Conversations With...

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The Issue:
Free Enterprise - Left Behind after Sarbanes-Oxley?

This edition of Washington Legal Foundation's CONVERSATIONS WITH examines how the Sarbanes-Oxley Act of 2002, and the resulting further criminalization of business conduct, has impacted entrepreneurial risk-taking in America. Former Attorney General of the United States and Pennsylvania Governor Dick Thornburgh leads an informative discussion with two leading business regulation and enforcement academics — Professor Craig Lerner of the George Mason University School of Law, and Professor Moin A. Yahya of the Faculty of Law at the University of Alberta. The participants share their insights on whether Sarbanes-Oxley has provided sufficient benefits to the U.S. economy and shareholders compared to its costs; how expanded white collar criminal enforcement and reduced standards of intent have contributed to the demise of the entrepreneurial spirit; and how the current enforcement climate could leave corporate offices and boards populated with carefree "swashbucklers" who would have little concern for preventing fraud and other illegal activity.

Governor Thornburgh: What kind of environment existed at the time Sarbanes-Oxley was adopted and passed? How did that influence how the legislation was written and its passage?

Professor Craig Lerner: The stock market had plummeted from its peak in early 2000, putting many investors in a foul mood. Then came the revelations of fraud at Enron, WorldCom, Adelphia and other companies. Many policymakers concluded that corporate criminals had plundered the hard-earned wealth of Americans and resolved to rid the world of white-collar bandits. With little deliberation, Congress enacted Sarbanes-Oxley (Sarbox). The Business Roundtable, whose members consist of large corporations, was notably silent during these developments. By contrast, the U.S. Chamber of Commerce, which has small firms among its constituents, fought against many provisions of the law.

Governor Thornburgh: Do you think Congress overreacted to the "corporate meltdowns" that preceded the legislation?

Professor Moin Yahya: Absolutely. Recall that in addition to a slowdown in what had been over eight years of

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economic expansion, the events of 9/11 came as a jarring jolt to the economy. There was a lot of anxiety in the air, and no doubt many firms were not sure if another attack would take place and this would affect their investments. Instead of Congress stepping in to reassure Corporate America that the government was there to keep the peace and protect the Nation, Congress lashed out the very group of people who are responsible for the growth in our economy, i.e. corporate executives and directors. As some wags have pointed out, the irony in all of this is that, even adding up all the corporate scandals of the early twenty first century, it is doubtful that even 1% of all American corporations were implicated. That's a lower rate of criminality that in the halls of Congress.

Governor Thornburgh: Could you discuss what could have been done differently legislatively, if anything, to more effectively address the goals of Sarbanes-Oxley? That is, if not Sarbanes-Oxley — what?

Professor Lerner: It is hard to know what the precise goals of Sarbanes-Oxley were. Perhaps one could say that the law was intended to reduce corporate fraud. Yet as Professors Larry Ribstein and Henry Butler have pointed out, the optimal amount of fraud is not zero. The cost of eliminating fraud would be prohibitively high. As it happens, the share price of any company reflects a discount for the possibility of fraud. Many provisions of Sarbanes-Oxley appear to be a quixotic attempt to align the incentives of managers and shareholders, but let's be realistic: no two human beings have identical interests. Call it agency costs, or just plain human selfishness. A plethora of laws already exist to address this problem. One solution to the problem of corporate fraud is to enforce those laws — criminal and civil, federal and state — that already exist. Our concern is that Congress seems to find endless provocations to legislate; whenever this is a corporate meltdown or accusations of fraud, we can expect newer and "tougher" laws.

Governor Thornburgh: Do you think a legislative response was, in fact, the most effective response?

