

EFFECTIVE CORPORATE GOVERNANCE?

Sarbanes-Oxley in the Courts

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Integrative Exercise

Abstract

After numerous corporate scandals at the turn of the twenty-first century, Congress passed the Sarbanes-Oxley Act which established federally mandated corporate governance policies. Although a highly contested piece of legislation, I argue that we would expect to see positive governance policies enforced in U.S. courts that apply the Act's statutes. However, after an assessment of U.S. Federal Appeals cases, I find that the Sarbanes-Oxley Act does not lead to positive governance policies enforced in the courts.

At the end of 2000, Enron posted a healthy profit of \$979 million (Mallin 2010). However, just nine months later in early October 2001, the corporation declared a non-recurring loss of \$1 billion and a write-off of \$1.2 billion against shareholders' funds (Mallin 2010). Finally, they filed for bankruptcy on December 2, 2001 in what was then the largest bankruptcy in history (Mallin 2010). In the months and years following, facts materialized showing the failure of corporate governance measures that allowed for a system wherein Enron could easily overwrite its growth and underwrite its losses (Mallin 2010).¹ Public outcry resulted in newly implemented corporate governance structures at the federal level through the Sarbanes-Oxley Act (SOX) which Congress passed in 2002.

Whether or not SOX has led to effective reform of corporate governance policies, however, is highly contested. The issue has resulted in numerous studies that have huge implications for our society. SOX's effectiveness could indicate whether other scandals will emerge on the large-scale level of Enron. My paper contributes to these studies by assessing the effectiveness of SOX in a way it has not been previously addressed – whether the application and interpretation of SOX in federal courts has resulted in upholding positive corporate governance practices and renouncing harmful ones. A study focused solely on judicial interpretation and application of SOX is an important addition to the literature, especially within our common law society. The American common law system relies on decisions in previous cases to set precedence for decisions and applications in future decisions. Therefore, an understanding of judicial interpretations and applications of SOX in courts allows for an understanding of whether

¹ The sudden implosion of Enron highlighted how the assumptions that we had previously relied on soon showed serious problems such as: “connections between the stock market prices and underlying economic realities, the reliability of independent auditors, financial standards, and copious disclosure in protecting integrity of financial reporting, the efficacy of corporate governance in monitoring managerial performance, the utility of stock options in aligning managerial and shareholder interests, and the value of employee ownership as both an incentive device as well as a retirement planning tool” (Gordon 2002: 1235).

SOX has created impediments to the detrimental practices at Enron and whether new, better governance practices have been implemented.

The Organization for Economic Cooperation and Development (OECD) broadly defines corporate governance as “a set of relationships between a company’s board, its shareholders and other stakeholders.” More specifically, Mallin (2010) describes five of the main features of corporate governance:

“1) it helps to ensure that an adequate and appropriate system of controls operates within a company and hence assets may be safeguarded; 2) it prevents any single individual having too powerful an influence; 3) it is concerned with the relationship between a company’s management, the board of directors, shareholders, and other stakeholders; 4) it aims to ensure that the company is managed in the best interests of the shareholders and other stakeholders; and, 5) it tries to encourage both transparency and accountability, which investors are increasingly looking for in both corporate management and corporate performance.”

In this paper, I argue that the Sarbanes-Oxley Act, if effective, will show positive corporate governance practices reflected in court rulings. I define positive corporate governance policies as those that increase the protection and security of outside investments and eliminate the types of fraudulent practices that led to the corporate scandals in the early 2000s. In order to evaluate my hypothesis, I analyzed twenty-six cases from U.S. Federal Appeals Courts that dealt with interpretations and applications of SOX statutes. I found that the cases, in general, did not enforce positive governance practices and in fact have led the courts to enforce many of the same policies that resulted in Enron’s downfall.

A Need for Legally Imposed Corporate Governance

In order to place my question into the larger area of theoretical research on corporate governance, I must first explain the fundamental issue that corporate governance attempts to regulate. The core issue in corporate governance is the balance between “managerial discretion” by the insiders versus protection of the outsiders (Murphy & Topyan 2005). This central issue

can be divided into two main problems that corporate governance faces which are relevant to my study, the “collective action problem” and the “principle-agent problem”.

In the collective action problem, dispersed common stock ownership means that many small shareholders are unable to effectively exercise their ownership rights (Murphy & Topyan 2005). Instead, management steps in to fill that void, often using it to enhance their own interests at the expense of the investors’ interests (Murphy & Topyan 2005). Although investors have a stake in making sure the corporation is maximizing their shareholder profits, many investors own too little of any one stock such that the costs of overseeing a corporation outweigh the benefits of doing so (Murphy & Topyan 2005).

Denis (2001) highlights the principle-agent problem: principles (the outside investors, creditors, and other stakeholders) must trust the agents (inside management) with their investments in the belief that the agents will maximize the shareholder value. However, agents have a conflict of interest of whether to maximize the principle’s value or whether to maximize their own value. Denis (2001) proposes three different remedies to this problem for the principles: 1) contractually “bond” the agent to do as the principle would like, 2) monitor agent’s actions, and, 3) have incentive agreements which reduce the conflict of interest between the agent and principle. However, in the first situation it is impossible to spell out every possibility and how the agent should react in a contract. In the second situation, the principles are not effective monitors because they are often dispersed holders of the stock and they do not have the knowledge to monitor agents. Finally, in the third situation, the conflict of interest can never be narrowed enough to effectively erase the principle-agent problem. Therefore, these inherent difficulties must be addressed in a different way. This is where legal mechanisms can step in to better control corporate governance and the interests of the shareholders.

Corporate Governance in the United States

The United States presents an interesting case on the topic of corporate governance. It is dissimilar to most other developed countries, in that it does not have a definitive corporate governance code (Mallin 2010: 43). Instead, a system of government acts and regulatory committees set up corporate governance in the United States. Congress expanded this method when it passed the Sarbanes-Oxley Act in 2002.

