

LOOKING BACK AND LOOKING FORWARD: SARBANES- OXLEY AND THE FUTURE OF CORPORATE GOVERNANCE

Scott Harshbarger and Goutam U. Jois***

I. INTRODUCTION

One of the most important questions facing American society today centers around the role of corporations. Undoubtedly, corporations wield a tremendous amount of power in contemporary affairs. For example, when Hurricane Katrina struck the Gulf Coast, Wal-Mart, the world's largest retailer, pledged \$1 million on August 30, 2005,¹ a full three days before government aid arrived.² While there are surely a variety of reactions to that course of events, this particular response highlights our country's reliance on corporate entities for a variety of societal functions beyond the "typical" roles of production and employment.³ One of the

* L.L.B., A.B., Harvard; Senior Counsel to the Firm, Proskauer Rose LLP. Mr. Harshbarger served as Attorney General of Massachusetts from 1991 to 1999 and District Attorney for Middlesex County, MA, from 1983 to 1991. He was also President and CEO of Common Cause from 1999 to 2002. His current practice focuses in significant part on corporate governance and related regulatory matters.

** J.D. Candidate, Class of 2007, Harvard; M.P.P., A.B., Georgetown; Student Attorney, Harvard Legal Aid Bureau. This Article is the product of several years' work and would not have been possible without the help and input of many different people. Pablo Eisenberg, a friend and mentor to us both, offered comments on earlier drafts of this and a related article. Thanks to Seth Ragosta, Benjamin Brinkert, Danielle Stockley, and Tina Gonzalez for research and editing assistance, and to Angela Frontiera for outstanding secretarial assistance on all of our various projects. We also appreciate the support of Murphy, Hesse, Toomey & Lehane, LLP, and Proskauer Rose LLP over the years in encouraging this work and providing opportunities to inform the Article with real-world experience. Finally, we would like to thank Prof. Judith Stephenson, Northeastern Law '87; as well as Umesh, Indira, Malasa, and Mallika Jois, and Elizabeth Brown, without whose support this project would not be possible.

1. See, e.g., Parija Bhatnagar, *Wal-Mart Closes 123 Stores from Storm*, CNNMONEY, Aug. 31, 2005, http://money.cnn.com/2005/08/30/news/fortune500/katrina_retailers/.

2. See, e.g., Scott Shane, *After Failures, Officials Play Blame Game*, N.Y. TIMES, Sept. 5, 2005, at A1.

3. See, e.g., E-mail from Don Davenport, Procomm Consulting Group, to authors, (Sept. 2, 2005, 10:24:07 EDT) (on file with authors) ("We are witnessing the result of years of government neglect . . . What does this say about a nation that turns to WalMart for relief supplies? The

biggest questions that comes to the fore when discussing corporations' role is that of corporate governance: how companies are run internally and what rules they will play by in the external world.⁴

In a narrow sense, good corporate governance means shareholders realize value and boards of directors have an easier time fulfilling their fiduciary duties. More broadly, corporate governance is about the principles that underlie democracy: transparency, checks and balances, and accountability.⁵ Good corporate governance means that businesses recognize the duties that correspond to the privileges that society has granted them: favorable tax treatment, limited liability, and so forth. When scandals strike the public or nonprofit sectors, there is often a loud call for accountability, ethics, and integrity, and rightly so. This is rationalized on the grounds that these entities receive public funding, subsidies, tax-exemptions and other related benefits. However, as the Katrina story indicates and as scholars have discussed,⁶ corporations

spokesm[e]n for WalMart and Lo[ew]s w[ere] on TV sending relief supplies before the President of the United States.”).

4. Corporate governance is “[i]n essence . . . the structure that is intended to make sure that the right questions get asked and that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable value.” ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 2 (3d ed. 2004). The primary participants are (1) the shareholders, (2) the management (led by the executive officer), and (3) the board of directors. *Id.* at 6.

5. Another article makes the analogy to democracy more forcefully. Paul Gompers, Joy Ishii, and Andrew Metrick write:

Corporations are republics. The ultimate authority rests with voters (shareholders). These voters elect representatives (directors) who delegate most decisions to bureaucrats (managers). As in any republic, the actual power-sharing relationship depends upon the specific rules of governance. One extreme, which tilts toward a democracy, reserves little power for management and allows shareholders to quickly and easily replace directors. The other extreme, which tilts toward a dictatorship, reserves extensive power for management and places strong restrictions on shareholders' ability to replace directors.

Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 107 (2003).

The connection between corporate governance and democracy in the abstract sometimes has real political implications in practice. Gretchen Morgenson reports that the issue of executive pay at two major utility companies is affecting the campaigns for political office in Illinois. Gretchen Morgenson, *Executive Pay Becomes Political*, N.Y. TIMES, Nov. 5, 2006, § 3, at 1. Gubernatorial candidates are promising to try to renew the freeze on electricity rates to assist consumers and prevent companies from using new stock plans to “capture a windfall from the rate increase” for executives. *Id.* Mark Hulbert writes that a new study strongly suggests that companies that make political contributions to the most Congressional candidates enjoy better performance in stocks and experience “faster subsequent growth in their profitability” than companies that contribute to fewer candidates. Mark Hulbert, *The Share-Price-to-Campaign-Contribution Ratio*, N.Y. TIMES, Nov. 5, 2006, § 3, at 6.

6. See, e.g., Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 120 n.465 (2004) (discussing the

play a significant role in society as well. Arguably, corporations exert more influence and play a greater role in our daily lives than other governmental or social institutions. Accordingly, we should be even more concerned about good corporate governance.

Corporate governance recently tends to bring to mind the Sarbanes-Oxley Act of 2002 ("SOX").⁷ SOX was passed in response to the corporate scandals of the early 2000s (particularly Enron and WorldCom).⁸ The Act has garnered much attention, as it represents the most sweeping and comprehensive overhaul of federal corporate governance law since the securities laws of 1933 and 1934.⁹ In the intervening four years commentators from all walks of political, legal and academic life have considered its utility.¹⁰ Corporate governance remains a timely issue. Recent class action and bankruptcy legislation, continued earnings restatements and accounting scandals, new regulations and investigations of hedge funds and mutual funds, white-collar criminal prosecutions, and recently-finalized settlements, fines,

influence that corporations have in society and in particular on regulations); cf. GEORGE J. STIGLER, MEMOIRS OF AN UNREGULATED ECONOMIST 115-118 (1988) (noting the "actual effects of economic regulations" and arguing that the regulations actually served the interests of firms and industries, not the public interest).

7. Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amendment in scattered sections of 15, 18 U.S.C.) [hereinafter SOX].

8. SOX was first introduced on February 14, 2002 and was signed into law on July 30th, 2002. *Id.* The SEC began investigating Enron in October, 2001 and WorldCom in March of 2002. See Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES, Aug. 26, 2002, <http://www.forbes.com/2002/07/25/accountingtracker.html> [hereinafter Timeline]; *Timeline of Enron Collapse*, WASH. POST, Sept. 3, 2004, <http://www.washingtonpost.com/ac2/wp-dyn?pagename=article&node=&contentId=A25624-2002Jan10>; *The Rise and Fall of WorldCom*, USA TODAY, http://www.usatoday.com/money/industries/telecom/2002-07-21-worldcom-chronology_x.htm (last visited Sept. 24, 2006).

9. See, e.g., Press Release, President George W. Bush, President Bush Signs Corporate Corruption Bill (July 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020730.html> (describing SOX as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt").

10. See, e.g., Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 NEW ENG. J. INT'L & COMP. L. 231 (2006); Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801 (2003); Susan J. Stabile, *Sarbanes-Oxley's Rules of Professional Responsibility Viewed Through a Sextonian Lens*, 60 N.Y.U. ANN. SURV. AM. L. 31 (2004); Timothy L. Weston, *Sarbanes-Oxley Section 404 Under Siege: Solutions for Solving the Problems of Implementing Section 404*, 60 CONSUMER FIN. L.Q. REP. 86 (2006); Erica Gann, Comment, *Judicial Action In Retrograde: The Case For Applying Section 804 Of The Sarbanes-Oxley Act To All Fraud Actions Under The Securities Laws*, 72 U. CIN. L. REV. 1043 (2004); Jennifer S. Recine, Note, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535 (2002); Michael D. Silberfarb, Note, *Justifying Punishment For White-Collar Crime: A Utilitarian And Retributive Analysis Of The Sarbanes-Oxley Act*, 13 B.U. PUB. INT. L.J. 95 (2003).

and penalties all indicate that the corporate governance landscape is still unsettled.¹¹ What balance will be struck in the relationship between corporations and other basic societal institutions? The answer remains uncertain.

Importantly, perhaps most important to shareholders, we now know that Enron and WorldCom were not just the work of a few “bad apples.” We have seen story after story of corporate malfeasance over the past four years.¹² As a result even honest, ethical CEOs are finding it harder to compete in the marketplace.¹³ Instead of embracing responsibilities to all of their stakeholders,¹⁴ too many corporate leaders try to shirk their obligations and get away with doing as little as possible.¹⁵

11. 2005 saw the passage of new class action and bankruptcy legislation. Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4 (codified as amended in scattered sections of 28 U.S.C.A.); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.A.). There was also a multitude of earnings restatements. A sampling includes the Bermuda-based insurance company Ace; Taser International, which makes stun guns; Kanebo, a Japanese cosmetics company; CharterMac, a real estate finance company; ConAgra, one of the country's largest food companies; and Eastman Kodak, the photography company. See Joseph B. Treaster, *Ace to Restate 5 Years of Earnings to Correct Accounting*, N.Y. TIMES, July 22, 2005, at C4; *Stun Gun Maker to Restate 2004 Earnings*, N.Y. TIMES, May 18, 2005, at C12; Todd Zaun, *Cosmetics Maker Restates Earnings*, N.Y. TIMES, Apr. 14, 2005, at C5; *Tax Errors Force ConAgra to Restate Earnings*, N.Y. TIMES, Mar. 25, 2005, at C13; *Kodak to Restate Some Earnings for Accounting Errors*, N.Y. TIMES, Mar. 17, 2005, at C3. Hedge funds were subject to regulation under the Investment Advisers Act as of February 1, 2006, see 17 C.F.R. § 275.203(b)(3)-2 (2005), until that regulation was struck down, see *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The SEC promulgated rules requiring mutual funds boards to have an independent chairman and also have at least three-fourths of their directors be independent. See SEC Release No. IC-26520, “Investment Company Governance” (July 27, 2004); see also 17 C.F.R. Part 270.0-1(a)(7)(i), (iv) (describing the three-fourths rule and the independent chairman requirement, respectively). However, that rule, too, was recently struck down for failing to comply with requirements under the Administrative Procedure Act. See *Chamber of Commerce of the United States v. SEC*, 443 F.3d 890 (D.C. Cir. 2006). For a discussion of relatively recent indictments over tax and accounting fraud, see *infra* notes 93-96. By the end of the 2006, the “McNulty Memo” had restrained government prosecutors, the SEC had promulgated a more lenient rule regarding Section 404 compliance for small firms, and the Federal Sentencing Guidelines for Organizations were revised in light of corporations' concerns. See *infra* notes 64-72 and accompanying text. In short, the landscape keeps changing at rapid pace — this Article will surely be outdated by the time it is printed — and the issue remains timely.

12. See generally Timeline, *supra* note 8.

13. See, e.g., Ken Belson, *WorldCom's Audacious Failure and Its Toll on an Industry*, N.Y. TIMES, Jan. 18, 2005, at C1 (discussing the impact of WorldCom's malfeasance on its competitors).

14. See, e.g., Chen & Hanson, *supra* note 6, at 34-35 (discussing the question of “stakeholder” obligations and whether corporations have obligations to non-shareholder constituencies); see also Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005). Corporate managers should have the discretion, but not a duty, to sacrifice some amount of profits in the name of the public interest. See *id.* at 743.

15. Conversely, when it comes to lining their own pockets, they are trying to get away with doing as much as possible. See *infra* Part IVB (discussing clawbacks). President Bush recently criticized business executives for excessive compensation. See Jim Rutengerg, *Bush Tells Wall St.*

Those charged with enforcing laws against corporations, primarily Attorneys General, the Securities and Exchange Commission ("SEC") and the Department of Justice, have their hands full aggressively investigating corporations, a situation that has led to antagonism. For example, New York Attorney General Eliot Spitzer has extracted settlements from corporations on a regular basis, to significant criticism.¹⁶ William Donaldson, former Chairman of the SEC, was regarded as anti-business because he pushed through aggressive regulations of corporations, mutual funds and others, even though he was appointed by President George W. Bush, a Republican.¹⁷ Christopher Cox has vowed to follow in Donaldson's footsteps, continuing the application of clear and consistently enforced rules.¹⁸

We argue that this antagonism is unnecessarily combative and counterproductive. Recent developments in corporate law illustrate a few major themes. First, regulators have woken up to the prevalence of corporate fraud and malfeasance. SOX was passed as a reaction to a few salient examples of corporate crime, but its proactive applicability and its potential lie in preventing such crime in the future.¹⁹ Second, this

to *Rethink Pay Practices*, N.Y. TIMES, Feb. 1, 2007, at C11. President Bush made the point that executives' pay should be based on increasing shareholder value and that investor trust is critical to the success of American markets. *See id.* The President's call sounds a common theme, but we should not lose sight of the fact that reform is not an end in itself. Trust in markets matters, but only to the extent that ethical conduct fosters trust. If investors regain trust in markets, only to get hoodwinked again, we will know that businesses lead to build more than just "trust."

16. Andrew Ross Sorkin, *Maybe Spitzer's Cape Was Too Big*, N.Y. TIMES, June 12, 2005, § 3, at 4 (discussing Spitzer's strategy of bringing charges and then negotiating a settlement, and praising a Bank of America broker for fighting the charges and getting acquitted). For a general discussion of Spitzer's various enforcement and prosecution efforts, see Michael Luo, *Spitzer Makes Push for New Laws to Help Punish Medicaid Fraud*, N.Y. TIMES, July 21, 2005, at B3; Jeff Leeds, *Sony BMG Called Close to Settlement with Spitzer*, N.Y. TIMES, July 23, 2005, at C1; Eric Dash, *Spitzer Says Banks Are Resisting Inquiry on Lending Practices*, N.Y. TIMES, Aug. 6, 2005, at C2.

17. *See, e.g.*, Joseph Nocera, *Starting Off by Doing Right on Options*, N.Y. TIMES, June 11, 2005, at C1 (describing former Chairman Donaldson as a "zealous regulator" and Donaldson's successor as "the anti-Donaldson, a pro-business California Republican").

18. Chris Cox, Congressman, Nomination Speech (June 2, 2005), available at <http://www.whitehouse.gov/news/releases/2005/06/20050602-4.html>.

19. Indeed, one unintended positive consequence of SOX was the revelation of stock option scandals. SOX requires more timely disclosure so grants are harder to hide. Previously, executives could disclose stock option grants as late as thirteen months after the grant itself; SOX has lowered that time frame to forty-eight hours. An extensive statistical study of option grants from 1992 to 2002 revealed that executives either "possessed truly extraordinary abilities to forecast precise overall market movements" or were "backdating the grants." Geoffrey Colvin, *A Study in CEO Greed*, FORTUNE, June 12, 2006, at 53. After SOX's new reporting requirement, "backdating virtually disappears." *Id.* Colvin's article was citing the groundbreaking study by Erik Lie at the University of Iowa. *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MANAGEMENT SCI. 802 (2005) available at <http://www.biz.uiowa.edu/faculty/eliel/Grants-MS.pdf>. *See also* David

regulation is here to stay. There is enough support from groups like institutional investors and regulators to ensure that SOX will continue for some time. Indeed, the debates today center on how much of SOX should be relaxed, not (generally) whether the law should be scrapped altogether.²⁰ Moreover, the steady stream of corporate fraud revelations (recently, for example, with accounting issues at Fannie Mae²¹ and options backdating at Apple²²) indicates that rolling back regulation would be the wrong move at the wrong time.

Simultaneously, however, it is smart politics to recognize that corporate interests have been particularly well-received in today's political climate. One group led by Hal Scott of Harvard Law School and another led by the U.S. Chamber of Commerce have been influential in calling for a relaxation of SOX requirements, particularly in the context of small firms.²³ Thus, any proposals to modify existing corporate governance or securities laws should aim to work *with* business leaders and not merely try to regulate them into submission, if such a thing were even possible.

In this Article, we argue that all groups: business leaders, regulators and shareholders, should recognize the steps that must be taken to create a competitive, fair and ethical corporate climate.²⁴ We are not calling merely for "voluntary cooperation" from businesses to improve the

Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997); David Henry, *A Sarbox Surprise: The New Requirements are Slowing Options Tricks*, BUS. WK., June 12, 2006, at 38. This is one of the rarely-discussed benefits of SOX. Another important benefit has been the revelation of accounting irregularities, malicious and otherwise, at smaller firms. See *infra* notes 127-30 and accompanying text (discussing how SOX, and Section 404 in particular, have subjected smaller firms to scrutiny for the first time, and how in many that scrutiny is revealing misconduct).

