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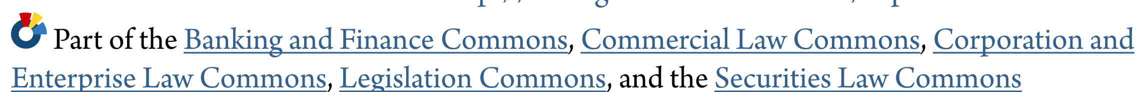
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"Sarbanes-Oxley and the Role of Lawyers in Public Companies"

Conference on Sarbanes-Oxley

Columbia University Law School

(April 2003)

by

Lawrence A. Cunningham
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Please note: This lecture draws upon the article *Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONNECTICUT LAW REVIEW 915-988 (2003), *reprinted at* 34 THE SECURITIES LAW REVIEW (Donald C. Langevoort, ed., 2004), a more formal development of its ideas which should be cited in preference to citing this lecture.

FINANCIAL LANDSCAPE AND SCANDALS

The late 1990s was a period of expansion and innovation that comes once a generation. Technological exploitation enabled widespread Internet use and proliferation of telecom infrastructure. In 1996 hardly anyone used email and a minority used cell phones; by 2000, nearly everyone used both regularly.

Heady financial times draw to investing millions of people who lack business knowledge and to business thousands who lack moral scruples. The combination produces exaggeration of achievements and obfuscation of setbacks. With flushness fueling financial fantasies, accounting and governance become obstacles to overcome or burdens to meet, not tools to promote quality financial reporting or disciplined management oversight. The spirit of the times overcomes the spirit of the rules.

The hallucinations of the late 1990s began to end in March 2000, when investors recognized that a financial bubble had arisen and drove stock prices plunging. The unraveling of Enron, a direct product of the era's financial fantasia, began in late 2001 and escalated in 2002. An accounting meltdown at Global Crossing began to tip the dominos in February 2002.

A wave of reported debacles followed in the Spring, but characterized by distinct misbehavior. The widely-publicized cases, Adelphia and Tyco, involved sweetheart insider loans, stories of greed not accounting, except in the same sense that Al Capone's schemes were about tax evasion.

Other accounting corruption stories long in the background became front-page news, including household names like AOL Time Warner, Rite Aid, and Xerox. The parade of disparate,

illicit, and over-exposed tales ran to ImClone Systems, whose CEO allegedly told his father and daughter about company prospects in violation of federal securities law.

Investors may have been able to properly classify these unrelated events for a while. Enron and the other ongoing accounting scandals were about ways companies dress up accounts to obscure the truth; the self-dealing loans at Adelphia and Tyco were relatively ordinary (if despicable) incidents of corporate misconduct; events at ImClone concerned arcane regulations governing insider trading. But non-experts in accounting, corporate governance, and securities law aren't good at maintaining these distinctions (especially when they've just lost enormous investment capital).

The gales of Enron and Global Crossing were strong and these other episodes amplified them. The tipping point arrived in June with a pure accounting deception so large there was no turning back from an Act of Congress, even for President Bush and other free-market Republicans– I'm referring to WorldCom, as well as at its capacity-swap trading partner Qwest.

Not coincidentally, several characteristics adorned each of the four massively scandal-ridden companies—Enron, Global Crossing, WorldCom, and Qwest. Most important but least noted is that they were all new: WorldCom went public in 1995, Global Crossing and Qwest both went public in 1997, and Enron revolutionized during the late1990s from a stodgy natural gas company into a broadband and risk management mirage. Also, these four companies, which I call the Big Four Frauds, used more appalling accounting and showed more shocking governance laxity, than other aggressions of the period (or any other). Third, all used as their outside auditor the once-venerable and now dead Arthur Andersen.

The multi-billion dollar scale of the Big Four Frauds wrought proportional personal losses

for millions, all amid the imploding financial bubble that stripped several trillion dollars more. The combination produced a natural tendency to overreact, provoking wholesale questioning of the quality of American financial reporting.

Some perspective was in order, but rarely broke through. One would have classified the disparate scandals better. This would have emphasized that Enron was essentially a Ponzi scheme, diabolically engineered and disguised by a few pathological fiends; that the other companies suffered from tele-dot-com mania going into the balloon, and tele-dot-com fever when it deflated. More broadly, everyone could have been reminded that when the balloon held helium, few complained of manifestly aggressive accounting when business performance was measured by revenue not earnings, eyeballs hitting Internet sites not dollars customers paid. But victims don't like to be blamed.

Despite such perspectives—unpopular but plausible—cries to do something were loud and could not be ignored. The result was the Sarbanes-Oxley Act of 2002.

