The Sarbanes-Oxley Act extends Washington's oversight of corporate governance practices but offers questionable benefits to investors.

The Creeping Federalization of Corporate Law

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The new millennium has not been kind to Wall Street. In 2000-'01, the stock market recorded back-to-back years of losses for the first time since 1973-'74. With a further loss in 2002, the market fell for three consecutive years for the first time since the Great Depression.

On top of the continuing retrenchment of the economy following the late '90s bubble, concerns over terrorism and the Middle East, and uncertainty over oil, investor confidence remains shaky in the wake of last year's corporate governance revelations. We all know the litany: repeated accounting scandals, of which Enron and WorldCom are merely the most notorious; a high profile investigation by New York's attorney general calling into question the integrity of stock market analysts; and so on.

In such an environment, it was inevitable that Congress and the Securities and Exchange Commission would step in to ease investors' fears. But how quickly we forget Ronald Reagan's adage: "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'"

In responding to the Enron and WorldCom scandals, Congress and the regulators have implemented a set of reforms that are deeply flawed. They have adopted policies that have no empirical support or economic justification. Worse yet, in doing so, they have eviscerated basic federalism rules that have long served us well.

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For over 200 years, corporate governance has been a matter for state law. Even the vast expansion of the federal role begun by the New Deal securities regulation laws left the internal affairs and governance of corporations to the states. To be sure, over the years, there have been countless proposals to federalize corporate law. To date, however, none have succeeded.

The collapse of Enron and WorldCom, along with the varying degrees of fraud uncovered at too many other companies, reinvigorated the debate over state regulation of corporate governance. Many politicians and pundits called for federal regulation not just of securities but also of internal corporate governance, claiming it would restore investor confidence in the securities markets. As Congress and market regulators began implementing some of those ideas, there has been a creeping — but steady — federalization of corporate governance law. The NYSE's new listing standards regulating director independence are one example of that phenomenon. Other examples appeared to little public debate in the sweeping Sarbanes-Oxley legislation. Taken individually, each of Sarbanes-Oxley's provisions constitutes a significant preemption of state corporate law. Taken together, they constitute the most dramatic expansion of federal regulatory power over corporate governance since the New Deal.

WHO REGULATES CORPORATIONS?

No one seriously doubts that Congress has the power under the Commerce Clause, especially as it is interpreted these days, to create a federal law of corporations if it chooses. The question of who gets to regulate public corporations thus is not one of constitutional law but rather of prudence and federalism.

Until the New Deal, corporate law was exclusively a matter

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ers refused to surrender their hopes for a more expansive federal role. Throughout the 1930s, there were repeated proposals to federalize corporate law. All failed.

Preserving federalism Legislative inaction is inherently ambiguous. All that can be said with certainty is that Congress chose not to act. Yet, the Supreme Court nevertheless has routinely rejected regulatory efforts to preempt state law and create a de facto federal law of corporations. As the Court noted in its 1987 decision in *CTS Corp. v. Dynamics Corp.*, "State regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law." The Court further noted that it "is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares." Concluded the Court, "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations."

for the states. Around the beginning of the last century, however, economic progressives began arguing for federal preemption — frequently in response to various corporate scandals of the day. After the Great Crash of 1929, serious consideration was given to creating a federal law of corporations.

The New Dealers' initial response to the Crash, of course, consisted of the now familiar federal securities laws. The key statute here is the Securities Exchange Act of 1934, which critics claimed was a federal attempt to usurp corporate governance powers. On its face, however, the Exchange Act says nothing about regulation of corporate governance. Instead, the Act's basic focus is trading of securities and securities pricing. Virtually all of its provisions are addressed to such matters as the production and distribution of information about issuers and their securities, the flow of funds in the market, and the basic structure of the market.

While the federal securities laws thus left the internal affairs and governance of corporations to the states, many New Deal-

It is state law, for example, that determines the rights of shareholders. State law thus determines such questions as which matters the board of directors, acting alone, may authorize and which must be authorized by the shareholders. State law typically requires, for example, that certain control transactions such as mergers or sales of substantially all corporate assets be approved in advance by the shareholders, and establishes the vote required (often a supermajority) for shareholder approval of such matters. State law likewise regulates the conduct of shareholder meetings, specifies who may call such meetings, and prescribes whether (and the procedures by which) actions may be taken without a shareholder meeting.