20. See, e.g., Mark A. Stein, *Airlines, Now Healthy, Getting Frisky*, N.Y. TIMES, Dec. 16, 2006, at C2. But see William A. Niskanen, *Enron's Last Victim: American Markets*, N.Y. TIMES, Jan. 3, 2007, at A21 (arguing that "[a]s Senator Sarbanes and Representative Oxley drift into retirement, their act should retire with them").

21. Eric Dash, *Regulators Denounce Fannie Mae*, N.Y. TIMES, May 24, 2006, at C1.

22. John Markoff & Eric Dash, *Apple Panel on Options Backs Chief*, N.Y. TIMES, Dec. 30, 2006, at C1 (describing the investigation into options manipulation at Apple and concluding that executives were at fault, not current CEO Steven P. Jobs).

23. See *infra* notes 138-47 (highlighting the activities of the U.S. Chamber of Commerce-led group).

24. The word "ethical" is important here. As we have pointed out in a related piece, an ethical dilemma is not deciding whether to break the law. An ethical dilemma arises when one could make the wrong decision *within* the bounds of the law. See Scott Harshbarger & Goutam U. Jois, *Detering White Collar Crime*, BOSTON BUS. J., Aug. 19-25, 2005, at 47; see also Damon Darlin, *Adviser Urges H.P. to Focus On Ethics Over Legalities*, N.Y. TIMES, Oct. 4, 2006, at C3 (describing the preliminary conclusion of the outside lawyer asked to review H.P.'s investigations policy, that "it was ethics, not the law, that needed to be paid more heed").

current situation. Indeed, SOX exists and is appropriate for this situation precisely because it imposes baseline obligations with which corporations are required to comply. Moreover, other regulations regarding independent directors, expensing of stock options, etc. are needed and are vital to keeping business interests in line with society's. However, business leaders and regulators will have an easier time promoting a healthy marketplace if industry gets "ahead of the curve." In the end, business leaders must do just that by leading and implementing broad mechanisms of self-regulation and monitoring. Most important, the changes that need to be made are neither radical nor difficult. Executives and regulators must adopt common-sense reforms. Through proactive regulation, public officials should create and align corporations' incentives so that they can then find market solutions to governance issues. Business leaders, regulators and citizens can work together to create a climate of corporate integrity.

Business leaders should:

- Conduct independent audits of governance structures, focusing on ethical conduct,
- Enact aggressive "clawback" provisions to keep CEOs accountable,
- Empower boards of directors to properly serve shareholders' interests,
- Recognize that "doing well" involves "doing good," and
- Use independent professionals as ballast to corporate leaders.

Regulators should:

- Recognize and reduce the high compliance costs on small- and mid-sized firms,
- Allow differently-situated firms to adopt different compliance procedures,
- Provide amnesty to companies that disclose wrongdoing up front, and
- Prosecute as a means toward an end, not as an end in itself.

Citizens and investors should:

- Demand good governance from the companies they invest in, even when markets are doing well.

II. THE SITUATION TODAY

A. Contemporary Background

The most important thing to note about recent corporate scandals is that they have continued unabated since the crisis in the early 2000s. Enron was just the tip of the iceberg: there was much more fraud, and it infected companies of all sizes in all industries. A sample of corporate scandals for everything from insider trading to outright theft includes ImClone (2001), Tyco (2002), WorldCom (2002), Adelphia (2002), HealthSouth (2002), Qwest (2002), NYSE (2003), Parmalat (2003), Marsh and McLennan (2004), AIG (2005), Krispy Kreme (2005), and Fannie Mae (2006), to name a few.²⁵ Wall Street did not escape unscathed, with Merrill Lynch, J.P. Morgan, Citigroup, and many other Wall Street brokerages all under investigation at some point for everything from illegal trading to conflicts of interest.²⁶ The mutual fund scandals particularly brought small investor and middle class attention to the dangers and costs of poor governance.²⁷ Politicians and governmental entities can no longer afford the appearance of being soft on corporate excess, and corporations are likely to feel the sting of an angry public as well.

Shareholder activism has even pressured those indirectly involved in malfeasance. For example, J.P. Morgan reached a \$1 billion settlement with Enron after the energy giant sued the bank, saying that J.P. Morgan contributed to the company's spectacular bankruptcy.²⁸ The SEC separately charged the banks with being complicit in the fraud, adding hundreds of millions more dollars to the disgorgements, fines,

25. See, e.g., Timeline, *supra* note 8 (referencing scandals at Arthur Anderson, Enron, Quest Communications International, Tyco, WorldCom, Adelphia, and Xerox); Francesca di Meglio, Inside the Parmalat Scandal: What You Need to Know?, ITALIANSRUS.COM, Dec. 28, 2003, <http://www.italiansrus.com/articles/ourpaesani/parmalat.htm> (discussing the Parmalat scandal); Greenberg Out, AIG Stock Sinks, CNNMONEY, Mar. 15, 2005, <http://money.cnn.com/2005/03/15/news/fortune500/aig/index.htm> (discussing the AIG scandal); Rick Brooks, Krispy Kreme Ousts Six Executives, WALL ST. J., June 22, 2005, at B3 (discussing the Krispy Kreme scandal); Dash, *supra* note 21 (discussing the Fannie Mae scandal).

26. Gretchen Morgenson & Patrick McGeehan, *Corporate Conduct: The Overview: Wall Street Firms ready to pay \$1 billion in fines*, N.Y. TIMES, Dec. 20, 2002, at A1.

27. Claudia H. Deutsch, *Revolt of the Shareholders*, N.Y. TIMES, Feb. 23, 2003, § 3, at 1 (describing how shareholders have demanded governance reforms at some of the largest companies, including Wal-Mart, GE, and Citigroup).

28. See, e.g., Julie Creswell, *J.P. Morgan and Toronto-Dominion Agree to Settle Suits in Enron Fraud*, N.Y. TIMES, Aug. 17, 2005, at C3; Press Release, JP Morgan Chase, JP Morgan Chase Announces Settlement with Enron (Aug. 16, 2005), available at <http://investor.shareholder.com/jpmorganchase/press/releaseDetail.cfm?ReleaseID=171010>.

and penalties paid.²⁹

Of course, this does not imply that all corporate executives, board members, and officers are ill-intentioned or even of dubious moral character. Many well-meaning business leaders are simply confused by a regulatory environment that is in flux, imposes costs, and poorly articulates what benefits, if any, accrue to the corporation.³⁰ Other business leaders might want to act but are unsure how, since they are under the constant scrutiny of regulators, auditors, and lawyers. The slightest misstep, even if done in good faith, can cost billions of dollars. Indeed, it is possible that not one of the executives of Enron, WorldCom, or any other now-vilified company set out to do evil. Instead, they were tempted to “fudge,” time and again, until a mere white lie became outright fraud.³¹ The “choices” that these individuals made were not choices as we commonly think of them, but decisions that were significantly constrained by the strong situational pressures that the market and its profit motive exerted.³²

Take the example of Bernard Ebbers, the former CEO of WorldCom. In August 2005, he was sentenced to twenty-five years in prison for his role in the company’s demise.³³ Yet while he was presiding over an eleven-billion dollar fraud,³⁴ Ebbers was very well-respected in the community for his generosity; he was a Sunday school

29. See SEC Charges J.P. Morgan Chase in Connection with Enron’s Accounting Fraud, Litigation Release No. 18252, Accounting and Auditing Enforcement Release No. 1820, 80 SEC Docket 2286 (July 28, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18252.htm>; see also SEC Charges Canadian Imperial Bank of Commerce and Three Executives with Aiding and Abetting Enron’s Accounting Fraud, Litigation Release No. 18517, Accounting and Auditing Enforcement Release No. 1932, 81 SEC Docket 3038 (Dec. 22, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18517.htm>.

30. See, e.g., Stephen Labaton, *A New Mood in Congress to Forgo Corporate Scrutiny*, N.Y. TIMES, Mar. 10, 2005, at C3 [hereinafter Labaton, *New Mood*] (discussing the push by businesses to rollback all or part of Sarbanes-Oxley).

31. See, e.g., E-mail from Frank A. Nicolai to authors (July 14, 2005, 22:49 EDT) (on file with authors) (“I do not believe that any of the CEOs . . . intended from the start to engage in fraudulent conduct . . . No, these people started down the slippery slope when they felt the pressure from adverse results . . . so they thought it [okay] to fudge a little . . .”).

32. See *infra* Part III (discussing the importance of situation in the corporate context). For an overview of how we are affected by situational forces, see generally Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129 (2003) and Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L.J. 1 (2004) (both describing the influence of situational forces on individuals’ decisions and in particular the situational pressures of markets).

33. See, Carrie Johnson, *Ebbers Gets 25-Year Sentence For Role in WorldCom Fraud*, WASH. POST, July 14, 2005, at A1 (noting also that WorldCom’s bankruptcy was the largest in U.S. history).

34. *Id.*

teacher and donated millions to local causes.³⁵ This is not to excuse the decisions of Ebberts or anyone else; their actions, while perhaps understandable, are wrong. It should teach us that the solution to the corporate governance problem is in one sense simple: instead of asking how to “rehabilitate” these “bad actors,” we should think about how to realign incentives and obligations so that the situational pressures push directors and officers to do the right thing.

As one of us knows from decades of experience in law enforcement, the importance of these incentives cannot be understated. Some small number of people, in Corporate America or elsewhere, will set out to break the law and will do so regardless of the regulatory environment. Another small number will do the right thing, again regardless of the prevailing winds. The overwhelming majority, however, takes its cues from the external situation. A weak regulatory response provides incentives for this large majority to skirt the law, while a strong response encourages proper conduct, even without prosecuting every instance of malfeasance. A social consensus around positive governance promises much greater results than individual policing could ever hope to accomplish.

B. The Role of Regulation

The role and nature of regulation depends critically on public and political opinion regarding corporate governance. When strategizing for the future, what executives should take from today’s corporate landscape is that the subjects of corporate ethics and governance are most definitely on the radar screen. As we have noted earlier,³⁶ the continuing debate over SOX, recent rules regarding hedge funds and mutual funds, and class action and bankruptcy legislation all illuminate issues regarding the relationship between government and business. Moreover, Senator Sarbanes and Representative Oxley have announced their resignations from Congress, and some believe the loss of these venerable advocates of the law will adversely affect its future.³⁷ Will these forces culminate in a pro-industry revision of SOX that rolls back regulation? Already, two committees are proposing revisions to SOX, hoping to loosen regulation by introducing “broad new protections to corporations and accounting firms against criminal cases brought by federal and state prosecutors as well as a stronger shield against civil lawsuits from

35. See, e.g., Carrie Johnson, *Fraud’s Many Helpers*, WASH. POST, Mar. 20, 2005, at B1.

36. See *supra* note 11.

37. And some hope that it will. See Niskanen, *supra* note 20.

investors.”³⁸

Such a revision would be deleterious for the long-term prospects of creating an ethical corporate culture. Strong regulatory mechanisms are needed to establish a baseline of conduct for business leaders.³⁹ Such regulation not only penalizes wrongdoing but also protects those who act properly. Without a regulatory baseline, well-governed companies are worse off for their competitors’ wrongdoing. For example, WorldCom’s fraudulent activity affected the entire telecommunications industry, as competitors struggled to match WorldCom’s fictitious profits and prices.⁴⁰ In such a situation, everyone suffers: not only the managers and executives who are unable to run their companies as well as they mistakenly thought WorldCom was, but also employees who lose their jobs and consumers who are left with a fragmented and unstable telecommunications industry.⁴¹

The loud advocacy against reform comes as many are calling for continued reform with equal vigor. And those yelling the loudest for reform are not radicals from the far left — they are mutual fund managers, institutional investors, and others in the mainstream business world.⁴² Law firms, too, are emphasizing their experience in the corporate governance field; plaintiffs’ firms are pushing for corporate responsibility and accountability,⁴³ while corporate defense firms tout their counseling and litigation expertise.⁴⁴ And there is evidence that, at least in some corners, those calls for a more transparent, ethical culture are being heeded. For example, *Yahoo! Finance* recently started

38. Stephen Labaton, *Businesses Seek New Protection on Legal Front*, N.Y. TIMES, Oct. 29, 2006, § 1, at 1 [hereinafter Labaton, *Businesses Seek New Protection*]. See *infra* notes 135-47.

39. But see Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3, 18-61 (2003) (arguing against regulatory responses to corporate fraud and suggesting that market mechanisms are best suited to improve corporate governance).

40. See Belson, *supra* note 13.

41. *Id.*

42. See, e.g., Troy Wolverton, *Shareholders Flex Muscles*, THESTREET.COM, June 2, 2005, <http://www.thestreet.com/pf/stocks/troywolverton/10226152.html>; Gretchen Morgenson, *Sometimes Investors Should Just Say No*, N.Y. TIMES, Aug. 14, 2005, § 3, at 1.

43. See, e.g., Milberg Weiss, *Why Milberg Weiss*, <http://www.milbergweiss.com/whymilberg/whymilberg.aspx> (last visited Sept. 5, 2005) (describing the firm’s “unique position to vigorously pursue all types of corporate wrongdoing”). It is worth noting that Milberg Weiss itself has been indicted for allegedly illegal (and unethical) conduct. See Martha Neil, *Milberg Weiss on the Hot Seat*, A.B.A. J. (Dec. 2006) at 34.

44. At risk of self-promotion, see, for example, Proskauer Rose, Proskauer Rose LLP – Corporate Governance/Corporate Defense, http://www.proskauer.com/practice_areas/areas/093 (last visited Aug. 8, 2006) (describing the firm’s ability to identify problems, work in appropriate internal investigation and deploy defensive strategies).

including a “Corporate Governance Quotient” on its company profile webpages; now investors can have governance information at hand while evaluating stocks.⁴⁵ Senior executives at top companies have been dismissed over ethical lapses, even in profitable times.⁴⁶ The seeds of good corporate ethics are starting to grow, albeit slowly. Nevertheless, the sprouts are fragile and can be destroyed with the slightest wrong move.

C. Federal Sentencing Guidelines for Organizations

It is worth pausing to provide a more concrete example of the general suggestions we have made thus far. In other words, how exactly can we nurture these sprouts? How can regulation facilitate the development of an ethical corporate culture?

The 2004 amendments to Chapter Eight of the Federal Sentencing Guidelines provide a good starting point.⁴⁷ Chapter Eight is commonly referred to as the “Federal Sentencing Guidelines for Organizations,” or FSGOs. The FSGOs articulate many of the same themes that we have mentioned. For example, an organization can qualify for a downward departure at sentencing if it had an effective compliance and ethics program (“ECEP”).⁴⁸ An ECEP must, *inter alia*, “promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”⁴⁹ Moreover, organizations are rewarded for self-reporting, cooperating with authorities, and accepting responsibility for wrongdoing.⁵⁰ The FSGOs recognize the need for cooperation between businesses and regulators, and shift the emphasis to preventing criminal misconduct rather than merely punishing it.⁵¹

The FSGO example also illustrates how the dialogue between business leaders and regulators can progress. For example, the

45. See, e.g., Yahoo! Finance, Profile for Yahoo Inc., <http://finance.yahoo.com/q/pr?s=YHOO> (last visited July 14, 2005) (providing “quotes and info” for Yahoo, Inc., including a Corporate Governance Quotient).

46. See, e.g., Landon Thomas, Jr., *On Wall Street, a Rise in Dismissals Over Ethics*, N.Y. TIMES, Mar. 29, 2005, at A1.

47. U.S. SENTENCING GUIDELINES MANUAL § 8 (2006) (amended version at 2006 Supp. to App. C, amdt. 673) [hereinafter USSG].

48. *Id.* at § 8C2.5(f)(1).

49. *Id.* at § 8B2.1.

50. *Id.* at § 8C2.5(g).

51. This is particularly important because it is impossible to prosecute every instance of wrongdoing. If the real goal is deterrence, and not merely prosecution for its own sake, regulators must create incentives for business leaders to do the right thing. In many cases, this would include the threat of prosecution and punishment, but it should also include rewards for good faith efforts to comply with the law.

