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CRITICIZING THE CRITICS: SARBANES-OXLEY AND QUACK CORPORATE GOVERNANCE

J. ROBERT BROWN, JR.*

I. INTRODUCTION

Sarbanes-Oxley ("SOX" or "the Act") was adopted in a rush, political expediency necessitating that something be done before the 2002 election to minimize voter backlash from the collapse of Enron and WorldCom. Two arguably moribund bills, with very different philosophies, were cobbled together, augmented, and passed in a flurry of activity,[1] ostensibly enacting the most far-reaching reforms of the nation's business practices since the Great Depression.[2]

SOX, named after its putative sponsors,[3] sought to improve corporate disclosure by increasing the gatekeeper function of outside accounting firms and heightening the supervisory role of top officers and the board.[4] It separated accounting and consulting services, increased the strength and independence of the audit committee, and required certification of financial statements by officers and assessment of internal controls by managers and auditors.[5]

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* Professor of Law, University of Denver College of Law. I want to thank Darius Dills at the University of Oklahoma for invaluable research in connection with this effort. Teresa Gabaldon, Donna Nagy, Bruce Price, Celia Taylor, and Eli Wald provided very useful comments. The views and errors are, however, mine.

1. *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1003–06 (2005).

2. So says President Bush and some commentators. *See* Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299, 301. Perhaps this assertion too should be put to empirical analysis.

3. One wonders whether Congressman Oxley appreciates the eternal linking of his name to a bill that has been so criticized. In the aftermath, he has not always been happy with the consequences of the Act. *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 160 (2006) ("Congress apparently will not rethink its choices, despite admissions by Congressman Oxley that the act is too inflexible for smaller companies.").

4. *See* Celia R. Taylor, *Breaking the Bank: Reconsidering* Central Bank of Denver *after Enron and Sarbanes-Oxley*, 71 MO. L. REV. 367, 367–68 (2006).

5. *See infra* Part IV.A–B.

SOX engendered an immediate cascade of criticism, much of the excoriation coming from the Academy, especially those adhering to the view that a corporation was a "nexus of contracts."[6] For them, the Act fixed non-existent problems, generated costs that exceeded benefits, and relied on approaches that took no notice of definitive economic data; "quack corporate governance" in a phrase.[7]

SOX suffered from uneven craftsmanship and was not fully vetted in the traditional manner.[8] Process, however, did not fully explain the immediacy and strength of the vituperative attacks. Instead, the Act amounted to an affront, indeed a rejection, of the view within the Academy that corporations were a "nexus of contracts" and that the evolution of corporate law was a race to the top. SOX did so by replacing enabling rules with categorical prohibitions and riding roughshod over hallowed principles of Delaware law.

This Essay will do three things. It will examine the position of these contractarians and briefly discuss the normative implications of their views. Second, it will examine their reaction to SOX and the reasons for the deep, almost indiscriminate, hostility. Finally, the Essay will undertake an examination of significant provisions of SOX to determine whether, in fact, they are as harmful and irrational as some have suggested or whether, to preview the conclusion, the jury remains out, the empirical basis for firm conclusions still unavailable.

II. NEXUS OF CONTRACTS AND THE NORMATIVE IMPLICATIONS

A widespread consensus exists in the Academy that corporate law should be designed to promote the most efficient use of assets. For some, this will occur only where managers and owners can bargain for

6. The stridency of the criticism was even more noticeable given the view held by some that the reforms contained in the Act were not all that significant. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 941–42 (2003). Others took a more balanced view of the Act. *See* Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 721–23 (2005).

7. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1585–91 (2005).

8. Because of the rushed nature of some aspects of SOX, opponents have tended to label the entire Act as rushed. *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 89 (2003) (concluding that in adopting SOX, Congress was "regulating in a panic"). To the extent "rushed" signifies an absence of hearings, deliberation, and consideration of the relevant issues, this is factually wrong. *See* Nagy, *supra* note 1, at 996–1003 (discussing lengthy hearings held on regulation of the accounting profession prior to the adoption of SOX).

the most efficient relationships, one that uniquely reflects the interests of the particular parties involved. They view corporations as a "nexus of contracts" and support regulatory regimes that promote private ordering. Contractarians, therefore, favor enabling provisions where parties can opt in or out and eschew the "one size fits all" approach of categorical rules.

As a matter of theory, the "nexus of contracts" approach has considerable merit. The importance of, and benefits from, private ordering are useful considerations in any assessment of corporate law.[9] As a normative matter, however, the approach is far less valuable.[10] While private ordering may theoretically be more efficient than categorical rules, there is no guarantee that in practice parties will enter into efficient bargains, either individually or in the aggregate. Market failure, disparities in bargaining, imperfect and asymmetrical information, moral hazards, satisficing, and the requirement of rational actors all conspire against efficiency. As a result, nothing prevents private ordering from resulting in greater inefficiencies than mandatory rules.

These normative concerns arise with particular force in the corporate context where management has an incentive to engage in self-serving behavior while shareholders suffer from a number of obvious disabilities, including the problem of free riders and rational ignorance. Logic would suggest that private ordering would reflect these dynamics, with agreements tending to favor managerial self-interest rather than efficiency.[11]

Contractarians attempted to overcome these concerns through resort to a correcting mechanism. Management entering into an inefficient arrangement would eventually see share prices fall, making the company susceptible to a hostile takeover. Once acquired, the new

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9. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 3 (2002) ("Accordingly, a model is properly judged by its predictive power with respect to the phenomena it purports to explain, not by whether it is a valid description of an objective reality.").

10. Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 863 (1997) (reviewing LAWRENCE E. MITCHELL, PROGRESSIVE CORPORATE LAW (1995)) ("In my view, however, contractarianism claims only to offer a richer metaphor than do traditional entity-based theories and, as such, a more useful heuristic for understanding corporations.").