The Supreme Court also has consistently recognized that state law governs the rights and duties of corporate directors. For instance, in its 1979 decision in *Burks v. Lasker*, the Court noted, "As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant state's corporation law. 'Corporations are creatures of state law' and it is state law which is the font of corporate directors' powers." State law defines the directors' powers over the corporation, for example. State law establishes the vote required to elect directors. State law determines whether shareholders have the right to cumulative voting in the election of directors, whether the corporation's directors may have staggered terms of office, and whether shareholders have the right to remove directors prior to the expiration of their term of office.

Or, at least, it did so until recently.

The anti-federalists strike back For proponents of a bigger federal government, corporate scandals are always a bullish signal. There is nothing a politician wants more than to persuade upset investors that he or she is "doing something" and being "aggressive" in rooting out corporate fraud. Hence, it was entirely predictable that the shenanigans at Enron, WorldCom, et al., coming after a period of steady decline in the stock market, would lead to regulation.

President Bush praised the Public Company Accounting Reform and Investor Protection Act of 2002 — popularly known as the Sarbanes-Oxley Act — for making "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Odd praise, indeed, coming from a conservative president. Such praise was especially odd coming from a former state governor with a track record of stated respect for basic federalism principles.

SARBANES-OXLEY AND CORPORATIONS

Because auditing failures by accounting firms, especially Arthur Andersen, received a substantial share of the blame for the Enron and WorldCom debacles, much of the Sarbanes-Oxley Act focuses on auditors and their relationship to public corporations. In regulating that relationship, however, Congress for the first time regulated such matters as the composition, role, and function of the board of directors of public corporations. For example, Sarbanes-Oxley requires national securities exchanges (such as the New York Stock Exchange and NASDAQ) to adopt listing standards mandating that listed companies have an audit committee and that that committee be comprised solely of independent directors. At least one member of the committee must qualify as a "financial expert" as defined by the statute. Given the NYSE and NASDAQ's recent expansion of their director independence standards, it is not clear that those provisions will result in any substantial new regulation. At the very least, however, they confirm and endorse the troubling expansion of stock exchange listing standards that displace state corporate law.

The audit committee must establish a system for employees to blow the whistle anonymously on questionable accounting or auditing matters. Also, the audit committee is charged with being "directly responsible for the appointment, compensation, and oversight" of the corporation's independent auditor. If that provision is interpreted to preclude not only corporate officers but also the board of directors as a whole from being involved in the hiring and firing of independent auditors, the provision will mark a substantial restriction on the power of the board. Finally, the audit committee is granted federal authority to retain independent legal and financial advisers whose fees are paid by the board. Each of those provisions preempts state law governing the board of directors.

Directors and officers The Act also partially preempts state law governing the appointment, removal, and compensation of directors and officers. As to the former, the SEC is now empowered to remove officers and directors from their positions, as well as bar them from serving at other public corporations, on mere grounds of "unfitness."

As to the latter, executive compensation long has been a controversial issue. Many critics of state corporate law complain that it does not do enough to limit allegedly excessive compensation. While Sarbanes-Oxley does not directly regulate executive compensation, it does contain a number of provisions that do so indirectly. First, in the event a corporation is obliged to restate its financial statements because of misconduct, the chief executive officer and chief financial officer must return to the corporation any bonus, incentive, or equity-based compensation they received during the 12 months following the original issuance of the restated financials, along with any profits they realized from the sale of corporate stock during that period.

There are many objections to that provision:

- It preempts the board's power over executive compensation.
- It fails to define the kinds of misconduct that trigger the reimbursement obligation.
- It requires reimbursement even if others committed the misconduct, and extends to the officers no good-faith defense.

All of those problems will tend to encourage CEOs and CFOs to resist restating flawed financial statements and/or to game the timing of their compensation and stock transactions relative to any such restatements.

Second, the Act prohibits a corporation from directly or indirectly making or even arranging for loans to its directors and executive officers, subject to some minor exceptions. That provision directly preempts the interested-party transaction provisions of state corporate law, which currently permit the making of loans to directors and officers provided they are authorized by a majority of the disinterested directors or the shareholders. Worse yet, the Sarbanes-Oxley Act fails to define many key terms. Under state corporate law indemnification statutes, for example, corporations frequently do (and in some cases must) advance legal expenses to covered officers and directors. Given the sweeping language of the Act's prohibition on insider loans, some observers believe it preempts state law in that respect and therefore prohibits any such advancement of funds.

