SARBANES-OXLEY IN HIGHER EDUCATION: BRINGING CORPORATE AMERICA'S "BEST PRACTICES" TO ACADEMIA

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INTRODUCTION

In the summer of 2002, Congress and the President responded to the spectacular failures of several multinational corporations[1] by imposing a new set of reporting obligations on all publicly-traded corporations. Named for its two principal sponsors,[2] the Sarbanes-Oxley Act of 2002[3] established new standards for accountability for corporate officers and board directors, new requirements for acceptable corporate conduct, and new penalties, both civil and criminal, for transgressions.

Over the past three years, the not-for-profit sector—which has experienced its own visible and dramatic failures[4]—has found itself under increasing pressure to "adopt Sarbanes-Oxley." New York Attorney General Eliot Spitzer was the first state law enforcement official to accept its principles and propose them as mandatory standards in his state;[5] governors, attorneys general, and legislators in

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1. Enron, WorldCom, Tyco, and HealthSouth are familiar examples. The list is long, impressive, and continuing to grow.

2. United States Senator Paul S. Sarbanes, chair of the Senate Banking, Housing and Urban Affairs Committee, and Representative Michael G. Oxley, chair of the House Committee on Financial Services.

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.A.) [hereinafter Sarbanes-Oxley Act].

4. The origins of Drexel University College of Medicine actually lie in the bankruptcy of the Allegheny Health, Education and Research Foundation ("AHERF") in 1997—at that time, the largest bankruptcy of a not-for-profit corporation in the country's history.

5. *See* FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *New York Attorney General Proposes Corporate Reforms Affecting Not-For-Profit Corporation, available at*

other states have followed suit;[6] the Internal Revenue Service ("IRS") has become more active in examining non-profits;[7] lawyers and judges have questioned what duties are owed to non-profits by their trustees; and calls for greater accountability are coming from inside academia as well.[8] Meanwhile, in Washington, the Senate Finance Committee has issued a draft report and held hearings on the issue of whether, and how, Sarbanes-Oxley ought to be imposed on not-for-profit corporations.[9]

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http://www.ffhsj.com/cmemos/040209_corp_gov_reforms.pdf (Feb. 9, 2004) (citing Draft Memorandum, Attorney General's Legislative Program, Program Bill #02-03; Legislative Bill Drafting Commission 06251-01-3; Program Bill # 01-03; Legislative Bill Drafting Committee 01369-03-3.); Daniel J. Tschopp, Steve C. Wells & Douglas K. Barney, *Financial Debacles and State Regulation*, CPA JOURNAL ONLINE, (July 2004) *at* http://nysscpa.org/cpajournal/2004/704/essentials/p64.htm.

6. California became the first state to enact "Sarbanes-Oxley for Non-Profits" when Governor Schwarzenegger signed Senate Bill 1262 on September 29, 2004. 2004 Cal. Legis. Serv. ch. 919 (S.B. 1262) (West). The law requires all charities that receive or accrue gross revenues of $2 million or more in any fiscal year to prepare annual financial statements that are audited by an independent certified public accountant pursuant to standards for auditor independence, to appoint an audit committee, and to make its annual financial statements available to the public. *Id*.

7. On August 10, 2004, the IRS announced a new enforcement effort, called the Tax Exempt Compensation Enforcement Project, aimed at identifying (and eliminating) the provision of excessive compensation and other forms of financial benefits by tax-exempt organizations to their officers, directors, and other insiders. IRS, *IRS Initiative Will Scrutinize EO Compensation Practices*, *available at* http://www.irs.gov/newsroom/article/0,,id=128328,00.html (Aug. 10, 2004). The IRS expects to contact nearly 2,000 charities and foundations to seek more information about their compensation practices and procedures. *Id*. This initiative comes at a time when the salaries of top administrators are rising in a visible way. *See* Julianne Besinger & Sarah H. Henderson, *It's Lucrative at the Top*, CHRON. HIGHER EDUC., Nov. 19, 2004, at B3 (special supplement on executive compensation). The IRS' interest is not solely with executive compensation, however. *See* Joe Stephens & David B. Ottaway, *IRS to Audit Nature Conservancy From Inside*, WASH. POST, Jan. 17, 2004, at A1.

8. *See, e.g.*, NAT'L ASSOC. OF COLL. & UNIV. BUS. OFFICERS ("NACUBO"), *The Sarbanes-Oxley Act of 2002: Recommendations for Higher Education, available at* http://www.nacubo.org/documents/news/2003-03.pdf. (Nov. 20, 2003); Erin Strout, *Money & Management Notes: Smith's President Wants Accountability*, CHRON. HIGHER EDUC., July 23, 2004, at A25; Julianne Basinger, *Colleges are Urged to Shift Their Accounting Practices in the Post-Enron Era*, CHRON. HIGHER EDUC., Jan. 9, 2004, at A32; CORP. BD. MEMBER, *Next on the Griddle: Nonprofit Boards available at* http://www.boardmember.com/issues/archive.pl?article_id=1179&V=1 (Nov.–Dec. 2003); BOARDSOURCE & INDEP. SECTOR, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, *available at* http://www.boardsource.org/clientfiles/Sarbanes-Oxley.pdf (2003); Martin Michaelson, *A New Era of Corporate Governance Bears Down on Higher Education: The Sarbanes-Oxley Act Adopted in Wake of Corporate Scandals May Have Some Major Implications for College and University Boards*, TRUSTEESHIP, Jan.–Feb. 2003, at 37; John Mattie & Jack McCarthy, *The Substance of Transparency: The Sarbanes-Oxley Act*, BUS. OFFICER MAG., Feb. 2003, at 39.

9. Hearings were held in Washington, D.C., on June 22, 2004, on the topic of "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities." The list of invited speakers can be found at http://www.finance.senate.gov/sitepages/hearing062204.htm (last visited Mar. 14, 2005). The day before the hearing, the committee released a "discussion draft" which is a catalogue of reforms and best practices for tax-exempt organizations that the committee had been developing for many months. *See* SENATE FINANCE COMM., *Staff Discussion Draft, available at* www.finance.senate.gov/hearings/testimony/2004test/062204stfdis

In large measure, non-profits enjoy the special benefits they receive—exemption from tax being chief among them—because they do the public's business.[10] The substantial financial assistance they receive indirectly from all

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.pdf (June 22, 2004). The draft is described as a "work-in-progress" and is meant to encourage additional comments and suggestions as the Finance Committee considers possible legislation; but despite the many serious concerns expressed by those who attended the hearings, the chair of the Finance Committee said that he intended to introduce changes "quickly, perhaps even this year." Brad Wolverton, *Nonprofit Leaders Express Concern About Some Ideas Advanced by Senate Aides*, CHRON. PHILANTHROPY, Aug. 5, 2004, at 39.

In October 2004, the Senate Finance Committee encouraged the Panel on the Nonprofit Sector to review the issues and undertake its own analysis of how the nonprofit sector could best achieve the highest ethical standards in governance, fundraising, and overall operations. On March 1, 2005, the Panel published its report and recommendations, inviting comment and noting that it intended to continue its efforts in a second phase of deliberations. *See* PANEL ON THE NONPROFIT SECTOR, INTERIM REPORT PRESENTED TO THE SENATE FINANCE COMMITTEE, *available at* http://www.nonprofitpanel.org/interim/PanelReport.pdf (Mar. 1, 2005).

The Congressional Joint Committee on Taxation has also responded to the Senate Finance Committee staff discussion draft. On January 27, 2005, it issued its own report and recommendations, entitled "Options to Improve Compliance and Reform Tax Expenditures." A substantial part of the 435-page report applies to non-profits, and many of the recommendations track those found in the Senate Finance Committee's report. The Joint Committee's Report is available at www.house.gov/jct/pubs05.html. The Joint Committee's report in now engendering response from the non-profit community. *See, e.g.*. NAT'L COMM. ON PLANNED GIVING, *Panel Makes Recommendations for Charitable Giving and Oversight*, *at* http://www.ncpg.org/gov_relations/?section=8 (last updated Mar. 9, 2005).

10. The tests under federal and state law are different, but their point is the same. Under Section 501(c)(3) of the Internal Revenue Code, a corporation must be:

> operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . .

I.R.C. § 501(c)(3) (2000).

In Pennsylvania, a corporation must satisfy a demanding five-part test to be considered a "purely public charity" to be exempt from taxation: it must (a) advance a charitable purpose, (b) donate or render gratuitously a substantial portion of its services, (c) benefit a substantial and indefinite class of persons who are legitimate subjects of charity, (d) relieve the government of some of its burden, and (e) operate entirely free of the profit motive. Hosp. Utilization Project v. Commonwealth, 487 A.2d 1306, 1317 (Pa. 1985).

