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SOx Appeals

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INTRODUCTION

Through the Sarbanes-Oxley Act (Sox or the Act), Congress appeals to two groups: regulators and private actors. Most of the new duties and liabilities that SOx creates have limited legal substance, advancing little beyond previous rules. However, we must look further to see how regulators and private actors are responding. The Securities and Exchange Commission’s (SEC) rulemaking efforts directly required under SOx have not been inspiring, but SOx has helped prod the SEC into rulemaking which potentially could prove more important than all of the provisions of SOx combined: rules giving shareholders the ability to nominate directors using the corporation’s proxy

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tools. The New York Stock Exchange (NYSE) and Nasdaq, prodded by the SEC in an atmosphere dominated by the political pressure which led to SOx, have passed rules concerning director independence and board committee structure and miscellaneous other topics. Three recent cases suggest Delaware is deferring less to director decisions. These responses illustrate the complexity of corporate law rulemaking today. Congress ultimately has the ability to set the rules, but usually lacks the expertise and inclination. SOx showed that it may now have the inclination, though the expertise is still questionable. In response, other regulators are creating new rules.

SOx also appeals to corporate officers and directors and other gatekeepers who supposedly monitor them (this paper focuses on officers and directors). The ultimate point of most of the new rules is to induce officers and directors to act more carefully and conscientiously. Conventional law and economic analysis suggest a cynical response: companies will respond with formalities, but individuals will not work harder and more faithfully. However, fearful overreaction or strengthened norms of good behavior may lead to a more earnest, substantive response. Evidence to date suggests a complicated mix of cynicism and earnestness.

Finally, SOx appeals, that is, it is an appealing reform. The new rules and induced behavioral changes supplement and strengthen an emerging system of a strong monitoring board. The process by which new rules have emerged helps enhance its appeal: although Congress has made a highly visible show of action, it has actually left it up to better-informed regulators and private actors to determine the detailed response to the scandals. This process has left much discretion in the hands of the best-informed parties, while inducing them to make needed reforms out of fear that if they do not, worse laws will follow.

Regulation of corporate governance in the United States has undergone a turbulent couple of years in the period since the scandals at Enron, WorldCom, and other companies came to light. The centerpiece, of course, is the Sarbanes-Oxley Act of 2002. I shall analyze the Act's effect on the directors and officers of public companies. At least this somewhat restricts the scope of the analysis of this Act, which has so many elements affecting so many parts of the corporate governance system that I, like most, find it hard to get a grip on the Act as a whole. However, even with this limit there are

1. See infra notes 86-91 and accompanying text.
2. See infra notes 89-105 and accompanying text.
3. See infra notes 108-24 and accompanying text.
4. See infra notes 125-43 and accompanying text.
still well over a dozen sections of the Act relevant to directors and officers. Worse, a core part of my argument is that we cannot understand the Act’s impact without understanding its interaction with initiatives from other regulators, especially the SEC, the stock exchanges, and the Delaware courts, so I will have to throw those into the mix as well.

SOx sweeps broadly, and at first glance, many of its individual provisions seem to strike deeply as well. My first point, however, is that this first glance is mostly deceptive. Looking at the provisions point by point suggests that almost all of them do little more than marginally change old rules, codify existing best practice, or regulate a limited bit of behavior. I speculate briefly as to why this is so and whether Congress was aware of it.

However, that cannot end the analysis. Explicitly or implicitly, through SOx Congress wound up making appeals to two sorts of actors: regulators and private industry participants. It showed them that Congress was upset and willing to act, even if its first reaction was wild and unfocused. This has helped increase the pressure on both types of actors to reform themselves, before Congress does more, and worse. We thus need to see how these two types of actors have responded to SOx and the scandals which gave rise to it.

All of the other regulators have been busy. My second point is that their combined, ongoing regulation has created a net effect significantly greater than SOx alone. SOx required the SEC to engage in a blizzard of rulemaking and studying. My impression is that most of the rules implementing sections of SOx have been relatively uninspired, doing little more than repeating what the Act already required. However, one piece of proposed rulemaking, although not itself part of SOx, could potentially go much further than anything else in the Act: the SEC is pondering changing the proxy rules to allow shareholders to nominate directors using the corporation’s proxy.

The New York Stock Exchange, prompted by the SEC, proposed a number of new listing requirements slightly before SOx passed, and Nasdaq proposed a similar set of rule changes. The SEC recently approved both sets of rules. These rules focus on putting independent directors more firmly in control of the board and its key committees. Another rule also requires

6. I make this point in section I, infra. I would modify the point somewhat, but not all that much, if I expanded my focus to include the Act’s effects on other actors, especially auditors. Lawrence Cunningham has similarly argued that most of the provisions of SOx are not very innovative or substantial. See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work), 35 CONN. L. REV. 915 (2003).

7. Section II, infra, examines the reactions of the SEC, the stock exchanges, and the Delaware courts.

8. See infra notes 86-91 and accompanying text.

9. See infra notes 93-96 and accompanying text.

10. See infra notes 97 and accompanying text.
shareholder approval of more equity compensation plans than currently require a shareholder vote.\textsuperscript{11} Most of the exchange rules either codify existing best practice or tweak that practice slightly.

The most important state regulator, the Delaware courts, took more time to respond, but recently they have showed signs of significant movement. Several recent cases toughen the definition of director independence (at least for the purposes of scrutinizing the recommendations of special litigation committees), weaken business judgment rule protection of ordinary business decisions, and weaken the ability of corporations to lock-up acquisition deals.\textsuperscript{12}

Once we integrate SOx with this broader set of new regulations, the pressure on officers and directors looks greater. Even so, the changes are far from revolutionary, although the regulatory process is proceeding and may yet create quite far-reaching change. It should be possible, so far, for most directors and officers to formally go through a new checklist of rule compliance without really changing how they do their jobs. Is that how they are in fact responding? If so, the new reforms will have failed. The ultimate goal of the reforms is to make directors and officers much more active and scrupulous in their task of monitoring the behavior of corporate employees. Are they working? A cynical version of economic analysis would suggest that they will not, that the reforms mostly create incentives to superficially comply with new formal procedures while not really intensifying effort.

However, my third point is that there are some indications that the response has been somewhat more earnest than a cynical version of economics would suggest. Ultimately, both SOx and the other regulators are appealing to private decisionmakers and monitors to do a better, more conscientious job. These appeals may be having at least some effect. Perhaps that is because cumulative uncertainty and cognitive biases have spurred people to actively avoid perceived new risks. Perhaps it is because the reforms have helped strengthen norms of proper behavior. Getting a handle on how private agents are responding to the reforms is quite hard, but of the utmost importance. My preliminary sense is that we are seeing a complicated mix of cynicism and earnestness in the response of directors and officers.\textsuperscript{13}

Thus, while at first glance SOx seems to go quite far and at second glance it appears quite limited, a third glance expanded to include the reactions of regulators and private actors suggests an intermediate picture of significant and still ongoing, but far from revolutionary, change. I conclude with brief speculation about whether this change is for the better or for the worse. My

\begin{itemize}
\item \textsuperscript{11} See infra notes 98-105 and accompanying text.
\item \textsuperscript{12} Section II, infra, discusses these cases.
\item \textsuperscript{13} Section III, infra, explores this issue.
\end{itemize}
conclusion is that SOx appeals—that is, it is an appealing reform. Unlike some, I think the U.S. system of corporate governance had serious and far-reaching problems in the nineties, at least creating an opening for significant reform. However, one must always question whether actual, inevitably imperfect, governmental responses have made things worse rather than better.

Ultimately, SOx's approach makes sense within the emerging American system. For better or worse, in recent decades the United States has moved from a system that left managers much discretion to balance the interests of shareholders, other stakeholders, and themselves to a system that relies on a strong board and other monitors to ensure that officers make decisions that best advance the interests of shareholders. SOx builds upon and advances that system. It strengthens the monitoring role of the board, auditors, and other actors. I am uncomfortable with this emerging American system. However, the moral and social preconditions that induced managers in the old system to take into account the interests of others have seriously eroded. Something must take their place, and monitoring by the board or others tied to a norm of shareholder profit maximization is, for better or worse, that something.