11. At least where the two diverge. Private ordering motivated by managerial self-interest will sometimes result in efficient behavior.

managers would undo the arrangement and redeploy the assets in a more efficient, higher-use manner.[12]

The availability of the correcting mechanism simplified the contractarian position. They did not have to argue that management would always or even frequently bargain in an efficient manner. It was enough that efficient arrangements were possible and that market mechanisms would allow only the efficient ones to survive.[13]

Although the view still occasionally surfaces,[14] scholars in general no longer rely on hostile takeovers as the guarantor of efficiency.[15] How could they? The market hardly exists.[16] Ironically, its demise came not from categorical rules imposed at the federal level[17] but from enabling provisions under state law.[18]

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12. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965); *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173–74 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841–43 (1981); Lucian Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030–31 (1982).

13. Thus, as two contractarians noted: "The market for corporate control provides the glue that holds together the nexus of contracts." Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 25 (1990).

14. *See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 30, *available at* http://ssrn.com/abstract=389403 [hereinafter Bainbridge, *Creeping Federalization*] ("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."); *see also* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 562 (2003) [hereinafter Bainbridge, *Director Primacy*] ("Also, an active market for corporate control, ever-rising rates of shareholder litigation, and, some say, activist shareholders constrain director conduct.").

15. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 56 (2002) ("Takeover regulation therefore has substantially diluted firms' agency-cost-control arsenal, forcing them to resort to second-best incentive devices and control mechanisms.").

16. Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 382 (2004) (noting that hostile takeovers "virtually disappeared as a corporate governance device at the start of the 1990s"). Recognizing this, adherents have searched for other disciplining market mechanisms, with hedge funds apparently the new hope. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 06-16, 2006), *available at* http://ssrn.com/abstract_id=919881 (undertaking study to determine whether "hedge funds [are] the 'Holy Grail' of corporate governance").

17. Which is not to say that some do not continue to criticize federal regulation, something put in place in 1968. *See* Ribstein, *supra* note 15, at 55–56 ("Extensive takeover regulation began in 1968 with the Williams Act, which imposed disclosure requirements on

The demise of hostile takeovers as a significant disciplining mechanism also altered the debate over Delaware law and the so-called race to the top, a central tenet of the contractarian view.[19] Under the internal affairs doctrine, the state of incorporation regulates the rights of managers and owners. It is management, however, that determines where to incorporate and presumably selects the state that best meets its objectives.[20]

In selecting the appropriate state, management has, broadly speaking, two possible motivations. One is efficiency. The company will incorporate in a jurisdiction that allows for the most efficient operations. The other is self-interest. The company will incorporate in a jurisdiction that allows managers to favor their own interests over those of investors, irrespective of the efficiency of the decision.[21]

For contractarians, the answer was efficiency. With Delaware engaging in an almost continuous process of eliminating categorical

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bidders and required them to structure their bids to give incumbent directors time to defend. This reduced potential gains from risky hostile bids, and therefore takeovers' effectiveness as a monitoring device." (footnote omitted)).

18. Management has a host of defensive tactics that can substantially raise the cost of acquisitions, particularly the poison pill. *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (analyzing the impact of poison pills and staggered boards). Of course, some have challenged this view. *See* Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21, 39 ("In summary, the U.S. experience has been that a poison pill has not frequently blocked a hostile bid, once made, from being considered by the shareholders. The pill will give target management that opposes the bid time to explain its position, to negotiate with the hostile bidder, or to develop an alternative strategy or bidder. Three critical corporate governance institutions—independent directors, the Delaware courts, and the capital market—combine to cause the pill to operate largely as a negotiating tool, rather than as a means to maintain company independence.").

19. It may be the case, as some have written, that "[t]his thirty-year debate has reached a stalemate, with neither side yielding much ground to the other." Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 883–84 (2006). Obstinacy does not, however, render resolution unimportant.

20. Reincorporation generally requires both board and shareholder approval. The transaction is, however, initiated by the board. *See* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1458, 1470 n.118 (1992).

21. There tends to be an all or nothing approach in discussing this issue. A race to the bottom may explain some corporate law reforms but certainly not all. *See* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 319–20 (2004).

rules,[22] public companies selected the state because of the increased opportunities for private ordering and the efficiencies that would result from these decisions.[23] The availability of hostile takeovers meant that it did not matter how often managers and shareholders actually entered into efficient arrangements; the inefficient ones would eventually be weeded out.[24] The existence of a correcting mechanism allowed contractarians to be uncompromising. Enabling provisions, by their very nature, were beneficial.[25]

With the disappearance of hostile acquisitions, however, the analysis had to shift. No longer able to show the ineluctable elimination of inefficient bargains, contractarians had to argue that the enabling approach in Delaware resulted in greater aggregate efficiency. That is, while conceding that some managers and owners would enter into inefficient arrangements, arrangements that would not necessarily be eliminated by market forces, it was still the case that the enabling approach, in the aggregate, produced more efficient behavior.

Contractarians attempted to address this new reality by pointing to a handful of event studies purporting to show that share prices increased upon reincorporation in Delaware.[26] This ostensibly represented the

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22. See the article by Delaware Chancellor William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (stating that the contractarian model is now the "dominant legal academic view"). The best example may be the elimination of the prohibition on discriminating among shareholders of the same class. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 958 (Del. 1985). Delaware was the first state to permit companies, in their charter, to waive liability for directors. For the international perspective on this, see ORG. FOR ECON. CO-OPERATION AND DEV., PRINCIPLES OF CORPORATE GOVERNANCE 20 (2004) ("All shareholders of the same series of a class should be treated equally.").

23. Some have taken the position that the state law requirements are largely enabling, with the remaining categorical rules "trivial." *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 542 (1990).

24. Of course, with one substantial exception: they did not favor broad managerial discretion in the area of antitakeover tactics. *See* Easterbrook & Fischel, *supra* note 12, at 1201–03.

