties are virtually all publicly traded.

Nevertheless, even where the provisions are specifically directed at public companies, these provisions will, undoubtedly, have an indirect effect on contractors and sureties.

For instance, the new rules requiring disclosure of critical estimates, may result in the requirement that private construction companies, seeking bonding from publicly held sureties, or loans from publicly traded lending institutions, provide much greater disclosure of their financials, in order that the sureties and lenders meet the requirements of Sarbanes-Oxley.[11]

Impact on Outside Directors

ENR also opines that the new law will discourage people from willingness to serve as independent outside directors. This reluctance is likely to filter down to private corporations. *ENR* notes that, considering the increased potential for directors to be held liable, "one law firm is already offering to perform 'passive liability audits' for directors and executives in light of the new law."[12] Moreover, given the potential risks of serving as an independent director, private construction companies can expect their directors to be much more involved, asking harder questions and not assuming the passivity to which companies have become accustomed.

Whether public or private, all corporations are going to need directors. A partner in a national executive recruiting firm referred to its new "growth industry"—finding independent directors for public boards. One publicly traded company client had to turn out five of its current directors who could not meet the criterion of independence mandated by the law.

Sarbanes-Oxley Establishing "Best Practices"

Many believe that these new requirements will evolve into "best practices" that will provide reinforcement of existing state corporate law provisions or which may come about as a reaction to the new federal legislation.[13] Private construction corporations must, therefore, observe changes in corporate law legislation in their states of incorporation.

Moreover, if a contractor is seriously considering either going public or being acquired by a public company, it ignores the strictures of Sarbanes-Oxley at its peril since "a public company will want to have their governance practices, accounting reports and financial systems as close to the requirements of Sarbanes-Oxley as possible in order to avoid any problems."[14]

Requirement that Contractors Provide More Transparent Financials

ENR has noted that the law will require publicly traded construction companies to provide more information to its stockholders (and correspondingly, to the public), including surety underwriters.[15] Designers, as well, will be affected by their public clients' need for information since "capital investment decisions by public companies may require them to keep careful records of advice from design firms and contractors. Should projects prove costly and hurt a company's financial performance, the build/no-build decision and how it was made could become a focus."[16]

Clearly, publicly traded construction companies and publicly traded sureties will feel the impact. Not quite as apparent, however, are a number of other less obvious impacts.

Certified Disclosures Benefit Sureties

Benefits of this legislation include the increased and certified disclosure requirements that should provide more reliable information. From this surety, underwriters may make more informed decisions regarding whether, and to what extent, they will provide coverage to publicly traded contractors. Since there must be disclosure of "off the balance sheet" transactions, underwriters will have a better basis from which to make these decisions. CEOs and CFOs are required to certify that an SEC filing "fully complies with the requirements of those sections of the Exchange Act and . . . fairly presents, in all material respects, the financial condition and results of operations of the company."[17] This certification applies to quarterly filings and should not only be more

reliable but quite fresh. Assuming these "best practices" become part of corporate law generally, the information from private companies may become more reliable. ENR noted that "many CEOs

"When sureties sustain large verdicts and significant losses, there is intense scrutiny regarding the setting of reserves prior to those losses."

[of private companies] say they are already following the [Sarbanes-Oxley] law or plan to."[18]

Disclosures and Certifications Create Burdens for Sureties, Too.

The setting of reserves is a very important function that all sureties perform. Those public company sureties will have to be even more vigilant in ensuring their reserve accuracy. Recently, sureties have seen enormous verdicts against them. Moreover, a number of publicly traded sureties have gone into receivership. When sureties sustain large verdicts and significant losses, there is intense scrutiny regarding the setting of reserves prior to those losses. The potential liability of corporate officers, both civilly and criminally, will lead to the expectation that the heads of the surety claims departments are more careful in these determinations.

Contractors and Sureties are Going to Have Deal with the Bane of the Whistleblower.

In their zeal to eradicate fraud, Congress extended so-called "whistleblower" protection for employees and others who "assist in a proceeding . . . relating to an alleged violation of " securities laws. This provision reaches far beyond Wall Street. This remedial legislation assumes that only the noble will avail themselves thereof. Unfortunately, laws such as these protect both the virtuous and the ignoble.

