INTRODUCTION TO MICHIGAN STATE UNIVERSITY COLLEGE OF LAW SARBANES-OXLEY SYMPOSIUM: ENFORCEMENT, ENFORCEMENT, ENFORCEMENT . . .

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2004 MICH. ST. L. REV. 271

Michigan State University College of Law proudly hosted the symposium entitled "In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley—A Critical Review" (the Symposium) on September 19, 2003. The goal of the Symposium was to reflect on the impact of the Sarbanes-Oxley Act of 2002[1] (SOx), but only after the initial reactions to SOx had been expressed, disseminated and digested. The focus was to be a critical reflection on SOx generally, with special attention to the impact of SOx on key actors such as auditors, lawyers, and corporate directors and officers.

The "academic" perspective was represented at the Symposium by Professors Larry C. Backer, Stephen M. Bainbridge, Matthew J. Barrett, Marilyn Johnson, Peter Kostant, Brett McDonnell, Lisa H. Nicholson, Richard W. Painter, Larry E. Ribstein and David A. Westbrook. Also participating were the "actors" themselves, *viz.* David P. Cosper, the Chief Financial Officer of Ford Motor Credit Company, Mark Matthews, a partner at PricewaterhouseCoopers, and Hugh H. Makens, a partner in the Grand Rapids, Michigan law firm of Warner, Norcross & Judd. [2]

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

2. Of course, various of the academic commentators have practical experience while the "actors" have had connections to the academy.

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SOx was the culmination of several notable corporate scandals,[3] the bursting of the great financial bubble[4] of the 1990s and the swift reaction of politicians who, well-intentioned and informed or not, recognized the political appropriateness of legislative action. The scandals, the bursting of the bubble and the political response occupied a place in the media normally reserved for sensational murder trials. "Corporate America" had itself become a celebrity, famous and infamous, and SOx must be understood, in part, in that context.

Writing about SOx has become a cottage industry.[5] Commentators have argued that SOx represented an overreaction, was not broad enough, will be too costly or did not cost much at all under the circumstances. The Symposium reflected these diverse voices, but through the apparent dissonance, some common themes prevailed.

First, there did not seem to be any serious disagreement that the corporate scandals and the bursting bubble are evidence that there are problems to be addressed. The widespread fraud, some of which was very sophisticated (e.g., Enron) and some of which was simplistic (e.g., WorldCom), should have been preventable if the corporate and financial system was working properly. The mandatory disclosure system administered by the Securities and Exchange Commission (SEC) was designed to minimize such scandals. The elaborate system of monitors and gatekeepers,[6] consisting of, for example, auditors, directors, analysts and lawyers, authorized and enabled by both federal and state law, were supposed to ferret out bad actors.

There are, of course, different views about the approach of SOx in touching so many different areas of corporate and financial concern. Professor Ribstein argues in *Sarbox: The Road to Nirvana*[7] that the events which led to the adoption of SOx were fueled in part by market malfunction. However, he sees in SOx a hasty response by politicians which may not be effective and may be costly. Indeed, SOx may represent simplistic solutions to more complicated issues which require more nuanced solutions. Not all

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3. There are many available descriptions. *See, e.g.*, Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003).

4. Obviously this was not the first (and will not be the last) bubble with legislative reaction. *See* EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST(1999); Larry Ribstein, *Bubble Laws*, 40 HOUST. L. REV 77 (2003).

5. For both a critical discussion of the effort to use the scandals as a case study to develop theories and policy suggestions for corporate regulation and for a list of the "staggering amount of scholarship on Enron," see Gregory Mitchell, *Case Studies, Counterfactuals, and Causal Explanations*, 152 U. PA. L. REV. 1517, 1518 n.4 & *passim* (2004).

6. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002)

7. Larry E. Ribstein, *Sarbox: The Road to Nirvana*, 2004 MICH. ST. L. REV. 279.

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additional regulation is bad, but it is not a panacea and has unseen costs. Perhaps the preferred approach is what Professor Ribstein calls "humble" regulation—regulation that is nuanced, discriminating and limited.

Professor Westbrook notes, however, in *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*[8] that one of the inherent benefits of SOx is its attempts to encourage the relevant actors to find better methods of reporting financial information understandably for the public and not just for Warren Buffet. The result could be to enhance what Professor Westbrook refers to as "financial discourse." If one understands Enron and other business debacles as a failure of business culture, then reaffirming standards of business culture is an appropriate response.

Professor McDonnell offers yet another perspective when he argues in *SOx Appeals*[9] that while SOx itself may not contain many revolutionary changes (e.g., the provisions relating to officers and directors do not change pre-existing rules and practice very significantly), it has created the platform on which other regulators (the SEC through its rulemaking efforts, the New York Stock Exchange and NASDAQ through its listing requirements, state judges though their decisions, and others), all of whom are better informed in these matters than Congress, can act. It is also possible that the affected actors will change their behavior because they believe it to be important and there is high visibility to the rule changes.