25. Thus, even fiduciary duties should be subject to private ordering. *See* Butler & Ribstein, *supra* note 13, at 32 ("[T]he fundamentally contractual nature of fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts.").

26. *See* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1784–96 (2002). Some have attempted to show that particular categories of issuers benefit from incorporation in Delaware. Some, for example, argue that IPOs of Delaware companies receive increased valuation. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1560 (2002). The analysis proves too much. If it was that clear that incorporating in Delaware would improve share prices, then all similarly situated companies would do so,

market's judgment that Delaware's law was more efficient than the alternatives. The studies, however, did not make a strong case. They were inconsistent in result[27] and short-term in horizon,[28] offering no view on the long-term impact.[29] They also conflicted with the facts on the ground. To the extent reincorporation resulted in a predictable increase in share prices, the impetus for engaging in the transaction ought to have come from financial experts. In fact, the literature indicated that they were promoted by lawyers, not investment bankers.[30] Finally, common sense evidence suggested that in at least some instances, corporate law reform had managerial self-interest at its core.[31]

But the approach had a more fundamental problem. The argument that Delaware's law, as formulated, was efficient, did not speak to the

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which they do not. *See* Bebchuk et al., *supra*, at 1789 ("While Daines's study makes an impressive effort to control for as many parameters as possible, including type of business and firm size, it nonetheless remains true that if in a group of seemingly identical firms, some firms incorporate in Delaware and others do not, there must be omitted variables that produce this differential behavior. This is all the more true if it is supposed that one choice produces a substantial increase in firm value and the other does not.").

27. *See* Bebchuk et al., *supra* note 26, at 1791–92 ("These six studies . . . present a rather mixed picture. Roberta Romano's study, the earliest and most influential of the six, found a positive abnormal return of 4.18%. However, three of the subsequent five studies found abnormal returns in the vicinity of 1%, and two of the subsequent five studies, including the most recent event study which used the largest sample size, did not find an abnormal return that differed from zero in a statistically significant way." (footnotes omitted)).

28. *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2384 n.76 (1998).

29. Similarly, during the takeover era, the tendency was to note the short-term value of acquisitions to the bidder (generally neutral) without attempting to assess the longer-term impact. *See* J. Robert Brown, Jr., *In Defense of Management Buyouts*, 65 TUL. L. REV. 57, 96 (1990).

30. The literature identifies lawyers as the interest group most likely to promote reincorporations. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 470 (1987) ("[T]he rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state.").

31. Not all corporate law reforms are explainable as a product of the race to the bottom. *See* Brown, *supra* note 21. One that is, however, is the widespread adoption of waiver of liability provisions. They benefit management by allowing the articles to include a provision that eliminates monetary damages for breach of the duty of care. Nonetheless, in the last twenty years, a remarkably short period of time for legal reform, all fifty states put some type of reduced liability provision in place. While a possible example of "private ordering," the provisions have become ubiquitous, suggesting that they are not in fact a result of individual negotiation. Moreover, even if a waiver were necessary to attract the most efficient management in a particular case, the provision applied to all subsequent managers. Thus, these provisions essentially result in shareholders ceding away damages for mismanagement on an indefinite basis irrespective of the particular management involved.

impact of reforms.[32] Thus, the data did not address the consequences of regulatory changes, including the imposition of categorical rules. Doing so would create a new mix of legal requirements that might or might not result in greater overall efficiency.

III. THE REJECTION OF SOX

In the corporate law realm, scholars have characterized the contractarian view as "dominant"[33] and Delaware as the "genius" of American corporate law.[34] SOX, by rejecting both, amounted to an uncomfortable shock. The Act imposed categorical requirements[35] and preempted a number of state law provisions,[36] both inconsistent with the "nexus of contracts" approach and the race to the top.[37]

Predictably, SOX generated a deluge of criticism, much of it quite harsh.[38] Roberta Romano called SOX "quack" corporate law and concluded, after a survey of economic literature, that four pieces of the

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32. In fact, Delaware law has opted for a system of lax regulation of insiders, requiring periodic federal intervention. *See* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. (forthcoming 2006). Any study of the efficiency of Delaware law includes a regime that is limited by categorical rules imposed at the federal level.

33. Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1744 n.50 (2006) (citing an early source that described the view as the "dominant legal academic view").

34. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 554 (2002) ("Indeed, the dominant view in corporate law scholarship is that allowing Delaware to dominate national corporate law is not a problematic feature, but rather an important virtue, indeed the 'genius,' of American corporate law.").

35. Indeed, Congress did not even consider their literature on the subject. *See* Romano, *supra* note 7, at 1602 ("In the frantic political environment in which SOX was enacted, legislators adopted proposals of policy entrepreneurs with neither careful consideration nor assimilation of the literature at odds with the policy prescriptions.").

36. In truth, there was little in the legislation that could not have been fixed with more robust fiduciary duties. Unwilling to leave the matter to the decisions of the Delaware courts and the legislature, Congress effectively federalized important aspects of corporate law.

37. *See* Ribstein, *supra* note 15, at 57 ("The Sarbanes-Oxley Act changes course from this contractual approach to corporate regulation.").