With state and municipal finances challenged by increasing demands for service in a declining economy (generating less tax revenue), the beneficiaries of state taxes (especially school districts that depend upon property taxes) have begun demanding that these criteria are satisfied, and to sue when the potential tax revenue is sufficiently significant. In February 2004, for example, the Illinois Department of Revenue revoked the tax-exempt status of Provena Covenant Medical Center of Urbana, stating that it did not believe the hospital was operating with a charitable purpose, a ruling that could force the hospital to pay $1 million per year in local property taxes. *See*, Julie Appleby, *Scales Tipping Against Tax-exempt Hospitals: Critics Challenge Bill Collection, Charity Care, Salaries at Non-profits*, USA TODAY, Aug. 24, 2004, at B1. Even private high schools and public universities have been subject to this kind of attack. *See e.g.*, Pottstown Sch. Dist. v. Hill Sch., 786 A.2d 312, 319 (Pa. Commw. Ct. 2001) (holding that private high school was tax exempt); Pa. State Univ. v. Derry Towship Sch. Dist., 45 Pa. D. & C.4th 51, 58 (Pa. Commw. Ct. 2000) (holding that public university and medical center did not operate entirely free-from-profit motive, and therefore did not qualify as purely public charities for tax purposes); Michael Arnone, *Sinking Their Teeth Into Sacred Cows*, CHRON. HIGHER EDUC., Feb. 27, 2004, at A21.

levels of governments, even without regard to grants, arguably makes them more deserving of governmental oversight and control than publicly-traded companies, because it is the public's tax money, not that of private investors, that is being spent.[11] But as Senator Sarbanes has noted, Sarbanes-Oxley was not designed for non-profits, and the two worlds are clearly different.[12]

Whether Sarbanes-Oxley should be applied to non-profits in general, or to institutions of higher education in particular, will be decided by others. This article will explore the ways in which its "spirit" is consistent with the aspirations of academia, and suggest ways that colleges and universities—public as well as private—can implement the Act's "best practices" while minimizing the new (and substantial) burdens those practices can impose.[13]

I. SARBANES-OXLEY: AN OVERVIEW OF THE ACT

The purpose of the Sarbanes-Oxley Act of 2002 is simply stated: "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[14] The Act itself is not simply written: it is sixty-six pages long, has eleven Titles, amends both the civil and criminal laws of the United States,[15] and includes a "sense of the Senate" for good measure.[16] It even includes three separately-named Acts, including the "Corporate and Criminal Fraud Accountability Act of 2002"[17] and the "Corporate Fraud Accountability Act of 2002,"[18] both of which add altering, hiding and destroying documents and otherwise interfering with investigations to the list of crimes for which corporate officers, agents, and employees can go to jail.[19]

It is not the purpose of this article to teach Sarbanes-Oxley, and it will therefore

11. *See* Constantine Papadakis, *Both Sides [Now]*, TRUSTEESHIP, Nov.–Dec. 2004, at 34 ("Colleges and universities must be held to a standard higher than corporations because in many ways they are more important to society. They last longer than corporations that come and go, and they receive substantial financial assistance directly through grants and tax exemption.").

12. Senator Paul S. Sarbanes, Sarbanes-Oxley and Ethical Principles of Corporate Behavior, Address at Drexel University's Bennett S. Lebow College of Business Lecture Series , *available at* http://www.lebow.drexel.edu/events/sarbanes/sarbanesspeech.pdf (May 14, 2004) [hereinafter Address of Senator Paul S. Sarbanes].

13. *E.g.*, HIGHER EDUC. SPECIAL REPORT, *Sarbanes-Oxley: Voluntary Compliance Viewed as a Best Management Practice*, *available at* http://www.fitchrating.com (Jan. 27, 2004).

14. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. at 745 (Title clause).

15. The principal focus of the Act is the Securities Exchange Acts of 1933 and 1934, and Sarbanes-Oxley amends those Acts in more than twenty particulars. But the Act also amends Title 18 of the United States Code (crimes) to "law enforcement officers" in many respects. Among other things, the Act includes punishments for those who retaliate against those who provide information about violations of "federal law" —and this can arise within academia. *See infra* note 81 and accompanying text.

16. Sarbanes-Oxley Act § 1001 (not codified, but published as 15 U.S.C.A. § 78a note (1997 & West Supp. 2004).

17. Sarbanes-Oxley Act § 801 (codified at 18 U.S.C.A. § 1501 (2000 & West Supp. 2004)).

18. *Id*. § 1101 (codified at 15 U.S.C.A. § 78a (1997 & West Supp. 2004)).

19. It should be noted that these two changes to the criminal law apply to all business entities, including not-for-profits. *See id*. § 1107 (codified at 18 U.S.C.A. § 1513(e) (2000 & West Supp. 2004)); *infra* notes 81–89 and accompanying text.

not analyze its structure or attempt to address all of its sections and implications; that can be left to the accountants and law firms that have already flooded our desks with invitations to attend educational (marketing) programs on the topic.[20] The bottom line for those in higher education is that Sarbanes-Oxley, by its terms, was not intended to apply to the non-profit world.[21] The approach the Act takes to protecting investors, though, is of critical importance to non-profits, because it provides the keys to corporate accountability, which is the touchstone of the Act.[22]

The Act can be divided into three parts: internal controls (exercised by management), external checks (performed by the board or external auditors), and investigations (triggered by whistleblowers or others). The relevant sections of the Act can be structured along these lines as follows:[23]

1. INTERNAL CONTROLS

Sec. 302(a)(4,6). Corporate responsibility for financial reports [CEO Certification re: internal controls].

Sec. 307. Rules of professional responsibility for attorneys.

Sec. 402. Enhanced conflict of interest provisions.

Sec. 404(a). Management assessment of internal controls.

Sec. 406. Code of ethics for senior financial officers.

Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by

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20. Because of its far-ranging implications for public companies, especially the very serious sanctions for non-compliance, Sarbanes-Oxley has been dubbed the "Lawyer and Accountant Relief Act of 2002." For those who wish to remain current with developments in the law, the American Bar Association is offering a three-volume, 1357-page, loose-leaf "Practitioner's Guide" that promises to "giv[e] you unique insight on today's governance *industry*." THE PRACTITIONER'S GUIDE TO THE SARBANES-OXLEY ACT (John J. Huber et al. eds., 2004) (emphasis added).

21. The Act is replete with indications of this intent. By way of example, the Public Company Accounting Oversight Board ("PCAOB") is given responsibility for implementing the Act. Sarbanes-Oxley Act § 101(a) (codified at 15 U.S.C.A. § 7211 (1998 & West Supp. 2004)). By its name, the Act applies only to "public companies," but its purpose makes its jurisdiction specific: "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." *Id*. The Sarbanes-Oxley Act additionally amends the Securities Acts to include recognition of accounting standards which are "necessary or appropriate in the public interest and for the protection of investors" and needed to "improv[e] the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws." *See id.* § 108 (codified at 15 U.S.C.A. § 7218 (1998 & West Supp. 2004)).

22. *See* Address of Senator Paul S. Sarbanes, *supra* note 12, at 1 (quoting Michael Granof, accounting professor at University of Texas):

> The key to the law is accountability. Directors and senior executives must be answerable for what goes on in their organizations. The usual defense of being oblivious is no longer acceptable: senior executives must not only certify to the accuracy of their firm's financial statements, but they must also show that a system is in place to track and control costs.

23. With only very slight modification by the author, the following "Conceptual Map for Non-Profit Institutions" was developed by Paul N. Tanaka, university counsel for Iowa State University, for use at the 44th Annual Conference of the National Association of College and University Attorneys (June 2004). It is used with his permission.

chief executive officers.

2. EXTERNAL CHECKS

Sec. 201. Services outside the scope of practice of auditors.
Sec. 202. Preapproval requirements.
Sec. 203. Audit partner rotation.
Sec. 204. Auditor reports to audit committees.
Sec. 206. Conflicts of interest.
Sec. 301. Public company audit committees.
Sec. 302(a)(3,5). Corporate responsibility for financial reports [CEO Certification of accuracy and full disclosure to auditors]
Sec. 404(b). Management assessment of internal controls.
Sec. 407. Disclosure of audit committee financial expert.
Sec. 906. Corporate responsibility for financial reports.

3. INVESTIGATIONS

Sec. 303. Improper influence on conduct of audits.
Sec. 802. Criminal penalties for altering documents.
Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.
Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.
Sec. 1107. Retaliation against informants.