The process described in the earlier parts of the paper enhances my confidence in SOx. Although many have criticized Congress for acting hastily and thoughtlessly, I do not believe that Congress has changed all that much in SOx itself. Instead, it has induced better-informed regulators and private actors to take action. In doing so it has allowed better-informed actors discretion to make most decisions as to how to respond to the corporate scandals, while inducing them to act with care through the threat that more and worse legislation could follow if they do not succeed in handling the scandals. This is the core merit of the American mixed federal system of corporate lawmaking. In the end, SOx and the related reforms are on the whole improving U.S. corporate governance.

I. SOX PROVISIONS AFFECTING DIRECTORS AND OFFICERS, AND CONGRESSIONAL POLITICS

Some have portrayed SOx as a sweeping reform of American corporate governance. The Act touches on virtually every important monitor of corporations. In addition to officers and directors, it affects the regulation of

14. Section IV, infra, explores this issue.
15. President Bush referred to it as "the 'most far-reaching reform of American business practices' since the creation of the SEC." HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE xi (2002).
auditors, \textsuperscript{16} securities analysts, \textsuperscript{17} investment banks, \textsuperscript{18} lawyers, \textsuperscript{19} and credit rating agencies. \textsuperscript{20} It also adds a number of new criminal provisions \textsuperscript{21} and authorizes new funding for the SEC. \textsuperscript{22} My first point, though is that, at least as far as the provisions directly affecting directors and officers are concerned, SOx does not change pre-existing rules and practice all that much. This section makes the case for that point.

A. SOx’s Provisions

Well over a dozen sections of SOx are of particular interest to directors and officers. Those provisions are scattered throughout the Act, reflecting a rather haphazard structure, which in turn reflects a hasty enacting process. I present one way of categorizing and relating those provisions, and analyze how they differ from, or do not differ from, law and practice before the Act.

1. Audit Committee

The biggest focus of SOx is on the auditing process. The first two titles of the Act create new rules for auditors and a new oversight body that regulates auditors, the Public Company Accounting Oversight Board. \textsuperscript{23} SOx also attempts to make the board’s audit committee more actively involved in overseeing and evaluating outside and internal audits. The audit committee must be directly responsible for appointing, compensating, and overseeing the auditor. \textsuperscript{24} Existing New York Stock Exchange and Nasdaq rules already imposed similar requirements. \textsuperscript{25} All audit committee members must be independent directors, again a point covered under existing exchange rules. \textsuperscript{26}

\textsuperscript{17} See Sarbanes-Oxley Act § 501 (to be codified at 15 U.S.C. § 78o-6).
\textsuperscript{20} See Sarbanes-Oxley Act § 702, 116 Stat. at 797 (uncodified) (Commission study and report regarding credit rating agencies).
\textsuperscript{24} See Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)).
\textsuperscript{25} See NYSE LISTED COMPANY MANUAL § 303.01(B)(1) (2002); NASD SECURITIES DEALERS MANUAL R. 4350(d)(1) (1996).
\textsuperscript{26} See Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)); NYSE LISTED COMPANY MANUAL § 303.01(B)(2); NASD SECURITIES DEALERS MANUAL R. 4350(d)(2).
The audit committee must establish a procedure for receiving complaints about auditing matters and have authority to engage independent counsel and advisors. Under current state law, committees already have the power to hire advisors, and typically do so.27

Section 204 requires the audit committee to preapprove all auditing and non-auditing services which an auditor provides to the corporation.28 The New York Stock Exchange and Nasdaq already required that auditors submit to the auditing committee a statement delineating all relationships with the corporation, and that the committee must recommend action to ensure that the auditor is independent.29 The Act also requires auditors to submit a report to the committee setting out all critical accounting policies and practices and alternative treatments of financial information that have been discussed with management officials.30 Finally, companies must disclose whether or not the audit committee has at least one "financial expert."31 Existing exchange rules already required that all audit committee members be financially literate and that at least one have financial management expertise.32 In all, the Act's audit committee provisions do little if anything to go beyond existing New York Stock Exchange and Nasdaq requirements and established practice.33

2. Officer Certifications and Internal Controls

SOx contains three sections creating obligations for officers to make certain certifications and to maintain and disclose internal control procedures.34 On all annual and quarterly reports a company’s CEO and CFO must now certify that they have reviewed the report and that to their knowledge it does

27. See Cunningham, supra note 6, at 947.
29. See NYSE LISTED COMPANY MANUAL § 303.01(B)(1)(c); NASD SECURITIES DEALERS MANUAL R. 4350(d)(1).
30. See Sarbanes-Oxley Act § 204 (to be codified at 15 U.S.C. § 78j-1(k)).
32. See NYSE LISTED COMPANY MANUAL § 303.01(B)(2); NASD SECURITIES DEALERS MANUAL R. 4350(d)(2).
33. Accord Cunningham, supra note 6, at 938. Note, though, that SOx does extend these provisions to public companies covered by the Act, but not listed on the NYSE or Nasdaq.
not contain any untrue statement of a material fact or a material omission.\textsuperscript{35} Before this requirement went into effect the SEC had required similar certifications from the officers of just under one thousand of the nation’s largest companies.\textsuperscript{36} These certifications received great attention and apparently caused the certifying officers to pay more attention to these reports.\textsuperscript{37} This is a bit puzzling, as these certifications changed little in existing law. CFOs already had to sign annual and quarterly reports, CEOs had to sign annual reports, and the law already made them responsible for knowing misstatements or omissions in reports which they signed.\textsuperscript{38}

SOx also requires that the officers certify that they are responsible for establishing and maintaining “internal controls,” that they have designed those controls to ensure that material information is made known to them, that they have evaluated the effectiveness of the controls, that they have disclosed to the auditors and audit committees all significant deficiencies in the controls and fraud (whether or not material) involving employees with a significant role in the controls, and that they have indicated whether there were significant changes in the controls.\textsuperscript{39} Relatedly, but rather awkwardly so, one of the Act’s criminal provisions requires that the CEO and CFO certify that a periodic report fully complies with the periodic reporting requirements of the securities laws and that the information “fairly presents” the financial condition and results of operations of the company.\textsuperscript{40}

These internal control requirements go somewhat beyond existing law, but not all that far beyond. The Foreign Corrupt Practices Act already required reporting companies to devise and maintain a system of internal accounting controls sufficient to prepare financial statements and maintain accountability for assets.\textsuperscript{41} Well-established accounting rules and procedures already were

\textsuperscript{35} See Sarbanes-Oxley Act § 302(a)(1)-(2) (to be codified at 15 U.S.C. § 7241(a)(1)-(2)).


\textsuperscript{38} See Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. 41877 (June 14, 2002); Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000). In section III I shall return to the puzzle of officer reaction to the certification requirement.

\textsuperscript{39} See Sarbanes-Oxley Act § 302(a)(3)-(6) (to be codified at 15 U.S.C. § 7241(a)(3)-(6)).

\textsuperscript{40} See Sarbanes-Oxley Act § 906 (to be codified at 18 U.S.C. § 1350).

in place defining such internal controls. Under Statement of Accounting Standards 85 auditors already had to obtain management representation letters related to financial statements, and the SEC can and does obtain copies of those letters and charge their authors with violations of Rule 13b2-2, which prohibits making misstatements to an accountant in connection with an audit of financial statements. The new certifications, as interpreted by the SEC, require the internal control procedures to cover the gathering of information for all disclosure in periodic reports, not just for the financial disclosure sections. Again as interpreted by the SEC, the “fairly presents” language may help move to a more principles-based approach to accounting, codifying an old opinion by Judge Friendly. It goes beyond the old rules in some smaller ways as well. Moreover, compliance procedures to ensure compliance with the law were already encouraged under U.S. Sentencing Commission guidelines for organizational defendants and under the Delaware Caremark decision. These extensions of the old requirements strike me as not trivial, but of fairly limited importance on their face.

One other related provision requires companies to assess the effectiveness of the internal control structure and procedures for financial reporting in their annual reports. As the SEC has interpreted it, this relates only to the controls for gathering financial information, not for gathering all disclosure information. Companies will not want to make it appear that they have poor internal controls. However, one expects that this disclosure will frequently be not much more than boilerplate.