A second area of general agreement is that lawyers' sensitivity and approach to their clients' misdeeds helped fuel the scandals and should be altered. Lawyers have been salient in the commentary on the scandals. They are among the gatekeepers thought to have failed the corporate entity and hence Corporate America's shareholders.[10] Thus, the attorney's role became a concern of SOx. Under Section 307[11] and the rules promulgated by the SEC (the Part 205 Rules)[12], attorneys appearing and practicing before the SEC in any way in the representation of issuers must report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation to the chief legal counsel or the CEO and if there is not an appropriate response, must report the evidence to a committee of the board or to the board itself. Section 307 was a late floor amendment to the SOx; the sponsors believed that lawyers were integral to problems SOx was supposed to address and lawyers' obligations must be addressed in SOx. The SEC later promulgated

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8. David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441.

9. Brett H. McDonnell, *SOx Appeals*, 2004 MICH. ST. L. REV. 505.

10. *See* Coffee, *supra* note 6.

11. To be codified at 15 U.S.C. § 7245.

12. 17 C.F.R. Pt. 205.1-205.7.

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lawyers' obligations must be addressed in SOx. The SEC later promulgated the Part 205 Rules, which expands this basic imperative. These provisions address a recurring diagnosis of lawyers' shortcoming as counsel to the corporation: Lawyers too often see the corporate managers as their client and their economic interest is often consistent with the success of such management.

Professor Kostant concludes that Section 307 is an important milestone.[13] While Section 307 and the Part 205 Rules have flaws, they represent a major change for corporate lawyers which may also result in a normative change among these lawyers. Such a normative change would have positive consequences for corporate governance. These new provisions do not represent a "hard shove," but a "gentle nudge" to lawyers to change the focus in their representation from representing management to one with a broader focus. If SOx is successful is this regard, lawyers will accept at least a partial-gatekeeper focus.

Professor Bainbridge and Christina J. Johnson, in *Managerialism, Legal Ethics and Sarbanes-Oxley Section 307*,[14] argue that although such a provision is appropriate and is consistent with an anti-managerialist approach of SOx, it is not likely to have much of a practical impact. Section 307 and the Part 205 Rules leave the attorney with many authorized reasons to avoid reporting. The normal economic interests of management and outside counsel have not been substantially changed. As a result, the incentive of the attorney to report is minimized.

On the other hand, some of Part 205 Rules simply may be inappropriate instead of ineffective. Professor Nicholson[15] points out that Section 307 and the Part 205 Rules are applicable to subordinate in-house counsel as well. Given their sensitive role within the corporate hierarchy of authority, in certain respects, SOx imposes unrealistic requirements for this group. The subordinate in-house counsel do not enjoy the safe harbor available to outside subordinate counsel and therefore must go over the head of their supervisors in an effort to evaluate responses when they may not be equipped to do so. This puts subordinate in-house counsel in an untenable position.

Auditors are another class of monitor/gatekeeper who were seen as not effective in exposing developing scandals. The reasons for this (claimed) deficiency are varied. Never viewed as advocates for their corporate clients

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13. *See* Peter Kostant, *Sarbanes-Oxley and Changing the Norms of Corporate Lawyering*, 2004 MICH. ST. L. REV. 541.

14. Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299.

15. Lisa H. Nicholson, *SarbOx 307's Impact on Subordinate In-House Counsel: Between a Rock and a Hard Place*, 2004 MICH. ST. L. REV. 559.

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in the same way as lawyers, yet part of a business model of profit-seeking, auditing firms discovered that they could provide other services to their corporate clients which were more profitable and interesting than audit services. In some respects, audit services became "loss leaders" and an entrée for auditing firms to perform other services. Partners in auditing firms were rewarded (much like their lawyer counterparts) for increasing revenues from clients. Consequently, auditors had less incentive to be critical of their clients' financial practices—they had lost their "independence." Accordingly, SOx included a number of changes in the auditor regulatory scheme. Among other things, SOx created the Public Company Accounting Oversight Board (PCAOB).[16] The PCAOB is to regulate public accounting firms that audit publicly traded companies and adopt various standards and enforce compliance. Another solution adopted by SOx was to regulate the non-audit services performed in the hope that this would reduce the incentives and conflicts present. The segregation of servies is not total, however. SOx permitted auditors to continue to perform tax services for their audit clients.[17]

In his article, *"Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley*,[18] Professor Barrett argues that SOx did not go far enough in promoting auditor independence. In particular, the failure of SOx to prohibit audit firms from providing tax services to its audit clients and from selling tax shelters to anyone could undermine the positive steps taken in SOx to promote auditor independence and confidence in the integrity of audits of public companies.

