Saint Louis University Law Journal

Volume 47
Number 4 *Millstone Lecture (Summer 2003)*

Article 4

11-7-2003

Looking Beyond the Evildoers: Sarbanes-Oxley and the Future of Corporate Law

Thomas L. Greaney
Saint Louis University School of Law

Follow this and additional works at: https://scholarship.law.slu.edu/lj

Part of the Law Commons

Recommended Citation
Thomas L. Greaney, *Looking Beyond the Evildoers: Sarbanes-Oxley and the Future of Corporate Law*, 47 St. Louis U. L.J. (2003).
Available at: https://scholarship.law.slu.edu/lj/vol47/iss4/4

This Essay is brought to you for free and open access by Scholarship Commons. It has been accepted for inclusion in Saint Louis University Law Journal by an authorized editor of Scholarship Commons. For more information, please contact Susie Lee.

LOOKING BEYOND THE EVILDOERS: SARBANES-OXLEY AND THE FUTURE OF CORPORATE LAW

THOMAS L. GREANEY*

The simple, made-for-television account of the notorious scandals at Enron, Worldcom, Tyco, and most recently, HealthSouth, tells a tale of greed and the ineluctable temptations of money and power. A handful of evildoers, to use a currently popular expression, were able to corrupt their corporations' accountability systems and thereby profit personally. John Biggs' thoughtful Millstone Lecture provides a more nuanced—and perhaps more alarming—account suggesting that the key lessons of the past decade include warnings of deep-seeded malfunctions.

This essay agrees with John Biggs' assessment that problems infecting modern corporate governance are systemic and suggests that they are not remedied by legislation that relies exclusively on punishing evildoers or improving information dissemination. It also serves as a reminder that unintended consequences inevitably arise from sweeping legislative reforms and that political realities should dampen enthusiasm about federal remedies.

IDENTIFYING THE PROBLEM

If pressed for a signal indicator that something has gone badly amiss, consider the following statistics concerning the volume and impact of the restatements of earnings by corporations over the last five years. More than ten per cent of all listed American companies restated earnings between 1997-2002 at a cost of $100 billion in stock declines in the immediate three days after announcement.[1] Professor Cox's epigram that "restated earnings are fraud *sans* scienter"[2] captures well the import of this phenomenon. Investors have just as surely been misled, experienced real losses, and lost confidence in capital markets, even if erroneous earning reports and other forms of

* Professor of Law and Co-Director, Center for Health Law Studies, Saint Louis University School of Law.

1. Jonathan Weil, *Deals & Deal Makers: Restatements of Earnings Have Multiplied*, WALL ST. J., June 7, 2001, at C15.

2. James D. Cox, *What's In a Principle? Professional Accounting, Audit Committees and the Metrics of Financial Reporting,* Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21-22).

mismanagement are the product of neglect and technically lack intent under the legal definition of fraud.

Although many assessments of the nature of the corporate governance problem are available, the core issues can be broadly summarized, to borrow from the Powers Report, as "a fundamental default of leadership and management,"[3] and to borrow from Professor Coffee, the dereliction by "gatekeepers."[4] The rather startling consensus is that the key mechanisms of investor protection that academics and policy analysts have long heralded have simply not worked. These protections can be grouped into four categories:

- So-called gatekeepers (accountants, lawyers and market analysts) whose job is to stake their reputation on assuring that information is disclosed and procedures are followed.
- Financial incentives (bonuses, stock options, etc.) that were thought to align stockholders' interests with those of management.
- Legal sanctions and duties found in securities and fraud law and state fiduciary law that direct managers and gatekeepers to act as selfless agents serving the interests of shareholders and the corporation.
- "Trust" or internalized norms that operate to induce reliance based on one's integrity and character rather than on whether the individual has external incentives to refrain from exploiting another.[5]

The sweeping, post-Enron reforms aim, to a certain extent, to repair all of these protections. In Sarbanes-Oxley[6] and in the efforts of the reinvigorated enforcement agencies (including both the SEC and state securities regulators and attorneys general), one sees strong measures designed to improve the functioning of gatekeepers by empowering corporate audit committees, assuring the independence of outside auditors, reducing conflicts, and improving information dissemination through public reporting. The new regime seeks to correct misaligned financial incentives by compelling returns of bonuses and stock options where restatements occur and providing accelerated, more reliable disclosures. Legal sanctions are improved, somewhat controversially, by federalizing corporate governance law (e.g. forbidding loans to top management and dictating the composition and role of key board committees) and strengthening criminal penalties for securities law violations. Trust, arguably the safeguard least susceptible to enhancement by

3. William C. Powers, Jr., Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation, Testimony at the United States House of Representatives before the Committee on Financial Services (Feb. 4, 2002).