38. Not all contractarians viewed SOX this way. *See* Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 355 (2003) ("Sarbanes-Oxley was a measured and appropriate response to the abject failures in U.S. corporate governance typified by Enron. These failures were not merely failures in the system of mandatory reporting, though it is clear that mandatory rules did not serve us well. Rather, the corporate governance crisis in America, with Enron as its poster child, represents a failure of *both* our system of mandatory rules, and of the contracting processes, which, together, constitute the infrastructure of the U.S. corporate governance system.").

law had little or no economic support.[39] Larry Ribstein at the University of Illinois initially expressed opposition, sometimes in a cautionary manner,[40] sometimes not.[41] In time, his views became more consistently severe,[42] characterizing SOX as a "debacle."[43] Stephen Bainbridge at UCLA described SOX this way: "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."[44] More recently, he concluded that the Act "sacrificed the American economy at the altar of short-term political gain."[45] Professor Carney at Emory viewed SOX as the possible death knell for community banks.[46]

No provision escaped criticism. More independent directors and increased authority for the audit committee would be ineffective,[47] while

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39. *See* Romano, *supra* note 7, at 1529–43. They included an independent audit committee, the separating of accounting and auditing services, executive loans, and executive certification. *Id.*

40. *See* Ribstein, *supra* note 15, at 58; *see also* Larry E. Ribstein, *Sarbox: The Road to Nirvana*, 2004 MICH. ST. L. REV. 279, 279, 296 [hereinafter Ribstein, *Sarbox*].

41. "The Sarbanes-Oxley Act represents a hasty, panicked reaction of an electorate looking for an easy fix to the apparent 'problem' that stock prices go down as well as up." Robert W. Hamilton, Professor, Univ. of Tex. Sch. Of Law, The Seventh Annual Frankel Lecture at the University of Houston Law Center: The Crisis in Corporate Governance: 2002 Style (Nov. 8, 2002), *in* 40 HOUS. L. REV. 1, 49 (2003).

42. Larry E. Ribstein, *Sarbanes-Oxley After Three Years*, 3 N.Z. L. REV. 365, 382 (2005) ("In short, the first three years of SOX strongly suggest that it was, at best, an overreaction to Enron and related problems and, at worst, ineffective and unnecessary.").

43. *See also* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (forthcoming 2006) ("An understanding of these high costs and minimal benefits, and of the forces that produced this misguided legislation, may help to prevent a regulatory debacle in the future."). *But see* Ribstein, *Sarbox*, *supra* note 40, at 296 ("Sarbanes-Oxley may prove to be a favorable development.").

44. *See* Bainbridge, *Creeping Federalization*, *supra* note 14, at 26.

45. Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, 15 (UCLA Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 06-14, 2006), *available at* http://ssrn.com/abstract=899593. He adheres to the contractarian approach. *See* Bainbridge, *supra* note 9, at 11 ("In recent years, however, I have come around to the view that the corporation *is* a nexus of contracts in a literal sense, albeit a very limited one.").

46. Carney, *supra* note 3, at 160 ("With all of these changes, many of the smaller companies that went public in the late 1990s and foreign issuers that entered the U.S. market may wish to rethink their decision. . . . Say goodbye to the community bank that was owned by the community.").

47. Romano, *supra* note 7, at 1533 ("The compelling thrust of the literature on the composition of audit committees, in short, does not support the proposition that requiring

increasing costs.[48] Greater independence for accountants was harmful.[49] The prohibition on loans to executive officers represented a public policy error.[50] Separating accounting and consulting firms could negatively affect audit quality,[51] while the costs of reviewing internal controls outweighed the benefits.[52]

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audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance.").

48. Ribstein, *supra* note 42, at 369–70 ("There is, however, a significant question as to the effect of this specific fix [independent audit committee] on top of many regulators' myriad pre-SOX efforts to reform corporate boards. That is particularly so given the inherent difficulty of effective oversight of auditors, a task requiring significant information and expertise. Thus, there is little reason in theory to expect this reform to do more than increase governance costs.").

49. *See* Ribstein, *supra* note 8, at 88 ("But increasing auditor independence may reduce their access to information as well as their expertise, ability, and incentives. Also, separating audit and non-audit services may move auditing to smaller, less reputable, and more judgment-proof firms.").

50. Romano, *supra* note 7, at 1539 ("Because executive loans in many cases appear to serve their purpose of increasing managerial stock ownership, thereby aligning managers' and shareholders' interests, the blanket prohibition of executive loans in SOX is self-evidently a public policy error.").

51. *Id.* at 1535–36 ("The overwhelming majority of the studies . . . suggest that SOX's prohibition of the purchase of nonaudit services from an auditor is an exercise in legislating away a nonproblem. The majority . . . find no connection between the provision of nonaudit services and audit quality."); Ribstein, *supra* note 42, at 374 ("Third, altering gatekeepers' incentives in order to ensure their independence might negatively affect the overall quality of services.").

52. Romano, *supra* note 7, at 1543 ("The brief review of the empirical literature suggests that a case does not exist for the principal corporate governance mandates in SOX. The decisive balance of research indicates that those mandates will not benefit investors.").

IV. EXAMINING THE HOLES IN SOX[53]

With four years of experience, much of SOX can be examined in a calmer, although still preliminary, context.[54] Stripping away the ideology, it seems as if some of the provisions will likely result in positive changes,[55] although they may be modest. While at this stage the Act could perhaps withstand some refinements, the changes would likely be small and not undo any central thesis of the approach.[56]

A. Financial Disclosure

With respect to financial disclosure, SOX did two things of significance. The first was to require certification of the financial statements by the CEO and CFO.[57] The second was to require annual

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53. This Essay does not focus on the growing number of event studies that purport to assess the market impact of the Act. These studies, which have not been consistent in result, tend to focus on the market's reaction over an exceedingly brief period of time, usually a matter of days. Given the uncertainties that pervaded the early days of SOX, the negative market reaction in the short term would not be particularly surprising. *See Unease on Wall Street as Election Day Nears*, L.A. TIMES, Nov. 1, 2004, (Business Desk), at C4 ("The stock market hates uncertainty . . . ."). Whether a market penalty continues, however, is generally not answered by these studies. Most of these studies have difficulty isolating the effects of SOX from other contemporaneous developments. *See* Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, (The Univ. of Tex. Sch. of Law, Law and Econ. Research Paper No. 55, 2006), *available at* http://ssrn.com/abstract=876624. Litvak examines two groups of foreign companies co-listed in the United States, those subject to SOX and those not, and examines the market's reaction to certain "significant" developments in the adoption and implementation process of SOX. As a check, she pairs each foreign company with a similar company in the same industry, in the same country, and with a similar size. She concludes that the data shows "evidence consistent with the hypothesis that investors expected the Sarbanes-Oxley Act to have a net negative effect on companies to which it applied." *Id.* at 36. The main weakness in the study seems to be the dates defined as significant and not significant. In any event, the study does little more than demonstrate a market reaction to the entire Act at various stages of development, suggesting that the market's reaction was to uncertainty, rather than particular provisions, something that would ultimately dissipate.