Contractors already know that "whistleblower" protection is afforded in the OSHA and government contracts contexts. "Relators" is the term used to describe those persons. They are typically current or past employees who report alleged fraudulent actions on the part of their government contractor-employers in so-called "Qui Tam" or private attorney general actions. Government contract lawyers who have had dealings with them know what havoc these people can wreak.

Often relators are simply disgruntled or marginal employees, harboring grudges or seeking to avoid termination. They have been known to call the "hotlines" their employers are required to maintain, to insulate themselves from justifiable termination. Often, they are involved in fraudulent or other illegal conduct. Rather than being punished, they become "untouchable."

The Sarbanes-Oxley whistleblower provision covers not only officers and employees of publicly traded corporations, but also their contractors, subcontractors and agents. This group is insulated against discharge, demotion, suspension, threat, harassment or any other discrimination arising from their protected conduct.[19]

The scope of protected activity is also very broad, including any information relating to violations of mail, wire, bank or securities fraud laws, violation of any SEC rule or regulation or "any federal law relating to fraud against shareholders" including, undoubtedly, Sarbanes-Oxley.[20]

How difficult is it to conjure a circumstance wherein a contractor and a subcontractor are in a dispute where the contractor wishes to default terminate the subcontractor? The subcontractor accuses the contractor of mail or wire fraud, invoking the whistleblower provisions of Sarbanes-Oxley. Can the contractor now default terminate the subcontractor with alacrity, or does the contractor potentially run afoul of the provisions of the act?

This is not the only risk faced by the contractor. Sarbanes-Oxley provides severe criminal sanctions (18 U.S.C. § 1513(e)) of up to 10 years if an individual "knowingly and with intent to retaliate, takes any action harmful" to anyone who had provided truthful information in the investigation of the commission of *any* federal offense.[21]

Sarbanes-Oxley provides an extremely favorable burden of proof vis-a-vis retaliation. Once a whistleblower demonstrates, directly or circumstantially, that "protected activity" was a contributing factor in any adverse action against the whistleblower, the burden then shifts to the other party to prove, by clear and convincing evidence, that it would have acted in the same way had the employee not "blown the whistle." [Emphasis added][22] Thus, these new whistleblower protections are rife for mischief.

Disclosure Duties of Attorneys can Create Ethical Issues for Surety Lawyers.

The act requires attorneys who practice before the SEC to report material violations of law by their clients or employers to management. This raises the question of what obligation a surety or construction lawyer has to report violations of law to management when lawyers in his firm also practice before the SEC.

If these lawyers learn of violations, and if they also practice before the SEC, or have partners who do, are they required to report these, as yet, undetected allegations to management? Moreover, as will be discussed, *infra*, attorneys representing contractors and sureties are involved increasingly with discovery issues relating to electronic information. Do these attorneys have an obligation to bring issues relating to destruction of electronic information to company management?

Who Can Contractors or Sureties Use as Their Consultants?

Most of the top accounting firms have construction consulting services. In serious cases, large public contractors and sureties employ accounting firms to analyze claims and to be expert witnesses. Under Sarbanes-Oxley, if the accounting firm they are or would like to use is also providing audit services for the surety or the construction company, these accountants are apparently barred from doing so by Section 201 of the act. This restriction prevents the accountant from any potential conflict in its role as "public auditor."

Sureties and Contractors Need to Review their Document Retention Policies.

Sarbanes-Oxley adds a new section to Title 18, U.S. Code, i.e., § 1519. This provision is not limited in any way to public companies and applies to anyone who "knowingly alters, **destroys** . . ." etc., any document, etc., with wrongful intent involving "**any matter** within the jurisdiction **of any department or agency of the United States**, or any case filed under Title 11, or in relation to or **contemplation of any such matter or case**," faces the potential of substantial fines and imprisoned of up to 20 years, [Emphasis added].

This section could prove to be the most vexing of all for contractors and sureties who are involved in any construction project for the United States. The breadth of this language is extraordinary. For instance, if a government agency initiates default proceedings against a contractor, is this now an "investigation . . . of . . . [a] matter within the jurisdiction of any department or agency of the United States . . . or in . . . contemplation of any such matter or case . . . ?" Does this action trigger an obligation on the part of the contractor and surety to begin interdicting their standard document destruction/ retention policies, to ensure that no e-mails or other documents are not destroyed in the ordinary course? How does it avoid the contention that they have not destroyed "any record, document or tangible object"? Does this mean that once the parties have notice of a problem on a Federal project that they have an obligation to ensure that all "records, documents and tangible objects," (including e-mails) be retained?