Association for Corporate Counsel (“ACC”) identifies several shortcomings with the FSGOs in a 2005 white paper,⁵² but the paper makes strides in acknowledging, and working within, the spirit of the amendments. For example, the FSGOs require companies to report any evidence of wrongdoing to the government within a reasonable time.⁵³ The ACC instead recommends that the company either report such wrongdoing *or* develop and implement modifications to the company’s practices to remedy the situation.⁵⁴

The merits of the ACC proposal are open to question. It is true that implementing strong practices to remedy wrongdoing is more important than merely reporting it. The converse concern is that a lack of reporting encourages cover-ups and deceit. We take up this issue later.⁵⁵ For now, our intention is merely to point out that the ACC letter represents a type of dialogue, and it is precisely this type of dialogue between business and government leaders that is needed to foster developments in the spirit of good governance and competition.⁵⁶

Another concern of the ACC and others regarded the waiver of attorney-client privilege.⁵⁷ The ACC worried that “provisions now codified in Chapter 8 . . . would make waiver of the attorney-client privilege almost a certainty in order for a charged company to be deemed ‘cooperative,’ and thus eligible for more lenient treatment in settlement discussions or at sentencing.”⁵⁸ A flashpoint for this controversy was the so-called Thompson Memo, written in 2003 by then-Deputy Attorney General Larry Thompson.⁵⁹ Corporations were concerned that the Thompson Memo effectively required, *inter alia*, waiver of the attorney-client privilege, even though the memo wrote that

52. *The Federal Sentencing Guidelines for Organizations: What’s Up*, ASS’N OF CORP. COUNSEL, Feb. 2005, available at <https://www.acca.com/protected/article/attyclient/sentencing.pdf> (on file with authors) [hereinafter *ACC Letter*].

53. USSG § 8C2.5(f)(2).

54. *ACC Letter*, *supra* note 52, at 12.

55. *See infra* Part IV (discussing what steps regulators should take).

56. Another good example of the way our argument would work in practice regards recent regulation relating to expensing stock options. See our discussion of this subject in Part V below.

57. *ACC Letter*, *supra* note 52, at 1.

58. *Id.*

59. Memorandum from Larry D. Thompson, Deputy Attorney General to Heads of Department Components and U.S. Attorneys (Jan. 20, 2003), available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter *Thompson Memo*]. The Thompson Memo has come under heavy criticism from corporations. Judge Kaplan, of the Southern District of New York, recently chastised prosecutors’ heavy-handed tactics on a related matter. *See infra* note 61. Yet, overzealous prosecutors aside, it should be noted that the memo, by its terms, does not require such action. The prosecutors seem to be affected by the aggressive, antagonistic environment; it is our view that changing that environment will change the way prosecutors see their roles.

waiver requests should be limited to “factual internal investigation[s]” and emphasized that waiving privilege is not an “absolute requirement” for being deemed compliant.⁶⁰ Though this position is not ideal from ACC’s perspective, it showed at least some degree of flexibility on the part of the DOJ. Moreover, when prosecutors’ tactics in implementing the provisions of the Thompson Memo became increasingly overreaching, they were rebuffed by the courts.⁶¹ Thus the judicial branch can step in to play a role in the dialogue we envision.⁶²

The dialogue is in many ways ongoing. The FSGOs were revised effective November 1, 2006; the new version deletes the reference to waiver of attorney-client privilege in the section regarding culpability score.⁶³

Discontent over the Thompson Memo grew to such a pitch that the Department of Justice issued a revision of the documents, now dubbed the “McNulty Memo.”⁶⁴ The McNulty Memo emphasizes that prosecutors “may only request waiver of attorney-client or work product protections when there is a legitimate need for the privileged information to fulfill their law enforcement obligations. A legitimate need for the information is not established by concluding it is merely desirable or convenient to obtain privileged information.”⁶⁵ Prosecutors’ requests for waiver now require approval from several supervisors before a corporation may be asked,⁶⁶ and (presumably in response to Judge Kaplan) when deciding if a company should be indicted, prosecutors are instructed not to consider whether the company is paying employees’ attorneys’ fees.⁶⁷ All of these changes make strides toward requests made by corporations, although some argue the memo does not go far enough.⁶⁸

Indeed, in writing the memo, McNulty was careful to point out that

60. *Id.*

61. Judge Lewis A. Kaplan of the Southern District of New York issued a scathing opinion in which he criticized prosecutors’ tactics in the aftermath of the Thompson Memo. *See United States v. Stein*, 435 F. Supp. 2d 330, 363 (S.D.N.Y. 2006).

62. *Id.*

63. Compare USSG § 8C2.5(g), cmt. 12 (Nov. 1, 2005) with USSG § 8C2.5(g), cmt. 12 (Nov. 1, 2006). The latter deletes the reference to waiver.

64. Memorandum from Paul J. McNulty, Deputy Attorney General to Heads of Department Components and U.S. Attorneys (Dec. 12, 2006), available at http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf [hereinafter McNulty Memo].

65. *Id.* at 8 - 9.

66. *Id.* at 9-10.

67. *Id.* at 11.

68. *See, e.g.,* Martha Neil, *Thompson Memo Changes Not Enough, ABA Says*, ABA J. E-REPORT, Dec. 15, 2006, at <http://www.abanet.org/journal/ereport/d15specter.html>.

“the fundamental principles that have guided [the DOJ’s] enforcement practices are sound.”⁶⁹ The memo ostensibly did not change any of the underlying principles of prosecution or enforcement; instead, it merely clarified the role that waiver and payment of fees should play in determining whether a corporation was cooperating with regulatory authorities.⁷⁰ We agree with the McNulty Memo that the fundamental enforcement principles are sound. More than anything else, the McNulty Memo sends a signal to prosecutors that they should exercise better judgment and restraint in their work, and to this extent, we applaud it. However, we are concerned that this, the FSGO amendments, and the SEC’s new relaxation of SOX requirements⁷¹ are not the product of a dialogue between groups, but rather the first step of many in rolling back regulation. If it is in fact the latter, we are very concerned.⁷²

Both the private and public sectors have been given a brief window of opportunity. The salience of business issues in public policy and the ability of businesses to influence that policy means that corporate viewpoints are heard with unusual clarity. Simultaneously, the continued focus on good governance means we are facing a new reality, and that reality is here to stay. The puzzle lies in determining how to harness this opportunity for the benefit of businesses, regulators and citizens and to create a sustained, healthy and strong culture of corporate responsibility.

III. CHANGING THE CORPORATE CULTURE

In its credo, Johnson & Johnson says that it will “bear [its] fair share of taxes.”⁷³ This seemingly simple statement reveals a lot about the

69. Memorandum from Paul J. McNulty, Deputy Attorney General to Heads of Department Components and U.S. Attorneys (Dec. 12, 2006), at 1, *available at* http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf (two-page accompanying memorandum preceding McNulty Memo).

70. *See* McNulty Memo, *supra* note 64.

71. *See infra* notes 148-50 and accompanying text.

72. As an aside, it is interesting to ask why we say the company did not have a choice in the waiver or fees context. Judge Kaplan calls this a decision made with the “proverbial gun to the head.” *See infra* note 223. After all, they could just waive and get the credit, or not waive and accept the consequences. Of course, this is a classic example of where choices are not really free and constrained by situation. But what about elsewhere? Seeing the situational influences that affect some (corporations) but not others (prosecutors) sheds light on whose perspective we take in a given dispute. *See id.* (referencing Jon Hanson, who has made this point in a variety of contexts). We would do well to pause and ask why we take the corporation’s perspective here, as opposed to the prosecutor’s, when the prosecutors ostensibly are representing the public interest, not private interests.

73. Johnson & Johnson, Our Credo, http://www.jnj.com/our_company/our_credo (last visited July 14, 2005).

nature of corporate America. While all companies (and individuals, for that matter) seek to minimize their tax burden, taxes are nonetheless seen as a routine part of doing business. Similarly, directors, managers, executives, and employees must come to see ethical governance as *part* of doing business, not as something outside the system that they need to defend against.

This, of course, requires a shift in corporate culture, one that will not be easy to accomplish. But the first steps are relatively self-explanatory. After all, contemporary financial scandals often do not involve complicated legal or financial maneuverings.⁷⁴ This is low-hanging fruit, and when regulators see it they start to get hungry. Corporations fear this and have criticized regulators like Eliot Spitzer for going after companies too aggressively.⁷⁵ Spitzer may have been aggressive, but his attacks were brought on by the prevalence and audacity of corporate malfeasance.

We use the term low-hanging fruit to mean two things. First, these are easy targets for regulators. Second, and more important, these instances of malfeasance are easy for business leaders to fix. It seems that a typical reaction in a variety of regulated industries is to try and “outlast” a regulator. Instead of trying to see if they can just outlast the next aggressive regulator to come down the pike, directors and officers should get ahead of the curve and start thinking about how to meet regulators’ goals and add shareholder value.

For example, President Bush appointed Christopher Cox to succeed Donaldson as Chairman of the SEC.⁷⁶ Cox’s nomination prompted speculation as to whether Chairman Cox will be “pro-business” or “anti-business.”⁷⁷ While an article noted his “long record . . . of promoting the agenda of business interests,” a prominent plaintiffs’ lawyer said, “It’s hard to think of a worse choice for the S.E.C.”⁷⁸ These are simply the wrong points. If businesses and regulators recognize their common goal, an ethical, competitive, corporate culture, the entire frame of inquiry shifts. For example, regulators will not need to “crack down” if businesses take the lead in changing the corporate culture. Businesses

74. There are some who argue that Enron’s actions were not illegal, but merely complicated. See Malcom Gladwell, *Open Secrets: Enron, Intelligence, and the Perils of too much Information*, THE NEW YORKER, Jan. 8, 2007, at 44. Joe Nocera has strongly refuted this position. See Joe Nocera, *Tipping Over a Defense of Enron*, N.Y. TIMES, Jan. 6, 2007, at C1.

75. See, e.g., Sorkin, *supra* note 16.

76. See, e.g., Stephen Labaton, *Bush S.E.C. Pick Is Seen as Friend to Corporations*, N.Y. TIMES, June 3, 2005, at A1 [hereinafter Labaton, *Bush SEC Pick*].

77. *Id.*

78. *Id.* (quoting William Leach).

will not feel threatened by the SEC if they work proactively with the agency in crafting rules in the future.⁷⁹ Businesses should see the value of such cooperation because well-managed firms take the brunt of the injury when others act poorly. The goal should not be to maximize prosecutions or minimize regulations; instead, the goal should be to foster the kind of environment in which ethical conduct is rewarded.

These conflicts between personal and professional gain on the one hand and ethical behavior on the other must be recognized and addressed. They must be recognized by corporations because the market is best-situated to identify and respond to these situations.⁸⁰

A recent article critiques SOX for being a “regulatory response” to corporate fraud and argues that “market responses” would be superior.⁸¹ The article suggests that markets are best-situated to address problems, arguing that “contract and market-based approaches are more likely than regulation to reach efficient results.”⁸² We agree with this sentiment, to an extent. Regulations are necessary to establish the contours *within which* “contract and market-based approaches” can operate. If corporate actors know that unethical conduct will have significant legal (including criminal) ramifications, then they will be less inclined to engage in such conduct.⁸³ Thus, strong regulations are necessary precisely to *enable* contract and market-based approaches to operate in the right direction.⁸⁴

During the 1990s, the incentives for corporate executives were to fudge the numbers and engage in unethical conduct because the odds of getting caught, and the costs if they were caught, were astonishingly

79. All too often, business respond during notice-and-comment rulemaking simply to suggest that no new rules are necessary, instead of recognizing that rulemaking need not be a zero-sum, either-or game. In doing so, they cheat themselves of a valuable opportunity to engage regulators. For example, much of the early response from the corporate community was that compliance dates for SOX should be delayed significantly — even for the largest companies — or that regulation was unnecessary. See Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Release Nos. 33-8760, 34-54942, File No. S7-06-03, 2006 WL 3702644, at *6 (Dec. 15, 2006) [hereinafter SEC 33-8760]; U.S. Securities and Exchange Commission, Comments on Proposed Rule: Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, *available at* <http://www.sec.gov/rules/proposed/s74002.shtml> (last visited Jan. 10, 2007).

80. See, e.g., Chen & Hanson, *supra* note 6, at 23-32 (discussing the “meta script” of corporate law, which argues that markets are generally preferred to regulation).

81. Ribstein, *supra* note 39, at 61.

82. *Id.* at 3.

83. See Harshbarger & Jois, *supra* note 24.

84. As one of us argues in a separate law review article, any sort of “free market” necessarily involves interfering with individuals’ preferences to some extent — that is, any free market requires a degree of regulation. The debate, then, should not be between “regulation” and “no regulation,” but between the kind and degree of regulation that we will have. See Goutam U. Jois, *Can’t Touch This! Private Property, Takings, and the Merit Goods Argument*, 48 S. TEX. L. REV. 183 (2006).

low.⁸⁵ With such low costs and high benefits, tempted corporate executives easily succumbed. We must reform the regulatory environment to increase the costs of malfeasance so that market actors' incentives push toward ethical conduct, not toward cheating the system.

Regulation can play a role beyond simple cost-benefit analysis as well. Over time, regulations will become part of a corporation's situation and, as such, the costs and benefits will change the corporation's very culture. Regulation, often assumed to be exogenous, will over time become endogenous as companies incorporate regulatory requirements into their very idea of what it means to be in business.

This is not to say that regulation is perfect. For example, corporations often complain, rightly, that SOX is something of a blunt instrument: it fails to differentiate among firms, so that small- and mid-cap firms have to bear the same burden as Fortune 500 companies.⁸⁶ But the obvious flip side is that if executives and boards had taken the first steps in self-regulation, SOX would have never been necessary. If there had not been and did not continue to be a successive parade of spectacular corporate debacles, these issues would have never come up. Of course industry knows better than government what firms' capacities and needs are, but if corporate leaders fail to use that knowledge to implement reforms, government will repeatedly step in to fill the void.

That void certainly exists. Nearly five years after SOX, companies are still restating earnings on a regular basis, uncovering earlier misconduct.⁸⁷ Questions of executive compensation keep bubbling to the surface — most recently with the stock options scandal and a new S.E.C. rule,⁸⁸ and individuals question why “personal responsibility” means one

85. This was especially the situation in Silicon Valley in the 1990s, when executives felt a “sense of entitlement” and a “maverick culture” thrived, “where clever ways of gaming the system were admired rather than excoriated.” Gary Rivlin & Eric Dash, *Haunted by a Heady Past; Silicon Valley was Calming Down. Now, an Options Scandal*, N. Y. TIMES, July 22, 2006, at C1. In such an environment, where even the “independent” lawyers and accountants were part of the problem, see *infra* notes 132-33 and accompanying text, is it any surprise that malfeasance eventually came to light?

86. See, e.g., Jonathan D. Glater, *Here It Comes: The Sarbanes-Oxley Backlash*, N.Y. TIMES, Apr. 17, 2005, § 3, at 5 (discussing compliance costs generally); see also Matthew Keenan, *In Scandal Fallout, Small Firms Bear Big Burdens*, BOSTON GLOBE, July 4, 2004, at C8 (discussing compliance costs specifically for small firms).

87. See, e.g., Geraldine Fabrikant, *Cablevision to Restate its Earning*, N.Y. TIMES, Aug. 9, 2006, at C1.

88. See, e.g., Rivlin & Dash, *supra* note 85 (discussing options scandal); Jonathan Peterson & Kathy M. Kristof, *More Data on Pay at the Top is Mandated: The SEC Votes to Require More-Detailed, ‘Plain-English’ Disclosure of Executive Compensation*, L.A. TIMES, July 27, 2006, available at http://www.law.harvard.edu/programs/olin_center/corporate_governance/MediaMentions/07-27-06_LATimes.pdf (discussing new SEC rule); Jeanne Sahadi, *CEO Pay: Sky*

thing when they go bankrupt and another thing when United Airlines goes bankrupt.⁸⁹ The independence of some boards is still suspect,⁹⁰ while at the other extreme some boards are kept so far out of the loop that they don't even know of a pending merger.⁹¹ Silicon Valley, still reeling from the dot-com bust, is now awash in scandals regarding backdated stock options,⁹² a scandal that has reached to the heights of some of the most highly-regarded tech firms, such as Apple Computers.⁹³ In an article in *The New York Times*, Joseph Nocera wrote of the difficulty of changing a culture among accountants and predicted that "you can pretty much count on another round of accounting scandals."⁹⁴ Shortly thereafter, eight partners at KPMG were indicted for creating illegal tax shelters that reaped them millions of dollars in fees, while costing the government billions of dollars.⁹⁵ KPMG avoided imploding, just barely, but perhaps Nocera's prediction has already come true.

These vignettes are not the entirety of the problem; rather, they are symptoms of a larger problem in corporate ethics. Ultimately, regulators must set the framework and business leaders must enact policies to foster an environment that nurtures integrity, not one that shuns it. To be sure, laws and regulations are part of that environment: SOX, though imperfect, pushes in the right direction.⁹⁶ And consider the example from the beginning of this section: by recognizing its obligation to pay a "fair share of taxes," Johnson & Johnson implicitly acknowledges that paying taxes has been internalized. Taxes are part of the business environment and factor into the company's business judgments. Ethical corporate governance has yet to attain that level of respect and

High Gets Even Higher, CNNMONEY, Aug. 30, 2005, http://money.cnn.com/2005/08/26/news/economy/ceo_pay/ (stating executive compensation generally).