Finally, the Act prohibits executives from trading during so-called blackout periods in which employees participating in 401(k) and other stock-based pension plans are forbidden from trading. If the executive does so, the corporation may sue to receive any profits. If the corporation fails to do so, a shareholder may bring a derivative action à la the short-swing profit provision under §16(b).

Even when we turn from the provisions of the Act that directly mandate substantive corporate behavior to those that purport merely to regulate disclosure, we find that many provisions effectively displace applicable state corporate law. The relevant concept here is so-called "therapeutic disclosure." In other words, the Act uses disclosure requirements to effect changes in substantive behavior. For example, the corporation must disclose whether it has adopted a code of ethics for its financial officers. The Act identifies a host of issues the code must address, such as the handling of conflicts of interest and the like. If a company has not adopted such a code, it must disclose its reasons for not doing so. In addition, the corporation's management must annually issue an "internal control report" in which management acknowledges its responsibility for establishing and maintaining adequate internal financial reporting controls and assesses the effectiveness of those controls.

Even the widely touted requirement that the CEO and CFO certify the corporation's financial statements effects stealth preemptions of state law. Under that provision, the CEO and CFO are made responsible for the establishment, design, and maintenance of the corporation's internal financial controls. Hence, corporate boards have lost their freedom under state law to assign those duties to other corporate officers (let alone to omit such controls). State law governing the board's oversight responsibilities is further preempted by provisions requiring that the CEO and CFO report directly to the audit committee on an array of issues dealing with internal controls and financial reporting.

OTHER OVERSEERS

Congress is not the only regulator getting into the act. Under the NYSE aegis, a blue ribbon panel of usual-suspect Brahmins has "anointed boards of directors, especially 'independent directors' as the capitalist cavalry." Acting on the panel's recommendations, the NYSE adopted new stock exchange listing standards requiring that independent directors comprise a majority of any listed corporation's board of directors. The new standards also effect a number of changes to the NYSE's longstanding audit committee standards, which anticipate (and even exceed) those mandated by Sarbanes-Oxley.

Director independence The utility of director independence is now so deeply established in the conventional wisdom that it seems almost pointless to ask if corporations really need a majority of independent directors. But when one answers that question, it turns out to be pretty complicated.

The theoretical arguments are complex and highly contested. But we can cut to the bottom line: If independent directors have utility, there should be an identifiable correlation between the presence of outsiders on the board and firm performance. Yet, the empirical data on the issue is decidedly mixed. In fact, the bulk of the evidence suggests that board composition has no effect on profitability.

Anecdotal evidence confirms the view that board independence is hardly a panacea for all that ails corporate governance: The head of Enron's audit committee, Robert Jaedicke, was a professor of accounting at Stanford University and could hardly have been more qualified for the job. And we all know what happened at Enron.

Managerial accountability The new standards imposed by the NYSE and Sarbanes-Oxley are premised on the conventional wisdom that board independence is an unalloyed good. As we have seen, the empirical evidence on the merits of board independence is mixed, at best. Indeed, the clearest take-home lesson to be gleaned from that evidence is that one size does not fit all.

That result should not be surprising. On one side of the equation, firms do not have uniform needs for managerial accountability mechanisms. The need for accountability is determined by the likelihood of shirking, which in turn is determined by management's tastes, which in turn is determined by each firm's unique culture, traditions, and competitive environment. We all know managers whose preferences include a penchant for hard, faithful work. Firms where that sort of manager dominates the corporate culture have less need for outside accountability mechanisms.

On the other side of the equation, firms have a wide range of accountability mechanisms from which to choose. Independent directors are not the sole mechanism by which management's performance is monitored. Rather, a variety of forces work together to constrain management's incentive to shirk: the capital and product markets within which the firm functions, the internal and external markets for managerial services, the market for corporate control, incentive compensation systems, auditing by outside accountants, and many others. The importance of the independent directors' monitoring role in a given firm depends in large measure on the extent to which those other forces are allowed to function. For example, managers of a firm with strong takeover defenses are less subject to the constraining influence of the market for corporate control than are those of a firm with no takeover defenses. The former needs a strong independent board more than the latter does.

The critical mass of independent directors needed to provide optimal levels of accountability also will vary depending upon the types of outsiders chosen. Strong, active, independent directors with little tolerance for negligence or culpable conduct do exist. A board having a few such directors is more likely to act as a faithful monitor than is a board having many nominally independent directors who shirk their monitoring obligations.