4. John C. Coffee, Jr., *Understanding Enron: "Its About Gatekeepers Stupid,"* 57 BUS. LAW. 1403 (2002).

5. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1751 (2001).

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

SAINT LOUIS UNIVERSITY SCHOOL OF LAW

legal reforms,[7] is enhanced by strengthening formal independence of board members and gatekeepers, mandating internal policies on ethics, and imposing specific ethical duties on accountants and lawyers.

ASSESSING REMEDIES: UNQUANTIFIABLE GOALS AND UNANTICIPATED COSTS

What should we expect from these reforms? More fundamentally, by what metric should we measure their success? It is argued here that the most important improvements from Sarbanes-Oxley will not be readily observed and that some unintended consequences must be expected. That benefits are inchoate, of course, does not make them less important; the point is that the law's most useful role will be in shaping norms.

"TONE AT THE TOP": The central issue identified in the academic literature as impairing efficient functioning in corporations is the problem of agency. Not only is ownership separated from control, but also boards and officers control the flow of information that investors and gatekeepers require to ensure effective and efficient management of the corporation. Will the reforms succeed in changing CEOs' receptiveness to the spirit of full disclosure, accurate reporting, and the free flow of information upwards from below?[8] Many Sarbanes-Oxley reforms such as CEO and CFO certification are designed to change the attitude and direction emanating from the top echelons. Nevertheless, the effectiveness of this and other changes hinges on its effect on attitudes and prevailing norms within the boardrooms and executive suites.

INFRASTRUCTURE: Will Sarbanes-Oxley trigger the changes in the regulatory and market infrastructure necessary for the reforms to work? To take one example, there is a serious problem with concentration in the accounting industry. What used to be the Big Ten accounting firms has shrunk to what John Biggs calls the Final Four. Even that high concentration level is misleading, as for some industries only two or three accounting firms are viable options. Sarbanes-Oxley mandates a study of the issue, but a major question remains whether there will be a sufficiently vibrant market for

---

7. *See* Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 576 (2001).

8. SEC Commissioner Adkins described the Act's ambitions to change attitudes as follows:

> A lesson from the recent corporate failures in America is the importance of corporate culture and what we call the "tone from the top." A CEO's tolerance or lack of tolerance of ethical misdeeds and a CEO's philosophy of business conveys a great deal throughout the organization . . . . It is my hope that Sarbanes-Oxley may indirectly help directors in this regard. The law's effect will be to make board members be more inquisitive. Therefore, questions that might have seemed to be "hostile" to management two years ago will now be seen to be in furtherance of a director's function.

Paul S. Atkins, The Sarbanes-Oxley Act of 2002: Goals, Content and Status of Implementation, Remarks at the University of Cologne, Germany (Feb. 5, 2003), *available at* http://www.sec.gov/news/speech/spch020503psa.htm.

accounting services for the largest companies so as to allow the kind of shopping and, ideally, inter-firm rotation that Sarbanes-Oxley encourages. Similar questions can be directed at the functioning of the market for investment analysts, particularly whether reforms will ameliorate conflicts of interest or engender new avenues for abuse. Finally, a linchpin of Sarbanes-Oxley is the impact of the Public Company Accountancy Oversight Board. To fulfill its mission—bringing a measure of public oversight and independence to the generation of standards and practices of the accountancy profession—the Board will require acceptance from industry and support from political and administrative centers. The wrangling over the selection of the first chairman of the Oversight Board, which included allegations that the accounting industry resisted John Biggs' appointment because he was too well-versed in the issues facing the industry,[9] highlights the risk that even the best-crafted reforms will be vulnerable to interest group pressures.