89. See, e.g., Dale Russakoff, *Human Toll of a Pension Default*, WASH. POST, June 13, 2005, at A1.

90. Gretchen Morgenson, *Just a Friendly Group of 'Independent' Directors*, N.Y. TIMES, Aug. 29, 2004, § 3, at 1.

91. Gretchen Morgenson, *A Merger? Anyone Tell the Board?*, N.Y. TIMES, June 26, 2005, § 3, at 1.

92. See Rivlin & Dash, *supra* note 85.

93. See Markoff & Dash, *supra* note 22.

94. Joseph Nocera, *Auditors: Too Few to Fail*, N.Y. TIMES, June 25, 2005, at C1. See also Troy Wolverton, *The Big Four: Can't Touch This?*, THESTREET.COM, July 12, 2005, <http://www.thestreet.com/stocks/troywolverton/10231757.html>.

95. See, e.g., Jonathan D. Glater, *Charges are Tied to Tax Shelters; 8 Former Partners of KPMG Indicted*, N.Y. TIMES, Aug. 30, 2005, at C1.

96. See *supra* notes 39-49 and accompanying text. See also Scott Harshbarger & Robert Stringer, *Creating a Climate of Corporate Integrity*, CORP. BOARD (May/June 2003) at 10 (noting the role that SOX can play in fostering a "climate of corporate integrity").

significance in business culture.⁹⁷

Simultaneously, we must recognize that there are limits to what regulation can accomplish. It would be impossible to “regulate to perfection” executive compensation schemes, board independence, and subtle conflicts of interest because regulators do not have the time, information, or capacity to do so. Thus, leadership is important on the part of directors and officers as well as public officials.⁹⁸ So are partnerships between regulators and industries. Just as it is impossible to “regulate to perfection,” it is also impossible to prosecute every single wrongdoer. The best solutions come from cooperative efforts by regulators and companies to identify a common goal — a competitive, ethical corporate culture — and work collaboratively toward it.⁹⁹

In the end, the theme is quite simple: we are looking for accountability. The calls for integrity and accountability from politicians are rightly loud and constant. Citizens and elected officials constantly call on accountability from police officers, public school teachers, and nonprofit leaders. Why do we not ask the same of the private sector?

IV. DELVING INTO SARBANES-OXLEY

In this section, we want to situate our general discussion of corporate ethics in the specific context of SOX. First, 2006 marked a year of extensive discussion, and some decisions, about the (in)famous Section 404. Second, the unabated stream of corporate restatements and continuing scandals of executive compensation raise questions about the adequacy of the clawback provisions that currently exist in the law. Finally, the trials of former corporate executives raise the issue of white-collar crime generally, and the role of lawyers specifically.

97. At another level of abstraction, consider Chen and Hanson’s argument regarding the importance of situation. See Chen & Hanson, *supra* note 6, at 127-149. Laws and regulations, far from being external to the corporate world, are part of and shape the corporate situation. *Id.* Over time, companies will internalize the laws and rules and their conduct will change. *Id.*

98. See generally Scott Harshbarger, *Strengthening Democracy: The Challenge of Public Interest Law*, 56 ME. L. REV. 211 (2004) (discussing the importance of leadership and particularly the role of lawyers). Cf. *Ethical Dilemmas Associated With the Corporate Attorney’s New Role*, 52 AM. U. L. REV. 655 (2003) (discussing the role of attorneys under SOX).

99. Something we find curious is that the principles and the rhetoric found in the criminal prosecution context seems absent in the white-collar context. Those who call for “victim’s rights” in cases of assault or rape, for example, are often loath to do so in the case of corporate misconduct. Yet prosecution can be tough and smart, and we need not sacrifice our principles of justice and fairness — and, indeed, welfare maximization — in the corporate context. Cf. Harshbarger, *supra* note 98 (describing the Boston Safe Neighborhood Initiative).

A. Section 404

The beginning of 2006 featured extensive debate, and some rulemaking, about compliance with Section 404 of SOX, the so-called internal controls regulations.¹⁰⁰ Although all companies were to have complied with Section 404 by 2005, the SEC repeatedly deferred the effective date for smaller companies. Simultaneously, Chairman Cox made it clear that smaller companies would not be wholly exempt from the internal controls regulations.¹⁰¹ Eventually, the SEC promulgated relaxed requirements for smaller companies.¹⁰²

Many companies have complained about the requirements of Section 404, particularly because it imposes disproportionate costs on small and mid-sized firms.¹⁰³ One commentator remarked that, “[l]ike their peers at more sizable corporations, small-company executives must also help their auditors adhere to . . . the requirement under [Section] 404 that external auditors must attest to and report on their clients’ assessments of internal controls.”¹⁰⁴ While larger firms might spend as little as 0.06% of sales on Section 404 compliance, a smaller firm with less than \$100 million in revenue might see costs averaging 2.55% of sales.¹⁰⁵ This, according to a trade association, amounts to a “major

100. 15 U.S.C. § 7262 (2006). The text of Section 404 reads as follows:

(a) Rules required. The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal control evaluation and reporting. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Id.

101. Kathleen Day, *Sarbanes-Oxley Exception Denied; Small Public Companies Must Comply*, *SEC Says*, WASH. POST, May 18, 2006, at D2.

102. SEC 33-8760, *supra* note 79 (providing smaller businesses an extension through December 31, 2007); Steven Labaton, *S.E.C. Eases Regulations On Business*, N.Y. TIMES, Dec. 14, 2006, at C1 [hereinafter Labaton, *SEC Eases Regulations*].

103. See, e.g., David M. Katz, *Smaller Than a Sarbox?*, CFO.COM, March 24, 2005, <http://www.cfo.com/article.cfm/3764856>.

104. *Id.*

105. *Id.*

regressive tax on small and medium companies.”¹⁰⁶

These costs are significant and can influence companies’ decision-making. Companies might put off expansion or growth plans to avoid incurring costs in addition to Section 404 costs. Alternatively, and more dangerously in the context of our Article, a company might be tempted to “cut corners” in its Section 404 programs. For example, the company might enact compliance policies and procedures that effectively exist only on paper. An auditor might test the program, but the company might not emphasize the controls or the need to report misconduct, create a culture of compliance, and so on. Moreover, the provisions might divert money from other programs that would better serve the overall goal of fostering an ethical corporate culture. A small-cap firm that spent a disproportionately high amount of money on Section 404 compliance might then be forced, for financial reasons, to forego additional employee training, director orientation, or similar programs designed to better orient employees toward a genuine focus on ethical conduct.

We argue that regulators should be more accommodating of these concerns and allow smaller firms (we use that term to mean non-accelerated filers under 12b-2¹⁰⁷) to be exempt from the primary provisions of Section 404. Specifically, small firms’ external auditors should not be required to attest to an evaluation of the company’s internal controls. Instead, the auditor should merely verify the existence of the controls and allow company executives to develop the controls in a manner best fit for their company. However, the auditor should conduct a regular (though not necessarily annual) “performance evaluation” and evaluate the *actual incidence* of malfeasance within the company. The current rules which require “design evaluation” correctly place a priority on having systems in place. Smaller firms, however, should place the emphasis on outcomes, good governance *ex post*, rather than mere process *ex ante*.¹⁰⁸

Additionally, company officers should have to certify changes to procedures only annually, instead of quarterly.¹⁰⁹ For many of these entities, certifying officers have a good sense of what is happening in

106. *Id.* (quoting a study by the American Electronics Association).

107. *See* 17 C.F.R. § 240.12b-2 (2006).

108. *Cf.* Final Rule: Management’s Report On Internal Control Over Financial Reporting And Certification Of Disclosure In Exchange Act Periodic Reports, Release Nos. 33-8238, 34-47986, 80 SEC Docket 1014 § VII.E (Aug. 14, 2003) [hereinafter Final Rule] (distinguishing between performance and design standards).

109. 17 C.F.R. § 240.13a-15 (2006).

their firms. Unlike larger firms where the upward flow of information might be impeded, smaller firms' executives are often in a better position to foster an ethical corporate culture even in the absence of formal policies. Process and quarterly certifications will do little to improve that.

We do not, however, favor exempting small companies from Section 404 altogether. First, we believe that all companies need independent oversight and evaluation, not just large companies. Second, we are not convinced that compliance costs are as crippling as some critics make them out to be. For example, one article notes that "compliance cost[s] for smaller companies [are] at around \$1.2 million for the first year of implementation."¹¹⁰ They do not point out that costs decline over time: "31% in 2005 for small companies, according to one study."¹¹¹ As the author sardonically comments, "you wonder why our bankruptcy courts are not clogged with companies made insolvent by Sarbanes-Oxley compliance costs."¹¹² While regulators must recognize that costs are high, business leaders must recognize that oversight and accountability will inevitably involve cost. The question is one of the *degree* of oversight and accountability that we will require — not whether we will require them in the first place.

The costs of 404 compliance are well documented; the benefits less so. AuditAnalytics, a company that analyzes audit statistics, unearthed some interesting data regarding financial restatements over the past few years. In 2005 and early 2006, although the total number of restatements was up from the previous year, the increase is mainly among smaller firms.¹¹³ Smaller accounting firms, which audit these smaller companies, were in the past subject only to peer review.¹¹⁴ In a particularly egregious example, the head of an auditing firm went to jail for covering up an embezzlement scheme in a New York School District.¹¹⁵ "The

110. Jim DeMint & Tom Feeney, *Common-Sense Changes*, WALL ST. J., May 10, 2006, at A18.

111. David Weidner, *Investors and Executives Need Sarb-Ox: Now Isn't the Time to Shelve Post-Enron Reforms*, MARKETWATCH, June 21, 2006, <http://www.marketwatch.com/news/story/sarb-ox-critics-have-short-term-memories/story.aspx?guid=%7B4CD2779F%2D126D%2D45F0%2D9CAE%2D4C3567B20909%7D>. This underscores the reality that businesses were under-investing in internal controls in the years prior to SOX.

112. *Id.*

113. Floyd Norris, *High and Low Finance: Forcing Reality in Accounting of Tiny Firms*, N.Y. TIMES, Oct. 13, 2006, at C1.

114. *Id.*

115. *Id.* See also Paul Vitello, *Accountant Is Sentenced For Hiding Roslyn Thefts*, N.Y. TIMES, Jan. 26, 2006, at B4.

peer review of his firm had looked at precisely that audit, and found no problems.”¹¹⁶

Restatements are up among small firms because their auditors are now subject to oversight by the SOX-created Public Company Accounting Oversight Board (PCAOB).¹¹⁷ Faced with external scrutiny, those auditors are doing better work. Again, the vignette of the jailed accountant demonstrates the utility of legal responses when “self-regulation” breaks down. In this case, the peer reviews of audit firms were poor, approving even outright embezzlement.¹¹⁸ PCAOB’s oversight has helped keep those outside auditors honest. More relevant to this discussion, the newly-accountable auditors are more accurately uncovering misconduct at smaller firms.¹¹⁹ Exempting small firms from 404 requirements would enable this misconduct to go unnoticed.

It is also worth noting that we do not find compelling another criticism of SOX: that, as globalization continues to take root, issuers will either feel obligated to adopt (inefficient) U.S. standards¹²⁰ or not list on American exchanges in the first place.¹²¹ As proof of the latter proposition, SOX critics point out that although cross-border IPOs are at an all-time high, “nine of every 10 dollars raised by foreign companies in new stock offerings [in 2005] were raised abroad.”¹²² But will companies really leave U.S. markets for greener pastures? Possibly, but, as Nasdaq President & CEO Bob Grierfield notes, “a ‘race to the bottom’ can only be self-defeating.”¹²³ He points out that “ADRs fled the American market in droves” in the 1980s after the SEC “tightened up the 12(g)3-2b exemption” and that major American companies have experimented with foreign listings, “only to be disappointed with the results. The real lesson of the ‘80s is not how many companies fled from regulation, but how many came back.”¹²⁴ He predicts a similar about-face following the latest furor over 404 requirements, and we find his

116. Norris, *supra* note 113.

117. *See id.*

118. *Id.*

119. *See id.*

120. *See, e.g.,* Harvey Pitt, *Sarbanes-Oxley is an Unhealthy Export*, FINANCIAL TIMES, June 21, 2006, available at http://www.washingtonspeakers.com/prod_images/pdfs/PittHarvey.SarbanesOxleyIsAnUnhealthyExport.06.21.06.pdf.

121. *Cf.* Bob Greifeld, *It’s Time to Pull Up Our SOX*, WALL ST. J., Mar. 6, 2006, at A14 (noting that criticism but ultimately not swayed by it). This is related to the critique that argues that firms will either go private or simply not list in the first place to avoid regulation. *See* Emily Thornton, *A Little Privacy, Please*, BUS. WK., May 24, 2004, at 74.

122. DeMint & Feeney, *supra* note 110.

123. Greifeld, *supra* note 121.

124. *Id.*

argument compelling.¹²⁵

The SEC has reasoned that it would be “inconsistent with the purposes of the Sarbanes-Oxley Act to specify different requirements for small entities”¹²⁶ and has reinforced this belief recently.¹²⁷ This statement is not entirely correct. While different requirements *might* be inconsistent with SOX’s aims, they are not *necessarily* inconsistent. If they are designed, as our proposals are, in line with the overarching impetus behind SOX and our Article, then modified requirements could easily further the purposes of the Act.

Indeed, any revision of SOX, even for small companies, must recognize the simple fact that regulation works. In the first half of 2006, the eight largest accounting firms actually saw restatements drop by 31

125. See *id.* We also agree with Mr. Greinfeld’s plan to “self-initiate” a race to the top so that markets “can avoid overreaching regulation that constricts business and stifles initiative.” *Id.* NASDAQ has, in this vein, created “a new market tier with the highest listing standards on the planet.” His policy reflects one of our themes: if business leaders get ahead of the curve and self-initiate, to use his term, proactive changes, regulators will be less likely to “crack down.” We do not, however, agree with his proposal to exempt smaller companies from 404 altogether. *Cf. id.* It is also worth noting the new chorus of anti-SOX commentators complaining that SOX forces the world to adopt U.S. standards. See, e.g., Pitt, *supra* note 120. When the world converges in a “Race to Delaware” in corporate law generally, this is seen as proof of the power of markets and the validity of the consensus. See, e.g., Roberta Romano, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); S. Samuel Arshat, *Reply to Professor Cary*, 31 BUS. LAW 1113 (1976) (critiquing the position, initially put forth by Professor William Cary, that Delaware’s corporate law was creating a “race to the bottom”). The idea is similarly raised in the recent report of the Committee on Capital Markets Regulation. See Committee on Capital Markets Regulation, Interim Report of the Committee on Capital Markets Regulation, Nov. 30, 2006 [hereinafter CCMR Report], at 1, available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (noting that U.S. markets are less competitive compared with those abroad, because of SOX).

But if convergence is good elsewhere, why is convergence bad in the SOX context? Conversely, if convergence is bad, we should seriously question the so-called Delaware consensus. There is some literature on this subject. See, e.g., Mark Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003) (arguing that Delaware’s main competition in promulgating rules of corporate law is the federal government, not other states). Yet in the SOX context, for some reason, the U.S. regulatory regime is considered undesirable. We are unsure what to make of this dissonance, except to point it out and speculate that, perhaps, what is really motivating the comments is not a reasoned concern for what types of regulation may or may not be best for global markets, but instead, a single-minded concern with what regulatory regime is good for business, and nothing more.

126. Final Rule, *supra* note 108.

127. See *supra* notes 101-02 and accompanying text. *Cf.* Thornton, *supra* note 121 (noting the pressure SOX regulations are imposing on companies to stay or return to private status/selling or merging). Yet the benefits of Section 404 are well documented; compliance has improved internal controls while cost decline over time. See Floyd Norris, *Audit Law’s Costs Decline, Survey Shows*, N. Y. TIMES, Apr. 19, 2006, at C2. In the years since (some) companies have had to comply with Section 404, the number of companies with material weaknesses in their internal controls has declined significantly. *Id.* In short, costs decline over time and the law works. Businesses should recognize the benefits of the regulation while the SEC should recognize the costs; our proposal does both.

percent from a year earlier.¹²⁸ In contrast, “restatements more than doubled in the same period for smaller firms.”¹²⁹ This discrepancy is attributed to Section 404: smaller firms have to comply with the new rule; as a result, “someone is looking at those [smaller] firms for the first time.”¹³⁰ Moreover, evidence suggests that the restatements are being analyzed carefully in deciding whether executives should be held accountable.¹³¹ Only eight percent of CFOs were replaced when restatements were the result of errors involving “highly technical” judgments regarding derivatives,¹³² while thirty percent of CFOs were replaced when restatements were the result of revenue recognition, “a prime source of fraud.”¹³³ And even the CCMR Report agrees that SOX compliance costs decline over time.¹³⁴

With some of the concerns about SOX in mind, two committees are proposing regulatory changes in response to what they see as the excessive burdens of the recent increase in regulation. Members of both committees reported “that Section 404, along with greater threat of investor lawsuits and government prosecutions, had discouraged foreign companies from issuing new stock on exchanges in the United States in recent months.”¹³⁵ With the goal of increasing the “attractiveness” of U.S. capital markets, the committees hope to loosen regulations by introducing “broad new protections to corporations and accounting firms against criminal cases brought by federal and state prosecutors as well as a stronger shield against civil lawsuits from investors.”¹³⁶ Many of the proposals are being formed so that the S.E.C. and the Justice Department could implement the changes by promulgating new regulations.¹³⁷ Such a strategy, the thinking goes, would obviate the need for new legislation from Congress.

