Legal Backgrounder

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SARBANES-OXLEY AND THE COST OF CRIMINALIZATION

by

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> [A] danger to President Roosevelt's valiant and heroic experiments seems to arise from the disposition to hunt down rich men as if they were noxious beasts. It is a very attractive sport, and once it gets started quite a lot of people everywhere are found ready to join in the chase. . . . The question arises whether the general well-being of the masses of the community will be advanced by an excessive indulgence in this amusement. The millionaire or multi-millionaire is a highly economic animal. He sucks up with sponge- like efficiency money from all quarters. In this process, far from depriving ordinary people of their earnings, he launches enterprises and carries them through, raises values, and he expands that credit without which on a vast scale no fuller economic life can be opened to the millions. To hunt wealth is not to capture commonwealth.
>
> Winston Churchill[1]

In enacting the recent Sarbanes-Oxley Act, a number of lawmakers harkened back to the 1930s and the New Deal. Indeed, President Bush himself referenced President Roosevelt explicitly when signing Sarbanes-Oxley into law after the bill passed the Senate unanimously and passed the House by a near unanimous vote. On July 30, 2002, during the signing ceremony, President Bush notably proclaimed, "[m]y administration pressed for greater corporate integrity. A united Congress has written it into law. And today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Unfortunately, Sarbanes-Oxley also has in common with the "reforms" of FDR the tendency to deter lawful risk-taking and other socially beneficial business activity.

SARBANES-OXLEY IMPOSES NEW COSTS ON BUSINESSES AND SHAREHOLDERS

Severe White Collar Criminal Penalties. White-collar crime and the laws punishing it are certainly nothing new.[2] The United States has effectively punished white collar wrongdoers for years under existing federal criminal statutes, such as the mail and wire fraud statutes and the criminal false statement statute. Indeed, Arthur Anderson's downfall was initiated by a criminal indictment under existing federal law.

[1]Winston Churchill, GREAT CONTEMPORARIES 240 (New York: W.W. Norton & Co. 1990).

[2]George Robb, WHITE-COLLAR CRIME IN MODERN ENGLAND: FINANCIAL FRAUD AND BUSINESS MORALITY 1845-1920 144-46 (Cambridge: Cambridge University Press 1992) (describing a 1926 criminal case against officers of a corporation for using "secret [accounting] reserves" in order to manage earnings and manipulate stock prices.)

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WorldCom Chief Financial Officer Scott Sullivan has been indicted under existing federal criminal law and faces up to 65 years in prison if convicted on all counts under federal criminal laws already on the books before Sarbanes-Oxley. These laws and the penalties imposed thereunder have worked effectively and there is no reason to doubt that they are not sufficient to punish the current crop of corporate wrongdoers.

Sarbanes-Oxley nevertheless undertakes to amend and strengthen the criminal title of the United States Code in several significant ways, including the addition of a new crime for obstruction of justice in connection with a government investigation as well as one for securities fraud with a 25 year maximum sentence for each violation thereof, not to mention heightened criminal penalties for violating existing fraud statutes. In particular, Sarbanes-Oxley includes the following additions to the federal criminal code:

‣**Increased Penalties for Mail/Wire Fraud**. Sarbanes-Oxley provides for significantly increased punishment for violations of the federal mail and wire fraud statutes. 18 U.S.C. §§ 1341, 1343. The previous maximum punishment for a violation of § 1341 or § 1343 was five years. President Bush had proposed an increase in the maximum penalty to 10 years for each violation. *Let the Reforms Begin*, BUS.WK., July 22, 2002, at 28. Not to be outdone, however, Sarbanes-Oxley sets the maximum penalty at 20 years imprisonment for a single violation — thus, quadrupling the previous maximum.

‣**Criminal Liability for Securities Fraud**. The Act creates a new crime of "securities fraud" under the federal code. Specifically, the act imposes criminal liability for knowingly executing a scheme or artifice to defraud investors or obtaining money or property by means of fraud in connection with the purchase or sale of any security. Sarbanes-Oxley at § 807. This new criminal section, moreover, imposes a whopping 25 year maximum penalty for a single violation.