54. Portions of SOX still have not become applicable to small public companies. *See* Internal Controls, Securities Act Release No. 8731, Exchange Act Release No. 54,295 [Current Volume] Fed. Sec. L. Rep. (CCH) ¶ 87,619, at 83,383 (Aug. 9, 2006).

55. Boards arguably are acting in a more independent fashion. *See infra* note 116.

56. Thus, for example, the prohibition on executive loans could be amended to permit lending in areas unlikely to cause significant harm such as split-dollar insurance programs and relocation assistance. For other areas, such as whether to permanently exempt small companies from section 404, it is too early to determine. Even the Commission is having a difficult time with the issue. *See infra* note 67 (noting four-year delay in application of section 404 to smaller companies).

57. See section 302 of SOX. *See* 15 U.S.C. § 7241 (Supp. II 2002); Commodity and Securities Exchange, 17 C.F.R. § 240.13a–14 (2006).

disclosure of an "internal control report," with the outside accountant having to "attest to, and report on, the assessment made by the management of the issuer."[58]

In drafting these provisions, Congress confronted an almost complete void under state law.[59] Early cases in Delaware suggested that boards had no affirmative obligation to acquire information.[60] They did not have to implement systems designed to ensure that accurate financial and other information made it to executive officers or directors.[61] Later decisions took a somewhat different view but created a standard that effectively allowed directors to avoid liability by remaining ignorant about activities within the company.[62]

The changes made by SOX in this area generated the most obvious set of costs emanating from the legislation and, as a result, made it the favorite target.[63] Section 404[64] and its requirement that outside auditors attest to a company's internal controls has been labeled, perhaps

58. 15 U.S.C. § 7262(b) (Supp. II 2002).

59. Contrary to the usual adage, ignorance was a defense. In some of the celebrated criminal cases involving corporate fraud, CEOs took the position that they were not aware of the financial manipulations. Prosecutors were left having to prove that they somehow knew. In other words, there was not a sufficiently strong fiduciary obligation that required knowledge.

60. *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").

61. Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1136 (2003) ("In this sense Sarbanes-Oxley can be seen as attempting to calibrate the mandatory disclosure system to a world in which the board of a public corporation will have insufficient incentives to undertake high-powered monitoring of corporate finance and, therefore, market monitoring must be strengthened.").

62. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 366 (Del. Super. Ct. 2006) ("We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."); *see also* In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996). Putting aside that *Caremark* was only a Court of Chancery opinion, no subsequent decision ever found a company with inadequate internal procedures. For a discussion of these cases, see Brown, *supra* note 21, at 345–47. For a discussion of the evolution in the regulation of internal controls, see Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's Duty of Care as Responsibility for Systems* 5–11 (Georgetown Univ. Law Ctr., 2005), *available at* http://ssrn.com/abstract=808084.

63. For a list of possible costs, see Carney, *supra* note 3, at 144–52.

64. 15 U.S.C. § 7262 (Supp. II 2002).

wrongly,[65] the most expensive provision added by SOX.[66] Studies have attempted to quantify these costs, with most of the criticism focusing on the disproportionate expenses incurred by smaller companies.[67]

As an initial matter, it seems clear enough that SOX resulted in increased out-of-pocket expenses for public companies. In quantifying the costs, however, the data to date is generally weak and incomplete. First, much of what is used is anecdotal[68] and often relies on extrapolations from small samplings.[69] Second, the amounts overstate the continuing costs of SOX. They do not typically separate out expenses that were a one-time event necessary to bring companies into initial compliance,[70] a process that should become cheaper over time.[71]

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65. The costs emanating from this section are the most quantifiable and the most visible. The most significant cost of SOX, one occasionally mentioned by others but not discussed in great detail, may be the opportunity costs associated with CEO and CFO review in connection with the certification process. To the extent officers decide to undertake substantial due diligence in connection with the process, this is time taken away from running the business. Of course, there may be business benefits that accompany a greater understanding of the financial statements. Either way, this is a cost that is difficult to assess with any accuracy, so it often gets ignored.

66. *See* Carney, *supra* note 3, at 142 ("Section 404 of SOX, the principal factor in increased costs, deals strictly with financial statement issues, and leaves the rest of corporate disclosure untouched.").

67. Bainbridge calls this "[t]he most troubling aspect of the dramatic increase in compliance costs." Bainbridge, *supra* note 45, at 12. Interestingly, this has occurred despite a four-year delay in implementation for smaller companies. *See* Internal Controls, Securities Act Release No. 8545, Exchange Act Release No. 51,293 [2004–2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,335, at 81,841 (Mar. 2, 2005); *see also* Internal Controls, Securities Act Release No. 8731, Exchange Act Release No. 54,295 [Current Volume] Fed. Sec. L. Rep. (CCH) ¶ 87,619, at 83,383 (Aug. 9, 2006).

68. Thus, for example, Carney undertakes his own assessment of costs by looking at forty-four companies that engaged in "going private" transactions under Rule 13e-3 of the Exchange Act. He acknowledged that seventeen of the companies were "quite small," with profits or losses of less than $1 million. Carney, *supra* note 3, at 149. From these forty-four cases, he estimates the losses at $500,000 per company and places the cost of "total compliance" at $8 billion a year or, if capitalized at 3%, an even more impressive $266 billion. *Id.* at 151.

