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Sarbanes-Oxley's Insight: The Role of Distrust

MANY SCHOLARS HAVE DESCRIBED THE SARBANES-OXLEY ACT of 2002¹ (SOX) reforms as “window-dressing” designed mainly to mollify disappointed investors in anticipation of looming mid-term elections in Congress.² On this conventional view, Congress, in its haste to appear engaged and responsive to public outcry, adopted a host of ill-considered unproven measures intended to shore up investor confidence.³

Even more sympathetic commentators concede that much of Sarbanes-Oxley is sizzle rather than steak.⁴ They point to then-pending Securities and Exchange Commission (SEC) reforms, redundant requirements, and pre-existing legal obligations to demonstrate that Sarbanes-Oxley mostly reiterates and reemphasizes extant duties and recognized best practices, rather than introducing substantive reforms.⁵

These cynical views of Sarbanes-Oxley's political provenance have much to support them. Several of the Act's provisions were introduced (seemingly out of thin air) on the floor of the Senate during the legislation's forced march to enactment in late August 2002.⁶ Some aspects of the legislation were sloppily drafted. For exam-

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1. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2. Joshua A. Newberg, *Corporate Codes Of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 275 (2005) (describing the provisions of Sarbanes-Oxley as mere “window dressing”); cf. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1566–67 (2005). Although Romano describes the legislation as hastily adopted and ill-advised, she rejects the characterization of SOX as window-dressing. *Id.*

3. Romano, *supra* note 2, at 1528–29; see also HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE* 16–20 (2006); Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REG., Spring 2003, at 26.

4. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Just Might Work)*, 35 CONN. L. REV. 915, 918–19 (2003) (characterizing some SOX reforms as “mere stunts to promote investor confidence”).

5. See *id.* at 918; see also Lisa M. Fairfax, *Form over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 3–4, 42–45 (2002).

6. For example, section 307, which requires the SEC to adopt new rules governing attorney conduct, was introduced on the Senate floor by former Senator John Edwards. See Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, 2 CORP. GOVERNANCE L. REV. 6, 6–8 (2006). Similarly, section 402, which bans loans to executive officers and directors, was introduced on the floor by Senators Charles Schumer and Diane Feinstein and was adopted from the floor, without discussion or debate. See Romano, *supra* note 2, at 1527 n.16.

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ple, sections 302 and 906 of the Act impose duplicative financial certification requirements on senior corporate officers.⁷

Despite some valid concerns raised by Sarbanes-Oxley's many critics, the prevalent description of the Act as non-substantive and ill-conceived seems overstated. Instead, it appears that the promoters of the legislation had a sensible substantive agenda. At root, the underlying policy objectives of the Act were theoretically sound, even if the implementation was less than perfect. In enacting Sarbanes-Oxley, Congress sought to institute structural reforms to create constraints on misconduct that the pre-existing self-regulatory regime failed to provide.⁸

A common objective evident among the broad and far-reaching reforms is an effort to create institutional structures to impose the discipline that, due to limitations of human nature, individuals and groups find difficult to confer consistently.⁹ The Act's structural reforms are designed both to liberate and empower corporate monitors to perform their oversight duties more effectively.

The previous regime relied too heavily on personal integrity, reputational concerns and relationships of trust to control misconduct.¹⁰ The governance scandals at Enron and numerous other companies show how trust too often leads people astray. For example, Enron's board reposed an unreasonable degree of trust in Ken Lay and Andrew Fastow to manage potentially overwhelming conflicts of interest that the board had approved.¹¹ Likewise, WorldCom's directors deferred too liberally to chief executive officer (CEO) Bernie Ebbers as he led the company into financial disaster while diverting substantial corporate resources for his own personal use.¹² These and countless other corporate scandals exposed at the dawn of the new century reveal the stark reality that corporate directors are positioned poorly to monitor executives when they have personal relationships and positive feelings that lead them to lower their guard.¹³

An important aspect of many of Sarbanes-Oxley's reforms is the reintroduction of a notion that seems underappreciated in the dominant *laissez-faire* approach to

7. Pub L. No. 107-204 §§ 302, 906, 116 Stat. 745, 777, 806; see Fairfax, *supra* note 5, at 18–19. Section 302 is the civil certification requirement that is enforced by the SEC. Section 906 is a criminal certification provision, enforced by the Justice Department which subjects violators to criminal penalties (including prison).