THE ACT

Despite heavy advertising as the most "sweeping reform" of business practices since the New Deal, the Act is more sweep than reform. Most provisions codify existing law and practice or tinker at the edges– exceptions relate to auditing and internal control, but even there changes are not "sweeping reform."

I theorize that the Act's rhetoric-reality gap reflects uncertainty about how bad things are on the one hand and public perceptions that they are certainly awful on the other. Sweeping rhetoric lets the public think Congress is doing something; limited substance enables regulators to hold back in case less is wrong than many think. This view helps to explain the Act's call for 9 studies

investigating a wide range of potential cancers, addressing targets in a way that can be seen to threaten them into cleaning up their acts.

On the merits, the Act's changes are more likely to have psychological than substantive effects. And these may be significant.

I'll highlight a few examples of most concern to counseling the public company: auditing, controls, and certification.

AUDITING BOARD

Of the Act's many provisions, the silver bullet is its creation of the new auditing oversight board nicknamed Peak-A-Boo. Compared to the series of successive bodies overseeing the auditing profession over the decades, several differences stand out, intended to strengthen the board's independence from the profession: it is a creature of statute, not grace; a majority of its five members will be non-CPAs; and it will be funded by public company shareholders, not the auditing profession.

Despite these changes, the perception of greater independence may be more structure than substance. Standard setters and practicing auditors always operated under threat of SEC rebuke. Client advice was invariably couched in terms of whether a position would pass muster at the SEC. That threat remains the key disciplining power that will apply with the new board. To that extent, less has changed than meets the eye.

AUDIT FIRMS

As for auditing firms, independence is strongly influenced by what role auditors assume for clients in addition to certifying financial statements. Roles mushroomed in the past few decades as firms became multi-national, multi-service conglomerates.

Curtailing the influence of these activities, SEC reforms implemented in 2000 defined a range of services auditors could not render and still remain independent. Amid the pressure enabling and resulting from those efforts, all firms have withdrawn from those businesses, selling or divesting them.

Though these steps rendered the point substantially moot, the Act restricts them, much as an errant cowboy locks the stable after his wild horses have escaped. Strikingly, the Act restates and restricts exactly the same services restricted by the SEC reforms, using almost exactly the same language.

Untouched are tax and compliance services, still big money for the firms and a big portion of fees paid by registrants, though Peak-A-Boo has hinted it may touch them.

AUDIT PARTNERS

To enhance the independence of individual auditors within firms, the Act requires auditors to rotate lead and reviewing partners so that neither role is performed by the same accountant for the same company for more than five consecutive years. As with many other Act provisions, this references Enron and WorldCom, both audited by small, local Andersen offices where the lead partner developed a client relationship so lucrative that his independence may have been impaired. Nice going, but this is one of numerous examples of the Act federalizing as law existing auditing standards (though existing auditing standards set the limit at seven years which the Act cuts to five).

Stronger medicine is being considered, through one of the Act's 9 studies. One possibility is to mandate rotation of firms. A virtue of this approach is it would probably encourage more conservative accounting when choices are possible. The first thing new auditors tend to do is hunt for aggressive accounting and pressure to reverse it. The looming threat of such second guessing

would ordinarily induce incumbent auditors to insist on the more conservative approach at the outset.

Forensic accounting is dedicated to energetic identification of accounting aggression, irregularity or fraud. Accounting purists constantly wonder why that energy cannot be deployed during ordinary audits. One reason is the length of the firm-client relationship; one solution is to cap it.

AUDIT COMMITTEES

The greatest intensification of the Act appears to bear down on audit committees, who are charged specifically with various mandates. Most remain codifications.

I'll single out the oddest one for brief comment. Either a committee includes a financial expert or the company must disclose why not. First, stock exchange rules have required an expert for many years. Second, state law requires all directors to understand how to read a financial statement and spot red flags. Third, you can't be effective on an audit committee unless you have that skill.

This is why this is the oddest of the Act's audit committee rules: it is the most critical, already required by exchange and state rule, and yet is left voluntary on a have-or-disclose basis.

TOP OFFICERS

New CFO/CEO internal control certification rules look to prevent those officers from hiding behind the defense of ignorance, a defense Enron's executives invoked in Congressional hearings. The rules may be sensible, but few knowledgeable people believed those executives and none but the most sympathetic or gullible absolved them from responsibility.