This Article will address these three areas in turn, with specific reference to the interests and needs of higher education. It will conclude with some thoughts about why, and how, a college or university might adopt "the principles of Sarbanes-Oxley."[24]

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24. According to Senator Sarbanes, Drexel University was "the first university to voluntarily adopt the best practices of the Sarbanes-Oxley legislation." Address of Senator Paul S. Sarbanes, *supra* note 12, at 1. Their adoption came at the decision of the university's president, Constantine Papadakis, Ph.D., in November 2002, who decided to "voluntarily adopt for the University those reforms that make sense for us." Memorandum from President Constantine Papadakis, Ph.D., to Chair, Board of Trustees, Drexel University and Chair, Board of Trustees, Philadelphia Health & Education Corporation ("PHEC") *available at* http://www.drexel.edu/papadakis/sarbanes/Pennoni_Chuck_111902_Sarbanes_Oxley.pdf (Nov. 15, 2002). In doing so, he explained, "While non-profit entities like PHEC and Drexel are not subject to Sarbanes-Oxley, I believe that both entities should pay heed to that Act, for two principal reasons: first, they make good sense and are likely to become viewed as 'best practices'; and second, our auditors will likely be recommending them." *Id*. Among other things, he instructed his legal staff to prepare appropriate amendments to the corporate bylaws and to draft a "whistleblower policy;" he asked his senior vice presidents for finance and institutional advancement to draft a code of conduct; and he announced that the university's annual financial statements would be certified by himself and the university's CFO. That same month, the chair of the university's board of trustees, C.R. Pennoni, formed a special board committee on governance, compliance and audit, which spent ten months examining and addressing a wide variety of issues that were inspired by the Act's principles of corporate integrity and

II. INTERNAL CONTROLS

Sarbanes-Oxley is not designed to rid businesses of corruption. It does not punish anyone for embezzling, wasting corporate assets, excessive compensation, or anything else.[25] Those rules, and punishments, lie elsewhere.[26] Instead, its goal is to encourage the earlier discovery and disclosure of corruption. Its method is to require businesses to have enough incentives and mechanisms in place to persuade persons who are generally lower in the organizational chart to disclose problems (and possible wrongdoing) to someone with greater authority.

accountability. Chaired by Drexel Trustee John J. Roberts, formerly a Global Managing Partner at PricewaterhouseCoopers, LLP, the committee's work resulted in amendments to the corporation's bylaws, a university-wide code of conduct applicable to all segments of the university "from new hire to the Chair of the Board of Trustees," the establishment of a "whistleblower hotline" and adoption of policies to encourage accountability and minimize conflicts of interest. DREXEL UNIV., CODE OF CONDUCT 18, *available at* http://www.drexel.edu/hr/policies/OGC5.pdf (last visited Mar. 20, 2005).

Before the passage of Sarbanes-Oxley, though, Drexel had already implemented many of the Act's "best practices." In particular, the board of trustees already had an independent Audit committee that had its own charter and, among other powers, the ability to retain lawyers, accountants, and other consultants at its sole discretion. The charter was written in large measure by the committee's chair, Randolph H. Waterfield, a certified public accountant and formerly a partner in Ernst & Young, LLP. Materials relating to Drexel's adoption of the best practices of Sarbanes-Oxley are available on the Drexel University website at http://www.drexel.edu/papadakis/sarbanes.

25. *But see* Sarbanes-Oxley Act § 806 (codified at 18 U.S.C.A. § 1514A(a) (2000 & West Supp. 2004)) (Protection for employees of publicly traded companies who provide evidence of fraud.) *Id*. § 1107 (codified at 18 U.S.C.A. § 1513(e) (2000 & West Supp. 2004)) (Retaliation against informants.); *Id*. § 802 (codified at 18 U.S.C.A. §§ 1519–20 (2000 & West Supp. 2004)) (Criminal penalties for altering documents.); *Id*. § 1102 (codified at 18 U.S.C.A. § 1512 (2000 & West Supp. 2004)) (Tampering with a record or otherwise impeding an official proceeding.).

26. The precursor to Sarbanes-Oxley in the non-profit world was the "intermediate sanctions" legislation enacted by Congress in July 1996. I.R.C. § 4958 (2000). Those rules impose taxes on "disqualified persons" who engage in "excess benefit transactions" with tax-exempt organizations. *Id*. § 4958(a)(1) (2000). The sanctions applied to transactions occurring on or after September 14, 1995; they were "intermediate" because they were less than revoking the institution's tax-exempt status. *Id*. They required scrutiny of compensation paid to "disqualified persons"—a class of persons that included not just senior administrative staff of the non-profit, but any voting member of its board of trustees. *Id*. An "excess benefit" existed "if the value of what the organization receives in return is less than the value of what it provides;" and a "disqualified person" was prohibited from receiving any "economic benefit" from a transaction in any way, "direct or indirect." *Id*. § 4958(c)(1)(A) (2002). Thus, any contractual relationship between a university and a member of its board of trustees was subject to scrutiny, to make sure the board member (or his company) was not being paid more than fair value for goods or services it sold to the university. This inspired many colleges and universities to develop policies requiring their trustees and officers to disclose actual or potential conflicts of interest, and, if not total prohibition, then procedures requiring independent verification of the objective fairness of the contract's compensation terms. The Treasury Department published its final regulations in early 2002, just months before Sarbanes-Oxley was signed into law. *See* 67 Fed. Reg. 3076 (Jan. 23, 2002) (to be codified at 26 C.F.R. pts. 53, 301, 602). This remains an issue of significant importance to non-profits, with the establishment of the IRS' Tax Exempt Compensation Enforcement Project in August 2004. *See supra* note 7.

A. Chief executive officers ("CEO") and chief financial officers ("CFO")

The process begins with accountability: someone must be responsible for vouching for the accuracy of the financial reports. Sarbanes-Oxley imposes this obligation on two individuals: "the principal executive officer or officers *and* the principal financial officer or officers, or persons performing similar functions."[27] Both the president and the CFO are required to provide written certifications attesting to the completeness and accuracy of the reports that they are validating.[28] If the certifications are subsequently determined to be incomplete or wrong, the Act requires both officers to give back to the corporation any bonuses or equity they received, and all profits made on any of the company's stock that they sold, within the twelve months prior to the date of the certification.[29] Of course, the corporation's directors would be free to impose any other penalties they felt appropriate.

The new certification has six components, each of which is designed to ensure that the certification is meaningful:

1. The officer has "reviewed the report" (not just read it);
2. To the best of the signer's knowledge, the report does not contain any untrue statement that is material, or neglect to include any fact that would help to make any statement in the report "not misleading;"
3. The information "fairly present[s] in all material respects" the financial condition and operations of the company;[30]
4. The two officials have designed and implemented the "internal controls" that they believe are necessary to ensure that all material information (not just for the company, but for all of its "consolidated subsidiaries") has been provided to them and included in the reports, and have tested those controls to see if they are working;
5. They have provided the results of their tests to the corporation's independent auditors and the audit committee of the board of directors, and have identified any material weaknesses in the controls of which they have any knowledge; and,
6. They have disclosed in the report if there have been any significant changes since the date of the last such report, either in the internal controls or in any factors that could affect those controls.[31]

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27. Sarbanes-Oxley Act § 302(a) (codified at 15 U.S.C.A. § 7241 (1998 & West Supp. 2004)) (emphasis added).

28. *Id*. § 302(a). The Senate also wanted the corporation's chief executive officer to sign the corporation's federal tax returns, but the House of Representatives declined such a dramatic expansion of personal liability. *See id*. § 1001 (codified at 15 U.S.C.A. § 78a (1997 & West Supp. 2004)).

29. *Id*. § 304(a) (codified at 15 U.S.C.A. § 7243 (1998 & West Supp. 2004)).

30. This requirement is not limited to all "consolidated" entities. The Act also requires disclosures relating to "off-balance sheet transactions"—i.e., relationships with "unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, *or* significant components of revenues or expenses." *Id*. § 401(a), amend. (j) (codified at 15 U.S.C.A. § 78m (1997 & West Supp. 2004)).

31. *Id*. § 302(a)(1–6) (codified at 15 U.S.C.A. § 7241 (1998 & West Supp. 2004)).

Furthering the fourth requirement, the Act also requires that each annual report filed by the corporation include "an internal control report" which "state[s] the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and contain[s] an assessment of . . . effectiveness" of that structure and procedure.[32] This report, in turn, must be evaluated by an independent public accounting firm, attesting to and reporting on "the assessment made by the management" as part of its annual audit.[33] The accounting firm is regulated by the Public Company Accounting Oversight Board ("PCAOB"), whose job it is to set standards for the public accounting firms, to "oversee the audit of public companies," and audit the auditors.[34]

As an academic statement, no one could fault the Act's approach: the six components of the annual certification are the six basic questions that a chief financial officer or president would be asked under cross-examination by the lawyer representing the class in a securities fraud suit. They are the building blocks of competency. But like the speck of dust held by Horton, the simple words "internal controls" contain a universe. As listed by one consulting accounting firm that was proposing to help Drexel University comply with Sarbanes-Oxley, the financial functions requiring such "internal controls" included:[35]

Accounts Payable
Accounts Receivable
Auxiliary Accounting
Capital Asset Management
Cash Control
Contract and Grant
Administration
Construction Accounting
Debt Accounting
Endowment Accounting
Financial Reporting
Financial Systems and Operations
Internal Audit
Investment Accounting
Payroll
Plant Accounting
Purchasing
Student Loans/Financial Aid

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32. *Id*. § 404(a) (codified at 15 U.S.C.A. § 7262 (1997 & West Supp. 2004)).