One committee was formed by the head of the U.S. Chamber of Commerce and the other by Harvard Law School professor Hal S. Scott. The latter, the Committee on Capital Markets Regulation, released its interim report on November 30, 2006 and has found that SOX has increased regulation to the extent that it is hurting the competitiveness of

128. Norris, *supra* note 127.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. CCMR Report, *supra* note 125, at 47.

135. Labaton, *Businesses Seek New Protection*, *supra* note 38.

136. *Id.*

137. *Id.*

U.S. capital markets.¹³⁸ In their report, the Committee cites the costs of complying with Section 404 of SOX,¹³⁹ uncoordinated state and federal enforcement laws and activities,¹⁴⁰ the elimination of countless jobs due to the “criminal indictment of entire companies,”¹⁴¹ as well as the costliness of private enforcement in the form of securities law class action suits¹⁴² as major causes of the erosion of competitiveness.

Focusing on five categories requiring change, the Committee offered recommendations to decrease regulation and litigation while enhancing the rights of shareholders in order to improve the competitiveness of U.S. markets.¹⁴³ With regards to SOX, the Committee advised implementation changes, particularly of Section 404.¹⁴⁴ The Committee suggested that the SEC adopt a reasonable materiality standard both for internal controls and financial statements¹⁴⁵ and that the SEC and PCAOB adopt enhanced guidance on auditors’ role and duties in testing for compliance with Section 404.¹⁴⁶ The Committee went on to say that if the revised Section 404 regulations were seen as too burdensome for small companies even after the general reforms outlined above are implemented, legislative revisions may be necessary and, in this case, the SEC should recommend to Congress that small companies be exempt from auditor attestation and be subject to a different standard for management certification.¹⁴⁷

138. *See generally* CCMR Report, *supra* note 125.

139. *See id.* at 125-27.

140. *See id.* at 68-69.

141. *Id.* at 85.

142. *Id.* at 72.

143. *See id.* at 1-22.

144. *Id.* at 115-35.

145. *See id.* at 131-32.

146. *See id.* at 132.

147. *See id.* at 133. The Committee also made a variety of suggestions not related to SOX. For example, it recommended that shareholders receive increased rights, particularly through a change in their voting from plurality to majority, by requiring shareholder approval of poison pills, and by giving shareholders the ability to decide the manner in which disputes with their company would be resolved. *See id.* at 93, 102-04, 105-06, 109-12. To improve the regulatory process, the Committee suggests that the SEC and self-regulatory organizations better analyze the costs and benefits of new rules, that they more usefully differentiate between wholesale and retail investors, that they regularly test current rules according to the cost-benefit analysis, and that the SEC and other public enforcement bodies improve their communication and coordinate their movements. *See id.* at 60-65, 67-68.

In the category of public and private enforcement, the Committee suggested greater clarity for private litigation under Rule 10b-5 (for securities fraud), positing that the materiality and scienter requirements are unclear. *See id.* at 80-81. Criminal enforcement, the Committee suggested, should be a last resort, reserved for companies that have become criminal enterprises from top to bottom. *See id.* at 85. Moreover, the Committee proposed that outside directors not be held responsible for corporate malfeasance when such malfeasance was outside the scope of what they

So what will happen in fact? The SEC has recently promulgated new rules that were characterized as “a loose interpretation” of Section 404.¹⁴⁸ The revised rules allow auditors to employ a “material risk” standard, much like what the CCMR Report suggested, scrutinizing only those internal controls that would carry a material risk of having an adverse impact on financial statements.¹⁴⁹

This SEC’s new material risk standard, we believe, does much to reduce the compliance burden on small firms. It remains to be seen whether the Section 404 revision (and the McNulty Memo, released at approximately the same time¹⁵⁰) are viewed as a compromise between the two extremes — calling for a rollback of SOX and a maintenance of the regime — or merely the first of many steps that reduce regulatory requirements. If the latter, we worry that SOX’s protections may be diluted to the point of inefficacy. If the former, then we cautiously applaud a process that, at least in fits and starts, is starting to negotiate a median path that recognizes the benefits of a regulatory baseline while not imposing undue burdens on business.

might detect. *See id.* at 73. The interim report also suggested protecting outside board members against liability when they rely in good faith on the audited financial statements, speculating that otherwise, it would be difficult to attract independent directors to boards. *See id.* at 90-91.

Some of these suggestions are already being heeded. As of this writing, the S.E.C. had filed an amicus brief in the Supreme Court that would make it more difficult for shareholders to file lawsuits against corporations. *See* Brief for the United States as Amicus Curiae Supporting Petitioners, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 853 (No. 06-484). Simultaneously, “the agency’s chief accountant told a conference that it was considering ways to protect accounting firms from large damage awards in cases brought by investors and companies.” Stephen Labaton, *S.E.C. Seeks to Curtail Investor Suits*, N.Y. TIMES, Feb. 13, 2007, at C1. These reforms are ostensibly to help shareholders, but we are skeptical of such a claim.

A full analysis of, and response to, the CCMR report is beyond the scope of this Article, and we are confident that others will take up this task in the upcoming months. However, it is worth mentioning that the report takes a fairly harsh view of SOX specifically and regulation generally. Although we believe that U.S. capital markets must be competitive with those around the world, we also believe that the investor protections—tangible protections, such as regulation, as well as intangible protections, such as a general faith in the viability of U.S. capital markets—offered by U.S. markets are unparalleled. *Cf.* Griefeld, *supra* note 121 (noting that the real lesson in the 1980s, after U.S. markets tightened regulation, was “not how many companies fled from regulation, but how many came back”). Relaxing SOX requirements and making securities fraud lawsuits difficult might empower managers and increase their discretion to act in a relatively unfettered manner. We are not, however, convinced that doing so will serve the immediate goal of improving investor confidence in U.S. markets. We are even less convinced that doing so will serve the overall goal of nurturing a new culture of corporate governance in which the emphasis is on ethical conduct and not on wide-ranging discretion for managers with diminished oversight. Indeed, the burden of this Article is to challenge these arguments, and to provide an alternative.

148. SEC 33-8760, *supra* note 79; Labaton, *Businesses Seek New Protection*, *supra* note 38.

149. SEC 33-8760, *supra* note 79, at 6; Labaton, *SEC Eases Regulations*, *supra* note 102.

150. *See supra* note 67 and accompanying text.

B. Clawback Provisions

If Section 404 perhaps goes too far in certain regards, Section 304 does not go far enough.¹⁵¹ Section 304 provides a rather weak “clawback provision,” by which a company may recoup compensation paid to executives after malfeasance.¹⁵² Specifically, if an issuer of securities files an earnings restatement because of misconduct resulting in “material noncompliance” with financial reporting requirements, then the CEO and CFO are required to reimburse the issuer for (1) bonuses and other compensation received in the twelve months following the first filing of financials subject to a restatement; and (2) any profits derived from the sale of the issuer’s securities during those twelve months.¹⁵³

We argue that these provisions are extraordinarily weak. SOX recognizes that top executives set the tone in a company and that corporate culture depends critically on executives’ willingness to take responsibility for their company’s actions.¹⁵⁴ If executives are truly to have an incentive to manage a company ethically, they should forfeit pay when material noncompliance happens on their watch. After all, Section 302 requires executives to attest to the truthfulness of their company’s statements.¹⁵⁵ An earnings restatement necessarily means that earlier financials, to which the executive attested, were wrong.¹⁵⁶

Thus, SOX’s clawback provisions should be strengthened. The executives should forfeit compensation from the initial financial report until present, not just twelve months forward.¹⁵⁷ Moreover, the provision

151. 15 U.S.C.A. § 7243 (2006) (SOX § 304).

152. *Id.*

153. *Id.*

154. *See, e.g.*, 15 U.S.C.A. § 7241 (2006) (SOX § 302) (requiring company executives to personally certify and take responsibility for, inter alia, the accuracy of reports, the existence of internal controls, and appropriate disclosure).

155. *Id.*

156. At least three courts seem to have held that CEO and CFO certification, without more, is insufficient to constitute scienter under the securities laws for a securities fraud violation. *See In re Watchguard Sec. Litig.*, No. C05-678J, 2006 WL 2038656, at *12 (W.D. Wash. Apr. 12, 2006); *In re Invision Technologies, Inc. Sec. Litig.*, No. C04-03181 MJJ, 2006 WL 538752, at *7 (N.D. Cal. Feb. 27, 2006); *In re Lattice Semiconductor Corp. Sec. Litig.*, No. CV04-1255-AA, 2006 WL 538756, at *12, *15 (D. Or. Jan. 3, 2006). However, this is, at least arguably, distinct from the position we are advocating above. Disgorgement was always a remedy at common law and under the securities laws. SOX’s clawback provisions must be distinct from those causes of action; otherwise, § 304 would be superfluous. We argue here that CEO and CFO certification should be sufficient to demonstrate knowledge for § 304 clawback purposes. In the case of regular securities fraud actions, for example under Rule 10b-5, more may be required to properly allege scienter and survive a motion to dismiss, as happened in *Watchguard* and *Invision*.

157. Except, of course, for the unlikely cases where the time frame was less than twelve months, in which case they should forfeit pay for the full twelve-month period.

should be triggered by material noncompliance with *any* securities laws, not just financial reporting requirements. Additionally, executives could be required to reimburse some percentage of their salary greater than 100%. For example, executives might be required to reimburse issuers 125% of their compensation and then pay a fine to the SEC of an additional 25%, bringing total fines to 150% of all compensation (salary, bonus, and equity). Finally, there should be an explicit private right of action under Section 304, so that enforcement of the provision does not depend solely on the SEC's discretion.¹⁵⁸

This is particularly important because so many executives receive equity compensation. And while one argument suggests that stock options align the incentives of executives and shareholders — namely, increasing shareholder value — empirical evidence suggests that this might not be the case. Executives, instead of working for the benefit of shareholders, have an incentive to increase a company's short-term value and exercise their options regardless of long-term consequences. A 2005 study found that executives who received “substantial amounts of in-the-money options . . . were more likely to issue financial statements with non-GAAP accounting irregularities.”¹⁵⁹ The recent stock options scandal only increases the possibility of more malfeasance.¹⁶⁰ In other

158. Cf. 15 U.S.C. 7244 (2006) (SOX § 306) (explicitly affording a private right of action in the insider trading context). A similar provision could create a private right of action here.

A variety of federal district courts have considered the issue and found that there is no private right of action under Section 304. See, e.g., *Kogan v. Robinson*, 432 F. Supp. 2d 1075, 1076 (S.D. Cal. 2006); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (concluding that “Congress did not intend to create an implied [private] right of action in Section 304”); *In re BiSys Group, Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005) (holding the same, “substantially for the reasons stated in *Neer*”); *In re Whitehall Jewellers, Inc. S’holder Derivative Litig.*, No. 05-C-1050, 2006 WL 468012, at *7 (N.D. Ill. Feb. 27, 2006); *In re Digimarc Corp. Derivative Litig.*, No. 05-1534, 2006 WL 2345497, at *2-3 (D. Or. Aug. 11, 2006) (same). As of this writing, no U.S. Circuit Court of Appeal has issued a decision. See *In re Goodyear Tire & Rubber Co. Derivative Litig.*, No. 5:03CV2180, 2007 WL 43557, at *7 (N.D. Ohio Jan. 5, 2007) (noting that at least three cases have been docketed, but none has resulted in a decision). Although an argument can be raised that an implied private right exists under Section 304 using the four-part test from *Cort v. Ash*, 422 U.S. 66 (1975); see, e.g., Pl.’s Memo. of Law in Opp’n to Defs’ Second Motion to Dismiss Pl.’s Amended S’holder Derivative Complaint at 19, *Neer v. Pelino*, 389 F. Supp. 2d 648 (E.D. Pa. 2005) (No. 2:04-cv-4791-SD), and though we believe this argument has merit, Section 304 should be revised to make this explicit. In the interim, the SEC should be aggressive in pursuing the disgorgement remedy under this section — thus far, it has not done so even once. See Pl.’s Memo. of Opp’n to Defs’ Second Motion to Dismiss Pl.’s Amended S’holder Derivative Complaint at 17-19, *Neer v. Pelino*, 389 F. Supp. 2d 648 (E.D. Pa. 2005) (No. 2:04-cv-4791-SD).

159. Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of In-The-Money Options and Other Incentives* 33 (Working Paper Series, 2006), available at <http://ssrn.com/abstract=547922>.

160. At least one commentator has suggested that the backdating scandal is nothing more than run-of-the-mill securities fraud: the executives are essentially “lying to someone to get [him] to hold

words, equity compensation increases agency costs that must then be borne by shareholders.¹⁶¹ Shareholders must be reimbursed not only for the dollar value of the fraud but for these other, indirect, costs as well. For this reason, we propose stricter clawback provisions, including punitive damages mechanisms.

1. Boards of directors

Our discussion of clawbacks requires an argument for stronger boards of directors more generally. This examination in turn illuminates the dynamic between boards and executives, especially in the realm of compensation. In their recent book, Lucian Bebchuk and Jesse Fried argue that executives are essentially getting “pay without performance.”¹⁶² Simultaneously, while executive compensation has been rising, effectively linking pay to performance has proven elusive.¹⁶³ On the one hand, granting executives stock options seems to give them an incentive to increase shareholder value. But equity compensation and the likelihood of an earnings restatement are positively correlated,

the company’s stock or buy more.” Posting of Broc Romanek to <http://www.deallawyers.com/blog> (Aug. 7, 2006) (citing Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL’Y 195, 197 (2003)), for the definition of fraud: “lying to someone to get them to give you their stuff”). Though this view seems not to have caught on, if it did, presumably shareholders would have the full panoply of causes of action and remedies available to them, including under the securities laws and common law fraud. It is worth noting, however, that at press time, two Delaware courts have ruled that directors may be liable for “well-timed” stock options. *See In re Tyson Foods, Inc. Consol. S’holder Litig.*, C.A. No. 1106-N, 2007 WL 416132 (Del. Ch. Feb. 6, 2007); *Ryan v. Gifford*, C.A. No. 2213-N, 2007 WL 416162 (Del. Ch. Feb. 6, 2007). It is, of course, an open question whether the directors will *actually* be held liable or whether the promise of reform will be merely illusory. At least one law firm thinks that although the decisions will be “much-ballyhooed,” like the *Disney* decision, *see infra* notes 164-65, “it may be that such complaints will survive motions to dismiss but not give rise to actual liability when litigated to conclusion.” Robert A. Profusek et al., *Two Delaware Chancery Court Cases on Backdating and Spring-Loading Options Increase the Stakes for Directors*, http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S3993 (last visited March 1, 2007).

161. *Id.*

162. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004). Professor Bebchuk has been active of late, lambasting problems over high compensation, lack of shareholder rights, and most recently, backdated options. In an op-ed, he wrote, “For corporate America to improve its governance going forward, boards should face up to – and fully share with shareholders – past governance problems in their companies.” Lucian Bebchuk, *Inside Jobs*, WALL ST. J., Jan. 8, 2007, at A6 [hereinafter Bebchuk, *Inside Jobs*]. We wholeheartedly agree.

163. *See* Claudia H. Deutsch, *My Big Fat C.E.O. Paycheck*, N.Y. TIMES, Apr. 3, 2005, § 3, at 1. Providing non-equity compensation does not provide executives with an incentive to increase shareholder value, while providing equity compensation in the form of stock options only provides an incentive to boost the stock’s short-term price, which is generally not in line with shareholders’ interests. *Id.*

suggesting that the way options are granted is flawed.¹⁶⁴ For this reason, we suggest aggressive clawback provisions. Thus, no matter how an executive is compensated, he will be held to account if things go poorly.