43. See BLOOMENTHAL, supra note 15, at 66.
44. See infra note 83 and accompanying text.
46. See BLOOMENTHAL, supra note 15, at 45-46 (certifying officer must accept responsibility for establishing and maintaining controls; controls must ensure information made known to officers; must certify that has evaluated effectiveness within 90 days of report; must indicate significant changes in controls; must disclose to auditors and audit committees significant deficiencies).
47. See U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 cmt. n.3(k) (2002); In re Caremark Int'l, Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).
49. See infra note 85 and accompanying text.
3. **Bonus Forfeits**

One of the more intriguing provisions requires the CEO and CFO to reimburse the company for any bonus or other incentive- or equity-based compensation they receive during the twelve months following an accounting restatement due to "the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws." So far as I can tell, this is new.

This provision may target rather precisely one of the misincentives created during the go-go nineties. Some analysts have argued that the equity-based executive compensation which became increasingly important, particularly stock options, created incentive for executives to massage accounting data to make profits appear high in the short-run and thus drive up the company's stock price. Ultimately such chicanery must come to an end, as the misreporting snowballs. However, given the size of equity payoffs many executives received, even just a few quarters of good times could well lead to huge returns, enough to finance a cushy retirement after things went bad. The new provision reduces such incentives by requiring offers to forfeit gains received in the year before a recounting. This provision can be harsh, as it appears that it operates even if the restatement is not due to any misbehavior by the CEO or CFO. This, though, gives the officers added incentive to monitor the financial statements and try to make sure they do not have significant problems.

4. **Ban on Loans**

Perhaps the most flagrant excursion into territory usually regulated by state corporation law is the ban on personal loans to directors and executive officers. Most state laws used to ban loans to officers and directors. However, most if not all states now allow such loans, and police them through the general rules on conflict of interest transactions. SOx directly conflicts with this state law trend.

There is much uncertainty as to what exactly SOx bans. The law says that it is unlawful "to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or

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52. See BLOOMENTHAL, supra note 15, at 119.
53. See Sarbanes-Oxley Act § 402 (to be codified at 15 U.S.C. § 78m(k)).
for any director or executive officer (or the equivalent thereof) of that issuer."

Questions have arisen concerning travel expenses, company credit cards, relocation payments, retention bonuses, indemnification advances, deferred compensation, and a variety of other matters. In a widely-noted memorandum, a variety of leading law firms, including Cleary, Gottlieb, Cravath, Sherman & Sterling, Sullivan & Cromwell, and Wachtell, Lipton, took rather aggressive stances on many of these issues. How much impact this provision will have will depend on how such issues are ultimately resolved, first by private practitioners, and eventually by the SEC and perhaps the federal courts. The ban on loans is a more pronounced innovation than most of the Act’s director and officer provisions, although its wisdom is also more questionable. Its impact is relatively confined, however.

5. Enforcement Provisions

Several provisions create greater enforcement powers. With SOx the SEC now has the power to block persons from serving as officers or directors if their past behavior renders them unfit to serve. In the past it could only do so if they were "substantially unfit." What difference does a modifier make? Probably some, but it is not substantial.

Perhaps more importantly, the Act authorizes a large increase in funds to the SEC, including funds earmarked for adding at least 200 people to provide enhanced oversight of auditing. The SEC has been modestly funded, and particularly in the late nineties its staff was swamped. If a more active SEC leads to a greater probability of detecting fraud, that would be significant, as standard deterrence theory suggests that increased probability of detection is likely to do more to deter misbehavior than an increased penalty if caught. However, authorization of increased appropriation does not equal actually

54. Id.
56. See id.
57. It thus reminds me of the classic comment that a certain paper is both original and right, but unfortunately the parts that are original are not right and the parts that are right are not original. Alas, this is all too common a fate, for both laws and academic papers.
58. See Sarbanes-Oxley Act §§ 305, 1105 (to be codified at 15 U.S.C. §§ 77h-1(f), 78u(d)(5), 78u-3(f)).
increased appropriations, and this provision's effect thus depends in part on whether the President and Congress actually follow through in future budgets.

SOx also contains a variety of provisions creating new crimes, enhancing the maximum sentence and fine for old crimes, and extending the statute of limitations for securities fraud.\(^6\) Insofar as these measures increase deterrence against fraud, they could be significant. However, it appears that the new criminal provisions of SOx do not actually do very much. The new crimes largely overlap old crimes; higher maximum penalties matter little since even with the old penalties prosecutors could always charge multiple counts; and the statute of limitations already does not appear to be binding to most potential securities cases.\(^6\)

6. Miscellaneous

Finally, there are a variety of miscellaneous features with less direct or significant implications for directors and officers. Directors and officers are prohibited from trading company shares during pension fund blackout periods.\(^6\) This responds to specific outrage over such trading at Enron as its stock tanked, but it does not appear to strike at a core, systematic problem of corporate governance. Insiders must now disclose trades of company shares much more quickly than in the past.\(^6\) This will create a logistical headache for insiders and companies, but again there is no reason to think it will significantly change incentives to misbehave. A rule requiring disclosure of intent to trade before trading might have a significant effect, but that is not what Congress did.\(^6\)

Companies must now disclose whether they have a code of ethics for senior financial officers, and if not, why not.\(^6\) As someone else has remarked, only masochistic companies will not adopt such codes. Enron had a great code of ethics. It now sells well on eBay. Two provisions protect corporate whistleblowers from retaliation.\(^6\) This, again, is largely redundant with pre-existing law.\(^6\)

62. See Perino, supra note 59.
65. Disclosure before trading is now required for insiders at WorldCom/MCI, under that company's stringent new corporate governance rules. See infra notes 83 through 92 and accompanying text.
68. See Cunningham, supra note 6, at 965.
Beyond the provisions discussed above, the range of provisions affecting other actors also indirectly affects directors and officers. Insofar as auditors, analysts, credit rating agencies, and investment banks are induced to do a better job of monitoring corporate performance, that will affect executives. Except for auditors, SOx left regulation of these actors to future study and regulation by the SEC.69

Summing up, the Act does not seem very radical in its provisions regulating directors and officers. Most provisions either codify existing exchange rules or company practices or build incrementally on existing laws. However, transforming existing exchange rules and company practices into federal law may in itself have important effects, good and bad. We shall discuss the effects on behavior below.70 Of the two provisions which are most distinctly new, the forfeiting of bonuses following restatements is well-aimed while the ban on personal loans is more dubious. Neither makes an especially big or bold change.

B. The Politics of SOx

How did this messy Act come to be? The Enron scandal, problems at other companies, and a declining stock market induced politicians, including President Bush and SEC chair Harvey Pitt, to start calling for corporate governance reforms by early 2002.71 Bills started percolating through both the Senate and the House, with the Sarbanes bill in the Senate generally seen as tougher than the Oxley bill in the House. Even past supporters of weakened securities legislation signed on. After WorldCom revealed its problems in June, Congress moved quickly, passing a bill based largely on the Senate version. President Bush, generally not an enemy of big business, signed the bill into law on July 30, 2002.72

I see at least two somewhat differing theories explaining how SOx came to be. One theory sees it as a hasty, uninformed response to a perceived crisis. Congress pays only intermittent attention to securities law and even the members on the relevant committees are generally much less knowledgeable about this area than SEC commissioners, exchange rulemakers, or Delaware judges. The public pressure brought on by the scandals, however, meant that members felt forced to respond. Republicans, normally not advocates of

70. See infra sections III and IV.
72. See id. at 18-20.
increased business regulation, worried about the upcoming midterm elections. One could embellish this with a story about cognitive biases of both politicians and constituencies: the frauds making daily headlines made certain sorts of corporate misbehavior highly visible in the minds of many Americans in the summer of 2002.73

Faced with these fears and the looming elections, Congress acted quickly, without time to reflect carefully about how best to respond. Many provisions of SOx are blatant and rather superficial responses to specific problems in the scandals, for instance the ban on loans (large loans were part of the problem at WorldCom and Adelphia), the pension blackout period ban on trading (Enron), whistleblower protections (whistleblowers were ultimately quite visible at Enron), and the many auditing provisions (Arthur Andersen had emerged as a leading bad guy).

A competing theory sees members of Congress as more crafty than that.74 This theory agrees with the first theory that the scandals and sense of crisis made ordinary voters anxious, enough so that corporate governance could become an electoral issue. However, this account notes that politicians must care not only about the general voters, but also about interest groups with particularly strong concerns about a given policy area, as those groups provide much money in campaign contributions, and are more likely to pay long-run attention to what is going on in the area. In this area, interest groups of note include corporate directors and officers, accountants, corporate lawyers, major institutional investors, and plaintiffs' lawyers. Although the last two groups provide some pressure for tougher regulation, the balance of interest group pressure would seem to be opposed to such regulation.