33. *Id*. § 404(b) (codified at 15 U.S.C.A. § 7262 (1997 & West Supp. 2004)).

34. *Id*. § 101(a) (codified at 15 U.S.C.A. § 7211 (1997 & West Supp. 2004)). In this way, the Act answers the question, "Who watches the watchers?" Each public accounting firm is required to register with the PCAOB, including submission of "a statement of the quality control policies of the firm for its accounting and auditing practices." *Id*. § 102(b)(2)(D) (codified at 15 U.S.C.A. § 7212 (1997 & West Supp. 2004)). The PCAOB establishes "such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports." *Id*. § 103(a)(1) (codified at 15 U.S.C.A. § 7213 (1997 & West Supp. 2004)). The PCAOB has the jurisdiction to ensure that the accounting firm has diligently reviewed the adequacy of the public corporation's internal controls (§ 103(a)(2)), to audit the accounting firms (§ 104), conduct investigations and disciplinary proceedings (§ 105), suspend or revoke the registration of the accounting firm and bar individuals from being associated with registered accounting firms (§ 105(3)), and impose fines of up to $15 million for corporations (§ 105(c)(4)(D)), as well as to refer the matter to the appropriate federal authorities for prosecution under the criminal code.

35. Note that this list is not exhaustive; it is just what this particular consultant proposed to review.

For each process, the first step toward ensuring that adequate controls are in place is simply documentation of the current processes ("documentation"). Using these records, consultants will analyze each process to see what kinds of controls the system already has ("analysis") and what is missing ("gap analysis"). Then they will determine what new controls are required ("diagnostics"), designing and installing what it lacks ("remediation"). Finally, consultants will test them ("validation") and then audit them on an annual basis (or otherwise, as needed).[36] At our option, the consultants were also willing to compare our controls to those of our peers ("benchmarking"). Thus, the origins of the name "Auditors Relief Act of 2002."[37]

Such a huge undertaking will take thousands of hours of staff time and hundreds of thousands of dollars in consultant fees and expenses. With administrative staffs already at their minima and little flexibility in budgets, it will be the rare president who agrees to perform this level of review and remediation on systems that do not appear to be broken or, if they are, that are costing the college or university so little. But what Sarbanes-Oxley has done for academia is make explicit the assumptions behind the presentation of financial statements, and challenge institutional leadership at least to make a reasonable inquiry into the accuracy of those assumptions.

Given this roadmap, a prudent president will assess the institution's financial systems to identify the areas in which it is most at risk for holes and "disloyal" conduct. Are there written policies specifying the amount of money that different levels of employees can spend and whose signatures are required on contracts of different dollar values or risks?[38] Are those who buy or those who handle the institution's cash sufficiently trained and supervised? In academia, purchasing authority is often decentralized, with departments having the ability to spend their budgets as they see fit—is there review and oversight at that level? While consultants may be helpful to some degree, an institution's senior administrative staff can undoubtedly do a good job of identifying the areas of risk on their own.

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36. Sarbanes-Oxley does not allow the same auditors to both design/implement these systems and then audit them. Sarbanes-Oxley Act § 201(a) (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)). The job of auditing the new systems would have to be handed off to the institution's independent auditors, whose annual fee would be adjusted accordingly.

37. The consultant's proposal did not include the Drexel University College of Medicine, a subsidiary corporation. The College of Medicine has twenty-three different departments, each of which is involved with patient billings and/or grant revenues. Under Sarbanes-Oxley, the president and chief financial officer of the parent corporation are responsible for certifying the adequacy of the controls employed in all "consolidated subsidiaries." Sarbanes-Oxley Act § 302(a)(4)(B) (codified at 15 U.S.C.A. § 7241 (1997 & West Supp. 2004)). Thus, even if Drexel University had engaged the consultant for the whole of the scope of work it proposed, the result would have been inadequate to meet the requirements of Sarbanes-Oxley.

38. Many institutions have established "approval authority" guidelines that relate to purchases, where the dollar value of the transaction is apparent and where the budget serves as an internal control through its line items. The more difficult cases involve contracts where an institution agrees to indemnify, defend, or waive claims for consequential damages. Furthermore, the delegation of signature authority comes typically from the president, who specifies the limits of that authority. But has the board imposed any limits on the president? Are operating expenses treated the same as capital expenses, e.g., construction projects, deferred maintenance, and the lease or purchase of land?

The president and CFO can then locate the areas that pose the greatest risk, in dollars and reputation, and focus resources on those risks, in an organized approach. If that is done, and made the subject to review by the board of trustees, then the spirit of Sarbanes-Oxley has been adopted.[39]

B. Codes of Conduct

Beyond the processes are the personnel. Sarbanes-Oxley requires that each regulated corporation have an agreed-upon statement of what constitutes acceptable behavior. The Act encourages each regulated corporation to adopt and publish a "code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions."[40] The Act expects that such codes will require compliance with all applicable laws and regulations;[41] that is the easy part. It also seeks to impose on corporations and their officers the "ethical" duty to ensure that all financial reports are "full, fair, accurate, timely, and understandable."[42] This is a call to reform the culture of business—a call that is more likely to be welcome in academia than Wall Street, where "shared governance" is not the dominant operating principle.

More than this, though, Congress expressed its hope that such codes would "promote . . . honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships."[43] Many professional associations, including NACUBO, have offered sample codes that call on financial officers to act with the highest integrity.[44] But other than establishing a tone, they typically do not provide much instruction; and unless there is commitment at the highest levels of the administration to enforce their terms,[45] they can be perceived as meaningless, thereby eviscerating their only purpose.[46]

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39. This process does not require certification. Governing boards, however, would undoubtedly appreciate notice that the president had undertaken this review and attempted to ensure that the areas of greatest financial risk to the institution were being addressed. This is an appropriate conversation to include with each annual or quarterly report made by the president to the board. *See* Sarbanes-Oxley Act § 302(a) (codified at 15 U.S.C.A. § 7241 (1997 & West Supp. 2004)).

40. *Id*. § 406(a) (codified at 15 U.S.C.A. § 7264 (1998 & West Supp. 2004)). More precisely, the Act requires that the Securities and Exchange Commission issue rules that will require each corporation to "disclose" in its public filings whether it "has adopted" such a code and, if not, "the reason therefor." *Id*. The law itself does not contain any penalties for not adopting such codes.

41. *Id*. § 406(c)(3) (codified at 15 U.S.C.A. § 7264 (1998 & West Supp. 2004)). Note, however, that this is listed as the last of the three components.

42. *Id*. § 406(c)(2) (codified at 15 U.S.C.A. § 7264 (1998 & West Supp. 2004)).

43. *Id*. § 406(c)(1) (codified at 15 U.S.C.A. § 7264 (1998 & West Supp. 2004)).

44. NACUBO, *supra* note 8, at 11.

45. Sarbanes-Oxley does not require enforcement mechanisms for codes of ethics.

46. Here is one such provision, taken from Drexel's Code of Ethics for Senior Financial Executives:

> The executive's ethics shall reflect due regard for possible conflicts of interest. He or she shall be prepared to assist in the clarification, disclosure, and ethical handling of

Unlike private business, higher education has a second domain in which money might corrupt: fundraising. Those who obtain grants from government agencies are already subject to strict conflict of interest rules and reporting requirements;[47] but no such regulations exist for those who seek to raise money from "friends of the university." Is it "ethical" or acceptable to condition the decision to invest university funds in a specific fund or with a certain investment advisor only on the condition (express or implied) that the advisor or fund makes a contribution to the university? "Quid pro quo" might work in business; but does it work in academia? Deciding to have a "code of ethics," in the spirit of Sarbanes-Oxley, may well inspire debates that might otherwise never have occurred, and lead to new rules that will be statements of high calling, but deleterious either to the institution's bottom line or to its sense of self.

C. Beyond the Money

The objective of ethical conduct will undoubtedly resonate well in higher education, where the absence of strife and bias (or at least the full disclosure of interest and bias) is a cornerstone of academic integrity. The "principles of Sarbanes-Oxley," then, may inspire colleges and universities to formulate policies relating to conflicts of interest and commitment[48] and codes of conduct that apply

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> possible real or apparent conflicts of interest that may arise in the institution. To this end, each executive shall refrain from accepting duties, incurring obligations, accepting gifts or favors of monetary value, or engaging in private business or professional activities where there is, or would appear to be, a conflict between the executive's private interests and the interests of the institution.

DREXEL UNIV., CODE OF ETHICS FOR SENIOR EXECUTIVE OFFICIALS, *available at* http://www.drexel.edu/papadakis/sarbanes/MEMO_TO_EMPLOYEES.pdf (last visited Mar. 20, 2005). But crafting such codes is a complex task. The quoted language suggests, for example, that a CFO does not need to disclose any conflicts; he just needs to be "prepared to assist" in their disclosure. Is it up to the financial officer to decide if there is, or might be, a conflict of interest?