The Sarbanes-Oxley Act of 2002 (SOX) was passed after public outcry from the numerous failures of large corporations (starting with Enron but soon followed by WorldCom and Global Crossing) that showed gaps in corporate governance structures. SOX was the most extensive set of federal and business regulations passed by Congress since 1934 (Murphy & Topyan 2005). Specifically, SOX focuses on several different areas of corporate governance including: CEO and CFO certification of corporate financial reports; the strengthening of external auditor independence as well as the strengthening of the internal audit committee; and, forming a new external regulatory body for auditors, the Public Company Accounting Oversight Board (PCAOB) (Table 1) (Mallin 2010).

Since its implementation in 2002, there has been an explosion of studies assessing the effectiveness of SOX. Some scholars, such as Chhaochharia and Grinstein (2005), have studied the direct link between SOX and changes in board structure leading to stronger board independence. Further studies have examined effects of firms that voluntarily deregistered with the Securities and Exchange Commission (SEC) both pre- and post-SOX (Leuz et al. 2008). What studies have not assessed yet is whether reliance on SOX in the courts has led to enforcement of positive corporate governance policies. This is perhaps due to the hierarchical system of response under SOX; the SEC and PCAOB have original jurisdiction in handling

complaints. If a party contests a decision at that level, then the case proceeds to the Federal Appeals Courts. Scholars have focused mainly on the first response system. However, it is important to understand how the courts have applied and interpreted SOX in order to have a better overall understanding of its effectiveness or ineffectiveness.

Method

Debates on Methodology for Corporate Governance

The passing of SOX resulted in a debate over the effectiveness of legally implemented corporate governance policies. Scholars such as De Nicolo et al. (2008) argue that tracking changes in corporate governance through legal implementation of corporate governance regulations is much less effective than tracking corporate governance through outcome-based measures. They argue that tracking changes in corporate governance through *de jure* implementation is difficult because of lags in implementation and/or enforcement (De Nicolo et al. 2008). Furthermore, *de jure* implementation is not a true reflection of corporate governance measures because many corporations choose to improve their governance on their own (De Nicolo et al. 2008). Self-motivated changes, however, run contrary to the principle-agent problem discussed previously. The agents (the insiders who run the corporations) will not increase governance standards on their own because it will always be against their interest to do so. Moreover, De Nicolo et al. fail to acknowledge the benefits of *de jure* implementation in a common law society. American common law relies on previous court decisions to set precedence for future court decisions. Therefore, if the courts originally and consistently hold corporations with harmful corporate governance practices accountable in the courts, this then signals to other corporations that such practices will be penalized. Although tracking changes in

corporate governance policies because of a court-mandated order may be difficult, it is still extremely helpful and important to understand how the court has interpreted SOX.

In this paper, I argue that legal application of corporate governance policies through SOX would lead to enforcement of positive governance in the courts. La Porta et al. (2000) find that legal implementations of corporate governance procedures are the best way to ensure investor protection from expropriation. In their study, La Porta et al. (2000) state, “When investor rights such as the voting rights of the shareholders and the reorganization and liquidation rights of the creditors are extensive and well enforced by regulators or courts, investors are willing to finance firms. In contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well.” Jensen and Meckling (1976) find the usefulness of the courts in ensuring investor protection through the enforcement of contracts that courts uphold to legally imposed standards. La Porta et al. (2000) further address the contentions of imposing legal regulations on the free market. They contend that such impositions are necessary because a contract struck between an individual investor and a corporation, without any contract regulation by the courts, is very difficult for courts to interpret and uphold (La Porta et al. 2000). Therefore, it is cost effective to have broad corporate governance policies that apply to every contract between an investor and a corporation.

Researchers, such as La Porta et al. (2000), theorize that legal implementation of corporate governance policies leads to better protection of outsiders (investors, creditors, and other stakeholders). As the scale tips toward outside interests, corporate practices move away from risky and fraudulent policies such as expropriation and overwriting profits; those same risky and fraudulent practices caused the collapse and reverberating effects of corporations

during the early 2000s. Therefore, to move away from such practices would be an overall improvement in corporate practices.

Legal implementations of corporate governance highlight important indicators of the effectiveness of corporate governance which look to the legal rights of outsiders. La Porta et al. (1998) identified several key legal rights of investors and creditors that are present in good corporate governance structures. Investor rights cover the following: voting powers, ease of participation in corporate voting, and legal protections against expropriation by management (La Porta et al. 1998: 1115). They further found legal rules pertaining to the rights of creditors: respect for security of the loan, ability to grab assets in case of a loan default, inability of management to seek protection from creditors unilaterally (La Porta et al. 1998: 1115). These legal rules measure the ease with which investors and creditors can exercise their powers against the inside management which again relate back to the tipping of the scale away from risky and fraudulent corporate practices.

My Methodology

The Sarbanes-Oxley Act is a broad piece of legislation that covers numerous issues of corporate governance (Table 1). Its use by corporations is similarly wide-ranging and its enforcement through different government institutions is hard to track at-large. Furthermore, SOX is still a new piece of legislation as only nine years have passed since its initiation. This leads any study of the effectiveness of SOX to be qualitative and tentative (Coates 2007).

As was discussed, Congress passed SOX in reaction to the rise in corporate scandals at the turn of the twenty-first century. They passed SOX in order to assuage investor fears over greedy corporations and as a way to impede such scandals from occurring again. To be truly effective, outside investors and creditors must be able to rely upon SOX when there are fears of

corporate scandals. People must be able to use the protections laid forth in SOX to stop the type of behavior that occurred in the Enron scandal. Judges have the power to interpret statutes and apply them to cases before them. If SOX were truly effective in stopping the type of corporate scandals it is meant to stop from occurring, then we would see judges relying on SOX to uphold good governance practices.²

I chose to study how the United States Courts of Appeals used SOX to uphold either claims of outsiders or insiders. I chose to look solely at the level of the Courts of Appeals because they have original jurisdiction, under SOX, to be the first court to assess any contested rulings from the SEC as well as the PCAOB. Furthermore, reliance on judicial opinions from federal courts controls for the types of laws relied upon; that is, it eliminates the possibility of interpreting SOX in light of differing state laws.