8. Stephen M. Cutler, Director, SEC Div. of Enforcement, Address at UCLA School of Law: The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program (Sept. 20, 2004), available at <http://www.sec.gov/news/speech/spch092004smc.htm>.

9. See Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 139–44 (2006).

10. See *id.* at 125–27.

11. WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 3–5, 22–24 (2002).

12. See generally RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR FUTURE OF MCI, INC. 1–3, 26–38 (2003) (describing the numerous violations of corporate governance principles committed by Ebbers for his own personal gain).

13. See David Bank & Joann S. Lublin, *Giving at the Office*, WALL ST. J., June 20, 2003, at A1; see also BREEDEN, *supra* note 12, at 40–41.

corporate governance: the need for institutional structures to reflect more *distrust*. Corporate governance literature is rife with books, articles, and reports heralding the need to “restore trust” in corporate America.¹⁴ It is quite possible that these exhortations miss the mark. It may be that we have overemphasized the value of trust and failed adequately to appreciate the importance of *distrust*.¹⁵

This Essay expands on ideas I have presented elsewhere regarding the misplaced faith of many corporate theorists in the power of trust and loyalty to guide corporate officials to act responsibly.¹⁶ This Essay also builds on observations of political theorist Dennis Thompson, outlined in the essay, *Restoring Distrust*.¹⁷ Professor Thompson calls for greater recognition of the ethics of oversight, which he defines as “the moral responsibility for seeing that other people act rightly and, when they do not, the responsibility for acting to correct the problem.”¹⁸ He maintains that we should hold overseers responsible for “acts of omission as much as for acts of commission; gross negligence as much as for intentional wrongdoing; offenses of oversight as much as for the primary offenses over which the oversight is exercised; and inappropriately trusting friends and colleagues as much as for mistakenly trusting enemies and rivals.”¹⁹

When we acknowledge the necessity for a healthy measure of distrust, we must necessarily move from an individualistic approach to ethics to a view that focuses on the soundness of our institutions.²⁰ On this view, having the right structures matters more than having the right kind of people. As Professor Thompson explains, when we pay more attention to the need for distrust, “we will make sure that the institutions on which we depend are designed in a way to encourage good behavior in the absence of good character, and in the absence of trusting personal relations.”²¹

When we view the scandals of the early twenty-first century as evidence of weaknesses in institutional structures rather than a reflection of the failure of individual ethics, the Sarbanes-Oxley reforms seem far more defensible than its critics have allowed. There are a number of ways in which Sarbanes-Oxley recognizes the need to introduce more distrust into corporate governance systems. Significant examples include the creation of the Public Company Accounting Oversight Board (PCAOB),

14. See, e.g., TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD* (2006); *RESTORING TRUST IN AMERICAN BUSINESS* (Jay W. Lorsch et al. eds., 2005); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001). See also BREEDEN, *supra* note 12.

15. DENNIS F. THOMPSON, *RESTORING RESPONSIBILITY: ETHICS IN GOVERNMENT, BUSINESS, AND HEALTHCARE* 248 (2005).

16. See Jones, *supra* note 9, at 129–30.

17. See THOMPSON, *supra* note 15, at 245–66.

18. *Id.* at 245.

19. *Id.* at 253.