Another example from the same code: "The executive shall be dedicated to exercising his or her special competence and knowledge to ensure the most effective use of institutional resources, and shall be prepared to work with others in the institution to this end." *Id.* Why not "shall exercise" and "shall work?" And when the CFO does not work well with others (i.e., violates the Code) and is not sanctioned by the president for this "violation," what message is then sent to everyone else in the department about the university's "ethical" commitment?

With a (tenured) faculty predisposed to providing immediate and critical analysis—a situation totally foreign to most for-profit corporations—a university ought to be careful before adopting a code of ethics.

47. The rules issued by the National Institutes of Health ("NIH") provide ready examples of these requirements. *See, e.g.*, NIH, *Objectivity in Research*, ¶ 7, *available at* http://grants2.nih.gov/grants/guide/notice-files/not95-179.html (July 14, 1995); NIH, OFFICE OF EXTRAMURAL RESEARCH, *NIH Medical & Behavioral Research Grant Policies, Guidelines & Funding Opportunities, at* http://grants2.nih.gov/grants/oer.htm (last modified Feb. 2, 2005). For a general review, see NIH, *Conflict of Interest Information and Resources, at* http://www.nih.gov/about/ethics_COI.htm (last reviewed Feb. 14, 2005).

48. In the for-profit world, the issues are conflicts of interest. *See* Sarbanes-Oxley Act § 402 (codified at 15 U.S.C.A. § 78m (1997 & West Supp. 2004)). In the not-for-profit world, however, it is the organization's mission that is critical. For that reason, many universities (including Drexel) have policies on "conflicts of interest *and commitment*" and require employees to act in the best interests of the university—a concept that can be very difficult to define in

to the entire university community, not just to those who handle the money. Indeed, unlike for-profits, it is not "all about the money" for non-profits; more often, it is all about the organization's good name. Colleges and universities live and die on the basis of their reputations. Good faculty and good students will not go to bad places; alumni/ae and foundations will not give them gifts; government agencies and corporations will not give them grants; and scandal corrodes collegiality like almost nothing else.

Anyone who reads *The Chronicle of Higher Education* for any period of time will see what really matters in higher education: resume fraud by a president or a coach,[49] misconduct involving a student,[50] fundraising for political candidates,[51] dishonesty (plagiarism or fabrication) by an administrator, teacher, or researcher,[52]

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particular instances. *See* DREXEL UNIV. CONFLICT OF INTEREST AND COMMITMENT POLICY, *available at* http://www.drexel.edu/provost/policies/conflict _of_interest.asp (last modified Nov. 16, 2004).In academia, where the hypothetical rules, debates about "conflicts of commitment" can be expected to delay adoption of any policy. The well-established "duty of loyalty" that an employee clearly owes to her employer at law will be understood by faculty as a "loyalty oath" that is both insulting to be requested, and never to be given. Thus, the process by which a conflict of interest policy is developed and imposed requires most careful attention. As is often the case in academia, the process may well determine the product.

49. *See* Julianne Basinger, *4 Years After a Scandal, a President Steps Down,* CHRON. HIGHER EDUC., Mar. 5, 2004, at A23:

> Academe also has done some soul-searching in recent years reacting to questions that have arisen about the credentials of coaches and professors. In late 2001, a reporter discovered inaccuracies in the official biography of the University of Notre Dame's new football coach, George J. O'Leary, and he was fired after only five days on the job. That incident touched off a wave of résumé-checking that ended up putting a few more coaches out of work. Professors, too, have come under fire, including Joseph J. Ellis, a Pulitzer Prize-winning historian at Mount Holyoke College who claimed a military record in the Vietnam War that he never had, and Quincy Troupe, a poet who retired as a professor at the University of California at San Diego last June after it was discovered that he had lied about having a college degree.

See also, Welch Suggs, *U. of Louisiana at Lafayette Fires Coach Over Diploma-Mill Degrees*, CHRON. HIGHER EDUC., July 30, 2004, at A27 (discussing the firing of University of Louisiana at Lafayette's men's basketball coach for claiming degrees which he had not received).

50. A sexual relationship is the easiest to imagine, but the opportunities for professional misconduct are plentiful. For example, during the summer of 2004, nearby LaSalle University (Pennsylvania) was rocked by the allegation that two coaches had discouraged one student (or more) from reporting a possible rape by an athlete. Welch Suggs, *La Salle U. Suspends 2 Basketball Coaches Amid Probe of Rape Charges Against Players*, CHRON. HIGHER EDUC., July 23, 2004, at A33. The university's president acted promptly and properly; both coaches immediately took leaves of absence and later resigned from the university. *Id*. But is there any doubt at all that the university will feel the repercussions for years, from losing potential student applicants and alumni financial support, to receiving greater oversight by the trustees and accrediting bodies? How many times will LaSalle's name now be included in articles about misconduct with students?

51. *See* Scott Smallwood & Alice Gomstyn, *Peer Review*, CHRON. HIGHER EDUC., Oct. 24, 2003, at A8 (focusing on the resignation of the president of University of South Florida's College of Medicine following criticism for asking staff members to contribute to a U.S. senatorial campaign).

52. The president of Hamilton College resigned after it came to light that in a number of instances he had used plagiarized material in speeches he had delivered in the nine years since assuming office. Maurice Isserman, *Plagiarism: A Lie of the Mind*, CHRON. HIGHER EDUC., May

self-dealing by members of the board of trustees.[53] The opportunities for public embarrassment are seemingly endless, primarily because so many people associated with the institution can cause it harm. For that reason, if they are thinking about codes of conduct, colleges and universities would perhaps do a better job of risk management by attending to all conduct that could cause it material harm,[54] not just financial loss.[55]

III. EXTERNAL CHECKS

Sarbanes-Oxley does not rest with imposing new requirements on a corporation's management and giving new powers to government prosecutors to enforce compliance. Instead, it totally rewrote the obligations of those who are in a good position (if not the best) to check up on management: the board of directors and the external (independent) auditors. The Act now puts them at personal risk if a corporation under their review misrepresents its financial condition or otherwise violates the disclosure laws.

A. Independent Auditors

Colleges and universities are not generally required to obtain independent review of their financial statements,[56] so many do not even engage outside auditors

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2, 2003, at B12.

53. *See* Julianne Basinger, *Boards Crack Down on Members' Insider Deals*, CHRON. HIGHER EDUC., Feb. 6, 2004, at A1.

54. Before Sarbanes-Oxley, Drexel University had a published policy on conflicts of interest and commitment, under which each employee with the ability to obligate the university was required to submit a signed statement once each year, either confirming the absence of any such actual or potential conflicts, or disclosing them. DREXEL UNIV. CONFLICT OF INTEREST AND COMMITMENT POLICY, *available at* http://www.drexel.edu/provost/policies/conflict_of_interest.asp (last modified Nov. 16, 2004). The passage of Sarbanes-Oxley prompted Drexel's board of trustees to call for the creation of a more comprehensive code of conduct, which would provide a single reference point for the behaviors that the university expected of its "members" (which term included those who did business with the university, as well as its employees and trustees). That code was written by a university-wide advisory committee (consisting of faculty, staff, and administrators), reviewed by the faculty senate, and adopted by the board of trustees in December 2003. DREXEL UNIV. BD. OF TRUSTEES QUARTERLY MEETING, *available at* http://www.drexel.edu/papadakis/sarbanes/r_code_of_conduct.pdf (Dec. 17, 2003).

55. This is not to suggest that academia does not have it share of problems related to the misuse of funds. *See, e.g.*, Karen Fisher, *The University of North Carolina System has Taken Charge of Financial Matters at the North Carolina School of the Arts*, CHRON. HIGHER EDUC., Nov. 26, 2004, at A19 (discussing an audit that revealed that "nearly $1 million had been diverted to non-academic uses); Joann S. Lublin, *Travel Expenses Prompt Yale To Force Out Institute Chief*, WALL STREET J., Jan. 10, 2005, at B1; Piper Fogg, *Grant-Theft Auto*, CHRON. HIGHER EDUC., Feb. 4, 2005, at A7 (involving faculty member at George Washington University who was charged with embezzling almost $600,000 in federal grant money); Erin Strout, *Iowa State Restores Misspent Donation*, CHRON. HIGHER EDUC., March 11, 2005, at A29 ; John Gravois, *Yale Forces Out Tenured Professor for 'Financial Misconduct'*, CHRON. HIGHER EDUC., Jan. 21, 2005, at A10; Paul Fain, *Former Morris Brown President Indicted*, CHRON. HIGHER EDUC., Dec. 17, 2004, at A35.