I obtained the judicial opinions that relied on SOX through the LexisNexis Academic database. I started by researching only those judicial opinions that relied on a statutory interpretation of SOX. I then whittled down the cases by looking solely at cases decided by the United States Courts of Appeals. The courts handed down opinions on 63 such cases between June 5, 2006 and September 30, 2010. I further narrowed down the cases I looked at by my choice to not assess cases concerning the statute of limitations clause in SOX. I did not assess such cases because they do not have a direct bearing on the effectiveness of SOX resulting in better corporate governance.³ The elimination of these cases left 26 cases for me to assess.

² Good governance practices are here defined as those practices which would increase the protection and security of outsider investments and eliminate the types of fraudulent practices that led to the corporate scandals in the early 2000s.

³ Cases surrounding the statute of limitations under SOX have generally found that SOX does not apply retroactively to issues of fraud that occurred prior to its passage in 2002. Although it extends the amount of time under which one can make a claim, this is only applicable to issues that occurred after the passing of SOX. See: *Glaser v Enzo Biochem, Inc.*, 126 Fed. Appx. 593 (4th Cir. 2005).

I then read the judicial opinion of each of these 26 cases, looking specifically for different factors such as: the status of the litigants (whether they were insiders or outsiders); the legal issue under question; judicial statutory interpretations of SOX; and, who the ruling was in favor of (Table 2 & Table 3). Once I assessed the cases, I categorized them by the legal issue under which they arose. I then compared each legal issue to the base assumptions one would expect to see if the application of SOX in courts resulted in enforcement of positive governance measures. These base assumptions come from the issues of corporate governance that arose in the Enron scandal and the expectations of how SOX would positively affect the issue. These base assumptions were then compared to the way SOX was used in the courts to address the legal issues.

Analysis

Base Expectations

Congress passed the Sarbanes-Oxley Act in direct response to dramatic corporate governance failures at Enron and WorldCom (Becht et al. 2003). It therefore “targets primarily the kinds of abuses in earnings manipulation and financial reporting uncovered by the Enron and WorldCom failures. Its main aim is to restore confidence in company financial statements by dramatically increasing penalties for misreporting earnings performance and reducing conflicts of interest for two main groups of monitors of firms, auditors and analysts. In addition, SOX provides stronger protections for whistle-blowers” (Becht et al. 2003: 66). The wording and direction of SOX adopts the goal of assuaging investor fears by putting in place roadblocks that would prevent the type of scandals that led to SOX in the first place. Analyzing SOX in terms of the different policy areas it addresses allows us to draw up basic assumptions on what we would see if SOX were effective.

SOX addresses nine specific corporate governance policy areas (Table 1). Of these nine mandates, two specific areas are relevant to my study: whistleblowing and CEO liability and accountability. These two are the only areas of SOX that have been addressed by the courts (with the exception of the statute of limitations clause which was excluded from this study as previously mentioned). I will first set forth my base assumptions of what we would expect to see if SOX were effective in enforcing positive governance under these two areas. Effective governance being that which leads to institutional changes that do not allow for the type of corporate scandal we saw with Enron.

Whistleblowing

Whistleblowing played such a large role in bringing to light the Enron scandal, that the person responsible for bringing it about – Sherron Watkins – was named *Time* magazine’s Person of the Year 2002 (House et al. 2004). Although not considered to be a technical whistleblower by some scholars, Watkins wrote a letter to Enron CEO Kenneth Lay in 2001 warning him “that Enron ‘might implode in a wave of accounting scandals,’ predicting that hidden ‘improper – possibly illegal-partnerships’ would lead to the energy-trading giant’s collapse (Scott and Lucas 2004).⁴ Although this letter did not surface to the public until after Enron declared bankruptcy, it does show a clear role that employees inside a corporation can play in reporting on scandals before they happen.

Prior to SOX, the Whistleblower Protection Act of 1989 protected whistleblowing activities in the United States.⁵ Congress realized the prominent role played by whistleblowers

⁴ Some scholars do not consider Watkins a whistleblower in the technical sense as she did not alert any authorities outside the Enron corporation who may have taken action to prevent and stop poor governance practices. See: House et al. 2004 and Ackman 2002.

⁵ “A federal agency violates the Whistleblower Protection Act if it takes or fails to take (or threatens to take or fail to take) a personnel action with respect to any employee or applicant because of any disclosure of information by the employee or applicant that he or she reasonably believes evidences a violation of a law, rule or regulation; gross

when they addressed the issue in SOX (Dworkin, 2007). Understanding what SOX addresses and how as to whistleblowing will give us our base assumptions we would expect to see if SOX led to effective policies. We can understand what SOX addresses in two ways that are commonly relied upon in legal studies – legislative intent and plain language of the text.

When asked whether current whistleblower protection is adequate, Senator Paul Sarbanes, who co-sponsored SOX, explained how SOX covers whistleblowers in an interview in 2004:

“This legislation includes numerous protections for whistle-blowers. Under the Act, audit committees of public companies are required to set up procedures to receive and address complaints regarding auditing and accounting issues. In addition, the Act requires audit committees to have procedures for employees to submit their concerns confidentially and anonymously to the audit committee, which enables the committee to investigate these concerns. A number of provisions were added to protect corporate employees who report fraud so they cannot be discharged, demoted, threatened, or otherwise discriminated against. This is a good question because understandably, employees can be apprehensive about blowing the whistle on their company. Even with this kind of protection, it takes a degree of courage for people to come forward. I think the legislation not only protects good people but also reinforces their best instincts. The legislation makes it much more difficult for the so-called "bad actors" to pull others down to the lowest denominator. Ultimately, I believe that people want to do the right thing. That's what's expected of them and that's what the system should and does support and reinforce. The people who do the wrong thing are the ones who should end up paying the penalty” (Lucas 2004).

In understanding and interpreting legislation, it is important to look at what Congress intended the legislation to do. One acquires a good understanding by examining Senator Sarbanes’ answer on what SOX was intended to do – it was intended to add “numerous protections” for potential whistle-blowers so that they could not be “discharged, demoted, threatened, or otherwise discriminated against” when they were simply being “good people” acting on their

mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety” (U.S. Securities and Exchange Commission, 2008).

“best instincts.” The legislature intended the act to be broad in order to encompass protection for all employees who are simply “good people” working against the “bad actors.”