How could the politicians please both the general voters and the interest groups? One strategy is to pass legislation which on its face appears to create tough new rules, but which in its details does not really do all that much. The superficial toughness will please general voters, who are not informed enough

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to see the details. The weak details will reassure the interest groups. SOx seems to fit this pattern pretty well.

I see no need to choose between these two theories. Congress has many members; one theory may apply better to some while the other applies better to others. I do not think the two differ importantly in their implications for the argument that follows.

We are left, then, with a law that, at least with respect to directors and officers, promises much but delivers little. Can we then conclude that talk of a major shift in American corporate law regulation is unfounded? Not yet. There are other important sources of corporate law rules in the U.S. We must look to what is happening with them and how SOx is affecting those sources.

II. THE REACTIONS OF OTHER REGULATORS

Congress certainly is not alone in setting laws affecting corporate governance in the U.S. The other most important actors are the SEC, the major stock markets (NYSE and Nasdaq), and the Delaware courts. All of these regulators are much more specialized and focused on corporate governance than Congress. Such specialization in regulators tends to lead to a tradeoff. On the plus side, the specialized institutions are more expert and knowledgeable than generalists, and less likely to make random or wild decisions. On the minus side, the specialist institutions are likely to be more

75. Some scholars think a similar argument explains some delegations of authority to agencies: Congress expects that the agencies will regulate in a way that helps well-organized groups, but the general public will not know what is going on. See Peter H. Aranson, Ernest Gellhorn, & Glen O. Robinson, A Theory of Legislative Delegation, 68 CORNELL L. REV. 1, 57 (1982). James Krier and Roger Noll tie a similar theory of agencies to an availability bias story, arguing that after an issue has become salient to the general public legislators will “tie themselves to the mast” with a vague statute, but later on, as the issue becomes less visible, an agency will “strike when the iron is cold” and implement the statute weakly. See Roger G. Noll & James E. Krier, Some Implications of Cognitive Psychology for Risk Regulation, 19 J. LEGAL STUD. 747, 774 (1990).

76. A few other actors deserve mention. The Delaware legislature sets the statutory structure for Delaware law, but today fiduciary duty rules do most of the work in constraining directors and officers, and the courts set the fiduciary duty rules. Other states matter too, to some degree, and many of them follow the Model Business Corporation Act. I understand that the American Bar Association committee that maintains the Model Act is drafting some changes in response to the scandals, but those changes are not yet public. Other regulators that one would have to consider in a review of all of SOx would include the Public Company Accounting Oversight Board, which SOx created, and state bar associations and their regulation of lawyers. I actually have some hope that § 307 of SOx will help spur state bars, the ABA, and private counsel to create more effective reforms of professional rules and practice. In particular, I hope to see the development of a best practice of regular meetings between inside and outside counsel and the audit committee or full board.
biased, both because they are the subject of more intense and more regular influence activities by interested parties, and because there is a selection bias in who becomes involved in such institutions.  

I have suggested that a typical and sensible approach to relationships between specialist and generalist regulatory institutions is for the generalists to allow the specialists to do most of the rule-setting, giving them a good deal of room to set rules as they see fit. However, if some rules seem to be going too far in favoring special interests, and too far from what the generalist institutions think would be best, then the generalists should intervene and set their own rules.  

The setting of corporate governance law in the U.S. fits this pattern. Congress does not act terribly often, normally allowing the specialist regulators to set the rules. However, when Congress perceives that things have gone wrong, it will occasionally step in. Would the specialist regulators have acted as they did anyway, without the pressure that Congress created with SOx? That is of course a counterfactual that we cannot answer. The regulators would surely have done something, but I doubt that they would have gone as far as they have.

Congress perceived that things had gone rather badly wrong by the summer of 2002, and it stepped in. As we have seen, it stepped in with much flash, but considerably less substance. In doing so, though, it increased the pressure on the specialist regulators. They now know that not only does the American system of corporate governance have some serious problems, but also that Congress is willing to try to act to fix those problems. Congress is also quite capable of bungling the job badly. Even if my second theory of the politics of SOx is right, if things continue to go badly Congress will feel a

77. See McDonnell, supra note 74.

78. See id. An example of such an approach is the Chevron rule for court deference to agency interpretations of statutes.

79. A growing theme in recent literature has been to stress the extent to which the federal government, through securities law, helps set corporate governance rules in the U.S. In addition to McDonnell, supra note 74, see Mark J. Roe, Delaware's Competition, 117 HARV. L. REV. 588 (2003); Renee Jones, Rethinking Corporate Federalism in the Era of Corporate Reform, 29 J. CORP. L. (forthcoming 2004); Robert B. Thompson and Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 VAND. L. REV. 859 (2003).

80. The second, crafty Congress story of the genesis of SOx that I tell above does suggest a problem for this theory. On the “strike when the iron is cold” theory that Noll & Krier suggest, see supra note 75, once the issue of corporate governance has receded from the headlines, shouldn’t we expect that captured specialized agencies will weaken the provisions of SOx, not press further as I suggest here? That could happen, but is less likely to happen if the agencies think that there is a decently likely chance that future scandals could bring corporate governance back to Congress’s attention in the future. If there is such a chance, then behaving in an overly permissive way today creates a heightened risk of future scandals that could provoke much worse Congressional rulemaking tomorrow.
need to step in again, making life more complicated than it already is for the
regulators and the regulated. It would therefore behoove the regulators to act
to improve the situation and forestall further Congressional intervention.

Indeed, the regulators have acted, in the case of the SEC explicitly in
reaction to Congress, and more implicitly and indirectly so in other cases. We
must look at these various responses.

A. The SEC

SOx has kept the SEC extremely busy. Many of its provisions required
the SEC to engage in rulemaking to operationalize the law, and many other
provisions required the SEC to engage in studies of a variety of issues. Most
of these requirements had deadlines attached. The under-staffed SEC had to
move fast on many fronts at a time when it was stepping up its review of issuer
filings in response to concerns about fraud and misreporting.

In part as a result, much of the SEC’s rulemaking directly in response to
SOx has been relatively uninspired. Many of the new rules do little more than
repeat the statutory language. For instance, in response to the audit committee
requirements of section 301, the SEC promulgated new rule 1Oa-3. The rule
closely resembles the statute. Its main divergence is in a list of exemptions,
particularly focused on foreign issuers. There is some guidance beyond the
statute, but not all that much.

A similar story holds in the area of internal controls. The SEC
promulgated new rules 13a-14, 13a-15, and 15d-14 and 15d-15 to implement
section 302 of SOx. The text of the certifications quite closely tracks the
statute’s text. The main innovation is that the SEC adopts a new term,
“disclosure controls and procedures.” This definition clarifies that the required
controls concern information needed to engage in required securities law
disclosure. This goes beyond existing controls needed to collect information
needed for financial reports, although given how much and varied information
is required for financial reports, it is not clear that it goes all that much beyond
the existing controls. The SEC largely leaves it up to companies to decide
what specific procedures are necessary, although it does suggest the use of a
disclosure committee. Similarly, the rules for disclosure of internal financial

81. See supra notes 24-27 and accompanying text.
82. On the need for such exemptions, See Lawrence A. Cunningham, From
Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX, 1 INT’L
abstract=462142.
83. See Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67
reporting controls required under section 404 again closely track the statute.\textsuperscript{84} These rules limit disclosure only to financial reporting controls, not to the somewhat broader disclosure controls and procedures, a result largely dictated by the language of section 404.

Even if the rules promulgated directly under SOx have not been exactly eye-openers, one recent piece of public deliberation by the SEC is potentially much more important. The SEC may revise its proxy rules to allow shareholders to nominate directors using the company’s proxy materials, under certain circumstances.\textsuperscript{86} Nothing under SOx requires this, and of course it is quite possible that the SEC would have suggested it in response to the scandals even had SOx never passed. However, I suspect that SOx has emboldened the SEC to consider more radical measures.

