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SARBANES-OXLEY'S IMPACT ON STATE CORPORATE GOVERNANCE

by
David A. Kotler and Rick Swedloff

In the wake of 2002's major corporate scandals, Congress passed the Sarbanes-Oxley Act. With its stated purpose to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws," the Act is the most sweeping grab of federal power in the area of corporate law since the 1930s. Indeed, as President Bush acknowledged during the Act's signing ceremony: "[T]oday I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Much has been written about the Act's encroachment on the regulation of attorney conduct, an area traditionally reserved for the states. However, what could be of longer lasting importance is that under the Act, the federal government had encroached on the states' traditional role of regulating corporate governance.

Over the past decade, the Supreme Court has protected states from overarching federal regulation by sharply demarcating, and in some cases explicitly limiting, Congressional power. Despite this, no one has questioned Congress' authority to pass Sarbanes-Oxley. *See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, SECURITIES & EXCHANGE at 26 (2003). This is because corporations, and their governance, are undeniably part and parcel of interstate commerce. As such, Congress has the power to regulate both corporations and corporate governance under the Commerce Clause. The real question, however, is whether Congress should do so.

For the past seventy years, there has been a rough division between the spheres of influence of the federal and state governments: the federal government has held the primary responsibility for regulation of fair disclosures and securities market regulation, while the state governments have retained responsibility for corporate transactions and board conduct. *See* William B. Chandler III and Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance: Preliminary Reflections of Two Residents of One Small State*, at 29 (Feb. 26, 2002), *available at* http://papers.ssrn.com/abstract=367720. Admittedly, these divisions are not clear cut, and there has been a natural give-and-take between the federal and state mandates. For instance, federal disclosure laws have influenced boardroom practices, while state fiduciary duty laws have, in turn, influenced the types of federally-regulated disclosures that corporations make. *See id*.

Through Sarbanes-Oxley, however, Congress made broad inroads into the states' traditional control of corporate governance. In making these intrusions, Congress moved away from the flexible approach of state law toward a specific set of procedural proscriptions. Generally speaking, states looked at most corporate governance issues through the lens of the fiduciary duties of care and loyalty. Through this rubric, state courts have fashioned a workable framework that is flexible enough to evaluate corporate actions and decisions in diverse corporate structures and unique situations. In contrast, the Act places restrictions on certain kinds of actions, and requires a strict new set of procedural safeguards in the boardroom, without reference to the duties

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David A. Kotler is a partner with law firm of Dechert LLP. **Rick Swedloff** is an associate with the firm.

of care and loyalty.

Specifically, The Act places new limits on three categories of corporate governance. First, Congress prohibited a number of transactions between the corporation and its officers and directors. Section 402 of the Act prohibits a public corporation from making personal loans to its executives. Section 306 of the Act makes it unlawful for an officer or director to trade in the corporation's securities during statutory blackout periods. Lastly, Section 304 of the Act provides that any CEO or CFO of a public corporation that is required to prepare an accounting restatement due to the "material noncompliance" of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws must reimburse the issuer for (1) any bonus or incentive-based compensation received during the prior twelve-month period, and (2) any profits from the sale of the issuer's securities. As noted above, prior to Sarbanes-Oxley, courts would consider these transactions by considering whether the board breached its state-law created fiduciary duties. Now, these transactions, even if beneficial to the company or its shareholders, and even if not a breach of any fiduciary duty, are strictly prohibited.

Second, Congress mandated adherence to certain procedures for the boards of directors. Sections 404, 406, and 407 of the Act respectively require that the board: include an "internal control report" in each annual report which describes how management will oversee financial reporting and provides an annual evaluation of the oversight procedures; adopt a code of ethics for senior financial officers or disclose why the corporation has not done so; and, disclose whether a member of the audit committee is a "financial expert," and if not, why. But, boards already had to oversee financial reporting of the company and had to act ethically at all times to meet their duties of care and loyalty. If the traditional state law fiduciary duties are not enhanced by these new federal requirements, then it is difficult to understand why Congress included these provisions in the Act.

Third, Congress prescribed new structural requirements for the constitution of corporate boards. Under Section 301 of the Act, Congress mandated the constitution of an audit committee of the board of directors. That committee, which is responsible for the oversight of a registered public accounting firm, must be made up of members of the board who, other than in their capacity as board members, do not accept any compensatory fee from the issuer, and are not affiliates of the issuer or its subsidiaries. Again, boards were already required to oversee the actions of their auditors and to act independently. This new committee simply represents added costs to corporate governance. Ultimately these costs will be borne by the shareholders and customers of the affected companies

Sarbanes-Oxley is a significant first federal step into an area traditionally reserved for the states. However, it is not just issues of comity that caution against changing the traditional boundaries between the federal and state governments. There are three main reasons why this increased regulation may not be the most efficient answer.

First, history has shown that bureaucrats enforcing the legislation passed by Congress tend toward "conservative" regulation, calculating the optimal number of regulatory failures at zero. This, in turn, leads to over-regulation, as bureaucrats will not necessarily take market efficiencies into account when drafting regulations. Rather, they will attempt to create a single set of rules that will minimize the likelihood that there will be a single violation of the statutory prohibitions. *Cf.* Adam C. Pritchard, SELF-REGULATION AND SECURITIES MARKETS, SECURITIES & EXCHANGE at 34-35 (2003).

Second, with more regulation comes significantly greater costs on the corporation. Here, some of those costs are transparent. Many public corporations will have to reformulate their boards, hire new accountants, and follow certain procedural guidelines. Other costs will likely develop as the SEC finalizes its rulemaking. Such costs, which could run into the tens of millions of dollars for the largest of corporations, will undoubtedly be passed on to the corporation's customers and shareholders.

Third, and perhaps most importantly, for corporations, a one-size-fits-all approach to corporate regulation may crowd out creative approaches that best fit new and developing corporations. *See* Chandler and Strine, *supra*, at 36. To the extent that the new federal regulations encroach on the ability of the states to regulate unique issues through more flexible doctrines, there may be significant and unseen barriers to developing corporations.

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