56. Institutions receiving over $500,000 in federal funds are required to have an A-133 Audit. *See* Circular No. A-133, 68 Fed. Reg. 38,401 (June 27, 2003).

to validate their annual financial statements. If "the spirit of Sarbanes-Oxley" means anything, it probably requires at least this much.[57] No amount of oversight by even the best intentioned boards of trustees (or trustee audit committee) can match the expert analysis provided by accounting firms of the financial condition of a corporation. Surely it is a "best practice" of business to get an independent, expert review of the company's financial books and records once each year.[58]

Testimony given to the Senate Banking Committee confirmed that the accountants who had been auditing public companies had "fallen asleep at the switch" as a result of long, comfortable relationships with their clients.[59] For that reason, the Act imposed a series of new rules on the auditors who were certifying the financial reports, such as: the lead engagement partner must be rotated at least every five years,[60] the audit firm cannot provide most "non-audit service[s],"[61] and the audit firm cannot work at all for a company whose senior financial staff includes anyone who worked on the company's audit within the past year while then employed by the audit company.[62] These rules are designed to ensure "auditor independence"[63] and to reduce the possibility that the auditor upon whom the public depended for accurate information would become "too close" or "too loyal" to the subject of its audit.[64]

In reality, few colleges and universities are going to be all that important to public accounting firms, and it is unlikely that any lead auditor would compromise his or her judgment to "save the account;" so the rules that Sarbanes-Oxley imposes on outside auditors have little urgency for academia. The Act does

57. If a college or university is unable to provide this level of review, the board should at least retain a certified public accountant to serve as its consultant and receive advice on what it should be looking for when it reviews the financial statements prepared by management. *See infra* note 75 and accompanying text.

58. Accounting firms do provide different levels of reviews. Certifying the financial statements provides the highest level of review, and the greatest level of confidence in the accuracy of the reports, but it is also the most expensive. Less-extensive and expensive examinations include "compilations" and "reviews." For further information, visit the website of the American Institute of Certified Public Accountants at www.aicpa.org.

59. Address of Senator Paul S. Sarbanes, *supra* note 12, at 3.

60. Sarbanes-Oxley Act § 203 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)). Beyond this, the Act instructs the Comptroller General to review whether audit *firms* ought to be rotated periodically. *Id*. § 207 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)) (emphasis added).

61. *Id*. § 201 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)).

62. *Id*. § 206 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)).

63. The responsibility owed by independent auditors to the public has been part of the law for more than twenty years. In 1984, the Supreme Court noted:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. . . . This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

United States v. Arthur Young, 465 U.S. 805, 817–18 (1984).

64. The fact that Sarbanes-Oxley will not eliminate questionable or improper conduct, or ensure that directors act properly, is easily demonstrable. *See, e.g.*, Jonathan Weil & Joann S. Lublin, *TIAA-CREF Faces Questions On Governance: Fund's Brass Failed to Inform Key Panel About Improper Deal With Ernst, Its Outside Auditor*, WALL ST. J., Dec. 6, 2004, at C1.

suggest, however, that those receiving and reviewing the outside auditor's reports should consider, from time to time, whether some change in the external auditor ought to be made to ensure objectivity and independence.

B. Board Audit Committee

All an auditing firm does is report. It needs someone to report to. The Act requires that the independent auditor report to the board's audit committee or, if there is none, to the full board of directors.[65] While the Act does not require there to be a separate audit committee, it is very likely that most boards will create such committees, for one reason: the Act threatens the members of the audit committee with personal liability for misfeasance. This is not directly stated in the Act; rather, all the Act does is require that all of this information about the true financial condition of the company go to the audit committee, which the Act makes "*directly responsible* for the appointment, compensation, and oversight of the work of [the outside auditor]."[66] At that point, the law takes over: what would a prudent person do if he or she had this information and was charged with that responsibility? Because the amount of information will be large, and largely technical, and because it will take a substantial amount of time and knowledge to master those data,[67] it is predictable that most directors will want a special audit committee to be created;[68] and it is probably wise for college and university boards to do so.[69]

The Act imposes on the board (and audit committee) the same, common-sense rules that it imposes on management: there cannot be any conflicts of interest, and there must be some expertise in (or available to) the board in reviewing financial matters.[70] Further, all members of the board are required to disclose any ownership interest they have directly or indirectly in the company.[71] No member

65. Sarbanes-Oxley Act § 204 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)); *Id*. § 205 (codified at 15 U.S.C.A. § 78c(a) (1997 & West Supp. 2004)).

66. *Id*. § 301 (codified at 15 U.S.C.A. § 78F(m)(2) (1997 & West Supp. 2004)) (emphasis added).

67. Many boards will offer training to the members of their audit committees. No matter how much training is given, no trustee—especially a volunteer without financial expertise—is likely to feel that the training is enough to make him or her into an expert.

68. Boards might be tempted to add "audit" to the jurisdiction of its finance committee, because those with expertise in business matters most likely serve on that committee. But the audit function is intended to be a check on the spending (finance) function. For that reason, combining the two functions into one board committee would be a step in the right direction, but not full adoption of the spirit of Sarbanes-Oxley.

69. It is typical for board bylaws to include a provision indemnifying trustees (and others) for acts within the scope of their duties. Some even provide for the advancement of costs. This contractual right, however, does not prevent the claim from being asserted, which exposes the trustee to the risk of reputational injury. Whether the college or university can pay, and whether the institution's insurance covers the claim, are other considerations. Finally, college and university bylaws often do not provide indemnity in the case of "gross negligence" (and some state laws do not even permit such agreements). Many trustees will not be gifted, expert, or even experienced in reading financial statements. What does "gross negligence" mean for them? Is it enough for them simply to attend all meetings and rely upon the one "financial expert" to ask all the right questions?

70. Sarbanes-Oxley Act § 101 (codified at 15 U.S.C.A. § 7211 (1997 & West Supp. 2004)).

71. *Id*. § 403(a) (codified at 15 U.S.C.A. § 78p (1997 & West Supp. 2004)).

of the board that is "affiliated" with or working for the company can serve on the audit committee.[72] And, although not required, the Act provides that an audit committee should have "at least 1 member who is a financial expert"[73]—that is:

> [A] person [who] has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer . . . .
>
> (1) an understanding of generally accepted accounting principles and financial statements;
>
> (2) experience in –
>
> > (a) the preparation or auditing of financial statements of generally comparable issuers; and
> >
> > (b) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
>
> (3) experience with internal accounting controls; and,
>
> (4) an understanding of audit committee functions.[74]

As with the other parts of Sarbanes-Oxley, these requirements make eminent sense. Perhaps in publicly-traded corporations, where the directors are well compensated and drawn from similar entities, there is some chance of getting this one person on the board and appointing her to the audit committee. But does this practice make sense in academia?

At public colleges and universities, the trustees are assigned to the board by persons or officials outside the institution's control; at private colleges and universities, they are appointed or elected for a variety of purposes (including honor and recognition); but even where there is discretion over whom to appoint, and even if there were someone in the community with the requisite expertise who had the requisite commitment to higher education and the willingness to volunteer, few indeed would accept this honor when it came with the threat of personal liability for providing poor oversight over the institution's finances.

The Act does provide some support for the members of the committee: it requires that the audit committee be given the power to hire "independent counsel and other advisors, as it determines necessary to carry out its duties."[75] This is

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72. *Id.* § 301 (codified at 15 U.S.C.A. § 78j-1 (1997 & West Supp. 2004)). Note that this includes the president, who is often a member of all board committees.

73. *Id.* § 407 (codified at 15 U.S.C.A. § 7265 (1997 & West Supp. 2004)). If the audit committee does not have such a member, it must provide a written statement of the reasons that it does not. *Id.*

74. *Id.* § 407(b) (codified at 15 U.S.C.A. § 7265 (1997 & West Supp. 2004)) (emphasis added).

75. *Id.* § 301. Note that this does include the authority to directly hire attorneys. That power may be critical in the event that the committee decides to investigate alleged misconduct by the president or any senior administration official who may be a peer of, or superior to, the university's general counsel. Performing investigations through counsel, instead of through internal audit staff (for example), will often extend a cloak of confidentiality to the process and results—both desirable for the college or university.

similar to the authority the Act gives to hire an independent auditor.[76] In academia, then, if the college or university does not employ an independent auditor to review the financial books and records, the college or university's audit committee (or full board) should retain a certified public accountant to advise it on how it should go about confirming the accuracy of the statements. Such "contracted expertise" at least begins the process of independent review that the Act would demand if a college or university was a publicly traded corporation.

Ultimately, though, it is the full board (and not just one of its committees) that bears the responsibility for governing the institution and ensuring the transparency, accuracy, and accountability of its operations.[77] The members are intended to serve as a check on the president and senior management. But who picks the board? If the president plays a dominant role in that process and succeeds in having supporters elected to the board, the same risks of over-familiarity are spawned. The public depends upon the trustees to ask the "hard questions" and challenge the president. For this reason, the board should also strive to ensure appropriate separation from the president, in both the nomination of trustees and the review of the president's performance and compensation.[78]

The obligation imposed on the board audit committee by Sarbanes-Oxley does not end with reviewing what management and the external auditor provide. In addition to this "formal" reporting system, the Act seeks to encourage (and enable) the lower-level employee to bring their problems, complaints and "concerns" to their superior's attention and, if need be, directly to the audit committee.[79]

C. Hotlines

Board audit committees must establish "procedures for . . . the receipt, retention, and treatment of complaints . . . regarding accounting, internal accounting controls, or auditing matters [and for] the confidential, anonymous submission by employees . . . of concerns regarding questionable accounting or auditing matters."[80] The requirements of confidentiality and anonymity include within them the protection of whistleblowers from retaliation—something that the Act specifically requires with respect to allegations of fraud.[81]

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76. *Id*. § 301.