It is common for all large organizations to have standard document retention/ destruction policies in order to save the limited storage capacity of their computers. The potential of a substantial fine and a 20-year sentence, however, creates an enormous dilemma.

Some of the most devastating documents used against corporations have been e-mail. Recent Microsoft litigation and investigations of Merrill Lynch demonstrate this clearly. Is the answer to save all e-mail? Is there, truly, a way to do so?[23]

Cases imposing sanctions for failure to maintain electronic information are proliferating. In the recent Fourth Circuit case of *Trigon Insurance Co. v. United States*,[24] the court required the government to pay the costs for computer forensic experts to restore deleted drafts of its key expert's reports, consistent with the document retention policy of the expert's firm. The government was required to pay the plaintiff's attorneys fees regarding the alleged spoliation issue.

In reviewing these precedents, and taking into consideration the breadth of language in the newly enacted §1519, it is no wonder that "[g]iven the political and legal forces at work today, as well as the potential consequences of evidence spoliation charges, there is certainly 'no time like the present' for financial firms and other corporations to focus on electronic document retention policies as one of the significant corporate management issues that must be thoroughly reviewed."[25]

Conclusion

Obviously, this is not an exhaustive treatment of the Sarbanes-Oxley Act. It is meant only to be a "wake-up call" to those who are either totally unaware of the act or who are laboring under the mistaken assumption that this legislation is limited in scope and is not likely to affect them.

This 131-page law will likely affect everyone involved in the construction process, including sureties and his or her lawyers. "Forewarned is forearmed." ⚖

Endnotes

1 Pub. Law No. 107-204, Also known as the "American Competitiveness and Corporate Accountability Act of 2002," the act takes its name from the two principal authors, Senator Paul Sarbanes (D—Md.), and Congressman Michael G. Oxeye (R—Ohio). A more extensive article by

Sarbanes-Oxley *continued on page 27*

Dan Toomey is a partner in the Tysons Corner office of Venable, Baetjer & Howard's construction group. A former division chair of the ABA Forum on Construction, Toomey is an adjunct professor of construction law at his alma mater, Georgetown University Law Center.

Tamara McNulty is an associate in the Tysons Corner office of Venable, Baetjer & Howard's construction group. McNulty is a graduate of the University of Wisconsin Law School and a member of the bars of Wisconsin, Virginia and the District of Columbia. She practices primarily in the areas of surety, construction law and commercial litigation.

Sarbanes-Oxley *continued from page 21*

these authors discussing this topic appears in the winter edition of the Construction Lawyer, of the ABA Forum on Construction.

2 *The New York Times* noted in its October 1, 2002, business section at p. C1 that, "The sinking feeling that gripped the American stock market caused the Standard and Poor's index of 500 stocks to plunge 17.6 percent, its worst quarterly showing since the market crashed in late 1987." *The Wall Street Journal* noted on September 30, 2002, that industrial stocks were at their lowest point in four years, hammered by persistent worries about an unsteady economic recovery.

3 *Los Angeles Business Journal*, August 26, 2002, p. 24

4 Hamilton & Trautmann, SARBANES-OXLEY ACT OF 2002 LAW AND EXPLANATION (CCH, Inc. 2002) (hereinafter "Hamilton").

5 *Financial Times*, August 22, 2002, p. 27.

6 148 *Cong. Rec.* S7350-04.

7 *The New York Times* predicted [correctly] the likely indictment of former CFO of Enron, Andrew S. Fastow, in connection with criminal fraud in connection with his role in such off-balance-sheet transactions, noting that these activities "might prove to be the most explosive element of a raft of allegations that the government is expected to bring against Mr. Fastow." p. C1 (October 1, 2002).

8 Kaplan & Hannapel, "Life After Sarbanes-Oxley—Hear the Whistle Blow," *Legal Times*, P.32 (October 7, 2002).

9 For an excellent and concise summary of the new criminal penalties, *See*, W. Warren Hamel, Thomas J. Kelly, Jr., Kathleen S. Dolan, "Life After Sarbanes—They Got Tougher," *Legal Times*, p. 34 (October 7, 2002).