Professor Yahya: The problem with Sarbanes-Oxley is that it tried to address major structural economic problems in the economy by prescribing a code of conduct for all officers and directors — a one size fits all. Undoubtedly, some of the large corporations may be able to comply with all the minutiae mandated by Sarbox, but for most American corporations, the costs are large and the benefits are not clear. (This is probably why the Business Roundtable did not vigorously oppose the law, as Craig pointed out earlier.) Ignored in the legislative response was the role of the shareholders and institutional investors, both of whom are better at detecting fraud in Corporate America than the U.S. Attorneys. To be sure, investors — such as those that ran up the share price of Enron — sometimes make mistakes. But they are likely to learn from their errors and be more careful in the future. If there are fewer Enron scandals in the future, it may have nothing to do with Sarbanes-Oxley; it may simply be because investors are more careful and diligent.

Governor Thornburgh: Sarbanes-Oxley was a step toward federalizing corporate law and corporate governance. Do you think this trend will continue?

Professor Lerner: Until the early twentieth century, states, and not the federal government, regulated corporate governance. The federal securities laws of the 1930s did not contemplate federal preemption, at least over corporate governance matters. Indeed, over the next few decades, as UCLA Professor Stephen Bainbridge has written, attempts by federal agencies to expand their regulatory powers over corporate governance were rejected by the U.S. Supreme Court. Several provisions of Sarbanes-Oxley are something of a turning point, then. I am thinking, for example, of the provisions governing the composition of, and compensation for, boards of directors. As Bainbridge and others have noted, what's great about state regulation of corporate governance is the possibility of experimentation and competitive federalism. Unfortunately, many in Washington, D.C. pay lip service to the virtues of federalism all the while exploiting any opportunity to expand the powers of the federal government at the expense of the states.

Governor Thornburgh: In your 2007 American Criminal Law Review article, *Left Behind After Sarbanes-Oxley*, you argue that there are three kinds of corporate executives — bean counters, swashbucklers and ideal entrepreneurs. Can you explain what you mean by these terms?

Professor Yahya: As we elaborate in the article, we imagine the competition for corporate control as waged by three types of managers- ideal entrepreneurs (who are risk-neutral with respect to business decisions, but risk-averse with respect to compliance with the criminal law); swashbucklers (who are risk-neutral with respect to both business decisions and criminal law compliance); and bean counters (who are risk-averse on both of these margins). From society's perspective, the best environment is one that allows the ideal entrepreneur to triumph. Unlike bean counters, he is willing to take entrepreneurial risks that benefit society. And unlike swashbucklers, he is hard-wired to comply with the criminal law.

Governor Thornburgh: How does Sarbanes-Oxley affect the competition between these three human types?

Professor Lerner: We predict that many ideal entrepreneurs will simply flee the world of publicly traded corporations. Think of it this way: In the realm of tort law, many have argued that the current product liability regime stifles the entrepreneurial spirit. Exit from a sphere of activity should be even more pronounced when entrepreneurs face potential criminal liability. And remember that laws like Sarbox do not simply expand the scope of the criminal law; such laws seem to move us closer to something like de facto strict liability — that is, ambiguously defined terms, uncertain enforcement strategies and steep penalties. What our model predicts is that some ideal entrepreneurs will be induced to overinvest in precautions (in a sense, becoming more like bean counters), and still others will abstain from the activity completely. Sarbanes-Oxley may have the perverse consequence of driving away the very kinds of corporate managers society

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Governor Thornburgh: In your view, what effect does the erosion of the attorney/client privilege have on the phenomenon of "ideal entrepreneurs" being driven out of the corporate world?

Professor Yahya: Without the ability of managers to freely consult legal counsel and without fear of these consultations being made public, ideal entrepreneurs are far less likely to put themselves in managerial positions where they may find themselves liable when the finances of the company go south. Hanging corporate managers out to dry when there is the slightest sign of trouble is no way to attract top talent. In the long run, we may actually get fewer and fewer of our best and brightest interested in becoming managers of large publicly traded corporations. Just as the medical malpractice crisis seems to have deterred many of the best young men and women from pursuing a career in medicine, in the long run, our legal regimes may deter those with a talent in management from pursuing a career in publicly traded companies.

Governor Thornburgh: Because Sarbanes-Oxley presents greater risks to corporate executives, to what extent do you think their tenure will be shorter and salaries higher?