69. A considerable amount of this data is cited by Carney. *See* Carney, *supra* note 3, at 147–48. Some rely on a study conducted by the law firm Foley & Lardner LLP. *See id.* at 148 n.54. The most recent version, dated June 15, 2006, involved the distribution of surveys to "9,000 CEOs, CFOs, General Counsel, Chief Compliance Officers, Board Members, Directors and other executives of both public companies and private organizations." FOLEY & LARDNER, LLP, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY 18 (Jun. 15, 2006). As the survey noted, responses were received from 114 public companies. While the evidence is useful, it hardly seems comprehensive and could easily be prone to selective response from companies feeling the most aggrieved by the impositions of SOX.

70. *See* Ehud Kamar, Pinar Karaca-Mandic & Eric L. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* 19 (USC Center in Law, Economics and Organization Research Paper Series, Paper No. C06-5, USC Legal Studies

Third, some of the costs attributed to section 404 would have occurred anyway, even had the provision never been adopted.[72] To the extent accounting firms were forced into a more distant, gatekeeper role, it is reasonable to assume that their fees would rise, with or without section 404.[73] Moreover, while the gatekeeper role was enhanced by other provisions of SOX, it is likely that even absent legislation, accounting firms, in the aftermath of Enron and WorldCom, would have gone in this direction in order to reduce legal exposure.

Similarly, the impact on smaller companies ignores the fact that these companies are notorious for having poor internal accounting systems.[74] Particularly as they grow in size, they will need to improve

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Research Paper Series, Paper No. 06-10, 2006), *available at* http://ssrn.com/abstract=901769 (reporting data showing adverse affect of SOX in first year but not in subsequent years).

71. Some of the costs arose at least in part from the uncertainty of the requirements. As greater certainty descends and, frankly, cheaper alternatives develop, such as implementation software, these costs should decline. *See* CFO RESEARCH SERVS. ET AL., COMPLIANCE AND TECHNOLOGY: A SPECIAL REPORT ON PROCESS IMPROVEMENT AND AUTOMATION IN THE AGE OF SARBANES-OXLEY 17 (2005) (a report prepared by CFO Research Services in collaboration with Virsa Systems and PricewaterhouseCoopers LLP) ("Sarbanes encourages companies to focus on the areas of improvement the legislation is aimed at, and to do so in the most efficient way possible—generally through greater automation. One executive points out that his company now has a conscious policy of replacing manual with automated controls and reporting every chance it gets. Not all are prepared to go that far, but most are moving that way.").

72. U.S. GOV. ACCOUNTABILITY OFFICE, GAO-06-361, CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES 18 (2006) ("These challenges were undoubtedly compounded in companies that needed to make significant improvements in their internal control systems to make up for deferred maintenance of those systems.").

73. The increase in costs likely was exacerbated by the oligopolistic nature of the accounting industry, with companies having little choice on rates and services. There are four independent accounting firms. They audit "98 percent of U.S. publicly traded company sales (revenues)." U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 72, at 8. Public companies in many cases will use two of them, one for auditing and one for consulting services. Thus, unhappy with services or charges, public companies have few alternatives.

74. *Hating Higgs*, THE ECONOMIST, Mar. 2003, at 63 ("Simon Bartholomew of Russell Reynolds, an executive-search company, says it is harder for small quoted companies to recruit high-quality non-executives, because they often have weaker financial controls, their boards carry less prestige and they pay less."); Charles Batchelor, *Inventive Managers on Course for Disaster*, FINANCIAL TIMES (London), Oct. 20, 1992, at 19 ("A survey of small, high-tech companies showed the most common causes of crises were weak general management, poor financial controls, product competition and problems in diversifying and making acquisitions."); Carl Mortished, *Flotations*, TIMES, Dec. 30, 1997, at 22 ("Most small companies are deservedly small. They are rotten investments because of their weak managements, small markets and bad financial controls."); *see also* U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 72, at 14 ("Further, resource and expertise limitations that characterize many smaller companies as well as their general lack of familiarity or

these systems. One suspects that SOX accelerated an improvement process at least some of which would have, or should have, occurred anyway.

The other data subset used to demonstrate the high cost of SOX concerns the number of companies "going dark," those allowing the number of shareholders of record to fall below 300.[75] The consequences of going dark are severe. No longer subject to the periodic reporting requirements,[76] the companies cannot be traded on an exchange or the Bulletin Board[77] and are limited to unregulated markets such as the automated pink sheets.[78] In general, only the smallest of companies with limited liquidity allow this to happen.[79]

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experience with formal internal control frameworks contributed to the challenges and increased costs they faced during section 404 implementation.").

75. 15 U.S.C. 78l(g) (Supp. II 2002); *see* Reporting Requirements-Smaller Public Companies, Securities Act Release No. 8666, Exchange Act Release No. 53,385, [2005–2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,523, at 83,062 (Feb. 28, 2006) ("An issuer 'goes dark' when holders of record of all classes of securities fall below the 300 holder threshold and it files a Form 15 terminating its reporting obligations under Section 12(g) or suspends its obligations under Section 15(d)."). Where this occurs, a company need only file a Form 15 with the Commission. Filing this form immediately suspends the issuer's Exchange Act reporting obligations. If, after ninety days from the date of filing the Form 15, the Commission has not objected, the suspension becomes a permanent termination. *See* Commodity and Securities Exchanges, 17 C.F.R. § 240.12g-4 (2006). A Form 15 does little more than contain a representation about the number of shareholders. *See* Exchange Act Release No. 20,784, Fed. Sec. L. Rep. (CCH) ¶ 83,508, at 86,669 (Mar. 30, 1984). A company may also go dark by buying back shares or engaging in other transactions designed to reduce the number below 300. In those circumstances, the company must file a Schedule 13E-3 with the Commission and distribute the information to shareholders. Commodity and Services Exchanges, 17 C.F.R. § 240.13e-3(3) (2006).