This measure would be radical indeed. If pushed far enough, it alone might very well have a greater effect than all of SOx combined. If institutional investors were to use this tool regularly,\textsuperscript{87} it would do far more to create truly independent directors than any rule-making trying to define “independent director” can. As of this writing, though, the rule remains merely a proposal, and has received much opposition.\textsuperscript{88} Even if passed, the rule as proposed has some important limitations. Only shareholders who have held at least five percent of the outstanding shares for at least two years would have the right to nominate directors.\textsuperscript{89} They would only be able to nominate one to three directors (depending on the number of directors being elected), and never close to a majority.\textsuperscript{90} They could nominate only if certain trigger events occur.\textsuperscript{91}

Still, even if opponents manage to defeat or further dilute the proposed shareholder nomination rule, the idea is now out there. If new corporate

\textsuperscript{84} See supra note 48 and accompanying text.
\textsuperscript{87} This is a big if, though. See Robert C. Pozen, Institutional Perspective on Shareholder Nominations of Corporate Directors (Harvard Law & Econ. Discussion Paper No. 429, Aug. 2003), at http://ssrn.com/abstract=437160.
\textsuperscript{89} See Security Holder Director Nominations, 68 Fed. Reg. at 60,820 (proposed Rule 14a-11(d)).
\textsuperscript{90} See id. at 60,822 (proposed Rule 14a-11(d)).
\textsuperscript{91} See id. at 60,819 (proposed Rule 14a-11(a)). The two trigger events are a director receiving over thirty-five percent withhold votes, and a majority of shareholders voting to opt in to the Rule 14a-11 regime.
governance problems occur, the SEC (or perhaps even Congress) may then decide that it is time to try riskier medicine. Alternatively, shareholder activists may try to pursue the idea through other venues. For instance, the new WorldCom/MCI corporate governance rules provides for a process of consulting with the largest shareholders over director nominees. If these shareholders are unhappy with who is nominated, they are allowed to include their own nominees in the company's proxy materials.92

Finally, the SEC has stepped up its enforcement activity. Of particular note is its involvement in the restructuring of WorldCom, where the SEC pushed for the appointment of a "corporate monitor" who has made extremely extensive and aggressive recommendations, discussed below. That directly affects just one company, but it puts ideas out there for other companies to follow.

B. The Stock Markets

Even before SOx passed, the New York Stock Exchange proposed extensive new rules to the corporate governance section of its Listed Company's Manual.93 Nasdaq proposed less extensive changes a day earlier, then announced revised proposals that were closer to the NYSE proposals.94 Given the timing these were obviously not direct responses to SOx. However, prodding from SEC chair Harvey Pitt in February 2002 initiated the rulemaking,95 and Pitt in turn was responding to the mounting political pressure which soon produced the Act.96 The SEC took its time in approving these proposals, but recently did approve them.97

The main focus of the exchange rules is on encouraging more active monitoring and involvement by independent directors.98 The rules somewhat

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94. See BLOOMENTHAL, supra note 15, at 93.
95. See id. at 90.
tighten the definition of an independent director and require that a majority of all directors be independent. The rules also mandate the existence of three committees: audit, compensation, and nomination or corporate governance.99 All three must include only independent directors. All three must have charters, whose contents are spelled out in some detail, and all three must regularly monitor their own activity. The rules also require that boards which do not have a separate chair and CEO100 must have a lead independent director.

The market rules also require that a broader range of equity compensation plans must have shareholder approval. Companies must adopt and disclose governance guidelines and codes of business conduct and ethics. The NYSE is allowed to issue a public reprimand letter upon finding a violation of any listing standard; ultimately, companies could be de-listed for violations.

It is not clear how far these new rules go. The new independence definitions are probably little more than twiddling—they do not go to the heart of the structural problem of close relationships between the CEO and nominally independent directors.101 The new audit committee rules are also just incremental, as the exchanges had just recently adopted their own fairly strong audit committee rules. Shareholder approval of equity compensation plans is more significant, but the old rules already covered the most objectionable sorts of plans.102 Ethics codes are nice, but of questionable importance. Ethical behavior is crucial; ethics codes, not so much.103

The most potentially important new exchange rules concern the compensation and nominating committees. Compensation of executives has become both exorbitant in itself, and also a major incentive to engage in accounting manipulation.104 If truly independent directors can be made to more actively run the process of determining top executive compensation, that could make a real difference. Similarly, real director independence has proven

99. Existing rules already required the first, but not the other two.
100. The proposals do not require this separation, which is common in many other countries, and a common suggestion of corporate governance reformers.
101. As we shall see, a recent Delaware case goes further. See infra notes 106-18 and accompanying text.
102. The plans not covered previously but covered under the new rules are broad-based plans and plans that provide that no single officer or director may acquire more than one percent of the outstanding shares and does not authorize the issuance of more than five percent of the outstanding common stock.
103. See Langevoort, supra note 34, at 106.
elusive in part because CEOs typically dominate the process of choosing directors. If nomination committees with all independent directors can dampen that dynamic, that could also make a real difference. Those are both big ifs, though—an issue we will explore in the next section.

C. Delaware Courts

State law is of course the traditional source of most corporate law in the U.S. and Delaware is the dominant state of incorporation for public corporations. Within Delaware, judicial decisions rather than legislative changes tend to be the most important source of rulemaking. The Delaware Chancery and Supreme Courts are among the most important and highly-respected corporate lawmakers in the U.S., although there is a longstanding controversy as to whether Delaware is too permissive in its law as a way to encourage corporations to incorporate there. Thus, how Delaware courts have reacted to the new political atmosphere is quite an interesting question. Of course, it is not easy to say whether the decision in any particular case is a response to background political conditions. However, we shall see that there is good reason to believe that several recent cases do show Delaware courts adjusting their traditional approach in response to new conditions.

Three recent cases are of particular note. First is Omnicare, Inc. v. NCS Healthcare, Inc. The case involved a merger between NCS and Genesis. The merger agreement required that the transaction be put to a shareholder vote even if the NCS board no longer recommended it. Furthermore, a voting agreement with two board members who together controlled about two-thirds of the outstanding voting rights of NCS required that they vote their shares in favor of the merger. Together, these two provisions guaranteed that the merger would be approved. As it happened,
NCS received a better offer from Omnicare, and the board recommended a no vote on the Genesis merger, but the merger was nonetheless approved.

The Delaware Supreme Court held that Unocal heightened scrutiny applies to a board decision to provide lock-up protections to a merger deal.\textsuperscript{110} Under Unocal Corp. v. Mesa Petroleum Co., one first asks if the board had reasonable grounds to believe a danger to corporate policy exists, and then asks if its defensive response was reasonable in relation to the threat posed. A response is not reasonable if it is coercive or preclusive. The Court in Omnicare held that the voting agreement was preclusive. Its reasoning attempts to balance providing room for the board to make decisions with the right of stockholders to make the final decision concerning a merger. The court’s rhetoric suggests less deference to boards and more concern for protecting shareholder choice than is usual for this court.\textsuperscript{111}

The second notable case is In re The Walt Disney Co. Derivative Litigation.\textsuperscript{112} The case concerns the highly lucrative contract Michael Ovitz received for his failed year as President of the Walt Disney Company. According to the complaint, the compensation committee spent very little time studying this important document initially, and did not monitor continuing negotiations over it, despite unusual features which made it even more outrageously lavish for Ovitz than is the norm for top American executives today. Chancellor Chandler held that the complaint adequately pleaded facts which if proved could show that the board did not act honestly and in good faith. If so, not only would it lose business judgment protection, but it would also lose the protection of Disney’s charter provision waiving personal damages to directors for breach of the duty of care.\textsuperscript{113}

In some ways this is an even more shocking extension of the duty of care than Smith v. Van Gorkom.\textsuperscript{114} Most analysts had come to believe that Van Gorkom was limited to the merger and acquisition context, where special concerns exist about the objectivity of directors.\textsuperscript{115} Disney is not that context, though. Instead it applies to compensation decisions, a hot topic nowadays.

\textsuperscript{110} See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
\textsuperscript{111} However, the facts in Omnicare are pretty odd, particularly the presence of a lock-up agreement with two controlling shareholders, and the decision is a divided 3-2, unusual for Delaware. It could therefore be that the case has limited precedential value.
\textsuperscript{112} 825 A.2d 275 (Del. Ch. 2003).
\textsuperscript{113} DEL. CODE ANN. tit. 8, § 102(b)(7) (1999) allows corporate charters to contain provisions protecting directors from personal damage liability for violations of the duty of care, but does not allow charters to limit liability for acts or omissions not in good faith.
\textsuperscript{114} 488 A.2d 858 (Del. 1985).
If Delaware courts are now willing to waive business judgment rule protection in a wider range of contexts, that is a significant change indeed.