Federal preemption The NYSE's new standards strap all listed companies into a single model of corporate governance. By establishing a highly restrictive definition of director independence and mandating that such directors dominate both the board and its required committees, the NYSE fails to take into account the diversity and variance among firms. The NYSE and Congress therefore should have allowed each firm to develop the particular mix of monitoring and management that best suits its individual needs.

The NYSE should be especially cautious about promulgating corporate governance listing standards because such standards effectively preempt state corporate law by creating a uniform quasi-federal law of public corporations. There is no reason to believe that the exchanges will do a better job of creating corporate law than do the states; indeed, there is good reason to believe that they will do a worse job. In addition, by virtue of the SEC's considerable influence over the exchanges, the expansion of exchange listing standards in the corporate governance area permits a backdoor power grab by the SEC over matters that Congress and the courts have left to the states. By virtue of the unique relationship between the SEC and the exchanges, the commission naturally exercises considerable informal influence over exchange rulemaking. The late Donald Schwartz aptly referred to that influence as the SEC's "raised eyebrow" power. In light of the adoption of the NYSE committee's initiatives, the exchanges role in corporate governance — and, hence, the SEC's ability to influence the rules by which corporations are governed — will expand dramatically. Federal preemption of state corporation law will have finally arrived, at least de facto.

FEDERALISM AND INCORPORATION

Who has it right — Congress or the states? Does the Supreme Court's defense of what might be called "corporate federalism" make policy sense?

The basic case for federalizing corporate law rests on the so-called "race to the bottom" hypothesis. States compete in granting corporate charters. After all, the more charters the state grants, the more franchise and other taxes it collects. According to the race to the bottom theory, because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes allowing corporate managers to exploit shareholders. As the clear winner in this state competition, Delaware is usually the poster-child for bad corporate governance. Interestingly, the two main poster-children for reform, Enron and WorldCom, were not Delaware corporations; they were incorporated in Oregon and Georgia, respectively.

Basic economic common sense tells us that investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not lend to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers therefore have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters thus should deter states from adopting excessively pro-management statutes.

Academic research The empirical research bears out that view of state competition, suggesting that efficient solutions to corporate law problems win out over time. Consider the following:

Roberta Romano's event study of corporations changing their domicile by reincorporating in Delaware, for example, found that such firms experienced statistically significant positive cumulative abnormal returns. In other words, reincorporating in Delaware increased shareholder wealth. That finding strongly supports the race to the top hypothesis. If shareholders thought that Delaware was winning a race to the bottom, shareholders should dump the stock of firms that reincorporate in Delaware, driving down the stock price of such firms. As Romano found, and all of the other major event studies confirm, there is a positive stock price effect upon reincorporation in Delaware.

The event study findings are buttressed by Robert Daines' study comparing the Tobin's Q of Delaware and non-Delaware corporations. (Tobin's Q is the ratio of a firm's market value to its book value and is a widely accepted measure of firm value.) Daines found that Delaware corporations in the period 1981-1996 had a higher Tobin's Q than those of non-Delaware corporations, suggesting that Delaware law increases shareholder wealth. Although subsequent research suggests that the effect may not hold for all periods, Daines' study remains an important confirmation of the event study data.

Additional support for the event study findings is provided by takeover regulation. Compared to most states, which have adopted multiple anti-takeover statutes of ever-increasing ferocity, Delaware's single takeover statute is relatively friendly to hostile bidders. An empirical study of state corporation codes by John Coates confirms that the Delaware statute is the least restrictive and imposes the least delay on a hostile bidder. Given the clear evidence that hostile takeovers increase shareholder wealth, Coates' finding is especially striking. The supposed poster child of bad corporate governance, Delaware, turns out to be quite takeover-friendly and, by implication, equally shareholder-friendly.

Federalism and liberty The takeover regulation evidence is especially important because state anti-takeover laws are the principal arrow in the quiver of modern race-to-the-bottom theorists. In a series of articles, Lucian Bebchuk and his coauthors point out that state takeover regulation demonstrably reduces shareholder wealth but that most states have nevertheless adopted anti-takeover statutes. Even many advocates of the race-to-the-top hypothesis concede that state regulation of corporate takeovers appears to be an exception to the rule that efficient solutions tend to win out. But so what? Nobody claims that state competition is perfect. The question is only whether some competition is better than none. Delaware's relatively hospitable environment for takeovers suggests an affirmative answer to that question.