Professor Lerner: One recent study found that, since Sarbanes-Oxley, CEOs are receiving more fixed compensation and less incentive-based compensation. Another recent study found a 91.3% increase in Fortune 100 CEO departures in the five years following Sarbanes-Oxley compared to the five years prior to the law. The latter study is consistent with our predictions. In the post-Sarbanes-Oxley world, neither the bean counters nor the swashbucklers may last too long. The former, who are technically solid but lack any entrepreneurial spirit, will be rewarded for their skill in keeping the company out of trouble; but at some point sub-par profits will force the company's board of directors to seek new managers. Swashbucklers, by contrast, will generate high returns, but they are likely in it only for the short-haul, and there is always the risk that their cavalier attitude towards the criminal law will stir up a scandal that will culminate in their ouster.

Governor Thornburgh: Sarbanes-Oxley requires that the entirety of the public company's audit committees and the majority of corporate management be comprised of independent directors. Consistent with the thesis of your article, commentators have noted that independent directors, given their more limited expertise and familiarity with the corporation, will be more conservative and more risk-averse. Could you elaborate?

Professor Yahya: Independent directors have no real stake in the corporation. They have no real ownership in the company. Hence their incentives to make the company a profitable entity are far less than for those directors who have a real stake in the corporation. Outside directors will only want to ensure that all the forms and regulatory paperwork is filled out properly and will not be too interested in whether the firm's long term strategies are

best serving the shareholders.

Governor Thornburgh: Does Sarbanes-Oxley change the type of person who will serve on a Board?

Professor Lerner: At least one study concluded that boards of directors now garner higher pay and are composed of more lawyers, consultants and financial experts. This is, again, what we would predict. Given the onerous reporting requirements and the composition rules regarding the various committees (such as the audit committee), one would expect boards of directors to be increasingly filled with people focused on regulatory compliance rather than generating profits for shareholders.

Governor Thornburgh: One of Sarbox's goals was to restore investor confidence, in light of the corporate fraud scandals. Peter J. Wallison has argued that investor confidence did not, in fact, decline in response to the corporate scandals of Enron and WorldCom. Indeed, he cites evidence that the Dow actually fell on the days that Sarbanes-Oxley was debated and then was passed by Congress, suggesting a correlation between the Dow plunging and the anticipation of onerous regulation. Can you discuss the possibility that the political class, in this crisis atmosphere, offered a false choice: further regulation of the corporate world or further loss of investor confidence?

Professor Yahya: A great economist once said that the first rule of economics is scarcity and the first rule of politics is to forget the first rule of economics. This is unfortunately the lesson in almost all political decision making: a false dichotomy is presented when in most situations the status quo or simply letting the market work out the issues would be a superior solution. Had Sarbanes-Oxley not been passed, the market would have been more vigilant in distinguishing those corporations that were solvent from those who were not. Corporations would also have the opportunity to credibly signal to the market their solvency as well as genuine growth opportunities. Instead, the market is now faced with a barrage of paperwork that is meant to assure them that certain steps have been taken without any meaningful sense of who is truly compliant and who isn't.

Governor Thornburgh: In general, can you comment on how effectively Sarbanes-Oxley actually has met its stated policy goals?

Professor Lerner: Two recent studies highlight the difficulties with Sarbanes-Oxley and are consistent with our predictions. On the one hand, a recent study by three economists at the University of Pittsburgh concluded that American companies have, since Sarbanes-Oxley, reduced expenditures on research and development, increased holdings in low-risk investments, and are less willing to test the IPO waters. On the other hand, the 2007 Oversight Systems Report on Corporate Fraud surveyed certified fraud examiners; three-quarters of the respondents reported their impression that institutional fraud is more prevalent today than before Sarbanes-Oxley. How can there be less risk-taking but more fraud? Here is our proposed solution: Sarbanes-Oxley has caused some ideal entrepreneurs to flee American publicly traded corporations, either for the

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greener pastures of Europe or private equity. And perhaps a growing number of those left behind are both the bean counters (who are less inclined to seek out risky ventures) and the swashbucklers (who are not easily deterred by the criminal law).