10 *Engineering News Record* (ENR), "News Site: Management: Governance Rules Touch Industry," August 12, 2002, pp. 10-11.

11 *Ibid.*

12 *Id.* at 11.

13 Andrew J. Sherman, "Corporate Governance and Reporting in the new age of Scrutiny: Implications for Both Public and Privately-Held Companies," Wingman Center for Entrepreneurship, University of Maryland, (October 31, 2002) (unpublished).

14 *Id.*, at 7.

15 *Ibid.*

16 Supra, n. 10, at 11.

17 24 *New York Law Journal*, p. 9 (August 22, 2002).

18 *Supra*, n. 10, at 11.

19 Kaplan & Hannapel, "Life After Sarbanes-Oxley—Hear the Whistle Blow," *Legal Times*, P.32 (October 7, 2002)

20 *Ibid.*

21 *Ibid.*

22 *Ibid.*

23 For an interesting article discussing this dilemma, see Tambe, Redgrave 17 *Washington Legal Foundation Legal Backgrounder* (August 9, 2002) No. 31. Interestingly, on December 4, 2002, *The Washington Post* reported that five Wall Street companies had agreed to pay $1.65 million each to the SEC for failing to properly save e-mail. *Wash. Post*, December 4, 2002, p. B-1.

24 204 F.R.D. 277, 201 U.S.Dist. LEXIS 18824 (E.D. Va. 2001).

25 *Supra*, n. 24.

Implied Indemnity *continued from page 17*

potential liability for purely economic damages, is unclear.

16 One or two cases have arisen in claims for breach of express or implied warranties under the Uniform Commercial Code. *See Whittle v. Timesavers, Inc.* 572 F. Supp. 584 (W.D. Va. 1983); and *Wingo v. Celotex Corp.*, 834 F.2d 375 (4th Cir. 1987). Both of these cases involved claims for personal injuries based upon the theories of negligence and breach of warranty. Unlike cases involving claims for purely economic damages, a lack of privity does not insulate the proposed indemnitor from liability to the original plaintiff for injury to person or property, either under a negligence or a breach of warranty theory. Also, the lack of privity is no defense under Virginia Code § 8.2-318 to an action against a manufacture or seller of the goods for breach of warranty or for negligence resulting in an injury to person or to property. Therefore, the requirement that the proposed indemnitor be liable to or owed a duty to the original plaintiff was met in these cases. They offer questionable support for a claim of implied indemnity against liability for purely economic damages. Although a lack of privity does not bar of claim for direct damages for breach of warranty under the UCC, under *Beard Plumbing & Heating v. Thompson Plastics*, 254 Va. 240, 491 S.E. 2d 731 (1997), "economic consequential damages" are precluded where no privity exists so it must be presumed that implied indemnity will not lie against liability to a third party for this type of damages.

17 *See Richmond Metro Authority v. McDevitt St. Bovis, Inc.*, 256 Va. 553,507 S.E. 2d 344 (1998), to the effect that the negligent performance of a duty imposed upon a party by contract is not actionable in tort absent a corresponding common law duty. *cf. Accordia of Virginia Ins. Agency, Inc. v. Genito Glenn, L.P.*, 263 Va. 377, 560 S.E. 2d 246 (2002), upholding the trial court's submission of a negligent performance of a contract claim for economic loss damages to the jury where privity existed between the parties.

18 *Sesenbrenner v. Rust, Orling & Neale, Architects, Inc.* 236 Va. 419, 374 S.E. 2d 55 (1988); *Blake Const. Co. v. Alley*, 233 Va. 31, 353 S.E.2d 724 (1987).

19 *Valley Landscape Co. v. Rolland*, 218 Va. 257, 237 S.E.2d 120 (1977); *Virginia Int'l Terms., Inc. v. Chesapeake Marine Terms., Inc.*, 879 F. Supp. 31 (E.D.Va 1995).

20 *International Surplus Lines Ins. Co. v. Marsh & McLennan, Inc.*, 838 F.2d 124, 126 (4th Cir. 1988), quoting *Peoples' Democratic Republic of Yemen v. Goodpasture, Inc.*, 782 F.2d. 346 (2nd Cir. 1986).