Turning to the language in SOX, whistleblowing is specifically addressed in §806 and §1107. §806, titled “Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud”, states that “No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934, or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 ... may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee to provide information ... which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343 [wire fraud], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders...” The provisions under §806 differ from most previous state and federal statutes protecting whistleblowing by specifying internal whistleblowing as an appropriate channel (Dworkin, 2007). SOX also encompasses a broader definition of the types of prohibited retaliation as well as the definition of covered employees than previous whistleblower laws (Dworkin, 2007).

§1107 provides for criminal penalties against corporations that knowingly and intentionally retaliate against whistleblowers: “Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.” The extreme penalties listed in §1107 are unique to whistleblower legislation. However, a high bar was set in order to impose these

penalties – the whistleblower had to be correct in their information and must prove intent on the part of the defendants to act that way (Dworkin, 2007). However, the statute is also broadly written, protecting against “*any* action harmful to *any* person ... for providing *any* truthful information relating to ... *any* Federal offense.”

I made core predictions in what one would expect to see with whistleblowing protections based on the provisions for protection of whistleblowers and how these differ from previous legislation. If SOX created effective protections for whistleblowers, such protections would be relied upon in the courts when addressing issues of whistleblower protection. The broad language in SOX should be reflected in the courts’ interpretation and application of §806 and §1107. This would lead to widespread protection of almost all whistleblowers as SOX provides under §806 that whistleblowers must only “reasonably believe” that the activity they are reporting on violates one of the many forms of fraud covered under the statute. The broad types of retribution whistleblowers are protected from – they cannot be “discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against” – further implies coverage of almost all whistleblowers.

CEO and CFO Accountability and Liability

One of the major pitfalls in the Enron scandal was the actions of the heads of the corporation. Throughout the 1990s, Enron’s management consistently underwrote losses on published financial reports by setting up a system of special purpose entities (SPE) (Mallin 2010). These SPEs gave the appearance that key exposures were covered by third parties when in fact the SPEs were really just extensions of Enron itself and thus those risks were not covered (Mallin 2010). Furthermore, Enron used some of the SPEs to directly transfer funds to head executives (Mallin 2010).

Gray et al. (2005) explain how the executives of large corporations were largely a protected class before the implementation of SOX in 2002. Prior to that, no one was able to hold them to any set standard and there were no strong penalties in place to deter them from their wrongdoing (Gray et al. 2005). When Congress passed the Sarbanes-Oxley Act in 2002, they specifically addressed the role of CEOs and CFOs in accounting for the good practices of their companies. SOX legislation was not the first, however, in addressing the issue of fraud and theft; such laws are ancient (Coates, 2007). SOX, rather, is unique in attempting to address issues that arose under previous ineffective laws which allowed for fraudulent practices.

One of the largest areas that SOX addresses is the accountability of CEOs and CFOs in certifying their companies published statements (Zhang and Wiersema, 2009). §302 of SOX, titled “Corporate Responsibility for Financial Reports,” mandates that the “principal executive officer or officers and the principal financial officer or officers ... certify in each annual or quarterly report filed or submitted ... that 1) the signing officer has reviewed the report; 2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made; ... 3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.”

§304 outlines penalties against CEOs and CFOs for issuing improper or false statements: “If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, ... the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer ... and (2) any profits realized from the

sale of securities of the issuer ...” Such legislation was in response to the increasing policy of corporations to issue restatements (Figure 1). The policy of issuing restatements is detrimental to outside shareholders as they are unable to effectively interpret the company’s profits or loss. In addressing the issue, SOX broadly holds the CEO and CFO of a company accountable for issuing a financial statement. If SOX led to truly effective reform in corporate governance policies, the courts should rely on SOX to condemn the negative practices of CEOs and CFOs. In particular, we would see the courts holding the CEOs and CFOs liable for any misstatements in the financial reports offered by a company as SOX mandates the CEOs and CFOs certify the accuracy of these reports.

U.S. Federal Court of Appeals Cases

Whistleblowing

There were fifteen cases on whistleblowing under SOX that made their way to the United States Appeals Courts (Table 2). Of those fifteen that made it to court, thirteen of the cases were decided in favor of the employer rather than the whistleblower. From these cases, we can derive how judges have interpreted and applied SOX in corporate whistleblowing suits.

In general, judges have looked to regulations put forth by the Department of Labor as a test of whether an employee has a prima facie case under SOX (*Allen v Administrative Review Board* 2008). These regulations encompass four required elements that an employee must prove by a preponderance of the evidence⁶ in order to get protection under §806⁷ of SOX: “i) he or she engaged in protected activity, ii) the employer knew or suspected that the employee engaged in a protected activity, iii) the employee suffered an unfavorable personnel action, and iv) the

⁶ A burden of proof commonly understood to mean “more likely to be true than not.” The burden is satisfied if there is a greater than fifty percent chance that each element is true.

⁷ SOX §806, “Protection for Employees of Publicly Traded Companies who Provide Evidence of Fraud,” lists the protections attributed to whistleblowers. See: Sarbanes-Oxley Act 2002.

protected activity was a contributing factor in the unfavorable action” (29 C.F.R. §1980.104(b)(1)(i)-(iv)). Judges analyzed this standard in eleven different decisions⁸, finding in favor for the employers in all but one case – *Van Asdale v International Game Technology* (2009). In general, this is due in part to the way in which judges have defined the terminology in the four elements listed. It is also due to the restrictions judges have set on the ways whistleblowers can fulfill the above requirements.