Bebchuk et al.'s arguments in favor of federal preemption, moreover, betray a complete lack of sympathy for the vital relationship between federalism and liberty. In other words, even if Bebchuk could prove that state competition is a race to the bottom, basic federalism principles would still counsel against federal preemption of corporate law. The corporation is a creature of the state "whose very existence and attributes are a product of state law." States have an interest in overseeing the firms they create. States also have an interest in protecting the shareholders of their corporations. Finally, as the Court noted in *CTS v. Dynamics*, a state has a legitimate "interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." In other words, state regulation not only protects shareholders, but also protects investor and entrepreneurial confidence in the fairness and effectiveness of the state corporation law.

According to the Supreme Court's *CTS* decision, the country as a whole benefits from state regulation in this area. As Justice Powell explained, the markets that facilitate national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that corporations generally are organized under, and governed by, the law of the state of their incorporation. That is so in large part because ousting the states from their traditional role as the primary regulators of corporate governance would eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law. As Justice Brandeis famously pointed out in his dissenting opinion to *New York Ice Co. v. Liebman*, "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory and try novel social and economic experiments without risk to the rest of the country." So long as state legislation is limited to regulation of firms incorporated within the state, as it generally is, there is no risk of conflicting rules applying to the same corporation. Experimentation thus does not result in confusion, but instead may lead to more efficient corporate law rules.

In contrast, the uniformity imposed by Sarbanes-Oxley will preclude experimentation with differing modes of regulation. As such, there will be no opportunity for new and better regulatory ideas to be developed — no "laboratory" of federalism. Instead, we will be stuck with rules that may well be wrong from the outset and, in any case, may quickly become obsolete.

The point is not merely to restate the race to the top argument. Competitive federalism promotes liberty as well as shareholder wealth. When firms may freely select among multiple competing regulators, oppressive regulation becomes impractical. If one regulator overreaches, firms will exit its jurisdiction and move to one that is more laissez-faire. In contrast, when there is but a single regulator, exit is no longer an option and an essential check on excessive regulation is lost.

In other words, by promoting the economic freedom to pursue wealth, competitive federalism does more than just expand the economic pie. A legal system that pursues wealth maximization necessarily must allow individuals freedom to pursue the accumulation of wealth. Economic liberty, in turn, is a necessary concomitant of personal liberty — the two have almost always marched hand in hand. The pursuit of wealth has been a major factor in destroying arbitrary class distinctions, moreover, by enhancing personal and social mobility. At the same time, the manifest failure of socialist systems to deliver reasonable standards of living has undermined their viability as an alternative to democratic capitalist societies in which wealth maximization is a paramount societal goal. Accordingly, it seems fair to argue that the economic liberty to pursue wealth is an effective means for achieving a variety of moral ends.

In turn, the modern public corporation has turned out to be a powerful engine for focusing the efforts of individuals to maintain the requisite sphere of economic liberty. Those whose livelihoods depend on corporate enterprise cannot be neutral about political systems. Only democratic capitalist societies permit voluntary formation of private corporations and allot them a sphere of economic liberty within which to function, which gives those who value such enterprises a powerful incentive to resist both statism and socialism. As Michael Novak observed in *Toward a Theology of the Corporation*, private property and freedom of contract were "indispensable if private business corporations were to come into existence." In turn, the corporation gives "liberty economic substance over and against the state."

CONCLUSION

What then is to be done? In the first place, Congress should back off. Edmund Burke famously echoed Plato in his assertion that prudence was the chief virtue of true statesmen. Prudence demands that the law of unintended consequences be given its due. The prudent legislator is hesitant to promulgate purported reforms that may give rise to new and unforeseen abuses worse than the evil to be cured. Sarbanes-Oxley's many so-called reforms likely to do just that. At the very least, prudence demands that Congress allow Sarbanes-Oxley to shake out and reveal its flaws before attempting further tinkering.

Second, in implementing Sarbanes-Oxley, the SEC and other regulators must pay due respect to the principles of federalism that have governed corporation law since the New Deal. As a general rule of thumb, federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective. In contrast, regulating the substance of corporate governance standards is appropriately left to the states. Sarbanes-Oxley disrupted that balance. The SEC now should set about restoring it. R

READINGS

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