‣**Enhanced Attempt/Conspiracy Penalties**. Sarbanes-Oxley borrows from, of all places, the narcotics crimes subchapter of the United States Code to impose enhanced penalties for conspiracies or attempts to violate the mail and wire fraud statute.[3] The Act provides that any person who attempts to commit or conspires to commit a mail or wire fraud offense shall be subject to the same punishment as for a violation of the underlying, primary offense. Sarbanes-Oxley at § 902. Thus, a conspiracy to commit mail/wire fraud or an attempt to commit mail/wire fraud is now subject by statute to the same punishment as the actual primary violation of the laws against mail fraud. *Id*.

‣**False Certification of Financials**. Sarbanes-Oxley imposes, as an ongoing obligation, the requirement that *both* the chief executive officer and the chief financial officer of every publicly-traded corporation certify that their company's financial statements are accurate. Sarbanes-Oxley at § 906. The Act establishes severe criminal penalties for any violation of this certification requirement. Specifically, the Act provides for a maximum penalty of 10 years for a "knowing" violation of this requirement, and a maximum penalty of 20 years in prison for "willfully" violating the certification requirement.

‣**Obstruction of Justice**. Sarbanes-Oxley establishes revised and new obstruction of justice crimes that punish with up to 20 years in prison anyone who (1) alters, destroys, mutilates, conceals, covers up falsifies or makes a false entry in a document or other object, or attempts to do so with the intent to impair the objects integrity or availability in an official proceeding; or (2) otherwise obstructs, influences or impedes any official proceeding, or attempts to do so. *Id*. at § 802 and § 1102.

‣**Audit Recordkeeping Requirements**. Sarbanes-Oxley imposes a requirement on all public company auditors to maintain audit and work papers for a minimum of 5 years. The Act also requires the SEC to establish regulations requiring auditors to preserve a wide-range of work papers (including memoranda and e-mails) for a designated period of time. The Act provides for criminal liability and imprisonment of up to 10 years for anyone who "knowingly and willfully" violates these requirements. *Id* at § 802.

[3] *Compare* Sarbanes-Oxley at § 902 *with* 21 U.S.C. § 846.

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‣**Amendments to Federal Sentencing Guidelines**. The practical effect of the enhanced maximum penalties described above depends significantly on the federal sentencing guidelines. In that regard, the Act requests that the United States Sentencing Commission "expeditiously consider the promulgation of new sentencing guidelines or amendments to existing sentencing guidelines to provide an enhancement for officers and directors of publicly-traded corporations who commit fraud and related offenses." *Id*. at § 1104.

The Costs of Increased Punishment. While most people can agree that white-collar criminals should be punished — in some cases, punished severely, — when they commit criminal acts, there are nonetheless social costs of being too vigilant with the punishment of corporate wrongdoers. According to President Bush's pollster, Matthew Dowd, "[t]he public doesn't distinguish between corporate scams involving billions of dollars and street crime; but up until now, it seemed like the Wall Street guys were less likely to get punished." *Let the Reforms Begin*, BUS.WK., July 22, 2002, at 28. The problem with this approach, however, is that there is a very real and socially significant difference between corporate crime and street crime. Simply put, corporate officials serve an immensely useful social purpose; street thugs do not. And although some corporate crimes are indistinguishable from holdups, often that is not the case. The line that Sarbanes-Oxley attempts to delineate between criminality and lawful, socially beneficial risk-taking, is a fine one and, therefore, risks deterring socially beneficial risk-taking by honest businessmen. In many cases, corporate "wrongdoing" only gets labeled as such with the benefit of hindsight assisted by the creativity of plaintiffs' lawyers. To the extent Sarbanes-Oxley punishes risk-taking that might be misconstrued after the fact as fraud, the law will have economically harmful effects.

Though undoubtedly tempting to politicians of either party wishing to make a statement that they are protecting the interests of wronged shareholders, the substantial ratcheting-up of criminal liability that is effected by the Sarbanes-Oxley Act risks harming shareholders in the long run. Professor John Coffee explained the general problem as follows:

> [M]anagers and directors are inherently likely to be more risk-averse than shareholders desire, even without the threat of liability for negligence. Shareholders enjoy limited liability and also have the ability to diversify their portfolios so as to minimize the risk of any single investment. Managers cannot diversify their portfolio equivalently because they are essentially overinvested in their own firms. From this premise, modern portfolio theory implies that managers are more likely to be risk-averse than the shareholders they represent. Whereas a single bad corporate decision will have only a minimal effect on fully diversified shareholders, it can devastate the personal fortunes of the corporation's managers who cannot spread their risks equivalently. In addition, managers, unlike shareholders, face the potential risk of individual civil or criminal liability for actions undertaken on behalf of their corporation. Also, given the preference for internal promotion within most firms, the manager laid-off by one firm in the wake of insolvency or financial crisis has little prospect of making a costless transfer to another firm at an equivalent level and salary. As a result, the manager's inability to diversify his substantial investment in his firm implies that he should be more risk averse than the shareholders he represents. Adding substantial financial [and criminal] liability into this balance would only exacerbate the problem and make it less likely that managers would act as their shareholders prefer.