Judges have narrowly defined the “protected activity” that whistleblowers partake in to mean an activity where the whistleblower can make a prima facie showing that he or she “reasonably believed” his or her employer’s conduct was illegal or fraudulent (*Gale v U.S. Department of Labor*, 2010; *Harp v Charter Communications, Inc.*, 2009; *Day v Staples, Inc.* 2009). The issue of whether an employee had “reasonable belief” that his/her employer was violating the types of fraud set forth in SOX has raised controversy over how a “reasonable belief” can be defined in the courts. In *Allen v Administrative Review Board* (2008), a judge wrote, “An employee's reasonable belief must be scrutinized under both a subjective and objective standard. The objective reasonableness of a belief is evaluated based on the knowledge available to a reasonable person in the same factual circumstances with the same training and experience as the aggrieved employee.” Another judge in *Livingston v Wyeth, Inc.* 2008, summed up the argument: “To ‘reasonably believe’ that company conduct ‘constitutes a violation’ of law, as those terms are used in [SOX], a plaintiff must show not only that he believed that the conduct constituted a violation, but also that a reasonable person in his position would have believed that the conduct constituted a violation.” Further interpretation concluded

⁸ See: *Allen v Administrative Review Board* 2008; *Getman v Administrative Review Board* 2008; *Livingston v Wyeth, Inc.* 2008; *Welch v Chao* 2008; *Potter v Hughes* 2008; *Platone v US Department of Labor* 2008; *Day v Staples, Inc.* 2009; *Harp v Charter Communications, Inc.* 2009; *Van Asdale v International Game Technology* 2009; *Gattegno v Administrative Review Board* 2009; *Gale v US Department of Labor* 2010.

that “reasonable belief” can only be based on a violation that has occurred or is in progress – not a belief that “a violation is about to happen upon some future contingency” (*Livingston v Wyeth, Inc.* 2008).

Judges have denied the reporting of certain activities to constitute whistleblowing under SOX §806, ruling that these activities do not meet one of the specific forms of fraud outlined in SOX.⁹ These activities include things such as: billing discrepancies (*Platone v U.S. Department of Labor*, 2008); untimely implementation of good manufacturing practices (*Livingston v Wyeth*, 2008); computer interest-calculation problems, and untimely refunds (*Allen v Administrative Review Board*, 2008). Judges have also narrowly defined “unfavorable personnel action” to exclude the possibility of damage to professional reputation and future work prospects (*Gattegno v Administrative Review Board*, 2009).

Another important judicial interpretation of SOX came from *Guyden v Aetna* (2008). After an employee, Guyden, notified her supervisors of a possible SOX violation, they fired her from her job. Although the employee had a clause in her contract signing away her right to protection under SOX, she argued that such protection was nonarbitrable because “arbitration is inconsistent with the purpose and structure of” SOX (*Guyden v Aetna* 2008). Guyden argued that §806 served two purposes – a public purpose as well as its “private compensatory function.” Under this view, “an individual who brings a SOX whistleblower claim is acting as a private attorney general, and the resulting litigation serves as a vehicle for transmitting to the public information about the corporation's fraudulent activity. [Guyden's] argument thus connects the SOX whistleblower provision with the policies of SOX more generally, the purpose of which is to enforce the accountability and transparency needed for well-functioning capital markets”

⁹ SOX §806 specifically outlines the types of fraud that a whistleblower can report on: §1341 [mail fraud], §1343 [wire fraud], §1344 [bank fraud], or §1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

(*Guyden v Aetna* 2008). However, the judge responded to Guyden's argument stating that although "the broad purpose of the Sarbanes-Oxley Act is to strengthen the integrity of capital markets" the whistleblowing provision "fills a far narrower gap" which is to protect "employees when they take lawful acts to disclose information or otherwise assist . . . in detecting and stopping actions which they reasonably believe to be fraudulent." The judge ruled that the whistleblowing protection offered under §806 is arbitrable in employee contracts. That is, an employee can sign away their right to protection for partaking in whistleblowing in an employment contract.

The final important judicial interpretation of SOX ruled that SOX whistleblowing protection does not have extraterritorial effect. In *Carnero v Boston Science Corporation* (2006), a Brazilian subsidiary of a Delaware corporation employed an Argentinean citizen who informed his superiors that the corporation was overcharging customers in Latin America; the company subsequently fired the employee. A judge ruled that although the suit would normally be valid under SOX §806, because the actions took place outside of the United States, SOX did not apply. The judge stated, "Where a statute is silent as to its territorial reach, and no contrary congressional intent clearly appears, there is generally a presumption against its extraterritorial application. It is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States. While the Sarbanes-Oxley Act's purpose of protecting investors and building confidence in U.S. securities markets may be a factor supporting extraterritorial application of [SOX], . . . the text of [SOX] remains silent as to any intent to apply it abroad. . ." (*Carnero v Boston Science Corporation* 2006).¹⁰

CEO and CFO Accountability and Liability

¹⁰ See: *Equal Employment Opportunity Commission v Arabian American Oil Co.*, 499 U.S. 244 (1991)

The other eleven cases referred to the United States Appeals Courts under SOX, dealt with issues of CEO and CFO accountability and liability (Table 3). Among these cases, judicial interpretation of SOX can be explained via four different issues: 1) criminal culpability of CEOs and CFOs under SOX; 2) whether financial misstatements signed by the CEO and CFO are indicative of scienter¹¹; 3) whether there is a private right of action¹² under §304¹³; and, 4) whether the reprimands under §304 are applicable if a financial statement is not reissued after a misstatement.

One of the areas addressed by judges is the criminal culpability of CEOs and CFOs under SOX. Thus far, judges have upheld criminal proceedings and have enforced the use of criminal penalties outlined in SOX against fraudulent corporate insiders. Specifically, in *Cohen v Viray* (2010), a judge ruled that the CEO and CFO cannot be released from criminal liability under SOX §304 through a civil settlement with investors; they must still be held liable for their actions. Judges have also applied criminal penalties in SOX to issues beyond CEOs and CFOs. In *U.S. v Panice* (2010), a judge held that the outline of criminal penalties in SOX applied to Panice's Ponzi scheme. The judge ruled that SOX was "enacted to protect investors and build confidence in U.S. securities markets" and even though Panice's Ponzi scheme was not at the same level of Enron, it was still "serious fraud and bilked investors of millions of dollars" (*U.S. v Panice*, 2010).

¹¹ "Scienter" refers to the intent or knowledge of wrongdoing prior to committing a crime.

¹² "Private right of action" refers to the ability of private parties to bring a lawsuit, even though it is not explicitly listed as a remedy by a statute.

¹³ SOX §304, "Forfeiture of Certain Bonuses and Profits," lists penalties against CEOs and CFOs if a restatement is required to be issued. See: Sarbanes-Oxley Act 2002.