76. A company with shares traded on an exchange must file periodic reports. *See* 15 U.S.C. § 78l(b) (2000 & Supp. II 2002). Note that these are not the only companies that may deregister and cease filing periodic reports. Until recently, NASDAQ required companies listed in the automated trading system to register under section 12(g), thereby becoming subject to the periodic reporting requirements. When NASDAQ qualified as an exchange, see In the Matter of Nasdaq Stock Market LLC, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550 (Jan. 13, 2006), listed companies became subject to the reporting requirements under section 12(b). To the extent they delist and have less than 300 shareholders of record, they will not be required to file periodic reports.

77. *See* NASD, Manual Rule 6530 (2006), *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000866; Reporting Requirements-Smaller Public Companies, *supra* note 75 at 83,055 ("Since 1999, the NASD has required companies traded on its Over-the-Counter Bulletin Board ("OTCBB") to file reports under the Exchange Act. Under Exchange Act rules, registrants must file annual and quarterly reports disclosing information about their companies." (footnote omitted)).

78. In these markets, brokers cannot engage in trading activity unless they are in possession of the information required by Rule 15c2-11 of the Exchange Act. Commodity and Securities Exchanges, 17 C.F.R. § 240.15c2-11 (2006). The pink sheets are an electronic quotation system that has almost no requirements for listing. The name comes from the color

The number of companies "going dark" because of SOX is hard to discern.[80] A GAO report noted a post-SOX increase in the numbers,[81] with some companies unsurprisingly giving as one explanation the costs (including those imposed by SOX) of maintaining public company status.[82] Nonetheless, the numbers are at best modest, increasing from 143 in 2001, the last full year before the adoption of SOX, to 245 in 2004;

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of paper used when the quotes were printed in hard copy. *See* Phlocorp., S.E.C., Initial Decision Release No. 304 at n.4 (Feb. 17, 2006) (admin. proc.) ("The Pink Sheets is an electronic inter-dealer quotation system that displays quotes and last-sale information for many over-the-counter securities. The name comes from the color of paper used when the sheets circulated in hard copy. Unlike the OTCBB, the Pink Sheets does not require companies whose securities are quoted on its system to meet any listing requirements. Many of the companies listed on the Pink Sheets do not file periodic reports or audited financial statements with the Commission."). For a nice article describing the obligations (or lack thereof) of companies traded in the Pink Sheets, see Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities*, 39 IND. L. REV. 309 (2006).

79. They likely fall under the definition of micro-cap stocks, a group of companies that raise continuing concern over fraud. *See* Specified Information, Exchange Act Release No. 41,110, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,121, at 81,871 (Feb. 25, 1999) ("Because incidents of fraud and manipulation involving micro-cap securities are a serious concern, the Commission, along with other regulators, has made combating micro-cap fraud one of its top priorities."). For one definition of micro-caps, see Smaller Public Companies, Securities Act Release No. 8666, Exchange Act Release No. 53,385, [2005–2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,523, at 83,031 (Feb. 28, 2006) ("[C]ompanies whose outstanding common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization" (i.e., companies with equity capitalizations below approximately $128 million) would qualify as micro-cap companies.).

80. Even before the adoption of SOX, the number of companies "going dark" was on an upward trajectory. *See* U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 72, at 22. The GAO analysis does not take into account the impact of the weaker stock market.

81. *Id.* at 21 ("[T]he number of public companies that went private has increased significantly from 143 in 2001 to 245 in 2004, with the greatest increase occurring during 2003. However, the 245 companies represented 2 percent of public companies as of January 31, 2004. Based on the trends observed in 2003 and 2004 and the 80 companies that went private in the first quarter of 2005, we project that the number of companies going private will have risen more than 87 percent, from the 143 in 2001 to a projected 267 through the end of 2005." (footnote omitted)).

82. It was not, however, the only factor. *See id.* at 24 ("From 1999 to 2004, more companies cited market and liquidity issues than the indirect costs associated with maintaining their public company status. Companies in this category cited a wide variety of issues related to the company's publicly traded stock such as a lack of analyst coverage and investor interest, poor stock market performance, limited liquidity (trading volume), and inability to use the secondary market to raise additional capital.").

less than two percent of all public companies.[83] Moreover, in terms of size, they are small[84] and trade in the least liquid markets.[85]

Others have studied leveraged buyouts ("LBOs") and "going private" transactions.[86] Data suggests that in the first few years after the adoption of SOX the number of these transactions increased, although again, the numbers are modest.[87] These types of transactions occur for a variety of reasons,[88] with the cost of remaining public only one factor.[89] While SOX no doubt played a role on the margins (as did the costs associated with remaining public in general),[90] attributing the increase, or even a significant portion of the increase, to the Act is a stretch.

LBOs typically involve the repurchase of shares from public stockholders at a premium financed mostly by borrowing, using the assets of the company as leverage. Thus, the cost of the shares is the key variable.[91] Even before the adoption of SOX, share prices essentially collapsed, only reaching bottom in late 2002.[92] The decline made LBO

83. *Id.* at 21. The number overstates their importance. As a percentage of revenues or assets of public companies, they would likely constitute a substantially smaller percentage. *See id.* at 21–22.

84. *Id.* at 21–22 ("Our analysis also indicated that companies going private during this entire period were disproportionately small by any measure (market capitalization, revenue, or assets).").

85. In fact, 25% traded in no market at all. Another 37% were traded in the OTC Bulletin Board and 14% in the Pink Sheets. The remaining percentages were as follows: NASDAQ (17.6%); AMEX (5.3%) and NYSE (1.8%). *Id.* at 25.

86. *See* Carney, *supra* note 3, at 153–59.