John C. Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 823-24 (May/Aug. 1984).

It is with such concerns undoubtedly in mind that the Chief Executive of Genentech wisely cautioned about an early version of Sarbanes-Oxley, "[w]e need to be careful that we do not put into place mechanisms that will stifle the growth of the majority of companies that are honorable." *Let the Reforms Begin*, BUS.WK., July 22, 2002, at 28

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SARBANES-OXLEY — AN UNNECESSARY ACT?

Apart from the additional costs it imposes on shareholders, the Sarbanes-Oxley Act is also an unnecessary piece of legislation. The increased costs that the Act imposes are likely to remedy little of the damage wrought in financial markets of late. Sarbanes-Oxley's fundamental shortcoming is that, to the extent that the legislation is intended to respond to the recent declines in the stock market, the legislation mistakes a mere market correction — albeit a dramatic one — for preventable corporate wrongdoing.

Investments are little more than risk/return ratios. During the period 1994 to 2000, there was considerable focus in America on the second half the investment equation — *return*. The gains experienced by many who were invested in the stock market during that period were impressive and were often well in excess of historical averages. Thus, in late 1999, based on Standard & Poor's own calculations, the price/earnings ratio of the S&P 500 exceeded 50. By as late as August 21, 2001 — after the markets had already seen over a year of significant declines — the *Wall Street Journal*, in a front-page news story, reported that the price/earnings ratio of the Standard and Poor's 500 Index was 36.7. Jonathan Weil, *What's the P/E Ratio? Well, Depends on What is Meant by Earnings*, WALL ST. J., Aug. 21, 2001, at A1. Taking Standard & Poor's own calculation, moreover, the p/e ratio was, at that time, a staggering 45.[4] Market price/earnings ratios simply could not be sustained at those levels. From its peak in early 2000, the NASDAQ index has fallen by nearly 75% and has fallen nearly 50% since mid-2001. The broadly diversified, large cap S&P 500, moreover, has declined by nearly 40% from its high in early 2000 and approximately 25% since mid 2001. The near-relentless downward march of the markets, from late 1999 to early 2002, was to a large extent the product of little more than that unavoidable other half of the investment equation — *risk*.

There has, no doubt, been duplicity and corruption mixed into the collapse of the 1990s market. For one, financial restatements in the years 2000, 2001 and 2002 were significantly more numerous than at anytime in recent history. While the scope of the financial fraud has lately been significant and the fraud reportedly egregious, it has nonetheless infected a relatively small number of public companies and a very small fraction of the total market capitalization of the financial markets. An investor who followed the unassailable principal of diversification would have had relatively little exposure to the adverse consequences of recent financial frauds. Financial fraud has played a relatively small role in the demise of the 1990s market. This is not in any way to excuse or diminish the corporate transgressions of the late 1990s and early 2000s. Rather, it is simply to suggest that the real causes of the widespread investor losses over the past three years and, therewith, the unsurprising distaste — if not distrust — of the markets arguably has much more to do with *fully disclosed* market factors than with preventable misbehavior by auditors or company management.

CONCLUSION

In seeking to remedy a largely non-existent problem underlying recent shareholder losses, the Sarbanes-Oxley Act has imposed significant new costs on public corporations and their stakeholders. One example of such costs is the increased risk-aversion that is promoted among managers of businesses as a result of the increased potential criminal liability imposed on corporate officers and directors.[5] These risks may be offset by greater integrity and transparency in financial markets. Whether the benefits exceed the risks — and whether Sarbanes-Oxley ultimately will promote the commonwealth — remains to be seen.

[4]The long-term historical average p/e for the S&P is 14.5 and in down economies, the average has been in the mid-to-high single digits.

[5]For an example of another significant cost that will be borne by shareholders, compare sections 101 through 209 of Sarbanes-Oxley with Calmetta Coleman and Cassell Bryan-Low, *Audit Fees Rise, and Investors May Pay the Price*, WALL ST. J., Aug. 12, 2002, at C1.

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