A second area that has been widely addressed by judges is whether financial misstatements signed by the CEO and CFO pursuant to SOX §302¹⁴ are sufficient evidence in and of themselves of wrongdoing. The courts have widely held that misstatements in financial reports, although certified by the CEO and CFO, are not sufficient evidence of scienter in and of themselves (*Garfield v NDC Health*, 2006; *Central Laborers' Pension Fund v Integrated Electrical Services*, 2007; *Indiana Electrical Workers' Pension Trust Fund IBEW v Shaw Group, Inc.*, 2008; *Western Pennsylvania Electrical Employees Benefits Funds v Ceridian Corporation*, 2008; *Glazer Capital Management, LP v Magistri*, 2008; *Zucco Partners, LLC v Digimarc Corporation*, 2009). *Garfield v NDC Health* (2006) set forth the predominant legal rule relied upon by the courts on this issue: "a Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements. This requirement is satisfied if the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions." The judge ruled that needed to be a distinction, otherwise "scienter would be established in every case where there was an accounting error or auditing mistake made by a publicly traded company" (*Garfield v NDC Health*, 2006).

A further issue addressed by judges has been whether shareholders can bring a lawsuit against a company for overstating the company's profits. In *Diaz v Davis* (2008), shareholders filed a class action lawsuit against the corporation after the corporation publicly announced that due to accounting errors, it had likely overestimated earnings for the previous six quarters. The shareholders claimed that "the officers and directors breached their fiduciary duties to the

¹⁴ SOX §302, "Corporate Responsibility for Financial Reports," mandates that CEOs and CFOs must certify each annual or quarterly report filed stating that the report has been reviewed and is true to the officer's knowledge. See: Sarbanes-Oxley Act 2002.

corporation and its shareholders by issuing misleading financial statements and misrepresenting the business and prospects” (*Diaz v Davis* 2008). The courts have ruled that there is no private right of action in SOX §304 that allows outsiders to sue insiders for overstating profits (*Diaz v Davis*, 2008; *Pirelli Armstrong Tire Corporation Retiree Medical Benefits Trust v Raines*, 2008). These judges rely on the fact that “§304 of the Sarbanes-Oxley Act did not explicitly create a private right of action because nothing in the text made any mention of a cause of action” (*Diaz v Davis*, 2008). They found that SOX §304 only provides for the Securities and Exchange Commission to sue the CEO and CFO if the company has to restate its profits (*Pirelli Armstrong Tire Corporation Retiree Medical Benefits Trust v Raines*, 2008).

Finally, justices have addressed the issue of whether, under SOX §304, CEOs and CFOs are mandated to return bonuses or other incentive-based or equity-based compensation if there are reissue corrections of misstatements in their certified financial reports. In *Teachers’ Retirement System of Louisiana v Hunter* (2007), the judge ruled that despite inconsistencies in a company’s financial statement filed under SOX §302, if the CEO and CFO do not release a new statement with correct earnings §304 does not apply. That is, if they do not issue a restatement of profits, SOX does not mandate CEOs and CFOs to return bonuses or other incentive-based or equity-based compensation.

Comparison of Base Expectations and U.S. Federal Appeals Court Cases

Whistleblowing

At the outset of my analysis, I established what one would expect to see if SOX had created effective enforcement of corporate governance policies in the courts. I theorized that the broad structure of SOX in its whistleblowing sections would allow for broad application and protection of employees who partook in those activities. However, the ambiguity of the broad

legislation without explicit definitions of certain terms, has allowed the courts to narrowly define many aspects of SOX's whistleblowing protections. This has been done largely to the detriment of the employees as their burden has been raised to meet the protection standard under SOX §806. The burden has shown to be too high for most employees to reach with only two out of the fifteen cases reaching the United States Appeals Courts resulting in favorable opinions for the whistleblowers.

Further examination of the two cases out of the fifteen that resulted in judgments upholding the whistleblowers is important to understand how these two cases differ drastically from the other thirteen. One of these cases – *Stone v Instrumentation Laboratory Company* (2009) – dealt with overturning a lower court's misinterpretation of the whistleblower's right to *de novo* review in federal district court. The Department of Labor has original jurisdiction under SOX to hear complaints related to whistleblowing. However, if the Department of Labor has not issued a finding within 180 days, SOX allows the whistleblower to bring his case directly to federal court. In *Stone v Instrumentation Laboratory Company* (2009), Stone attempted to bring his case to federal court after not hearing back within the statutory 180 days from the Department of Labor. Originally denied the right to bring his case to court by a lower appellate court, the Federal Court of Appeal upheld his right to bring the case. Although a finding in favor of a whistleblower, this finding does not advance the rights of whistleblowers in any significant way.

In the second case that resulted in a judgment favorable to the whistleblower – *Van Asdale v International Game Technology* (2009), it is important to understand that the Van Asdales' were attorneys themselves who had extensive knowledge of and access to legal interpretations of SOX. They therefore were able to easily meet the burden of articulating a specific type of fraud covered by §806. This level of the burden was the most common

unsurpassable hurdle experienced by other attempted-whistleblowers who did not have legal training. Those without specific knowledge of technical aspects of the law have thus far been unable to achieve protection against retribution. As we cannot expect all employees of all companies to have this specified knowledge this presents an obvious disadvantage to whistleblowers.

As whistleblowing protection in SOX does not directly address two issues that have come before the courts – contract negotiability and jurisdiction applicability – allowing these issues to be decided in the courts has resulted in further damages to employee rights. Allowing for whistleblower protection under SOX to be contract negotiable effectively eliminates this provision; corporations may simply require that all employees waive their whistleblower rights. Such an outcome would allow for the continued quieting of employee complaints that occurred at Enron, an outcome that one would expect SOX to prevent if it pushed for effect governance policies. Furthermore, application of SOX’s whistleblower protection to only those actions that occur within the United States also harms from the type of action one would expect SOX to protect against. In our global economy, many corporations conduct business outside of the United States. If a business conducts fraudulent activities it may affect shareholder interests, but would not be protected under SOX as it currently stands.

CEO & CFO Accountability and Liability

In looking at the actual outcome of SOX interpretations in courts to the expected outcome if SOX were successful, there is evidence both for and against the effectiveness of SOX. On the one hand, judges effectively relied upon criminal penalties laid out in SOX against fraudulent CEOs and CFOs. This has positively enforced a heightened liability of those in charge of companies that commit fraud, just as I theorized SOX would if it were effective.