77. If a member of the board does not get the information that he or she needs to satisfy this obligation, the appropriate response is for the member to resign. *See* Pamela Gaynor, *O'Neill's Exit Stirs Criticism of UPMC*, PITTSBURGH POST-GAZETTE, Dec. 10, 2004 (reporting on the resignation of former U.S. Treasury Secretary Paul O'Neill from the board of directors of the University of Pittsburgh Medical Center, who noted "he often felt he needed far more information that he was given to fulfill the responsibilities of a director"; as if to prove the point, the fact of his resignation was not released to the other members of the board, or the public, for three months).

78. *See supra* notes 7 and 26 and accompanying text. There is no doubt that the quality of the people sitting on the board affects the institution's credibility. *See, e.g.,* Gaynor, *supra* note 77, at A1.

79. Sarbanes-Oxley Act § 301; *Id.* § 806 (codified at 18 U.S.C.A. § 1514A(a) (2000 & West Supp. 2004)).

80. *Id*. § 301.

81. *Id.* § 806. The Act also makes it a crime to retaliate against anyone who provides any "law enforcement officer" any "truthful information" about the "commission or possible

Whistleblowers and hotlines are subjects warranting their own articles.[82] The existence of a hotline may give disaffected employees just another way to complain; policies protecting whistleblowers will undoubtedly prompt employees on the verge of termination to call to report improper conduct (and thereby invoke the protections against retaliation that the law requires);[83] and the promise of confidentiality might create a new contractual obligation that can result in a suit for damages if the caller is later identified (a likely result in departments that are small). Needless to say, the rights of whistleblowers are still being defined by the courts, and they can substantially complicate procedures that the university might already have in place.[84] Even so, they are probably an indispensable element of the integrity of the system, if the college or university is serious about making its managers accountable for their actions. Without a hotline and policies protecting those who call, it is expecting too much of subordinates to ask (or require) them to report on their supervisors or the senior officers of the college or university.[85]

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commission" of any violation of any federal law. *Id*. § 1107 (codified at 18 U.S.C.A. § 1513(e) (2000 & West Supp. 2004)). The law forbids taking "any action harmful to [the whistleblower], including interference with [his or her] lawful employment or livelihood." *Id*. This amendment *does apply* to academia, as it applies to *all* persons and *all* federal laws. *Id*. Given the expansive definitions of "mail fraud" and "wire fraud," and the federal rights afforded to employees against discrimination, it is very likely that complaints to the hotline will implicate "federal law." The crime, though, comes only in providing information to "law enforcement officers"—and the definition of "law enforcement officer" does not include the person who answers the hotline. But query whether it applies to the Equal Opportunity Commission and complaints made to it of violations of federal anti-discrimination laws.

82. *See, e.g.,* Christopher Westfall, *Whistleblower Rules Become a World Into Itself*, KPMG AUDIT COMM. INSIGHTS, *available at* http://www.kpmginsights.com/aci/display_aci_analysis.asp?intAnalysisTypeID=1&intInsightsTypeID=1&edition_id=4628&content_id=442569 (June 30, 2004).

83. *Cf.* Allison S. Wellner, *A Battle Over Ethics*, CHRON. PHILANTHROPY, Aug. 5, 2004, at 36 (involving an employee of Western University of Health Science who was fired and subsequently sued by the university for reporting potentially fraudulent practices to the IRS and state attorney general.) The university, believing itself the victim of a disgruntled former employee, argued that the employee made the allegations in order to obtain a better contract for a friend and in an effort to disrupt a planned merger. *Id.*

84. In the first reported decision involving a whistleblower, a corporate CFO asked to have an attorney present when he was questioned about allegations that he had made. *See* Molly McDonough, *Fired CFO Wins Early Sarbanes Claim*, A.B.A. J. EREPORT, Feb. 15, 2004, *available at* http://www.moreombudsman.com/cfo_win.asp. When that request was denied on the ground that it would destroy the confidentiality of the investigation, the CFO refused to attend the meeting. *Id*. Fired for insubordination, he successfully sued and was awarded back pay plus compensatory damages. *Id*. It does not take much effort to imagine the effect this series of events had on the working relationship in that office. *Id*.

85. *See* Alison Stein Wellner, *In the Trenches: How Whistle-Blower Policies Protect Charity Workers Who Report Ethics Lapses*, CHRON. OF PHILANTHROPY, Apr. 15, 2004, *available at* http://philanthropy.com/jobs/2004/04/29/20040429-293229.htm. The article discusses the use of such a hotline at Drexel University:

> Since its inception, the hot line has received about two telephone calls per month, says Dr. Papadakis [President of Drexel University]. Callers are not restricted from discussing any subject, he says, and about half of the calls have been on personnel issues -- for example, one caller complained about not receiving a promotion. Other calls were about more substantive matters, such as unauthorized access to the university's computer system, and a suspected irregularity in the hiring of a contractor.

In addition to encouraging employees to make full and prompt disclosures of questionable conduct, the Act makes it a crime to "alter[], destroy[], mutilate[], or conceal[]"[86] or "cover[] up, falsif[y], or make a false entry in"[87] a "record, document, or other object,"[88] or attempt to do so, "or otherwise obstruct[], influence[], or impede[] any official proceeding."[89] These crimes are limited to specific circumstances involving the securities laws or federal investigations, so they are not directly applicable; but they make the point that whatever a college or university does to adopt the spirit of Sarbanes-Oxley, it must think about how to preserve data once an investigation begins.[90] It is a "best practice" for many reasons to have a document retention (or document destruction) policy; but the college or university should remember to suspend that policy, specifically, once an investigation begins, and to impose sanctions if data is destroyed.[91]

D. New Rules for Attorneys

Finally, the Act imposes new duties upon lawyers. Any attorney working for a regulated corporation (by employment or engagement) is required "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or

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> In each case, there has been an investigation. Thus far, no impropriety has been uncovered. 'But this is a great way to communicate,' Dr. Papadakis says. Without the hot line, he notes, 'the information would not have come through, because the person was worried, or didn't want to do be identified, and we would have missed their contribution.'

Id.

86. Sarbanes-Oxley Act § 1102 (codified at 18 U.S.C.A. § 1512 (2000 & West Supp. 2004)).

87. *Id*. § 802 (codified at 18 U.S.C.A. § 1519 (2000 & West Supp. 2004)).

88. *Id*. § 1102.

89. *Id*. § 1102. Note that this prohibition applies not only to *existing* "official proceedings," but to proceedings that might later occur (the "official proceeding" need not even be "about to be instituted").

90. Indeed, the university may need to establish procedures on how such investigations should be conducted. When should the president (not) be told?

91. Under well-established principles of common law, destruction of documents (and other types of proof) leads to the presumption that whatever was destroyed was adverse to the interest of the person who destroyed it:

> The spoliation of papers and the destruction or withholding of evidence which a party ought to produce gives rise to a presumption unfavorable to him, as his conduct may properly be attributed to his supposed knowledge that the truth would operate against him. This principle has been applied in a great variety of cases, and it is now so well established that it is unnecessary to do more than state it.

McHugh v. McHugh, 40 A. 410, 411 (Pa. 1898), *cited with approval by*, Duquesne Light Co. v. Woodland Hills Sch. Dist., 700 A.2d 1038, 1050 (Pa. Commw. Ct. 1997). The destruction of evidence may also give rise to an independent cause of action for spoliation. *See e.g.*, M.L. v. Univ. of Pittsburgh, 26 Pa. D. & C.4th 106 (Pa. Commw. Ct. 1995) (allowing claim against fraternity for its destruction of the guest list for one of its parties, to impede the plaintiff from identifying her attackers) *questioned by* Elias v. Lancaster Gen. Hosp., 710 A.2d 65, 67 n. 3 (Pa. Super. Ct. 1998) (noting that while a few Pennsylvania trial courts have embraced spoliation of evidence as a separate cause of action other Pennsylvania trial courts have refused to recognize it as a separate tort).

the chief executive officer of the company (or the equivalent thereof.)"[92] What does "material" mean when applied to "breach of fiduciary duty"? When a trustee misses more than half of the meetings of the board committee on student life, that is probably a material breach of the obligation owed to the board, but it is probably not material to the health of the institution. But if that question is difficult to answer, what constitutes a "[material] breach" of a "similar obligation"? And how far does "agency" go in this context (as opposed to tort liability, for example)?