But boards should make responsible decisions even when things are going well. A recent court case held that the Disney board of directors was not liable for an outlandish compensation package that it paid to Michael Ovitz, holding that the plan, while extravagant, was within the bounds of the “Business Judgment Rule.”¹⁶⁵ Here, the directors escaped unscathed. The Chancellor wrote:

[I]t is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago [around 1995 and 1996], and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.¹⁶⁶

That reasoning is open to debate on the merits; for example, we believe that the board should have been responsible under theories that do not necessarily turn on twenty-first century notions of best practices such as breach of fiduciary duty or waste of corporate assets. However, it is quite clear that as increasing numbers of executives and others come under scrutiny for more recent malfeasance — such as John and Timothy Rigas, Bernard Ebbers, Richard Scrushy, the KPMG partners, Fannie Mae, and others — the Chancellor’s reasoning no longer holds. All business leaders today know about the new realities of corporate governance, and their conduct should be held to the highest ethical and legal standards. Defendants in the next round of shareholder derivative actions should not be allowed to avoid responsibility by claiming that corporate governance was not “on the radar” at the time. As we have repeatedly pointed out, it is on the radar, and it is here to stay.

The Wall Street Journal’s 2006 report on executive compensation illustrates the need for informed, engaged boards of directors. Using a new tool called “tally sheets,” boards are finally able to calculate exactly how much their CEOs are making.¹⁶⁷ The sheets are “[n]icknamed ‘holy cow’ sheets for the way they often expose the immense worth of current and potential payouts.”¹⁶⁸ The sheets give boards a heretofore absent ability to forecast total compensation under different scenarios covering

164. See Efendi, *supra* notes 159, at 31, 33.

165. *In re Walt Disney Co. Derivative Litig.*, No. 15452, 2005 Del. Ch. LEXIS 113, at *3 (Del. Ch. Aug. 9, 2005).

166. *Id.* at *4.

167. Joann S. Lublin, *Adding It All Up*, WALL ST. J., Apr. 10, 2006, at R1.

168. *Id.*

salary, bonuses, stock options, pensions, and other remuneration.¹⁶⁹

The remarkable thing is that tally sheets have been *absent* from the corporate landscape for so long. Indeed, among the 350 firms featured in the Journal's report, only fifty boards were using tally sheets.¹⁷⁰ Of the balance, it is an open question as to how many boards are unaware of the "holy cow" nature of *their* executives' pay.

The tally sheets vignette illustrates just one of the many ways in which boards must become more actively engaged and empowered to monitor the performance of their CEOs. Recently, the backdating of stock options, an alarmingly pervasive practice, seems to be the scandal *du jour*.¹⁷¹ Initially thought merely to pad executives' pockets, now it appears that "executives may have changed the so-called exercise date . . . to avoid paying hundreds of thousands of dollars in income tax."¹⁷² Again, boards are confronted with the question: are corporate executives going to continue to get "pay without performance?" Independent oversight is critical, both from government and watchdog groups as well as independent, empowered directors. When these controls break down, excess and scandal are only a matter of when, not if.

As we noted earlier, it is impossible for regulators and courts to monitor every instance of improper executive compensation or performance. Boards, then, become one of the first lines of defense against these excesses. They can only do their jobs if they are strong, empowered, sufficiently independent, and accountable.

C. *The Role of Professionals*

In a speech in 2004, one of us remarked:

[W]hat also leaps out at me is that in nearly every single transaction at WorldCom, Enron, Global Crossing, Adelphia, Tyco, Qwest, and any of the other leading examples of serious corporate problems involving crime, fraud, schemes, and malfeasance, in all those cases, there was a lawyer who, at some level, saw, heard, reviewed, analyzed, and billed for legal services rendered. What did we see? What did we do? What

169. *Id.*

170. *Id.*

171. Rivlin & Dash, *supra* note 85; Damon Darlin & Eric Dash, *2 Are Charged in Criminal Case on Stock Options*, N.Y. TIMES, July 21, 2006, at A1.

172. Eric Dash, *Dodging Taxes is a New Wrinkle in the Stock Options Game*, N.Y. TIMES, Oct. 30, 2006, at C1.

should we do now?¹⁷³

These questions regarding the role of lawyers specifically and of professionals generally are of utmost importance in setting the future course of corporate governance and ethics in this country. This begins with SOX's requirements for public companies to have audits conducted by independent accountants¹⁷⁴ and for lawyers to report evidence of illegal activity to the company's executives and independent directors.¹⁷⁵

These requirements are important when juxtaposed against the questions posed in the quotation at the beginning of this section. Indeed, the current options backdating scandal once again raises questions about lawyers and accountants and how they did — or did not — fulfill their professional roles. The backdating scandal is so jarring that commentator Ben Stein compares it to “pick[ing] lottery numbers *after* the winning numbers are drawn — and your stockholders supply the prize money.”¹⁷⁶ A prominent Silicon Valley law firm has come under suspicion, and accounting firms are not escaping unscathed.¹⁷⁷ Earlier, we discussed how WorldCom's actions led to a race to the bottom that affected the entire telecommunications industry.¹⁷⁸ Similarly, the heady days of the dot-com boom compromised lawyers' and accountants' independent judgment. Accounting firms' work, one commentator noted, became “client-driven . . . with the accounting firm saying ‘Sounds O.K. to me’ without exercising proper oversight.”¹⁷⁹ The same was true for law firms; instead of keeping companies honest, they caved to the “enormous pressure . . . to keep their newly minted clients happy.”¹⁸⁰ This, of course, reinforces our theme in this Article. Just like the corporate executives, the lawyers and accountants did not set out intending to do evil — to whitewash companies' dubious practices. Instead, market pressures forced them to accommodate their high-

173. Harshbarger, *supra* note 98, at 221.

174. See 15 U.S.C. § 78j-1(g) & (l) (2006) (SOX §§ 201, 206) (describing “prohibited activities” and “conflicts of interest” provisions, respectively).

175. 15 U.S.C. § 7245 (2006) (SOX § 307) (Rules of Professional Responsibility for Attorneys).

176. Ben Stein, *So Many Millions, So Little Body Armor*, N.Y. TIMES, Jan. 7, 2007, § 3, at 3 (emphasis added). Stein notes that the backdating problem is “precisely an example of a failure of internal controls,” thus undercutting the argument in the CCMR report that SOX “was supposedly too strict in requiring audits of internal controls.” *Id.* We completely agree with this sentiment, and it dovetails with our general observation that the calls for relaxing regulation might be more credible if there were not a steady stream of continuing corporate misconduct.

177. See Rivlin & Dash, *supra* note 85.

178. See Belson, *supra* note 13; see also *supra* text accompanying notes 8-15 and 40-41.

179. Rivlin & Dash, *supra* note 85.

180. *Id.*

profile, “rock star” clients, and in the process, they compromised the very judgment and independence that is their stock-in-trade.

Professionals play an important role in fostering an ethical corporate culture. Accountants, lawyers, independent directors, and others have the best access to a company’s policies and procedures and are almost always in a better position to find and correct malfeasance before regulators. Indeed, by the time a government agency comes to know of fraud, it is generally too late: shareholders, citizens, and communities have already been harmed in some way. In contrast, the professionals providing services to these corporations should have firsthand knowledge of where the company’s practices are suspect and where it might face risks.

In cases of malfeasance this raises two equally undesirable possibilities. On the one hand, the professionals might have been so inept that they were wholly unaware of the malfeasance that was taking place. On the other hand, and probably worse, the professionals were fully aware of the overstatements, the conflicts of interest, the insider trading, and blessed it anyway—collecting their fees and stamping their approval.¹⁸¹

A recent article points out that the government considers lawyers the “first line of defense” with regard to white-collar crime.¹⁸² Lawyers are generally in the best position to notice and curtail such crime. Moreover, lawyers can counsel their clients as to how best to *avoid* legal problems (as well as how to solve them when they occur). Professional associations for lawyers and accountants should establish high standards of conduct that go even farther than Section 307 in requiring members to work aggressively to deter and then report malfeasance. In exchange for doing so, the individuals and organizations involved should get immunity from government prosecution. Moreover, in the event of related litigation with the government, the disclosure of such wrongdoing, even if done by third-party professionals, should serve as a mitigating factor when considering what penalties to assess against the corporation. This demonstrates how the relationship between regulators, corporate leaders, and professionals can and should be directed to foster an ethical, competitive corporate culture — not merely for regulators to

181. Cf. Harshbarger, *supra* note 98, at 221 (“Is it okay if we simply didn’t know what our clients were doing? Were we like the New York Stock Exchange Board—either we knew the facts and felt they were perfectly okay, or at least didn’t cross any legal boundary, or, on the other side, which is probably worse, did we not know or want to know what was occurring, and yet we took our fees?”).

182. See Richard M. Strassberg et al., *Lawyers on Trial*, 234 N.Y. L.J. 9 (2005).

punish all executives or for all corporations to see how they can skirt or otherwise evade the law.¹⁸³

V. THE VALUE OF AN ETHICAL CULTURE

The obvious question is whether our call for an ethical corporate culture is somehow disjointed from the typical concerns of a business. In this Article, we call for corporations to embrace a broader view of what it means to do business, including ethical governance. Is this prescription at odds with what it means to increase shareholder value? A variety of research indicates otherwise.

An ethical culture simply makes good business sense. The problem, as we have outlined above, is not with “corporate governance,” as some narrowly define it. We are not interested in some ranking, a number tacked on after a ticker symbol — a number that may or may not mean anything.¹⁸⁴ Instead, we are interested in a broad-based shift toward an ethical corporate culture: a shift that ultimately makes money.

This might be intuitive.¹⁸⁵ an ethical company is less likely to run

183. One major issue that corporations face in cooperating with regulators involves the waiver of attorney-client privilege. Specifically, corporations that turn over certain documents to regulators are often deemed to have waived the privilege, even when “limited waiver” agreements exist; every court except the Eighth Circuit has rejected such arrangements, arguing that any disclosure, even to a regulator, waives the privilege. *See Diversified Indus. v. Meredith*, 572 F.2d 596, 607, 611 (8th Cir. 1978) (recognizing limited waiver); *but see In re Qwest Commc’ns Int’l Inc.*, 450 F.3d 1179, 1192-1193 (10th Cir. 2006) (rejecting selective waiver); *Permian Corp. v. United States*, 665 F.2d 1214, 1221 (D.C. Cir. 1981) (same). In the federal courts, questions of privilege are governed by federal common law. *See* FED. R. EVID. 501. We support the proposed Rule 502, which would allow for limited waiver. Under this scenario, companies could disclose information to regulators, work to solve what problems exist, but be permitted to assert the privilege as to those documents and those subjects in litigation against private plaintiffs. *See* ADMIN. OFFICE OF THE U.S. COURTS, PRELIMINARY DRAFT OF PROPOSED AMENDMENTS TO THE FEDERAL RULES OF PRACTICE AND PROCEDURE SUBMITTED FOR PUBLIC COMMENT, A SUMMARY FOR BENCH AND BAR (August 2006), available at http://www.uscourts.gov/rules/Brochure_2006.pdf; Report from Hon. Jerry E. Smith, Chair, Advisory Committee on Evidence Rules, to Hon. David F. Levi, Chair, Standing Committee on Rules of Practice and Procedure (June 30, 2006), available at http://www.uscourts.gov/rules/Excerpt_EV_Report_Pub.pdf.

We of course understand (particularly as one of us has taught legal ethics for decades) that these issues, involving lawyers’ duties and obligations, are complex; we do not try to do the topic justice here. It is, nonetheless, a critical part of the new reality, and professionals must do more than use their duties as a shield. There are affirmative obligations, as well as opportunities, for lawyers, accountants, auditors, and others to offer real, independent, and strategic advice. These professionals, as always, play an integral role in the reform we envision.

184. *See, e.g., Corporate Governance by the Numbers: It Doesn’t Work*, KNOWLEDGE@WHARTON, Sept. 22, 2004, available at <http://knowledge.wharton.upenn.edu/article/1041.cfm>.

185. Or it might not. If the costs of crime — the magnitude of punishment times the odds of getting caught — are low, then crime does pay, and either the costs, odds, or both would need to be

into financial, accounting, or legal trouble. Less trouble means lower costs associated with trouble; lower costs mean more profits in the long run. But this is not just armchair philosophy; good ethics can mean more money in the short run as well. GovernanceMetrics International (GMI) recently examined governance practices at 3,220 companies worldwide.¹⁸⁶ The companies that received GMI's highest rating outperformed the S&P 500 by an average of over 11% for the 12 months ending February 28, 2005.¹⁸⁷

GMI's study offers more than just hindsight. For example, Krispy Kreme recently lost 81% of its value after its accounting practices came under scrutiny.¹⁸⁸ After an investigation, a special committee of Krispy Kreme's board of directors concluded that the company "failed to meet its accounting and financial reporting obligations to its shareholders and the public."¹⁸⁹ The committee attributed this failure directly to a "corporate culture driven by a narrowly focused goal of exceeded projected earnings by a penny each quarter."¹⁹⁰ How would GMI's data have affected this failure of corporate ethics? "In June 2003, GovernanceMetrics gave Krispy Kreme relatively low marks for its [corporate governance] policies, raking it 4 out of 10 overall. Then, in January 2004, [GMI] dropped its rating to 2.5. In July, Krispy Kreme disclosed that securities regulators were investigating its accounting."¹⁹¹ Krispy Kreme's accounting fraud was foreshadowed by GMI's ratings.

Another study similarly links good governance and shareholder value, finding that companies with strong shareholder rights yielded annual returns that were 8.5% higher than companies with weak shareholder rights.¹⁹² When discussing the study, one of the co-authors indicated surprise at the findings. "As a financial economist," he said, "I expected important things like governance *already reflected in stock prices* and therefore wouldn't see much of a difference. We found otherwise."¹⁹³ His comment is important for two reasons. First, it reinforces GMI's conclusion that good governance yields returns for

increased.

186. Gretchen Morgenson, *Companies Behaving Badly*, N.Y. TIMES, Mar. 6, 2005, § 3, at 1.

187. *Id.*

188. *Id.*

189. Krispy Kreme Doughnuts, Inc., Krispy Kreme Announces Completion of Special Committee Investigation (Aug. 10, 2005),

<http://phx.corporate-ir.net/phoenix.zhtml?c=120929&p=irol-newsArticle&ID=741862&highlight>.

190. *Id.*

191. Morgenson, *supra* note 186.

192. Gompers et al., *supra* note 5, at 109.

193. *Studies Show Impact of Governance Practices*, N.Y.S.E. NEWSLETTER, June 2003, available at <http://www.nyse.com/content/articles/1054291475066.html> (emphasis added).

shareholders. But it also represents a deeper point. Throughout this Article, we have argued that corporate leaders must see good governance as *endogenous* to the business process that is, as a normal part of doing business. Metrick essentially assumed that they already did — hence his intuition that governance practices would already be reflected in stock price.¹⁹⁴ The fact that governance was not reflected in stock price confirms our argument: the empirical data indicate that neither business leaders nor investors are yet factoring governance into their business decisions.¹⁹⁵

Another example from 1999 demonstrates the positive relationship between good governance and financial success. The World Trade Organization's meeting in Seattle, Washington, that year was besieged by protestors and collapsed in short order.¹⁹⁶ Soon thereafter, many corporations' stock prices took a hit.¹⁹⁷ But that fate did not befall all companies equally.¹⁹⁸ In industries known for environmental problems (such as energy, steel, and mining) and labor abuses (such as apparel, toys, and sporting goods), those companies with a reputation for social responsibility did better than those without.¹⁹⁹ While the companies without such a reputation saw stock prices drop by an average of over 3%, the companies *with* a reputation for social responsibility saw their prices decline only slightly.²⁰⁰ Along the same lines, a June 2003 article in the New York Stock Exchange Newsletter surveyed a variety of studies from markets around the world that all point to the same conclusion: good governance means good business.²⁰¹

And these financial benefits parallel similar legal benefits. A company with a strong ethical culture is less likely to lose a lawsuit or have to pay out millions in a settlement. Of course, some people will still file lawsuits primarily to harass a company, but when those situations come up a company can be relatively more secure knowing that it

194. *Id.*

195. Unlike, say, taxes, which we have discussed earlier. *See supra* note 73 and accompanying text. Note also that GMI's data also indicates that corporate governance is currently treated as exogenous to the business process. Since GMI's metric for Krispy Kreme was declining *before* stock price declined, we can infer that the elements of good governance were not *already* reflected in stock price, just as the Gompers study found. Gompers et al., *supra* note 5, at 146. In other words, the market is (at least in those examples) not acting on the governance information available to it.

196. Marguerite Rigoglioso, *In Bad Times, It Pays to Be Good: A Reputation for CSR May Shield Companies From the Public's Ire*, STAN. SOC. INNOVATION REV., Summer 2005, at 14.