Governor Thornburgh: You talk in your article about the dilution of the *mens rea* requirement and the movement to strict liability. Can you talk about how that dilution has occurred?

Professor Lerner: Under the common law, there was ordinarily no criminal liability for mere negligence; to obtain a criminal conviction, the state had to show that the defendant had a "guilty mind." For the most part, American law preserved this principle until the New Deal. In the 1943 opinion *United States v. Dotterweich*, however, the U.S. Supreme Court upheld the conviction of the president of a company that had shipped mislabeled drugs, even though he had no personal knowledge of the violation. The Court conceded that it might seem unfair to convict defendants who have no "consciousness of wrongdoing," but the Court found that doing so was necessary to promote the "public welfare." Congress has, over the past few decades, enacted hundreds of criminal laws, all nominally designed to secure the public welfare, and many of which preserve at most an attenuated *mens rea* requirement.

Governor Thornburgh: Federal statutes today provide for over 100 separate terms to denote the requisite mental state with which an offense may be committed. Can you address how, in your view, that contributes, at once, to the dilution of the *mens rea* requirement and the overly broad reach of criminal statutes?

Professor Yahya: Another way that *mens rea* has been diluted is the sheer number of criminal statutes on the books. The courts still hold to the fiction that ignorance of the law is no excuse, which makes sense when we are talking about murder and rape. But in the context of the hundreds of criminal statutes, all of them assume that the defendant knew that the act he was committing was crime. The various mental states referred to in the statutes generally refer to his knowledge that he was committing the act, not that he knew the act was illegal. Some of the statutes do not even refer to any mental state, just that the act was committed. There are (and this is just an estimate) over 4,000 federal criminal statutes scattered all over the United States Code, and no one has a handle on all of them — let alone the average individual who is charged with complying with all of them.

Governor Thornburgh: You have suggested that the composition of the corporate world will be radically changed by Sarbanes-Oxley and that the ideal entrepreneurs will be driven out, leaving that terrain to excessive risk-takers and the severely risk-averse. Do you think Sarbanes-Oxley inspired the perceived trend of entrepreneurs moving away from publicly held companies and toward private equity funds or are there other forces at work here?

Professor Lerner: Yes. One should expect that some ideal entrepreneurs have been driven away by the expensive compliance requirements and possible criminal penalties. The world of private

equity must be enticing.

Governor Thornburgh: Do you think that foreign companies should be exempt from Sarbanes-Oxley?

Professor Yahya: Ideally all companies, American and foreign, should be exempt from Sarbanes-Oxley. One problem with exempting only foreign companies, of course, is that it would disadvantage domestic companies and may even entice foreign companies to leave the American exchanges for the thriving bourses in Europe. The exemption of foreign companies may also serve to remind American legislators that something is terribly wrong when we are afraid to require foreign companies to comply with our own laws.

Governor Thornburgh: In order to try to retain the most desirable actors — the ideal entrepreneurs — how would you amend Sarbanes-Oxley?

Professor Lerner: Various discrete changes could be made that would dramatically improve the law and make conditions more favorable for ideal entrepreneurs. Sections 404 (governing internal controls) and 402 (prohibiting executive loans) could be amended to allow firms to opt out. Small firms could be exempted from many provisions of the law and criminal penalties for violations of several provisions could be removed. The certification provision, Section 302, could also be altered or eliminated. Optimism about any of these changes actually occurring is probably not warranted. A recent paper by James Fanto envisions a future in which large business firms have internal "monitors" employed by the SEC. In effect, the invasive regulatory regime that now governs banks could be applied to entrepreneurial firms. Fanto suggests that Sarbanes-Oxley could be viewed as a step towards what he calls paternalistic regulation of the public firm. This is obviously a recipe for economic stagnation.