LAW REFORM: By some accounts, Sarbanes-Oxley may mark the beginning of a shifting paradigm in corporate law. For one thing, it may portend increased federalization of corporate governance law, which has long been the province of the states.[10] Further, it may signal the reinvigoration of the fiduciary duty standards, which courts have watered down considerably and from which legislatures have permitted corporations to "opt out." Students of corporate law today find it astonishing that it was not until 1996 that the Delaware courts imposed upon directors a fiduciary duty to monitor compliance with the law.[11] Equally surprising, only in 1998 did they discover a generalized fiduciary responsibility to make truthful disclosures, even when not seeking shareholder actions.[12]

At the same time, it is important to remember some of the things Sarbanes-Oxley did *not* do. It did not reverse the actions by Congress and the Supreme Court that have arguably watered down legal sanctions on auditors and gatekeepers.[13] Nor did it directly tackle the misaligned incentives among

9. *See* Roel C. Campos, Statement at the Open Commission Meeting of the U.S. Securities and Exchange Commission on the New Public Accounting Oversight Board, (Oct. 25, 2002), *available at* http://www.sec.gov/news/speech/spch600.htm (dissenting from nomination of William Webster for chairmanship and describing reports of accounting industry lobbying efforts to oppose John Biggs for that position).

10. For a critical account of Sarbanes-Oxley's move toward federalizing corporate governance rules, see Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION (2003), *available at* http://ssrn.com/abstract=389403.

11. In Re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Chan. 1996).

12. Malone v. Brincat, 722 A.2d 5 (Del. Super. Ct. 1998).

13. Sarbanes-Oxley did not attempt to strengthen private enforcement of the federal securities laws by amending the Private Securities Litigation Reform Act of 1995, which may have deterred or impeded meritorious lawsuits. 15 U.S.C.A. § 78u-4 (2000). Nor did it review the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*,

SAINT LOUIS UNIVERSITY SCHOOL OF LAW

executives, for example, by increasing the holding period for insider stock ownership. It eschewed taking bolder action on conflicts of interest, such as mandatory rotation of audit firms. Relying heavily on disclosure as a curative, Sarbanes-Oxley may be faulted for neglecting to significantly improve the capacities of those who receive, analyze, and disseminate that information.

UNINTENDED CONSEQUENCES: Critics of Sarbanes-Oxley ask whether the realignment of responsibilities has gone too far.[14] In placing so much responsibility on the shoulders of the audit committee, for example, the law may create new problems. Will audit committee members, especially their financial experts, become more like management: full-time employees who are dependent on their high salaries and subject to conflicts of interest? Consider, for example, the list of characteristics that an SEC Commissioner recently suggested were needed for members of the audit committee: skepticism, inquisitiveness, and willingness to seek out advice from sources external to the corporation. While the need for a truly independent audit committee cannot be questioned, the reforms may risk creating an insulated center of power subject to abuse. The ready analogy drawn by some is to the special prosecutor legislation, which responded to perceived conflicts of interest in the Department of Justice by requiring referrals to independent prosecutors of certain allegations of criminal activity at high levels of the executive branch.[15] Other instructive lessons about well-meaning reforms are available. For example, Congress's decision to prohibit companies from deducting compensation paid to officers in excess of $1 million unless paid pursuant to a plan approved by the shareholders[16] may have helped fuel the precipitous growth in stock options as a means of executive compensation. In retrospect, this decision can be seen as paradoxically aligning management interest too closely with investors' interests in that it created overwhelming incentives to enhance short term profits by any means possible.

CONCLUSION

The old saw is that you can't legislate morality. But why not? If unchecked capitalism can create a climate in which community leaders betray their neighbors, law can surely effect some measure of change. Fiduciary duties, disclosure obligations, and reporting up and out by gatekeepers may help change attitudes, shift corporate cultures, and reinforce internalized boundaries of conduct. At bottom, they can prevent managers from putting themselves in positions of conflicting interests, and they can reduce

N.A., 511 U.S. 164 (1994), which held that private aiding and abetting actions against attorneys and auditing firms could not be brought under Rule 10b-5.

14. *See, e.g.,* Richard Epstein, *Sarbanes Overdose*, NAT'L L. J., Jan. 27, 2003, at A17.

15. *Id.*

16. *See* I.R.C. § 162(m) (2000).

SAINT LOUIS UNIVERSITY SCHOOL OF LAW

temptations, or what I was taught to call the "occasions of sin"—a good day's work for any statute.