20. See *id.* at 249.

21. *Id.*

which assumed oversight of the accounting industry,²² and section 404's internal control requirements, which seek to bolster and support the boards' ability to monitor financial reporting systems.²³

The PCAOB, an independent quasi-governmental body, oversees public accounting firms and establishes auditing standards.²⁴ The PCAOB assumed a number of functions previously performed by the American Institute of Certified Public Accountants (AICPA), an industry trade group.²⁵ In a related move, Congress mandated changes to the funding mechanism and governance structure of the Financial Accounting Standards Board (FASB), the accounting standards board that had been funded by the accounting industry prior to Sarbanes-Oxley.²⁶ The creation of PCAOB reflects Congress' reasonable skepticism regarding the accounting industry's ability to monitor itself and directors' ability to monitor corporate auditors.²⁷

In adopting section 404, which requires an annual assessment and audit of corporate internal controls, Congress recognized the need for more distrust of corporate accounting systems and the individuals who implement and monitor them.²⁸ Section 404 reflects the understanding that individuals often make mistakes and may sometimes seek to mislead others to hide poor performance or enhance their reputations.²⁹

The relative costs and benefits of the PCAOB and section 404 are the subject of an extensive and intense academic debate.³⁰ Rather than engage in this debate, I will focus on a few of the smaller-scale reforms that have received less attention, but are also premised on the need to promote distrust by acknowledging the corrosive impact of personal relationships on effective oversight, and instituting mechanisms that mitigate these effects. Specifically, I will discuss Sarbanes-Oxley's ban on execu-

22. See Cassell Bryan-Low, *Accounting Changes Are in Store*, WALL ST. J., Sept. 10, 2003, at C4; see also Public Company Accounting Oversight Board, Standards, <http://www.pcaob.org/standards> (last visited Feb. 22, 2008).

23. Pub. L. No. 107-204 § 404, 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262).

24. For an overview of the background surrounding the creation of the PCAOB, see Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 983-1006 (2005).

25. See Cunningham, *supra* note 4, at 943-44.

26. *Id.* at 964-65. See generally William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5 (2007).

27. Nagy, *supra* note 24, at 983-1003.

28. Paul S. Atkins, Comm'r, SEC, Remarks Before the American Institute of Certified Public Accountants (Dec. 5, 2005), available at <http://www.sec.gov/news/speech/spch120505psa.htm>.

29. See John M. Darley, *The Cognitive and Social Psychology of Contagious Organizational Corruption*, 70 BROOK. L. REV. 1177, 1180-81 (2005).

30. For competing views of the merits of section 404, see J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQ. L. REV. 309, 320-28 (2006); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843 (2007); Romano, *supra* note 2, at 1595 n.214. A good summary of the current state of the debate can be found in Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007). For a discussion of the legitimacy of the PCAOB, see Nagy, *supra* note 24, at 1006-22.

utive loans,³¹ and the mandatory executive session that the New York Stock Exchange (NYSE) and Nasdaq imposed on listed public companies.³² Rather than seeking to marshal evidence to prove the effectiveness of these provisions, I instead will demonstrate why these reforms make sense as part of an effort to create more appropriate structures for effective institutional oversight.

Section 402 of Sarbanes-Oxley created an outright ban on corporate loans to executive officers and directors.³³ Before Sarbanes-Oxley, corporate loans to senior executives were a widespread and fairly uncontroversial practice.³⁴ Courts generally treated such loans as a legitimate use of corporate resources, beyond the scope of judicial review, provided requisite independent director approval was obtained.³⁵ Executive loans were justified most frequently as a means to promote stock ownership by executives, thereby aligning executives' interests with those of corporate shareholders.³⁶

These liberal corporate lending practices placed the compensation committee of the board of directors in an awkward position. A request for a loan from a trusted and well-respected executive was difficult to reject, especially when the board viewed part of its job as keeping the CEO happy. In most cases approval of the loan requests and loan programs was perfunctory.³⁷

As we all now know, many of these loans were later forgiven or an extra bonus was granted at a later date to help the CEOs repay the loans. Too often, what initially appeared to be a legitimate loan turned out to be a disguised form of additional compensation.³⁸ These permissive lending practices had the potential to be catastrophic, as was the case in WorldCom, Adelphia, Tyco and Enron.³⁹ Even in less dramatic situations, such practices likely contributed to the erosion of what purported to be an arms-length, rational compensation system.⁴⁰ The board thus became complicit in unsound practices mainly out of initial discomfort with turning down what seemed to be a reasonable request.