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. *See supra* note 193.

ensured independence, minimized conflicts of interest, and had its governance structures independently evaluated. In other words, the firm would have less to fear, since it had stayed ahead of the curve from the beginning and not simply waited until a crisis came along.²⁰²

In short, an ethical, transparent culture is not only the right thing to do but also acts as a prophylactic that protects everyone, from CEOs and boards to employees, investors, and other stakeholders. Indeed, any company might (and often will) encounter unethical or even illegal conduct. The key is to proactively discover these transgressions and to ensure that the isolated act does not become a pattern. Expecting employees to identify and correct irregularities immediately, before the regulators and lawmakers find out, will foster a sense of openness. Executives in particular can rest assured that problems will be remedied. After all, it is nearly impossible for a single CEO to know everything that is happening or might happen in a huge conglomerate. An executive should be able to trust her employees to prevent and eliminate malfeasance and should get support from the board for setting such expectations.

Finally, the example of Tyco indicates both the good and the bad about corporate reform. There, executives' wrongdoing resulted in a drop in stock price of roughly 80%.²⁰³ However, an aggressive internal investigation pushed for civil and criminal suits against the wrongdoers and found no evidence of systemic fraud.²⁰⁴ As a show of good faith, the company replaced all of its senior executives and instituted a comprehensive ethical program.²⁰⁵ On the one hand, this illustrates effective handling of a serious problem through internal investigation, effective outside counsel, and cooperation with government regulators. On the other hand, these changes only came after Tyco was on the brink

202. Cf. U.S.S.G. § 8B2.1(b)(1) - (7) (outlining an ECEP). See also FED. R. EVID. 501, *supra* note 183, annot. 502. Under limited-waiver agreements, companies that did detect, disclose, and remedy misconduct would be protected against private litigants.

203. Hiawatha Bray, *Tyco to Cut Jobs, Consolidate Troubled Company is Hoping to Save \$125M Annually, Trim \$27B Debt load Tyco to Sell Buildings, Aircraft, Pay Debt*, BOSTON GLOBE, June 14, 2002, at D1.

204. See generally Brooke A. Masters, *Tyco Finds \$1.3 Billion in Accounting Errors*, WASH. POST, May 1, 2003, at E04.

205. See generally Tyco Fraud InfoCenter, <http://www.tycofraudinfocenter.com/information.php> (last visited July 14, 2005). See also DAVID BOIES, *COURTING JUSTICE* 235, 467 (2004) (describing the proactive role his firm took in representing Tyco, voluntarily disclosing wrongdoing to the government and fully cooperating with government investigations). Boies and his firm did come under fire for declaring Tyco "clean" before all of the malfeasance was uncovered. See Floyd Norris, *Joy for Tyco's New Boss, Not for Investors*, N.Y. TIMES, Mar. 14, 2003, at C1; Andrew Ross Sorkin, *Tyco Inquiry Mostly Clears Its Accounting*, N.Y. TIMES, Oct. 25, 2002, at C4. Again, the important role that professionals play is clear.

of destruction. The puzzle for the future is determining how to get Tyco-style reforms without a Tyco-style crisis.

VI. THE IMPORTANCE OF SITUATION

In trying to solve that puzzle, there is one important fact to keep in mind. As described above,²⁰⁶ none (or at least nearly none) of the now-disgraced CEOs set out to defraud people or do evil. Instead, “they started down the slippery slope when they felt the pressure from adverse results — declining sales, unexpected adverse rulings by a regulator, etc. — and they began to realize that the expectations that they had created . . . could not be met. So they thought it okay to fudge a little. . . . Then, as the business conditions worsened, they succumbed to the temptation to fudge more and pretty soon they understood that they were engaged in significant wrongdoing.”²⁰⁷

These pressures, these temptations, are what Professor Hanson and his co-authors have described as situational forces.²⁰⁸ They have written extensively on the subject of situationism and have articles (both published and forthcoming) on situationism in corporate law.²⁰⁹ While it is not our intention to delve into an extensive situational analysis of corporate governance here, it is worth noting that the issues we raise intersect with work on situationism at a variety of levels. At the most basic level, we call for business leaders and regulators working collaboratively to create the situational forces to align incentives in such a way that fosters ethical conduct.

Until we do so, and until we abandon the myopic “rational actor model,” our policy prescriptions are doomed to fail. Consider the issue of executive pay. It was originally thought that CEOs should be paid a bonus to foster proper conduct: if the company did poorly, the executive would not receive a bonus, so the incentive would be to improve performance. Yet problems continued. Then, boards hit on the idea of stock options: by making executives also shareholders, they would internalize any costs they were previously externalizing on the company. But stock options were not a silver bullet either, because CEOs were too often tempted to boost short-term value while disregarding long-term prosperity. Thus, boards instituted restricted stock options, for example, those that would only vest after five or ten years.

206. See *supra* notes 13-18 and accompanying text.

207. Nicolai, *supra* note 31.

208. See *supra* note 32 and accompanying text.

209. *Id.*

At every turn, the assumption was that CEOs were solely “profit maximizing,” just as the traditional economic rational actor model would predict; however, a situational analysis would recognize the wider range of forces that affect CEOs. Of course money matters, but so does reputation. So does social standing, and so does respect from peers.²¹⁰ Money is a metric of that performance, but it is not the only metric. Many of the problems regarding CEO pay stem from this fundamental blindness. Indeed, increasing equity compensation is positively correlated with risk of earnings restatements.²¹¹ Clearly, the current system is not working.

Blindness to situation also explains why the nature of corporate governance reforms often turns out to be illusory. If reform were truly successful, then one would predict a significant reduction in corporate malfeasance after SOX. Yet stories of corporate misconduct have continued unabated. Why?

Again, the answer turns on situational blindness. Commentators on this subject have tended to view any misconduct as the work of a few “bad apples.” When we see more misconduct, we assume that there are simply more bad apples than there were earlier.²¹² The bigger question is rarely asked: what situation made this misconduct possible? We miss the orchard for the apples. When we do so, we forget that “bad apples are made, not born.”²¹³

Our prescriptions in this paper call for more situational awareness — to take a look at the orchard. If policymakers and business leaders do not address the situational causes of misconduct, it is a near guarantee that there will be more misconduct in the future. It is only by recognizing that situation matters that we can begin to take control of that situation and harness it for positive change.

As the WorldCom example shows,²¹⁴ the market’s situational pressures can be a tremendous force that drives companies to engage in

210. Cf. Joann S. Lublin, Creative Compensation Tactics Help Forge a Company’s Culture, Wall St. J. Online, April 17, 2006, <http://www.careerjournal.com/salaryhiring/hotissues/20060417-lublin.html>. The company’s president does not reward his employees with more money, which the traditional economic model would suggest is all that matters. Instead, he rewards them with an “experience,” such as being rich for an evening: getting picked up in a limousine, going to an expensive restaurant, and so on. *Id.* He believes, rightly, that these experiences are more memorable than a direct-deposited bonus. *Id.* The example illustrates yet another way in which people are not solely “wealth-maximizing.”

211. See *supra* notes 154-61, 164 and accompanying text.

212. Chen & Hanson, *supra* note 6, at n.285.

213. Scott Harshbarger & Goutam U. Jois, Op-Ed., *Cleaning Up the Corruption in Business and Politics*, BOSTON GLOBE, June 1, 2006, at A11.

214. See Belson, *supra* note 13; *supra* note 38 and accompanying text.

conduct that harms customers, employees, and shareholders. While the market forces companies to “keep up” with their malfeasant competitor, policy can foster countervailing situational forces. Indeed, if companies know that a malfeasant competitor will be held to account, then not only are the incentives to engage in malfeasance lowered, the incentives to match that competitor’s conduct are also reduced.

One way to accomplish this, in addition to the statutory revisions we suggest above and the policy prescriptions we list below, is to incorporate elements of truly independent oversight. Across industries, countries, and sectors, the lesson is the same: when stakes get large enough, the likelihood of ethical and legal misconduct increases.²¹⁵ In recent years, we have seen this misconduct in the corporate world, in corrections facilities,²¹⁶ in sports,²¹⁷ in religious institutions,²¹⁸ in campaign finance,²¹⁹ and at the United Nations.²²⁰ In situations like this, only real, independent oversight has the possibility of creating the right incentives; anything less will provide the illusion of reform, and perhaps even comfort, but it will not change the underlying situation.

To some extent, companies recognize the importance of situational pressures. For example, as discussed before, the Thompson Memo did not, by its terms, require companies to waive the attorney-client privilege or cut off employees’ legal fees.²²¹ However, the pressures on

215. See, e.g., E-mail from Frank A. Nicolai to Scott Harshbarger, Senior Counsel to the Firm, Proskauer Rose LLP (Jan. 16, 2006, 11:04 EDT) (on file with authors) (noting that “when the stakes get large enough,” there is a heightened need for vigilance as fraud is more likely to occur).

216. See, e.g., GOVERNOR’S COMM’N ON CORR. REFORM, COMMONWEALTH OF MASS., STRENGTHENING PUBLIC SAFETY, INCREASING ACCOUNTABILITY, AND INSTITUTING FISCAL RESPONSIBILITY IN THE DEPARTMENT OF CORRECTION (2004), available at http://www.mass.gov/EOops/docs/eops/GovCommission_Corrections_Reform.pdf (Scott Harshbarger, Chairman).

217. See, e.g., Stephen Cannella, *Due Process on the Hill*, SPORTS ILLUSTRATED, Mar. 11, 2005, http://sportsillustrated.cnn.com/2005/writers/stephen_cannella/03/11/steroids.congress/index.html (discussing the steroids scandal in Major League Baseball and the failure of league to address the problem).

218. See, e.g., CatholiCity, Catholic Commentary on the Scandals in the Church, <http://www.catholicity.com/scandals.html> (last visited Sept. 3, 2005).

219. See, e.g., Susan Schmidt et al., *Investigating Abramoff—Special Report*, WASH. POST, June 22, 2005, available at <http://www.washingtonpost.com/wp-dyn/content/linkset/2005/06/22/LI2005062200936.html> (discussing the Jack Abramoff lobbying scandal).

220. See, e.g., Colum Lynch, *Oil-for-Food Panel Rebukes Annan, Cites Corruption*, WASH. POST, Sept. 8, 2005, at A01 (describing corruption at the highest reaches of the UN relating to the Oil-for-Food program).

221. Cf. Brad D. Brian, *Corporate Responsibility: The Lawyer’s Role*, 32 LITIG. 1, 62 (Spring 2006) (noting that the waiver provision in the Thompson memo is “stated as a narrow exception”). We believe that waiver should be treated as a narrow exception and take no issue with the memo itself; we do, however, believe that some prosecutorial tactics may have crossed the line. See also *United States v. Stein*, 435 F. Supp. 2d 330, 363 (S.D.N.Y. 2006).

them may be so great that the “choice” they face is not a choice in the usual sense at all; prosecutors’ heavy-handed tactics put companies in a situation where they have no meaningful option to refuse.²²² But the idea we are discussing and that Hanson has written about is not like an item in a buffet, to be drawn from when the fancy strikes. Situational forces affect all of us, regulators and corporations alike, at all times. Just as the “choice” to waive the privilege may not be truly free, so too do pressures induce prosecutors to bring marginal cases or transgress ethical boundaries in their tactics.²²³ These poor decisions, we believe, are the result of the overly-antagonistic environment we described earlier.²²⁴

Obviously, those who committed crimes — the real bad apples — should be held to account. But Enron, WorldCom, AIG, and the others should not become scapegoats, and our policies should recognize a critical fact: that situation matters.

VII. MOVING FORWARD

So situation matters. How, then, can we — regulators, business leaders, and citizens — work to change that situation? Here, we propose a series of remedies that detail the points outlined at the start of this Article. It is important to remember, however, that this is not a problem that any one group could (or should) solve by itself; instead, forging a new, ethical corporate culture requires a concerted effort from several different groups.

These prescriptions are very specific at some points, but the ideas motivating the suggestions are applicable in a variety of contexts; the push toward greater transparency, accountability and ethics is not limited to any one sector. After Enron and WorldCom, the initial focus was on large, publicly traded corporations. Today’s new reality has affected accounting firms, investment banks, and mutual funds. Hedge funds and

222. *Cf. Stein*, 435 F. Supp. 2d at 363.

223. Interestingly, as Chen and Hanson point out, corporate law scholars (and corporations generally) invest a lot of time and money in promoting the idea that consumers are rational choosers, not moved by their situation. *See Chen & Hanson, supra* note 6. Yet in this context, corporations are arguing precisely that their choices are constrained by situational forces. Indeed, Judge Kaplan characterized prosecutors’ tactics as a “proverbial gun to the head.” *Stein*, 435 F. Supp. 2d at 336. Of course, many situations that consumers find themselves in on a regular basis might involve such situational constraints. One would think, though, that what’s good for the goose is good for the gander: if consumers are dispositionist choosers, then why can corporations not simply choose according to their preferences when faced with prosecutors’ requests? Of course, we do not believe that both corporations and consumers are capable of avoiding situational pressures; instead, we argue that both of them (and indeed all of us) are situational characters, again emphasizing the importance of situational forces, in corporate law as generally.

224. *See supra* notes 30-35 and accompanying text.

private equity firms are likely next in regulators' sights as the once-novel investment vehicles become increasingly mainstream;²²⁵ SEC Chairman Cox has pledged that the SEC will not back off of regulating hedge funds even though its old regulation was struck down.²²⁶ In short, this section outlines the kinds of changes that are needed if we are to foster a climate of corporate integrity.

A. Business Leaders

First and foremost, business leaders must see this as a window of opportunity and not a threat. Instead of instinctively opposing any attempt at regulation, directors and officers should offer their own suggestions for good governance and stay ahead of the curve. As described earlier, this will pay off, literally, in the marketplace.²²⁷ But it will also demonstrate that companies are willing to be critical of themselves and each other, and this will provide regulators with an incentive to focus only on the low-hanging fruit mentioned earlier. Indeed, the FSGOs make explicit provisions for "downward departures" if companies have effective compliance and ethics programs as well as if they self-report wrongdoing, cooperate with authorities, and accept responsibility.²²⁸ The simplest way for companies to improve their corporate culture is to adopt best practices from the private, public, and nonprofit sectors: independent and empowered boards, regular governance audits, checks and balances, accountability for principals, and so on.²²⁹

This will involve a learning curve as CEOs and boards of directors

225. The "mainstreaming" of hedge funds is perhaps best evidenced by the fact that the largest hedge fund manager is no longer some exotic boutique but Goldman, Sachs, & Co. See Alistair Barr, *Goldman is Now World's Largest Hedge Fund Manager*, MARKETWATCH, June 21, 2006, available at <http://www.marketwatch.com/News/Story/Story.aspx?guid=%7BE72DC62B-E5C7-4C92-91C6-1400725AC835%7D>.

226. See *Testimony Concerning the Regulation of Hedge Funds: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (testimony of Christopher Cox, Chairman, Securities and Exchange Commission) (indicating that regulation of hedge funds before the now-struck rule was "inadequate" and now, after the rule's rejection, "that is once again the case"). Cox went on to say that the SEC would "promulgate a new antifraud rule under § 206(4) of the Investment Advisers Act that would have the effect of 'looking through' a hedge fund to its investors" (instead of counting an LLC as one client, the change would count each investor in the LLC as a client) in order to clarify the fiduciary duties and obligations that the fund has. *Id.*

227. See *supra* notes 82-87 and accompanying text.

228. See USSG §§ 8C2.5(f) - (g).

229. See, e.g., Pablo Eisenberg, *Philanthropy Must Challenge Corporate America*, CHRON. PHILANTHROPY, Aug. 18, 2005, available at http://www.eisenhowerfoundation.org/aboutus/media/ChroniclePhilanthropy_challenge.html.

come to acquire the knowledge, skill, and attitude to make ethics an integral part of corporate culture. Over time the practices in place will be continually evaluated, modified, and revised.²³⁰ At every step of the way, as they innovate toward this end, business leaders should hold themselves out as models for others to emulate.

A few years ago, companies laid off employees in a race to the bottom, trying to match WorldCom's fictional profits.²³¹ This is the pitfall of being ethical in a competitive market: the pressures of competition are so severe that well-meaning companies find themselves forced to keep pace with the malfeasant competitor or suffer losses.²³² Next time, we can make the opposite of the WorldCom story happen: if the well-intentioned CEO knows that regulators will hold its competitor accountable, the market incentives are not for the ethical company to lower its standards, but instead, for the malfeasant company to *raise* its standards. This illustrates two points: first, if regulation properly aligns incentives, market forces can do the rest.²³³ Second, a strong regulatory baseline is absolutely essential to turn a "race to the bottom" into a "race to the top." Indeed, only such a baseline can provide business leaders with the protection they need to be ethical in a competitive market.