On the other hand, courts are enforcing increased rights of CEOs and CFOs under statutes originally meant to criminalize them. For instance, the fact that CEOs and CFOs do not need to return bonuses or other incentive-based or equity-based compensation if, after a mistake is found in an original financial report, they choose to not issue a restatement creates an incentive for these leaders to cover-up any mistakes that are found in their original report. It also creates incentive for CEOs and CFOs to simply not issue a restatement giving correct profits for the company. Such actions increase volatility in the markets and threaten outsider's investments – the type of issues one would normally see resolved in effective governance legislation.

The weight originally given to CEO and CFO certification of statements further decreases through the rulings that misstatements are not sufficient evidence of scienter. As plaintiffs cannot use misstatements to show intent of wrongdoing, the liability of CEOs and CFOs who sign them decreases. This may create an incentive for busy CEOs and CFOs to quickly certify a statement without ensuring it contains correct information. This is in direct contradiction to the base expectations that CEOs and CFOs would be held to the strictest liability in approving financial statements which outsiders rely upon in their investments.

Conclusion

"Enron's Capitalism: You have two cows. You sell three of them to your publicly listed company, using letters of credit opened by your brother-in-law at the bank, then execute a debt/equity swap with an associated general offer so you get all four cows back, with a tax exemption for five cows. The milk rights of the six cows are transferred via an intermediary to a Cayman Island company secretly owned by the majority shareholder, who sells the rights to all seven cows back to your listed company. The annual report says the company owns eight cows, with an option on one more" ("Enronism: Avenue of the Americas." 2002: 13.)

While the public was at first confused with the swift downfall of Enron in late 2001, the public quickly reacted in disbelief and shock when Enron's practices were exposed. Congress responded by passing the Sarbanes-Oxley Act, hoping to instill a sense of integrity in American

corporations. The effectiveness of the Act quickly became a debatable issue among scholars. However, left one area unturned – whether SOX led to positive governance practices enforced in courts that attempted to interpret and apply it. I argued at the beginning of this paper that if SOX were effective, that is exactly what we would expect to see. The importance of understanding SOX in this way comes from our basis as a common law society; it is important to understand how statutes are used in courts as that sets the precedence for future decisions.

However, after an analysis of how the Sarbanes-Oxley Act has been interpreted by the courts and applied to issues of corporate governance, it is evident that SOX has not led to effective corporate governance policies being enforced in the courts. If anything, the vagueness and ambiguity of the statute has exacerbated the problem as judicial interpretations have resulted in generally favoring insiders rather than outsiders. However, this must be understood within the limited nature of my study. Few cases have risen to the United States Federal Appeals Courts since the initiation of SOX in 2002. As SOX is still under ten years old, it remains to be seen how SOX will be applied to cases in the future.

In my study, I do not address issues of SOX brought to the Securities and Exchange Commission or to the Public Company Accounting Oversight Board. These two institutions often are the first respondents to issues raised under SOX before they reach the courts. SOX issues resolved in these institutions may result in different interpretations and applications of the statutes. Further research is needed in this area to assess whether SOX has led to effective reform under these institutions.

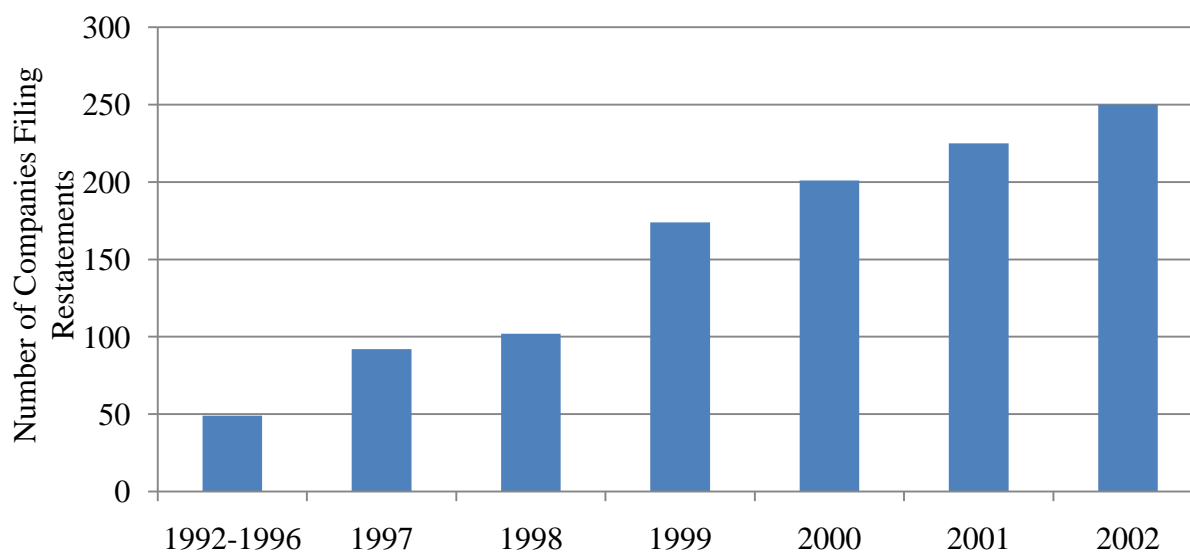
Appendix

Table 1: Sarbanes-Oxley Act of 2002 – Summary of Provisions

Sections	Topics
101-109	PCAOB's creation, oversight, funding, and tasks
302, 401-406, 408-409, 906	New disclosure rules, including control systems and officer certifications
201-209, 303	Regulation of public company auditors and auditor-client relationship
301, 304, 306, 407	Corporate governance for listed firms (audit committee rules, ban on officer loans)
501	Regulation of securities analysts
305, 601-604, 1103, 1105	SEC funding and powers
802, 807, 902-905, 1102, 1104, 1106	Criminal penalties
806, 1107	Whistleblower protections
308, 803-804	Miscellaneous (time limits for securities fraud, bankruptcy law, fair funds)