31. See *infra* notes 33–42 and accompanying text.

32. NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 48,745 (Nov. 4, 2003).

33. See 15 U.S.C. § 78m(k)(1) (Supp. II 2004).

34. See Romano, *supra* note 2, at 1538–39.

35. See DEL. CODE ANN. tit. 8, § 143 (West 2007); MODEL BUS. CORP. ACT § 3.02(11) (2000 & Supp. 2002). According to statutory provisions and judicial doctrine, loans to corporate officers and employees were evaluated under the business judgment rule provided that such loans were approved by independent directors or ratified by shareholders. DEL. CODE ANN. tit. 8, § 144; MODEL BUS. CORP. ACT § 8.62; see also Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Marciano v. Nakash, 535 A.2d 400 (Del. 1987); Brown, *supra* note 30, at 330–34 (noting infirmities with traditional state corporate law approach).

36. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 114 (2004); see also Romano, *supra* note 2, at 1539.

37. Prentice & Spence, *supra* note 30, at 1892–93.

38. See BEBCHUK & FRIED, *supra* note 36, at 114–17.

39. See Jayne W. Barnard, *Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act*, 31 OHIO N.U. L. REV. 325, 328–32 (2005); Prentice & Spence, *supra* note 30, at 1890–94.

40. Barnard, *supra* note 39, at 332–34.

Although the ban on loans is an oft-criticized provision of Sarbanes Oxley,⁴¹ I think its proponents correctly perceived that insider loans create temptations that are highly susceptible to abuse, even when all parties involved start out with good intentions. After all, with its own check-kiting scandal Congress has had ample experience with the potential abuse of lax monitoring of lending practices.⁴²

Another example of how Sarbanes-Oxley promotes more distrust is the new mandate for regular executive sessions of the board of directors.⁴³ The New York Stock Exchange and Nasdaq now require independent directors to meet outside of management's presence on a regular basis.⁴⁴ The mandatory executive session is not a formal Sarbanes-Oxley requirement, but was adopted by the stock exchanges as part of the Sarbanes-Oxley wave of reform.⁴⁵ The objective of the reform is to create a forum where outside directors can discuss issues and concerns they might be reluctant to raise in front of the CEO.

Like the ban on loans, routine executive sessions can help liberate directors from the fear of offending the executives they are charged with monitoring. The routine executive session provides a forum that facilitates critical discussions when they are necessary and helps cement the board's sense of itself as an independent body. Such routine sessions allow non-management directors to discuss sensitive issues without creating alarm or arousing a sense of disloyalty.⁴⁶ This built-in mechanism helps facilitate frank discussions that directors frequently report create a sense of discomfort they otherwise prefer to avoid.⁴⁷

In summary, an overlooked element in the current debate over the merits of the Sarbanes-Oxley Act is the Act's proper emphasis on the institutionalization of distrust as a central component of effective corporate governance. The Act and ancillary reforms created institutional structures that help foster independent thought and expression among directors and other corporate gatekeepers. Thus, what at first seemed to many to be trivial or counterproductive measures may instead represent essential components of institutional reform necessary to ensure the integrity of our corporate governance regime.

41. See, e.g., Cunningham, *supra* note 4, at 960–62; Romano, *supra* note 2, at 1538–40.

42. See Nancy Traver Washington, *Congress: Why Foley Stood Idle*, TIME, Apr. 13, 1992, at 29.

43. Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L. Rev. 1, 13–15.

44. NYSE, Inc., Listed Company Manual § 303A.03 (2004) (“To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.”); NASDAQ, Inc., Manual Online § 4350(c)(2), available at http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1 (“Independent directors must have regularly scheduled meetings at which only independent directors are present . . .”).

45. Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 980–81 (2003). See generally Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002).

46. See JAY W. LORSCH WITH ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS* 93 (1989).

47. *Id.*