And what about the "actors" themselves, the directors and officers, the auditors and the lawyers? There is ample evidence that externally, the affected actors and their firms have taken SOx reforms very seriously. Significant amounts of resources have been expended to educate those who are responsible for corporate disclosure or privy to information that is disclosed in order to comply with SOx. Anecdotally at least, many actors have reacted to SOx as congregants react to a sermon. David Cosper gave a vivid account of the immediate effect of the SOx culture—meticulous and redundant processes to surface, vet and test financial detail—and concluded with a positive assessment of the effect of the exercise on corporate diligence and good procedure. Mark Matthews noted SOx and the events which preceded it should be a catalyst for stronger, more transparent corporate reporting. The perennial concern that regulation imposes costs without

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16. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750-53 (to be codified at 15 U.S.C. § 7721).

17. Sarbanes-Oxley Act § 201, (to be codified at 15 U.S.C. § 78j-1(g)-(h)).

18. Matthew J. Barrett, *"Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 463.

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corresponding benefits received some attention from Hugh Makens, but the actors did not in general emphasize a theme of unnecessary cost.

In this sense, the conference participants from the corporate world reflected a relatively positive reception in the corporate world of the SOx reform. For the most part, corporate actors acknowledge the solemnity of the occasion and the need for a sermon, but whether there is a bona fide commitment to the lesson preached which will be internalized, is unclear. There is the legitimate concern that while the actors will initially take seriously SOx and its intent, over time the reinforcement of corporate care welcomed by the business world will dissipate. When the environment has changed, "human nature" will prevail and corporate actors will revert back to the old modus operandi. The Symposium participants noted that norm changing is necessary, but were unsure whether the norms could effectively be changed.

One avenue left largely unexplored by the Symposium is in what concrete ways can the changes mandated by SOx be internalized by human beings and institutionalized by entities. One of the possible answers lies in the level and type of enforcement that will take place by the regulators, including federal and state governments, self-regulatory organizations and private litigants. Again, anecdotal evidence suggests that there is a real level of concern among the actors. It is more than a reputational concern and more than an economic concern. It is an "existential" concern. It is a concern that if a professional, such as a lawyer or an accountant or a corporate manager, makes a serious professional misstep, she will not suffer merely a loss of reputation or money, but undermine the foundation of her personal and professional life—that is, her identity.

Enforcement is therefore a potential powerful tool. The threat of the dire consequences of one's loss of identity may change present behavior. If lawyers understand that the SEC or a State Bar may take action against them or if auditors believe that a poor judgment on material matters will bring the wrath of the PCAOB or the SEC or the directors fear the same from the SEC or private litigants, the environment generally and individual behavior may fundamentally change.[19] Of course, there are always questions about any particular regulator's effectiveness or capability.[20] But, if the regulators are

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19. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937 (2003) (noting that criminal law enforcement must be combined with government regulatory enforcement and private civil suits to affect business conduct).

20. For a skeptical view of the SEC's ability in this regard, see Michael A. Perino, *How Vigorously Will the SEC Enforce Attorney Up-the Ladder Reporting Rules? An Analysis of Institutional Constraints, Norms, and Biases*, VILL. L. REV. (forthcoming 2004).

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successful in their enforcement actions, those lessons will be learned by many actors, as the consequences of failure to learn and change are too substantial. It is more than a deterrent effect, although it may begin as such. It evolves into new standards of behavior. It is a combination of rational choice and unconscious instinct created by the new environment.[21] On the other hand, if enforcement is erratic and unfocused, the environment will not fundamentally change and actors could lose the strong incentive to alter behavior.

A regulator inclined to overly aggressive enforcement can produce disastrous consequences. Actors become risk averse, firms lose efficiency and the costs multiply. Further, Professor Backer's warning in *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*[22] is relevant.

Professor Backer paints a potentially ominous picture where SOx is seen as part of larger developing societal process. It represents "a shift from a market to a governmental system for developing behavior norms within firms and for disciplining actors who violate those norms. . . . SO[x] constructs a panoptic system of surveillance in which every watcher is watched."[23] This echoes Professor Ribstein's warning of the dangers of hasty over-regulation.

But, if it is true that SOx is "heavy rhetoric, light reform (and it just might work)"[24] then it is up to the regulators to enforce this "light reform" so that it does work. This is the next stage of the SOx evolution and it may be the most critical of all stages. Decisions about enforcement often take place largely outside of public discourse; in this instance, more public discussion about enforcement standards should be positive reinforcement. Strong, consistent and public enforcement may be the key to true reformation of the corporate and business system and its primary actors.

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21. *See* Moohr, *supra* note 19, at 956.

22. Larry Catá Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327.

23. Backer, *supra* note 22, at 331.

24. Cunningham, *supra* note 3.

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