Governor Thornburgh: Haven't smaller companies fared particularly poorly under the new certification system? Don't they represent the burdened "ideal entrepreneurs" too?

Professor Yahya: They do, and in fact, there are proposals to exempt them from the law's requirements. All this regulatory compliance is expensive and put smaller companies at a real competitive disadvantage.

Governor Thornburgh: Can you comment on the costs of Section 404 specifically and Sarbanes-Oxley generally?

Professor Lerner: Direct compliance costs have been estimated to be over $4 million per company per year. (One study estimated that companies would spend $6 billion to comply with Sarbanes-Oxley in 2006.) The indirect costs of section 404 are likely even greater, as Ribstein and Butler show in their book on Sarbox, *The Sarbanes-Oxley Debacle*. These costs include: the introduction of inefficient redundancies; the production of enormous and generally useless paper trails; the absorption of management time in bean-counting exercises; and the failure of corporate management to seize profitable business opportunities. These costs will be disproportionately born by small companies. The cited benefits of

section 404 specifically and Sarbanes-Oxley generally — the fostering of public confidence in the market and the reduction of corporate fraud — are rather nebulous and defy quantification.

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Governor Thornburgh: How would you respond to those who would say that the certification system has actually improved the level of responsibility that people take for their actions?

Professor Yahya: There is no evidence that the overall majority of corporate executives were not taking their financial reporting requirements seriously even before Sarbanes-Oxley. And it is unclear whether Sarbanes-Oxley has actually reduced the level of actual or perceived fraud.

Governor Thornburgh: What are your thoughts on the apparent over-reliance of Sarbanes-Oxley on the absolute value and accuracy of financial statements?

Professor Lerner: To the extent that Sarbanes-Oxley, through its widening of the scope of the criminal law and its draconian penalties, tries to promote investor confidence in the stock market, it is not clear that this is a good thing. Investors should not be too confident; any dollar invested in a company, after all, could be lost. It is better that small investors realize that the best way to hedge against the risk of corporate fraud is to own a diversified portfolio of stocks.

Governor Thornburgh: How, in your opinion, could the materiality standard in 404 be made more precise?

Professor Yahya: Section 404 requires a full blown discussion of the internal control mechanisms and any material weaknesses in the audit systems. It would make sense to instruct the Public Company Accounting Oversight Board (PCAOB) to revise the standard to a "material risk of fraud."

Governor Thornburgh: The Commission on the Regulation of U.S. Capital Markets also recommended that Congress incorporate Sarbanes-Oxley into the Securities and Exchange Act of 1934 in order to give the SEC greater flexibility in addressing issues related to Sarbanes-Oxley and so that there is greater clarity with regard to the SEC's authority to issue rules vis-a-vis Sarbanes-Oxley. Since greater clarity normally encourages more risk-taking, what do think of this recommendation?

Professor Lerner: The SEC may lack rulemaking authority to exempt small businesses altogether from the scope of section 404. It may, nonetheless, be able to tailor section 404 requirements to small issuers.

Governor Thornburgh: The Commission also recommended that the SEC comprehensively evaluate the Private Securities Litigation Reform Act (PSLRA), now over 11 years old, to determine if it is indeed meeting the objectives identified by Congress, including investor protection. Do you think this would be useful, in the context of your views on Sarbanes-Oxley?

Professor Yahya: One of the ironies of the past ten years is the growing use of criminal and regulatory sanctions and the lessening of the use of civil sanctions. The PSLRA struck a balance between appropriate litigation and appropriate defenses by corporations. On the other hand, the criminal and regulatory assault

by the state has grown. What is needed is a retrenchment from prosecutions and sanctions in the same way the PLSRA offered a retrenchment from abusive civil litigation.

Governor Thornburgh: How has the certification system burdened the business community now under Sarbanes-Oxley?