The most important thing companies can do is to have clear ethical standards in place that actively foster a culture of compliance with the letter and spirit of laws. The FSGOs suggest as much and provide a seven-point plan that, if met, would be sufficient to qualify for a downward departure at sentencing.²³⁴ However, the FSGOs are only one part of a larger picture. Indeed, if the guidelines were all that were needed, every organization would be in perfect compliance since they would always want to protect against more severe sentences. Instead, as the ACC's paper indicates, the FSGOs have been taken by many as the starting point for a needed dialogue between business and government leaders.²³⁵ In the meantime, business leaders must indicate to everyone in their firms, from the CEO and board to day-to-day managers and operators, that a transparent, ethical culture and not just mere compliance with the law is a priority for the company and its long-term planning.

230. And corporations are best-situated to make these types of modifications, since the information costs are prohibitively high for the government.

231. See Belson, *supra* note 13.

232. See generally Chen & Hanson, *supra* note 6 (describing the influence of situational forces on corporations).

233. Cf. *id.*

234. USSG § 8B2.1(b)(1) - (7).

235. See *supra* note 47.

The recent scandal at H.P. over “pretexting” illustrates the point that ethical considerations are important over and above legal considerations. In investigating boardroom leaks, H.P. resorted to practices of questionable legality.²³⁶ Although “the company’s lawyers had concluded pretexting was legal, . . . the documents and memos sent between the lawyers and detectives show that they had not given much consideration as to whether it was ethical.”²³⁷ When two investigators did raise ethical concerns, they were not taken as seriously as they should have been.²³⁸ This type of mentality is precisely that which we seek to change when we call for a broad-based shift in corporate culture.

These changes cannot be all talk; after all, Enron had an ethics manual that was half an inch thick.²³⁹ Business leaders must follow up with concrete steps to show that they are putting their money where their mouths are. We want “pay for performance” for our public school teachers, so why not our CEOs? In a relatively recent example, John Mack, the new CEO of Morgan Stanley, said that he will forego guaranteed compensation of \$25 million and instead receive pay based on the company’s performance.²⁴⁰ Such a move is a step in the right direction, and Morgan Stanley should be commended. But it should also be vocal and emphatic in underscoring its emphasis on accountability and increase pressure on its competitors to do likewise. Simultaneously, Morgan Stanley’s board should hold Mack accountable. We have proposed a legal reform that would strengthen SOX’s clawback provisions,²⁴¹ but if the board were serious about pay for performance it should have written even stronger provisions into Mack’s contract.

Additionally, companies should ensure that boards are *truly* engaged and independent. Donn Vickrey, a founder of Camelback Research, argues that many companies simply state that their directors are independent without demonstrating how — and worse, without recognizing glaring conflicts of interest.²⁴² He points to one example where a health care concern’s founder invested his money through an

236. Darlin, *supra* note 24.

237. *Id.*

238. *Id.*

239. Harry Hunt III, *Drop That Ledger! This is the Compliance Officer*, N.Y. TIMES, May 15, 2005, § 3, at 5.

240. CNNMoney.com, Morgan Stanley CEO Shuns Pay Guarantee, http://money.cnn.com/2005/07/08/news/fortune500/morganstanley_mack.reut (last visited July 14, 2005). See also Randall Smith, *Morgan Stanley’s Mack Gives Up Guarantee Following Pay Furor*, WALL ST. J., July 11, 2005, at C3.

241. See *supra* Part IVB.

242. Morgenson, *supra* note 90.

investment firm, founded by one of the directors that invested in health care concerns.²⁴³ In another case, a person was used to conduct an outside audit of a company.²⁴⁴ That same auditor was later hired as a director to chair the audit committee — a position in which he had to review the adequacy of his own earlier inquiry!²⁴⁵

A common reply from businesses is that independent boards are not sufficiently knowledgeable about the goings-on of a firm to make informed decisions.²⁴⁶ However, independence does not mean ignorance; companies can and should seek out directors who have relevant business, financial, or legal experience.²⁴⁷ Such directors can be found without resorting to the conflicts of interest and self-dealing described earlier. Again, this makes good business sense: Korean firms with independent directors making up at least half of their board had a 20% higher share price.²⁴⁸ Shareholders benefit in other ways as well. CEOs were more likely to get “lucky grants” — those that were most likely the result of backdating — when the board lacked a majority of independent directors, and outside directors were more likely to receive “lucky” grants when there were entrenchment arrangements in place that protected them from removal.²⁴⁹ The message is clear: independent directors can add checks and balances without sacrificing expertise, all while improving the company’s bottom line.

There are, of course, many other steps that can be taken. Companies should engage independent law firms to conduct regular audits of governance practices. Boards of directors should aggressively pursue clawbacks from malfeasant executives, perhaps even more aggressive than the 150% formula we suggested earlier.²⁵⁰ Lawyers, accountants, and other professionals should report malfeasance as high up in the organization as possible — directly to the board if necessary — and be

243. *Id.*

244. *Id.*

245. *Id.*

246. *See, e.g.*, Letter from David Gladstone, Chairman, National Association of Business Development Companies, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Feb. 11, 2004), available at <http://www.sec.gov/rules/proposed/s70304/s70304-15.pdf> (last visited Sept. 3, 2005).

247. *Cf.* Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE. L.J. 517, 563 (2003) (pointing out “that the selection of one director with financial expertise may offer more protection against restatements than an audit committee comprised of only [non-expert] independent directors”).

248. *See supra* note 192.

249. *See* Bebchuk, *Inside Jobs*, *supra* note 162.

250. *See supra* Section IVB.

permitted to make confidential, anonymous reports to the government if there are no satisfactory responses.²⁵¹

B. Regulators

For their part, regulators must ensure that prosecution and enforcement do not become ends in themselves. Particularly in the marketplace, laws must be enforced to foster competition and efficiency, not just for the sake of prosecuting. In this spirit, regulators should offer an “amnesty” period to companies that disclose knowledge of malfeasance within a reasonable amount of time, allowing companies enough time to investigate and address shortcomings.²⁵² In exchange for implementation of good faith measures to remedy these shortcomings, the SEC, Attorneys-General, and other regulators should agree not to prosecute these companies. To the extent possible, they should enter into limited-waiver and confidentiality agreements to ensure that privileged material disclosed to the government will not be available to private plaintiffs. When private litigation commences, the regulators should assert their own privilege over the corporate documents; in anticipation of private litigation, regulators should contract with the corporation to affirm that they will vigorously assert the privilege. Even if the firms subjected themselves to stock losses and potential lawsuits from private citizens upon disclosing, the costs would not be nearly as high as if they allowed problems to fester and explode at some point in the future. Even if the “market costs” (loss of shareholder value and lawsuits) were exactly the same, the company would *still* be better off without the threat of government prosecution and multi-million (or billion) dollar settlements because “[t]oday, more than ever, securities class action cases are more expensive to resolve and take longer to close.”²⁵³

Regulators must capitalize on this cooperation by being flexible

251. See *supra* Section IVC. Regulators could receive this information in anonymous or aggregate form. The evidence, if any, of wrongdoing could be inadmissible in court, thus ensuring that, for practical purposes, the information is treated as confidential. Attorney disclosure in this context should not be held to be a waiver of the attorney-client privilege, an issue that can be clarified through judicial determination or proposed Federal Rule of Evidence 502. In any event, even setting this aside, from a purely public relations perspective, there is no rationale for not disclosing to the highest level possible.

252. Cf. Thompson Memo, *supra* note 59, at § VI B (discussing amnesty in antitrust cases). The Thompson Memo also describes the mitigating effect of a corporation’s “timely and voluntary disclosure of wrongdoing” in determining whether to bring charges against a corporation. *Id.*

253. Carol A.N. Zacharias, *Trends in Securities Class Action Litigation and Directors and Officers Liability Insurance*, 20 JOHN LINER REV. 1, 14 (Summer 2006), available at http://www.ace-ina.com/docs/JLR_Summer_2006.pdf.

when the need arises. One of the frequently heard criticisms of SOX is that it imposes undue costs on small and mid-sized firms.²⁵⁴ The same compliance program that works for a Fortune 500 company would be ill-fitting for a small-cap firm that cannot afford to spend two or three percent of revenues on compliance. Thus, regulators should allow different-sized firms in different industries to determine on their own means to achieve the policy goals behind SOX, FSGO, or any other regulatory scheme. We have outlined one way that this could happen: by reforming Section 404 requirements for non-accelerated filers.²⁵⁵ This is, however, just one example of the type of flexibility that might be appropriate.

The SEC recently released suggested policy modifications for small companies, certain foreign investors, and newly public companies.²⁵⁶ The Commission proposes extending the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting; the compliance date would be extended by about 6 months.²⁵⁷ The SEC also proposed extending the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports to fiscal years ending after December, 2008.²⁵⁸ Finally, the SEC relaxed Section 404 requirements for small companies.²⁵⁹ This example shows that the SEC is, at a minimum, willing to accommodate some of the issues smaller companies face.

The ACC's letter describes another possibility of regulatory flexibility. Recall that the FSGOs require companies to report evidence of wrongdoing to the government within a reasonable time.²⁶⁰ The ACC instead recommends that the company either report such wrongdoing *or* develop and implement modifications to the company's practices to remedy the situation.²⁶¹ We pointed out earlier that this might provide an incentive to cover up fraud, since the company would know that it could "get away" with not publicizing its wrongdoing. Thus, we prefer a

254. See *supra* note 86 and accompanying text.

255. See *supra* Section IVA.

256. Press Release, U.S. Securities and Exchange Commission, SEC Offers Further Relief from Section 404 Compliance for Smaller Public Companies and Many Foreign Private Issuers (Aug. 9, 2006), available at <http://www.sec.gov/news/press/2006/2006-136.htm>.

257. *Id.*

258. *Id.*

259. See *supra* notes 148-49 and accompanying text.

260. USSG § 8C2.5(f)(2).

261. ACC Letter, *supra* note 52, at 12.

middle ground between the existing FSGO provision and the ACC recommendation. Companies should have to abide by the FSGO provision or report actual wrongdoing, not merely evidence of wrongdoing, within one year and make progress toward implementing new policies and procedures. This would give companies time to address the situation on their own, while mitigating the incentive to orchestrate a cover-up. Within parameters, companies should determine how best to implement the policy behind legislative and regulatory schemes, and regulators should be receptive to this.

Another good example is still in progress as of this writing. A recent SEC rule requires companies to count stock options as an expense on their ledgers.²⁶² We believe that this was the right decision, since options were liberally granted through the 1990s since companies did not have to consider these an expense. The new rule requires share-based compensation to be recognized as an expense based on fair value as of the grant date.²⁶³ However, this raises a follow-up question: what is an appropriate measure of “fair value”? We support the SEC’s attempt to “encourage[] . . . robust efforts in the private sector to design market instruments that have the potential to accurately measure the cost of employee stock option grants to the issuer.”²⁶⁴

In response to the rule, a variety of private sector actors offered means to value stock options. Cisco Systems, for example, offered a plan under which companies could sell similar securities to institutional investors to value their employees’ options.²⁶⁵ Although the SEC rejected this particular plan, it kept open the possibility of other market-based approaches and resisted using a “model-based” approach to value options.²⁶⁶ This provides yet another example of how a collaborative approach to addressing a problem is far more productive than a unilateral approach. Moreover, it shows how corporations can and should work within a regulatory baseline to find the best solutions.

Corporations are market actors and market actors respond to market

262. See FIN. ACCOUNTING SERIES, Statement of Fin. Accounting Standards No. 123, app. 240 (Fin. Accounting Standards Bd., revised 2004).

263. *Id.* at ii (Summary).

264. Press Release, U.S. Sec. & Exch. Comm’n, Statement of Chairman Cox Regarding Use of Market Instruments in Valuing Employee Stock Options, SEC Release 2005-129 (Sept. 9, 2005), available at <http://www.sec.gov/news/press/2005-129.htm> [hereinafter *Cox Statement*]; See *FASB and SEC Guidance on Applying Statement 123R*, DEFINING ISSUES (KPMG LLP, New York, N.Y.), Sept. 2005, available at <http://www.us.kpmg.com/services/content.asp?11id=30&12id=730&cid=1137#92>.

265. See, e.g., Floyd Norris, *U.S. Rejects Cisco Plan on Options*, N.Y. TIMES, Sept. 10, 2005, at C1.

266. *Cox Statement*, *supra* note 264.

incentives.²⁶⁷ If regulators set out the proper incentives — amnesty, tax credits, and credible threats of prosecution for those who do violate the law — firms will figure out on their own the best way to achieve those incentives, as the FSGO and stock option examples indicate. We need strong regulation and effective laws on the books; in several respects, we have argued that SOX does not go far enough. We also believe that corporate crime must be prosecuted aggressively and that fines and penalties should be imposed to the fullest extent necessary. At the end of the day, we only believe that these are means to an end. Under the current regime, a combative atmosphere pervades business-government relations, so that the only incentives are for each side to vilify the other. Instead, laws and regulations should provide a *framework* within which market actors determine the most efficient way to build value and foster an ethical corporate environment.

C. Citizens and Shareholders

If there is one thing that firms understand, it is economics; firms supply what is in demand. If investors (institutional and retail) continue to press for an ethical corporate culture, and if regulators establish a strong baseline, firms will provide one. But investors must be willing to put their money where their mouths are. It's easy to push for "good governance" when markets are doing poorly; poorly-governed firms, in the long run, cost investors money. But what about when stocks are rising? After all, institutional investors were not clamoring for more transparency and openness during the "Roaring '90s." Blaming "poor governance" (indeed, blaming anything) is easy when times are tough; investors who truly value integrity will hold companies to account even when times are good.

The study cited earlier indicated that governance is not already reflected in stock prices.²⁶⁸ But if investors internalize ethical governance into their decision-making — as, for example, the *Yahoo! Finance* profiles indicate — then, over time, we would expect governance to be reflected in stock price.²⁶⁹ This should give investors an incentive to call for good governance when times are good: if high stock prices already reflect governance, then preserving or improving those practices becomes more critical to preserving shareholder value; if already-high stock prices do not reflect governance (as the study cited

267. See generally Chen & Hanson, *supra* note 6.

268. See *supra* note 195 and accompanying text.

269. See *Yahoo! Finance supra* note 45.

earlier demonstrates), then improving governance practices will enhance shareholder value even more. Of course, as the GMI story indicates, if governance is poor, then improving practices might stave off financial losses or even bankruptcy.²⁷⁰

But an ethical corporate culture has to do with more than shareholder value. In a related context, we wrote that “[a]n ethical dilemma is not deciding whether to break the law. An ethical dilemma arises when principles collide within the bounds of the law.”²⁷¹ Similarly, an ethical dilemma for investors is not whether to lose money by investing in a poorly-governed company. An ethical dilemma arises when principles — shareholder value and governance — collide in the context of a well-performing company.

VIII. CONCLUSION

In the broadest sense, an ethical corporate culture is built on the same foundations as our democracy: checks and balances, openness, and transparency. It is based on good business judgment and profitability; it depends on free markets and competition. It is also built on professionalism, with lawyers, accountants and investment managers giving objective, expert advice, not swayed to the greatest extent possible by personal biases. Indeed, much of the breakdown over the past few years has involved a dereliction of duty on the part of those who were supposed to be exercising independent judgment in the corporate world. Among other things, we are asking for those professionals to play their roles, and in so doing, to protect the business leaders who are their clients.²⁷²

In a sense, our policy prescription is simple: regulators must align incentives to foster ethical conduct and to make it clearer when companies shirk this duty. Ever since Sarbanes-Oxley was passed, there have been those in the business community who have said that the regulatory response to corporate misconduct went too far and that markets should be allowed to work. Yet we have seen that markets, left to their own devices, create in some cases precisely the wrong incentives: options backdating, “pretexting” at HP, accounting misconduct, and more. Regulation allows the bad actors to be

270. See *supra* note 186.

271. Harshbarger & Jois, *supra* note 24, at 47.

272. When this judgment gets compromised, and there is no true independence between the professional and his client, the outsider and the insider are one and the same, thus violating the cardinal rule, that “[n]o man is allowed to be a judge in his own cause.” THE FEDERALIST NO. 10, at 79 (James Madison) (Clinton Rossiter ed., 1961).

sanctioned, but more than that, it helps turn around a race to the bottom.

Over the past few years, institutions from the Catholic Church²⁷³ to Major League Baseball²⁷⁴ have been the subject of scandal and controversy. The recent corporate scandals are just the most recent of the governance crises that have gripped American leadership in many other ways, and surely there will always be a few bad apples in every barrel. Over the past several years, however, we have seen a systemic failure of ethical conduct in American firms. If the leaders of corporate America can rise to the challenge — can overcome this governance crisis, grow, and lead as a result — they may be the first to turn a failure of leadership into a success that benefits us all.

273. See CatholiCity, *supra* note 218.

274. See Cannella, *supra* note 217. One sentence in the article is particularly apropos as an analogy: “The point of hearings like this is to generate publicity and force the people they’re questioning to police themselves.” *Id.*