On the other hand, an easy case can be made that the rules are incoherent. The rules require

CFOs to design internal controls and turn around and certify their integrity. It is this exercise in self-review that is the central criticism of auditors performing the non-audit services the Act prohibits. It was this exact threat that produced the scandals at WorldCom, where the CFO deliberately overrode internal controls to fabricate results.

A more sensible provision would call for one financial officer to design controls and another to test and certify them. (Incidentally, some companies, smarter than Congress in such matters, appear to be taking a version of this step in creating the new position of Chief Risk Officer.)

CONGRESS

The dog that didn't bark bears mention: the Act does nothing about stock option accounting. FASB has struggled for years to produce accounting rules that faithfully reflect the costs of stock options to shareholders. It has met political resistance at every turn, and Congress gives it no help in the Act.

Devolutionists could applaud Congressional restraint against enacting accounting rules as federal law. But the Act's entry into several other state law areas shows that its reticence on stock options is not the product of this principle.

Congressional reticence on accounting for stock options as an expense in the income statement can alternatively be explained by the Act's central codifying characteristic: no such extant rule exists, so there was nothing to codify. This reticence illuminates the Act's implicit political compromise: it mostly federalizes dozens of existing rules, but mostly refrains from federalizing anything new.

FORECAST

It is impossible to prove whether the Act will work. But a moment's reflection on the Big Four Fraud compared with the Act suggests that cultural features promoted the scandals that are not amenable to regulation, including investor exuberance, a periodic economic boom fostering economic hallucinations and mass stock market psychosis.

Suppose Global Crossing were created several years on, after the tele-dot-com burst and after the Act took effect. Would it attract the capital it did? What, if anything, would have impaired its accounting deceptions? The Act? What, if anything, might rejuvenate temptation? Market madness? Which is likely to dominate, the Act or madness?

If history is your guide, emotions beat governance. Put forensically, the late 1990s market exuberance did not arrive out of the blue, but follows a pattern. Regulatory breakdown is less likely than rationality breakdown the cause of schemes such as Global Crossing or Enron.

Standard-setting is critical, and must be tended, but regulations are not a final fix to forfend financial fraud. For that, a deeper investor and market rationality is required that history repeatedly teaches is unlikely to arrive. The best the regulator can hope for is deterring, not preventing. And modest acts, with rich rhetoric, may be best suited. It appears to be stiffening some spines at audit firms, on audit committees, in board rooms, among corporate advisors—and potentially reinforcing all these among state law judges articulating corporate law.

DELAWARE COURTS

Cause and effect is difficult to prove but it is notable that 5 important Delaware cases in the past year, in the Act's wake, have the Delaware Supreme Court reversing decisions of the Delaware Chancery Court that had favored managers.

All five are close cases, suggested by the Chancery's rulings, and in one case by the unusual fact that the Supreme Court's decision was a divided 3-2. The issues in the cases spanned the range of matters one sees in a basic Corporation law class:

● in *Saito v. McKesson HBOC*, the trial court construed narrowly a shareholder's statutory and common law right of access to books and records relating to merged company's financial and accounting records generated before the merger and by third parties and the Supreme Court reversed in part by broadening its interpretation of the scope of that right;

● in *Texlon v. Meyerson*, the trial court granted summary judgment on claims of breach of the duty of loyalty under the corporate opportunity doctrine and for the payment of excessive executive compensation, and the Supreme Court reversed this disposition as premature given conflicting evidence as to whether the corporate insider ever presented the corporate opportunity to the board, whether the board was independent, and what contributions the executive whose compensation was in issue made to the corporation;

● in *Parfi Holding v. Mirror Image Internet*, the trial court held that an arbitration clause in the agreement under which minority stockholders bought their stock rendered their claims subject to arbitration, and the Supreme Court reversed because the claims were for breach of fiduciary duty and therefore not claims based in the written contract;

● *MM Companies v. Liquid Audio*, the trial court held that a board's defensive action to enlarge its size from 5 to 7 did not implicate Blasisus and satisfied Unocal, and the Supreme reversed on both points, requiring the board to show both a "compelling justification" and that the action was proportional in response to a threat;

- *Omnicare v. NCS Healthcare*, deal protection provisions in a merger agreement were invalid where they effectively precluded the board from entertaining superior offers with no fiduciary out.

Whether particular Act provisions bear teeth, the rhetorical signals they send are strong, and these Delaware cases suggest a substantive ripple effect.

CONCLUSION

Rhetoric is powerful, whether on courts or accompanying legislation. In the case of the Act, the sweeping rhetoric was echoed dutifully throughout American power centers. On its own, that stiffens spines and promotes integrity, which in turn can justify investor confidence. And there may not be much more a legislator can do.