Professor Lerner: Top corporate executives and particularly CFOs are less able to look at the "big picture." More time must be spent micro-managing the company. Their job is now one of constant paperwork and regulatory compliance. This clearly diverts resources away from running the company and towards satisfying the various dictates of Sarbanes-Oxley. When Outback Steakhouse's CFO Bob Merritt resigned in April of 2005, he criticized the multiplying regulations that had changed the very nature of his job. He said that he regarded himself as a "business-development oriented person," but that the laws now required someone whose strength was administration. So, basically, because of Sarbanes-Oxley, we can expect different kinds of corporate managers, less interested in creating wealth and more concerned about avoiding legal entanglements.

Governor Thornburgh: What do you think of the importance of the convergence of international disclosure standards and international auditing standards?

Professor Yahya: Convergence is important at one level to ensure harmony amongst standards. On the other hand, there needs to be some divergence so that investors can flock to those regimes that best suit them. Just as we would want more federalism in corporate law, we would also want divergence across international standards so that the optimal systems may emerge and everyone may have a chance to find the appropriate standard for themselves.

Governor Thornburgh: To conclude, could each of you address what you think the future, under Sarbanes-Oxley, looks like? Specifically, is there inevitability to the movement to a strict liability regime or not?

Professor Lerner: Well, maybe not "inevitable," but it would be encouraging if more politicians in Washington, D.C. recognized the difficulties with indiscriminately expanding the regulatory criminal law. Some observers speculated that, with the retirement of Senator Sarbanes and Representative Oxley in 2006, it might be easier to amend the more problematic provisions of Sarbox, such as Section 404. (As long as they were powerful committee chairmen, the prospects of reform were nil.) But the reform effort seems to have stalled. Perhaps future legislators might come to see the wisdom of the older approach to the criminal law, which required the prosecution to prove a "guilty mind" on the defendant's part. More modestly, and realistically, perhaps some criminal laws will be amended to allow defendants to introduce, as a defense, that they took the necessary steps to comply with the law or to discover its meaning. Such facts could then be considered by the jury (or trier of fact) in determining the defendant's guilt.

Professor Yahya: What Craig suggests is something like the Canadian approach: perhaps Americans could learn something from their neighbors to the north, at least on this point!

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In Canada, *mens rea* is somewhat constitutionalized as a right for defendants charged with regulatory (and traditional) crimes. The state only has to prove that the act took place, but the defense is permitted constitutionally to adduce proof of due diligence and best efforts. This gives the defendant a fighting chance at rebutting claims of fraud and regulatory misfeasance. The result is a far lower rate of regulatory prosecutions and convictions (and far shorter sentences) than in the United States. It is not clear that the public in Canada has been swindled any more than in the United States by corporate scandals.

Professor Lerner: Under this sort of legal regime, ideal entrepreneurs can continue to engage in the regulated activity. They know that, even if some bad result occurs, they will not face the prospect of criminal liability.

Professor Yahya: What's bad about the current legal regime in America is that ideal entrepreneurs can have no such confidence. And unless the law credits the efforts of ideal entrepreneurs to abide by the criminal law, that law will not simply deter them; it will drive many of them away altogether. Society may not be pleased to discover who is left behind.

Governor Thornburgh: Thank you, gentlemen.

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Craig Lerner is Associate Dean for Academic Affairs and a Professor of Law at George Mason University School of Law. Prior to joining the George Mason faculty, Professor Lerner practiced law with *Wiley, Rein & Fielding; Cooper, Carvin & Rosenthal*; and *Winthrop, Stimson, Putnam & Roberts*. He was also Associate Independent Counsel with the Office of Independent Counsel during 1996-1998, and was a law clerk to Judge James L. Buckley of the U.S. Court of Appeals for the D.C. Circuit.

Moin A. Yahya is Assistant Professor of Law at the Faculty of Law at the University of Alberta and is a Fellow at the Institute for United States Policy Studies. Professor Yahya graduated *summa cum laude* from George Mason University School of Law in 2003, where he was the Robert A. Levy Fellow in Law and Liberty. Since joining the Alberta faculty, he has been appointed an Associate Dean and has engaged in an extensive amount of scholarship, placing articles in a wide variety of academic and popular publications.