The third notable case is In re Oracle Corp. Derivative Litigation.\footnote{116} The case involves an insider trading claim\footnote{117} against four Oracle board members, including its chair, Lawrence Ellison, and Michael Boskin, a Stanford economist and professor and former economic advisor to President George H.W. Bush. Oracle set up a special litigation committee to decide if it should recommend that the case be dismissed. The committee did recommend dismissal. The committee was composed of two directors who joined the board after the events in the underlying case had occurred. Both special committee members, Joseph Grundfest and Hector Garcia-Molina, were Stanford University professors.

Several of the defendants had close ties to Stanford, either as donors or, in Boskin’s case, as a professor himself. The ties between Grundfest, a law professor and former SEC chair, and Boskin were particularly tight, as both were fellows at the Stanford Institute for Economic Policy Research. By all standards of independence in either SOx or the exchanges, this is not enough to compromise the committee members’ independence. Yet, Vice-Chancellor Strine held that they were not independent enough for special litigation committee purposes, suggesting that the independence requirement is particularly stringent in this context, as it is hard for board members to recommend law suits against fellow members.\footnote{118}

This pushes the concept of independence further than Delaware courts have pushed it before. In doing so, Vice-Chancellor Strine recognizes concern over structural bias problems that corporate governance reformers have been pointing to for some time. Again, if this represents a trend, it could be significant.

Can we tell whether these cases represent a trend of Delaware courts getting tougher on directors, and if so whether that trend is a response to the corporate scandals and SOx? Three rather striking cases in a few months should make one take notice, and the general political context is there for all to see.\footnote{119} But we actually have something closer to a smoking gun. In a very interesting 2002 Business Lawyer article, Vice-Chancellor Strine speculates how courts might respond to new arguments plaintiffs lawyers might make in response to the scandals, noting that “[b]ecause some of the same arguments

\footnotesize{\begin{itemize}
\item \footnote{116} 824 A.2d 917 (Del. Ch. 2003).
\item \footnote{117} The case is already unusual in that it involves a state law fiduciary duty claim of insider trading, while a federal securities law parallel case has already been dismissed.
\item \footnote{118} See In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003).
\item \footnote{119} There are other cases of some note as well. See Jones, supra note 79; Sale, supra note 108.
\end{itemize}}
may also lie in the mouths of policymakers arguing for a stronger federal role in the regulation of director conduct, the Article [by Strine] is obliquely responsive to the debate on Capitol Hill.\textsuperscript{120} What are some of the arguments that Strine anticipates? Courts will be asked to look more closely at the independence of outside directors.\textsuperscript{121} That is Oracle. They will be asked to waive business judgment protection because directors did not exercise good faith.\textsuperscript{122} That is Disney. The courts may be less able to defend deferring to the judgment of directors over shareholders in acquisitions.\textsuperscript{123} That is Omnicare. It is all there in Strine's article. Delaware judges know what's going on around them and what's at stake, and it is indeed affecting their decisions.\textsuperscript{124}

Thus, the SEC, the exchanges, and the Delaware courts are all still reacting to the scandals and to SOx. The rules and decisions I have considered in this section put more constraints on directors and officers than SOx alone. However, there is still a question about how much effect the whole package is likely to have on the actual behavior of directors and officers. That is the central question, and we must now turn to it.

III. THE REACTIONS OF DIRECTORS AND OFFICERS

Directors and officers have a lot to do in order to assure compliance with all of the new rules described above. Will doing that make any noticeable improvement in corporate governance?

It is almost certainly possible to comply with all of the new rules and still do a lousy job of running and monitoring a company. After all, Enron's board complied with the old rules, and many of the new ones as well. What the rules try to induce is more effort and time on the part of directors and officers. They could wind up inducing only formal compliance with a host of checklists and boilerplate disclosure. In corporate America today many horses are being led from boardrooms and executive suites that still contain much shady dealing to the water of more ethical behavior. But will they drink?

\textsuperscript{120} Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1373 (2002).
\textsuperscript{121} See id. at 1377-85.
\textsuperscript{122} See id. at 1385-95.
\textsuperscript{123} See id. at 1399-1400.
\textsuperscript{124} Strine's article appeared before any of the three cases were published, although at least some of the litigation was already in process at the time of the article. See also William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. PA. L. REV. 953 (2003).
A cynical economists' understanding of behavior would suggest that little will change. The traditional law and economics approach focuses on rational deterrence theory. One considers both the potential penalties people face if they break the law and the risk of getting caught. The legal analysis of the previous two sections suggests that the rules and penalties have mostly not changed all that dramatically. Moreover, it is possible to comply with most of the new rules in letter while changing little in spirit. Directors who are independent on paper can be quite buddy-buddy with CEOs in fact. Audit committees can formally choose auditors when in fact they simply ratify what officers have suggested. Internal control procedures can yield disclosure committee meetings in which no one asks the hard questions. The ban on loans can be interpreted away, or compensation given in other, more damaging forms. New disclosure can look great, until you see the 10-K from which it was borrowed. The chances of any particular person getting caught misbehaving are still low enough that a calculated homo economicus would still feel little need to comply with the spirit of the new rules, although the SEC's higher budget could lead to increased enforcement.

Yet there are good reasons why behavior will change more than the above argument predicts. For one thing, much uncertainty surrounds the new rules, especially as they continue to change. Perhaps the chances of getting caught are really not very large, but who knows for sure? Given risk aversion, this increased risk could lead to more conservative behavior. The sheer number of new rules will force directors and officers to spend more time with lawyers over the next couple of years, and those lawyers will probably be giving quite conservative advice. The prominence of media and professional coverage and discussion of the new rules will make following them seem more important. Results from cognitive psychology suggest that people tend to over-focus on more recent and salient events.

Consider, for instance, the initial SEC officer certification requirement. These requirements explicitly added very little to the legal requirements

125. Is this phrase redundant?
127. The SEC suggests disclosure committees as a way of implementing internal controls, and practitioner materials suggest many companies are adopting such committees.
128. See Memorandum to Pamela Baker, supra note 55.
129. I did plenty of such borrowing when I was in practice. Back then, the hot new issue was plain English.
130. Clients might for once actually be inclined to listen to that legal advice.
131. See Jolls et. al., supra note 75, at 37.
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officers already faced. Yet, the certifications got much press coverage. Some of that coverage probably reflected dissembling—some corporate attorneys knew that little had legally changed, yet it was in their clients' interests to go along with the story that this was a big new thing, as a way of discouraging more radical change. However, there is some anecdotal evidence that many officers did take the certifications seriously. They spent a longer time reviewing the disclosure, and tried to ensure that they had enough information to change its accuracy. The visibility of the new rules may account for this, along with some increased risk of enforcement due to greater SEC attention to the issue.

The new rules as a whole may also be helping to change the norms of directors and officers. Norms have become a hot topic in corporate law. As scholars have become increasingly aware that other disciplinary mechanisms like takeovers, compensation, institutional investors, and independent directors do not do much good, they have started to see norms of good behavior as an important limit on managerial misbehavior. The new rules as a whole may help to convince many people that a higher standard of behavior applies than they had previously thought. Many of the new rules may also provide cover for already conscientious directors and officers who feel social pressure to not rock the boat. Now they can justify potentially disruptive behavior and uncomfortable questions as being required under the rules.

Relatedly but somewhat different, some scholars argue that laws may affect behavior by changing people's beliefs about how other people will behave. Where behavior is inter-dependent, there may be multiple possible equilibrium outcomes, and the law may affect people's beliefs about which equilibrium strategy other people will play, even if enforcement of the law is relatively rare. Director and officer behavior may be relevantly inter-dependent for several reasons. Some may be more willing to exercise extra care and avoid self-dealing if they believe that others are doing the same. To put it another way: Why be good if others are getting away with being bad? Also, mutual monitoring may be occurring, so that if persons believe that others are monitoring their behavior more closely than before, that provides another reason for behaving more carefully.