If the general counsel (or chief executive officer) "does not appropriately respond" with "appropriate . . . measures or sanctions" (presumably in the personal judgment of the reporter), the attorney is required "to report the evidence to the audit committee of the board . . . or to another committee of the board of directors comprised solely of directors not employed directly or indirectly" by the corporation.[93] How often do lawyers entirely agree with each other? Their ability to look at things from any angle and create arguments is what protects clients. In law firms, partners get the final word over associates, department chairs over all partners within their department. For colleges and universities that have legal staffs, the general counsel is the final word. But the Act allows no such deference to experience or authority: the junior attorney is charged with the obligation to go directly to the trustees if he or she does not think the general counsel (or president) has acted "appropriately."[94]

When it is "all about the money," the questions are fewer and perhaps easier to answer. In academia, though, the spirit of Sarbanes-Oxley requires a sensitivity to "big issues" that can arise in many contexts, and a common understanding by all attorneys who work for it (perhaps addressed in the retainer letter and written office policy) of the duty promptly to disclose actions of questionable integrity.[95]

IV. ADOPTING THE SPIRIT OF SARBANES-OXLEY

No college or university should blindly "adopt" Sarbanes-Oxley. Once that is done, or once that impression is given, the expectation will be created that the college or university will comply with the same requirements that are applicable to publicly-traded corporations; and as those corporations subject to the Act regularly attest, those obligations are exceedingly time-consuming and expensive. Unlike

92. Sarbanes-Oxley Act § 307(1) (codified at 15 U.S.C.A. § 7245 (1998 & West Supp. 2004)).

93. *Id*.

94. *Id*.

95. In the ashes of the bankruptcy of AHERF, criminal charges were brought against the non-profit corporation's general counsel for having allowed its executive officers to "borrow" funds from restricted endowments for general operating purposes. *See supra*, note 4. Tens of millions of dollars were lost. After years of litigation (primarily against insurance companies), less than twenty percent of the trust funds were restored. In that situation, any associate general counsel aware of what was happening was likely obligated to report the matter to the board's chair or audit committee, as a matter of professional ethics. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002) (referring to the "Organization as Client"). Those rules require "whistleblowing" only when the inappropriate action "is likely to result in substantial injury to the organization" and helps the attorney to identify factors to be considered and the various ways to respond. *Id*. As such, the profession's ethical rules are sufficient for academia, if the commitment is made to honor those rules.

corporations, the stocks of which are publicly traded, institutions of higher learning are in no position to pass those costs on to its customers, and therefore, they must be judicious in its application. Moreover, many of the inducements that lure employees of for-profit institutions to stray from propriety (e.g., bonuses, stock options) are typically not present in the not-for-profit world, and others (e.g., loans to help new officers move to their new jobs) are often necessary.[96] Financial misconduct is just one of a great many things that can hurt institutions of higher education. As one risk among many, its dimensions should be appreciated so that appropriate remediation can be accomplished in a planned and timely way.

At the same time, no college or university can afford not to adopt the "spirit" of Sarbanes-Oxley. What all institutions of higher education should take from the Act is an attitude: our investors—those who send us their children (and tuition), those who send us their gifts (alumni/ae and friends), and those who do business with us (in research and development efforts)—deserve to know that their money is being well and appropriately spent.[97] Those who give us their labor—those who teach along with the staff and administrators who support them—deserve to know that the business affairs of the corporation are being attended to with diligence and integrity. We should be willing to give them the evidence they need to satisfy themselves on those accounts, and that includes making a reasonable effort to ensure that the information we give them is "full, fair, accurate, timely and understandable."[98]

We should take more than this from Sarbanes-Oxley, however, because academia is not just "all about the money." The broader issues are risk, integrity and accountability. Financial misconduct is only one of the major risks that a college or university faces.[99] How (and how well and how often) does the college or university assess its (other) risks? Once those risks are known and prioritized, what systems are in place to address (monitor and control) those risks, and how adequate are those systems? Has the college or university clearly articulated the standards of conduct it expects of those who serve it (trustees, officers, management, employees, vendors)? If so, are there well-understood, and trusted, procedures in place by which misconduct can be discovered or reported? Who is responsible for maintaining the integrity of the system? Are managers held responsible for their conduct and that of those reporting to them? Do the employee and management training programs include ethics? Does the college or university have a compliance program? How is the board of trustees structured to oversee integrity and compliance issues? Are the various relationships among the board and the administration sufficiently defined?

These are good questions to ask at any time, and especially now, when

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96. *See* Sarbanes-Oxley Act § 402(a) (codified at 15 U.S.C.A. § 78m(k) (1998 & West Supp. 2004)).

97. *See*, *e.g.*, Paul C. Light, *Fact Sheet on the Continued Crisis in Charitable Confidence*, *available at* http://www.brook.edu/views/papers/light/20040913.pdf (Sept. 13, 2004); Greg Winter & Jonathan Cheng, *Givers and Colleges Clash on Spending*, N.Y. TIMES, Nov. 27, 2004, at A1.

98. Sarbanes-Oxley Act § 406(c)(2) (codified at 15 U.S.C.A. § 7264(c)(2) (1998 & West Supp. 2004)). *See supra* note 42 and accompanying text.

99. *See supra* notes 49–54 and accompanying text.

legislators are threatening to impose their own answers. Asking these questions is perhaps the single most important job of the non-profit trustee. Indeed, *not* asking them might be exactly the type of inattention that violates the two core fiduciary duties owed by trustees to their institution: the duties of care and loyalty.[100]

When Senator Sarbanes summarized the Act that bears his name, he identified this "set of fundamental guidelines:"

- Eliminate conflicts of interest. To do this, first identify them, and then identify and eliminate the conditions that give rise to them.
- Establish effective checks-and-balances mechanisms. Gatekeepers must carry out their responsibilities. They must not fall asleep at the switch or, indeed even worse, be lured from their post by quick easy money.
- Insist on disclosure, transparency, and openness.
- Assure effective oversight.
- Mandate accountability.
- Be forward thinking. It is not enough to deal with problems after the fact, when a lot of harm has been done to a lot of people. It is not enough to deal with problems as they arise. We must take the next step, and seek to prevent problems from arising in the first place.[101]

These principles are just as important to have guiding conduct in higher education as they are to have regulating the financial affairs of publicly-traded corporations. How they are imported and where they get applied will vary from institution to institution. But we who work in higher education and perform this public service should not await the next scandal, or the next legislative act, before making those decisions for ourselves.[102]

100. One leading decision identified "the core element" of a director's service to be the obligation to remain informed, and the core test of a director's service as "whether there was [a] good faith effort to be informed and exercise judgment." *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996).

101. Address of Senator Paul S. Sarbanes, *supra* note 12.

102. Appendix A includes fifteen questions that each institution ought to ask itself. Appendix B offers ten "best practices" for institutions of higher education.

APPENDIX A

FIFTEEN QUESTIONS TO ASK

1. Do your employees know why accurate financial information is so important?
2. Do they know that they are responsible and accountable for accuracy?
3. What is the level of training/expertise of the people who prepare the financial reports, and of the CFO and CEO who present them?
4. Does your institution know what the areas of real financial risk are (contracts, billings/grants, procurement, cash, bookkeeping, reconciling)?
5. How do you know that a sufficiently close watch is being kept in those areas?
6. Should you have an internal auditor?
7. Are the statements reported in accordance with accounting principles that are generally accepted?
8. Does the board know enough about numbers/financial reports to adequately assess them?
9. Is the board structured in a way to ensure independence (nominating committee), accuracy (board treasurer, finance committee, audit committee), and accountability (compensation committee)?
10. Is your relationship with your outside auditor too comfortable?
11. Do you know where there are conflicts of interest (staff, administration, board)?
12. Do your employees know what is expected of them (proper use of corporate resources, integrity in dealing with third parties, honesty in reporting, absence of conflicting commitments, etc.)?
13. Do your board members know what is expected of them (level of engagement, duties owed, conflicts of interest, etc.)?
14. Is there some means by which your employees can effectively and anonymously report their concerns without fear of retaliation?
15. Should you obtain outside assistance to evaluate the risks facing the institution?

APPENDIX B

TEN "BEST PRACTICES" TO CONSIDER

1. Background checks for new hires;
2. Annual disclosure of conflicts of interest, required of employees and trustees alike, pursuant to a written conflict of interest policy or bylaw provision;
3. Code of conduct for employees and trustees that includes sanctions for non-compliance and a credible system for investigating and responding to allegations of improper conduct;
4. Written whistleblower policy and procedures that provides confidentiality and protects the caller from retaliation;
5. Periodic "risk assessments" by outside consultants;
6. Annual audit of financial statements by an independent certified public accountant (and, if the institution is large enough, hire an internal auditor);
7. At least one "financial expert" on the board;
8. An audit committee of the board, with a written charter specifying its jurisdiction and detailing its authority;
9. A nominating committee of the board, to ensure board independence from the president and senior management; and,
10. Standing instruction to legal counsel to notify general counsel, president, chair of board audit committee, and/or chair of board of wrongful conduct that is material to the institution.