Source: (Coates 2007: 97)

Figure 1: Accounting Restatements by U.S. Public Companies 1992-2002



Sources: (Moriarity and Livingston 2001) for 1992-1996; (U.S. General Accounting Office 2002) for 1997-2002

Table 2: Federal Appeals Court Whistleblowing Cases under SOX

Litigants	Year	Summary	Group Upheld
<i>Carnero v Boston Science Corporation</i>	2006	Although meeting the normal burden under §806, a non-U.S. citizen working for a U.S. corporation abroad cannot be protected under SOX as it does not have extraterritorial effect.	Employer
<i>Platone v U.S. Department of Labor</i>	2008	Although Platone filed a successful complaint of fraud to OSHA, she failed to alert her supervisors with “definitive and specific” information about the fraud thereby alerting them to little more than a billing discrepancy which is not a “protected act” under §806.	Employer
<i>Potter v Hughes</i>	2008	Plaintiff failed to give “valid demand” to Board of Directors before filing her suit. The Board was entitled to receive a “valid demand” and was not required to piece together by inference the disparate events that, if taken together, might have been sufficient to require corporate action.	Employer
<i>Guyden v Aetna, Inc.</i>	2008	SOX §806 is arbitrable in employee contracts. Employee’s whistleblowing rights under SOX do not apply if there is a clause in their contract signing away those rights.	Employer
<i>Welch v Chao</i>	2008	An employee must have a “subjective belief” that his/her employer violated a pertinent law. Stating that a company violated generally accepted accounting principles (GAAP) without articulating how it constitutes fraud does not meet this burden and does not acquire protection under §806.	Employer
<i>Livingston v Wyeth, Inc.</i>	2008	Employee’s complaints that employer would not be able to timely implement good manufacturing practices is not protected under §806 as there was no “objectively reasonable basis” for the employee to have believed that the employer was violating securities laws.	Employer
<i>Getman v Administrative Review Board</i>	2008	Employee, a research analyst for a securities company, refusing to recommend high rating does not constitute “protected activity” under §806 if she cannot explain how it would violate securities law.	Employer
<i>Allen v Administrative Review Board</i>	2008	Dismissed employee’s whistleblower complaint as a computer interest-calculation problem, untimely refund problem, and billing problems do not qualify as fraud on the shareholders for lack of scienter.	Employer

<i>Stone v Instrumentation Laboratory Company</i>	2009	Upheld whistleblower's right to <i>de novo</i> review in federal district court if the Department of Labor has not issued final decision within statutory 180-day period.	Employee
<i>Gattegno v Administrative Review Board</i>	2009	A damning press release is not sufficient evidence in and of itself to show damage to a professional reputation. Therefore, Gattegno failed to show she suffered an unfavorable personnel action.	Employer
<i>Van Asdale v International Game Technology</i>	2009	Upheld employees' claims that they were unlawfully dismissed under SOX whistleblowing protection.	Employee
<i>Tice v Bristol-Myers Squibb Co</i>	2009	Employee cannot file wrongful termination case for another reason after losing under SOX §806.	Employer
<i>Harp v Charter Communications, Inc.</i>	2009	Employee failed first test of wrongful termination under SOX whistleblowing protection as could not show direct damning statements by supervisor.	Employer
<i>Day v Staples, Inc.</i>	2009	Employee failed to show that there was "reasonable belief" of fraud; denied protection under SOX §806.	Employer
<i>Gale v U.S. Department of Labor</i>	2010	Gale failed to establish a "reasonable belief" that his employer was engaging in prohibited activity under SOX as numerous complaints do not establish "subjective belief."	Employer

Table 3: Federal Appeals Court CEO & CFO Accountability & Liability Cases under SOX

Litigants	Year	Summary	Group Upheld
<i>Garfield v NDC Health Corporation</i>	2006	Mistakes in a corporation's financial report certified by the CEO and CFO are not indicative of scienter unless the CEO and/or CFO was "severely reckless" in certifying the accuracy of the financial statements.	Corporation
<i>Central Laborers' Pension Fund v Integrated Electrical Services</i>	2007	Under SOX, an inference of scienter is proper only if the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other "red flags," that the financial statements contained material misstatements or omissions.	Corporation
<i>Teachers' Retirement System of Louisiana v Hunter</i>	2007	Numerous GAAP violations do not meet the burden of "requiring" a corporation to release a new financial statement. If a company does not reissue a corrected statement, CEO and CFO penalties under SOX §304 do not apply.	Corporation
<i>Diaz v Davis</i>	2008	There is no private right of action under §304 of SOX; shareholders cannot sue corporations for overestimating earnings.	Corporation
<i>Glazer Capital Management, LP v Magistri</i>	2008	Financial certifications required under SOX §302 are not indicative of scienter in and of themselves.	Corporation
<i>Western Pennsylvania Electrical Employees Benefits Funds v Ceridian Corporation</i>	2008	An inference of scienter must be more than merely plausible or reasonable but at least as compelling as any opposing inference of non-fraudulent intent. Hundreds of accounting errors by numerous employees do not show sufficient inference of scienter.	Corporation
<i>Pirelli Armstrong Tire Corporation Retiree Medical Benefits Trust v Raines</i>	2008	There is no right of action under SOX §304; only SEC may sue the CEO and CFO if the company has to restate its earnings due to noncompliance with securities laws. Stakeholders cannot bring on a lawsuit.	Corporation
<i>Indiana Electrical Workers' Pension Trust Fund IBEW v Shaw Group, Inc.</i>	2008	SOX certification under §302, standing alone, is not indicative of scienter.	Corporation
<i>Zucco Partners, LLC v. Digimarc Corp</i>	2009	Statements made in filing a company's SOX certifications are not strong inference of scienter.	Corporation

<i>Cohen v Viray</i>	2010	Releasing CEO and CFO from liability for criminal actions in a settlement is not allowed under SOX §304; they must be held liable for their actions	N/A
<i>U.S. v Panice</i>	2010	SOX applies to Ponzi schemes because it was “enacted to protect investors and build confidence in U.S. securities markets”; though not at the level of Enron, Panice’s Ponzi scheme was serious fraud and bilked investors of millions of dollars.	N/A

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