My own vague sense is that for reasons such as these behavior is changing somewhat more than a cynical economist might expect, although the

132. See supra note 36 and accompanying text.
133. See supra note 37 and accompanying text.
135. See Bohnet & Cooter, supra note 126.
changes are far from revolutionary. Note that for some of the above effects to work, it does matter that SOx has taken pre-existing rules and practices and moved them into the federal code. By making these rules more prominent, it becomes more likely that private actors will notice them and expect others to notice and act on them as well. However, testing this vague sense that behavior has changed significantly is very hard. Over time scholars will try to gather statistics on corporate behavior and see if there has been measurable change in behavior associated with the new rules. I am somewhat skeptical about our statistical skill in making such inference, though, and at any rate, it will take a number of years before we start getting those results.

Sections I and II suggest that the two most important changes so far are in board structure and internal control. As to board structure, given the new rules most boards will be composed mainly of formally independent directors, and the boards will have audit, compensation, and nomination committees. However, will the independent directors on those boards and committees spend a lot more time now carefully reviewing material before meetings and asking probing questions of officers at meetings? Preliminary anecdotal evidence does suggest that directors now are spending significantly more time doing their jobs—one survey found that annual hours worked for a typical director were up to 250 in 2002, double the number in 1999. At least some believe that they are indeed using that time to engage in more searching inquiry. It is hard to tell yet whether we should believe this evidence. Even if for now directors are doing a more thorough job, the effect may be temporary. As new procedures become routine and current regulatory and media scrutiny dies down, they may revert to their old ways. Moreover, one can also argue over whether the increased time being spent by directors, if true, is really a good thing, a point we shall consider in the next section.

The other most important change is in internal controls. Here too, preliminary anecdotal evidence suggests some significant changes. Companies have instituted disclosure committees, a series of certifications by lower-level managers, and a variety of review procedures. Outside consultants are marketing a variety of systems to help companies comply with the new

136. As section II also suggests, shareholder nominations may be an even more important change, but the SEC has not yet approved proposed rule 14a-11.
137. See Carol Hymowitz, How To Be a Good Director, WALL ST. J., Oct. 27, 2003, at R1.
138. "Boards are being much more diligent than they ever have before" according to Patrick McGurn of Institutional Shareholder Services. Judith Burns, Everything You Wanted To Know About Corporate Governance, WALL ST. J., Oct. 27, 2003, at R6.
139. For the suggested approach to internal controls made in a comprehensive, practitioner-oriented, review of SOx by the Practising Law Institute, see JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK § 5.3.3 (2003).
Officers seem to be spending much time with these new procedures. Indeed, we shall see in the next section that some argue that they are spending too much time and money on them, although once again the increased time and expenditure is probably at least in part temporary, and will decrease somewhat as new procedures become routinized.

Overall, my sense is that the average response is somewhere between the cynicism economists would expect and a more earnest approach. Many audit committee members are spending more time researching and asking harder questions. Many officers are taking the new certification procedures at least somewhat seriously, and asking harder questions of their subordinates. Many companies are moving from stock options to restricted shares as a way of compensating executives.

One (quasi-) private initiative of particular note is WorldCom. In its bankruptcy, at the SEC's urging, the court appointed a special corporate monitor to recommend reforms in the company's corporate governance. The monitor is Richard Breeden, a former chair of the SEC. In August 2003 Breeden released a lengthy report with seventy-eight different recommendations. Some of the proposals are major departures from standard American practice. These include a non-executive chair, director term limits, a requirement that all directors but the CEO be independent, a process for allowing shareholders to suggest resolutions on the company's website, with suggestions that are popular enough being included in the company's annual proxy, and the director nomination process described above. Many of the new rules are put in the Articles of Incorporation, so shareholders must approve changes to them.

Breeden explicitly intends that other companies should consider these recommendations as well. Initial reaction suggests that few if any companies will go nearly as far as MCI/WorldCom. However, the report includes many recommendations, and others may follow some of them. Furthermore, if things go well at the new MCI and if problems recur at other companies, this extreme new example will be out there as a source of new reform ideas.

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141. See Breeden, supra note 92.
142. See supra note 92 and accompanying text.
Thus, a fairly complicated picture emerges as to what kind of effect SOx is having. A casual first glance suggests a law that is both broad and deep. A closer second look at the provisions affecting directors and officers suggests that most of them merely codify existing exchange rules or widespread best practice, incrementally advance on existing rules, or affect a relatively limited area of behavior. However, when we expand our view to include the reactions of the SEC, exchanges, and Delaware courts, and when we consider how directors and officers seem to be reacting to this wide range of new rulemaking, we get a picture of significant and still ongoing, but far from revolutionary, change. This puts me more or less in the middle of commentators. Some paint SOx as dramatically changing the regulatory landscape, while others argue that it has changed quite little.

A final question is whether this change has been for the better or for the worse. My answer here, defended in this section, is that SOx has appeal, that is, all-in-all it has improved the American system of corporate governance. Here again commentators are quite split. Note that there are a variety of possible combinations of positions. Commentators differ both as to how much SOx has changed the law and as to how much change is desirable. Table 1 schematically lays out the basic logically possible positions. One might believe that SOx has not changed the law too much, and that not much change is desirable, i.e., that before SOx the U.S. was already pretty close to an optimal legal regime for corporate governance. This is cell I of the table. Lawrence Cunningham’s impressive paper takes a position somewhat along these lines. Alternatively, one could agree with the position that significant legal change was not desirable, but think that SOx has instituted significant change. People taking this position, cell II of Table 1, typically accuse SOx of being over-regulation, which will lead to high compliance costs and discourage risks while not offering enough in benefits. I think that both Stephen Bainbridge and Larry Ribstein roughly fit in this cell, although

144. See infra section I.
145. See infra section II.
146. See section III.
147. See Cunningham, supra note 6.
148. See Stephen M. Bainbridge, The Creeping Federalization of Corporate Law, Regulation, Spring 2003, at 26; Bainbridge, supra note 98.
it is possible that both of them think that the legal framework before SOx was already somewhat over-regulatory, so that they might have advocated some significant change, but change quite different from SOx.\textsuperscript{150} One might think that SOx does not do very much, but that some significant reforms would help—cell III in Table 1. Douglas Branson takes a mild version of this position.\textsuperscript{151} Alternatively, one might think that significant reforms are desirable and that SOx has made significant changes. This position takes two different variants: it could be that SOx has made the correct significant changes (cell IVB), or it could be that its changes are the wrong ones (cell IVA). As mentioned above, either Bainbridge or Ribstein could fit into cell IVA to the extent that they were already rather unhappy with the law pre-SOx. At any rate, a hyper laissez-fair advocate would fit in cell IVA.

All in all, I would put myself into cell IVB. I have already argued why I think that SOx, viewed in its full context (including both the ongoing rule-making by other regulators and the reaction by private actors), has probably made some fairly significant changes. Now I must briefly indicate why I think those changes are probably desirable. I make two kinds of argument, substantive and procedural. The substantive arguments suggest that it is at least plausible that the recent reforms have benefits that outweigh their costs. The procedural arguments suggest that the way in which we have implemented the reforms should give us some confidence that they are likely to be effective.

\textbf{TABLE 1}

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<th>SOx makes relatively small change</th>
<th>Little change desirable</th>
<th>Significant change desirable</th>
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<th>SOx makes significant change</th>
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Substantively, the main thrust of the reforms is to try to nudge directors and a variety of other gatekeepers to monitor officers more closely, and to

\textsuperscript{150} If so, they would fit cell IVA.

limit the discretionary power of officers. If, like Bainbridge, Ribstein, and many corporate scholars over the last several decades, you believe that market mechanisms already do a largely adequate job of policing officers, then such reforms are likely to intervene too far, discouraging risk-taking and making it harder for directors and officers to exercise needed authority.

However, I am quite skeptical that the standard market mechanisms work well at all. Asymmetric information and collective action problems prevent market mechanisms from adequately constraining director and officer behavior. I believe that corporate officers in the nineties continued to have way too much leeway to make decisions that helped them at the corporation's expense. The scandals, the explosion of executive compensation whether or not officers performed well, and apparently widespread earnings management are some of the clearer signs of trouble. More deeply, I think the me-first attitude which became increasingly dominant has weakened employee loyalty to their companies, leading to a weakening of effort and lessened development of firm-specific skills. It is not enough to reply that the U.S. may well be better off than anyone else. Even if that is true, there may be much room for improvement. The U.S. probably had the world's strongest corporate governance system in the sixties, yet most observers would argue that it has improved greatly over the last few decades. The same could be true today.

As we have seen, the SOx and related reforms have affected directors and officers in two main areas, board structure and internal controls. Have the board reforms turned directors into more active monitors, and if so, at what cost? In the previous section I argued that preliminary evidence suggests that directors are indeed spending more time studying the company and asking hard questions. However, this gain comes at some cost. The increased time and risk of litigation have made recruiting directors harder, and forced companies to pay directors higher fees. Even if these costs are worth it for some companies, they may not be worth it for all, and mandating a detailed structure for all public companies sacrifices valuable flexibility. Still, if market mechanisms do not automatically lead to optimal structures, stock exchange mandates may lead to a better outcome. If the costs are too great for some smaller companies, it may be that too many companies went public in

152. My own guess is that how one compares the U.S. and the best alternative corporate governance systems, such as Germany and Japan, depends on how one values efficiency, innovation, equality, and security. See Brett H. McDonnell, Convergence in Corporate Governance—Possible, But Not Desirable, 47 VILL. L. REV. 341 (2002).
153. See Branson, supra note 151.
154. See supra note 137-38 and accompanying text.
155. See Burns, supra note 138.
156. See Bainbridge, supra note 98.
the late nineties boom, and that some would be better off going private. Current evidence on the effects of independent directors shows little sign of significant effect.\textsuperscript{157} However, it might be that with the new board structures directors will become more truly independent and active than before.

The other main reform has been increased pressure to create extensive internal controls. Some degree of internal control is essential for any large, hierarchical corporation. Lower-level employees are not necessarily motivated to always follow the corporation’s best interests, so some monitoring must occur. But too much monitoring can pile on added cost with marginal benefits that do not justify those costs, and no internal control system can guarantee that problems will not occur.\textsuperscript{158} Indeed, at some point internal controls may become counter-productive, hurting employee morale as they come to believe that the corporation does not trust them.\textsuperscript{159} Has SOx caused corporations to go too far in instituting internal controls? Some companies claim to have spent exorbitant sums on internal control systems in response to SOx.\textsuperscript{160} However, some of these claims are rather hard to believe, and even if true, it is not at all clear that they are even close to representative. Given current evidence, it is hard to tell whether the costs exceed the benefits. In his careful and detailed study of internal controls in the wake of SOx, Cunningham attempts to estimate the added benefits and costs. He finds that it is a close call, although the admittedly rough calculation is consistent with a claim that the benefits do outweigh the costs.\textsuperscript{161}

The question of evaluating the effect of SOx is yet more complicated for me because my metric for “better” and “worse” corporate governance differs from most American observers. Most Americans follow a shareholder primacy norm which says that corporations should be run in the interest of maximizing shareholder gain. I instead subscribe to a stakeholder position, maintaining that that the interests of other groups, especially employees, should count heavily as well.\textsuperscript{162} From this perspective, restraining officers and creating more active independent directors may or may not be a good thing. To the extent that the result is a greater focus on shareholders’ interests, it is ambiguous whether those interests are closer to those of employees than the interests of officers.

\begin{itemize}
\item \textsuperscript{157} See Bhagat & Black, \textit{supra} note 105.
\item \textsuperscript{158} See Cunningham, \textit{supra} note 34.
\item \textsuperscript{159} See \textit{id.} at 56-57 (manuscript); Langevoort, \textit{supra} note 34.
\item \textsuperscript{160} See Del Jones, \textit{Sarbanes-Oxley: Dragon Or White Knight?}, USA TODAY, Oct. 20, 2003, at B1.
\item \textsuperscript{161} See Cunningham, \textit{supra} note 6.
\item \textsuperscript{162} See Brett H. McDonnell, \textit{Corporate Constituency Statutes and Employee Governance}, 30 WM. MITCHELL L. REV. (forthcoming 2004).
\end{itemize}
However, my best guess is that corporations as a whole, including both shareholders and employees, will be better off if officers can be held more accountable. Decades ago, American corporations were much more managerialist institutions, with weak board dominated by the CEO and other inside officers. Internal controls were less pervasive. That system may have led to a stronger commitment to employees and greater trust within the corporation, as well as giving officers more chances to engage in self-dealing. Norms and community institutions may have put serious limits on that self-dealing. However, modern American corporations have already moved far from that model. The old commitments to employees have weakened, and employees in turn are much less likely to expect to spend a lifetime working for one company. The old internal and community norms limiting officers have weakened. In this environment, new controls are needed over both officers and employees. American corporate governance had already moved far in that direction over the last few decades, creating a norm of shareholder primacy and empowering a variety of institutions to help enforce that norm.\(^{163}\)

SOx and the associated reforms press further in that direction. Various threats of new liability may scare directors and officers into better performance. New norms may spur better behavior. More radically, greater shareholder control over director nomination and compensation may change director behavior quite a bit. I doubt these reforms can take us tremendously far from the pre-SOX status quo, but I think they may be taking us a noticeable distance. Those who, like me, prefer a stakeholder approach may not be happy with this evolution. However, operating within this context, the SOx reforms make sense.\(^{164}\)

The procedure by which the reforms have occurred give further confidence that they are for the most part helpful. One may well doubt the wisdom of Congress in this area. However, we have seen that although Congress and the President made a big display of grand, sweeping reform, the immediate changes reflected in SOx itself were rather modest.\(^{165}\) More change came through the SEC, stock exchanges, and Delaware courts.\(^{166}\) These regulators are more expert than Congress. Their problem is that they may also

\(^{163}\) See Branson, supra note 143; see also Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439 (2001). Given the increased importance of monitoring and systems of control in this evolving system, it would be interesting to see a Foucaultian take on the internal control measures of SOx. See MICHEL FOUCALUT, DISCIPLINE AND PUNISH: THE BIRTH OF THE PRISON (Alan Sheridan trans., Vintage Books Edition 1979) (1975).

\(^{164}\) I am thus suggesting that the SOx rules are a second-best response within the U.S. system of corporate governance, although I have qualms about that system.

\(^{165}\) See infra section I.

\(^{166}\) See infra section II.
be more subject to capture by management, and perhaps shareholders. SOx has thus had the good effect of forcing these specialized regulators to take action knowing that Congress and the general public are watching. In this it is a striking instance of how our federal system of corporate lawmaking works.¹⁶⁷

Moreover, both the Congressional laws and the rules emanating from the more specialized institutions have for the most part left corporations a fair degree of room to maneuver. The internal control rules leave officers much discretion to determine exactly what structures and procedures will work best.¹⁶⁸ Delaware courts, as always, step in on a relatively fact-specific basis, leaving both themselves and corporations room to negotiate how past decisions will apply in new situations. Even the stock exchange rules, which prescribe in a fair degree of detail, leave boards and their committees much room to decide how to carry out the tasks they are now required to undertake. By leaving corporations room to maneuver, while still requiring some significant changes in response to the scandals, regulators have left space for experimentation and adaptation to individual circumstances.

I thus believe that on the whole SOx and the various other reforms it has helped unleash is appealing. It also has unappealing bits, the whole is rather chaotic, and the process by which it was passed was rushed and often uninformed. We cannot yet tell the true long term effects, and scholars and others will surely debate those effects for a very long time. However, for the reasons I have canvassed in this section, I believe that the net effects will turn out to be positive.

CONCLUSION

At first glance, SOx appears to have made deep changes in many areas of corporate governance affecting directors and officers. A second glance, developed in section I, shows that most of the relevant statutory provisions do not go that far beyond prior rules and practice. A third glance, developed in section II, refines the analysis further, showing that SOx has helped spur the SEC, stock exchanges, and Delaware courts to further reforms, suggesting a total effect that may indeed be sizable. Moreover, section III gives some evidence that directors and officers have responded more deeply to the overall package of changes than a simple deterrence theory would suggest. Evaluating the net effect of all this is hard, and scholars and others will be sifting through the evidence and arguing about it for many years. However, section IV gives

¹⁶⁷ See McDonnell, supra note 74.
reasons for believing that the net effect is positive. Through its appeals to regulators and corporate actors, SOx has created a reform dynamic that is creating appealing changes in American corporate governance.