87. According to Carney, there were sixty-five LBOs in 2001 and 114 in 2004. *Id.* at 157. This is hardly enough growth to justify any conclusions about SOX even if they were all attributable to the Act, particularly given that many of them were small.

88. In fact, they may also be a mechanism used by management to "hide" from the judgment of the market. Brown, *supra* note 29, at 59.

89. *See* Carney, *supra* note 3, at 158 ("One of the difficulties with the data is that it doesn't discriminate between companies that go private simply because stock prices have declined drastically in some segments of the stock market and those that find the increasing costs of remaining public a sufficient motivation.").

90. Moreover, to assume that in LBOs companies avoid the costs of SOX is to assume that in the post-LBO environment, companies dispense with audited financial statements. In fact, this is likely not true. They would probably still need them for bank loans and to maintain financial records should the purchasers ever want again to bring the company public. *See* Jaclyne Badal & Phred Dvorak, *Theory & Practice: Sarbanes-Oxley Gains Adherents*, WALL ST. J., Aug. 14, 2006, at B3.

91. As nonacademics note, LBOs need "cheap stock." John Dizard, *Leveraged Buyouts Fail to Appear on the Radar Screen*, FINANCIAL TIMES (London), Apr. 25, 2006, at 14 ("The cheap stock part is also necessary. We know, for example, there will be no LBO of Google.").

92. The NASDAQ was trading at 4234.33 on September 1, 2000. From September of 2000 through January 2001, the NASDAQ dropped 45.9% to 2291.86. In October of 2002,

transactions more viable and, predictably, the numbers increased. Share prices on the NYSE recovered by late 2005 and 2006.[93] Unsurprisingly, the number of LBOs appears to have declined.[94]

Whether relying on costs associated with compliance or the number of companies "going dark" or engaging in LBOs, the analysis places little or no weight on the benefits associated with the reforms. Certainly, reforming internal controls will not "prevent" all fraud,[95] although reducing the control of the CEO and CFO over the finances by empowering the audit committee and accounting firms will prevent some instances of it.[96] Whether that alone will prove to be enough to justify the reforms and their attendant costs is an empirical question not ready to be answered.

But focusing solely on the prevention of fraud deliberately understates the benefits of SOX. More broadly, the Act also increases investor confidence in the efficacy of corporate disclosure,[97] something that will likely follow from an improvement in the integrity of financial

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the NASDAQ dropped as low as 1,108.49, a 78.4% drop from its all-time high of 5,132.52 in March of 2000. The Standard & Poor's ("S&P") 500 stock index closed at an all-time high of 1527 on March 24, 2000. Since then, the index has declined by about 28% to 1097 as of May 14, 2002, roughly where it was four years ago. The Dow hit an all time high of 11,723 on January 14, 2000. In October 2002, the market had fallen to 7286.

93. The NYSE has returned to dot com heights, with the Dow Jones hitting record highs in October 2006. The NASDAQ has not, although October brought five year highs. *See Dow Sets 4th Record Close in a Row*, L.A. TIMES, Oct. 27, 2006, at C4.

94. *Going Private is Going Out of Fashion*, SARBANES OXLEY COMPLIANCE J., Mar. 31, 2005, http://www.s-ox.com/news/detail.cfm?articleID=731 ("The number of U.S. companies seeking to go private decreased by nearly 50 percent in 2004, dropping from almost 100 in 2003 to less than 50 last year. It is the first year since 2001 that the number of initial public offerings exceeded the number of companies wanting to go private.").

95. Carney, *supra* note 3, at 142 ("These new procedures will not prevent all or even most financial fraud."); *see also* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 291 (2005) ("Yet one of the deepest ironies of SOX is that corporate America's expensive process of renovating internal controls pursuant to section 404 seems unlikely to forestall the kinds of high-level frauds that triggered public outcry and governance reform.").

96. One commentator noted that "there is circumstantial evidence suggesting that incremental improvements in fraud detection because of section 404 are likely to be modest" but then conceded that "[t]o be sure, the presence of internal controls may prevent or deter some frauds in the first place, and detection patterns may change in a world of controls improved by section 404, but it would be good to have evidence of such effects." Clark, *supra* note 95, at 294. While statistics may be absent, note the connection between instances of fraud and smaller companies. *See* Exchange Act Release No. 41,110, *supra* note 79.

97. Clark, *supra* note 95, at 308 ("The reforms may yet prove to be beneficial on balance, especially if the hoped-for general effect on investor trust is real.").

statements.[98] After all, most inaccuracies do not result from fraud. Companies may have inaccurate financial statements because they do not rigorously follow existing requirements or do not have adequate internal controls.[99]

This can be seen from the decision by foreign companies to accept higher costs in return for increased investor confidence. The United States is often viewed as a gold standard for purposes of accurate and complete disclosure, and foreign markets reward companies that meet these standards.[100] As a result, foreign companies often list in the United States not because they want to raise capital but because of the resulting increase in share prices that comes with increased investor confidence.[101] The reforms implemented by SOX arguably continue this approach.

Whatever the direct impact on investor confidence, SOX has apparently had some effect on the accuracy of financial disclosure.[102]

98. *See* U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 72, at 1 ("Regulators, public companies, audit firms, and investors generally agree that the Sarbanes-Oxley Act of 2002 has had a positive and significant impact on investor protection and confidence.").

99. Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 IOWA J. CORP. L. 267, 277 (2004) ("Historically, financial controls were intended to promote fair financial reporting, though after SOX they increasingly are intended to prevent fraud."); David Reilly, *Restatement Blame: Basic Mistakes*, WALL ST. J., Nov. 20, 2006, at C4 (noting that research by the SEC on the reasons for restatements found that 55% of restatements were due to "basic mistakes with nuts and bolts accounting").

100. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 673–76 (1999); *see also* Neeraj Bhargava, *Good Governance is Good Business*, WALL ST. J., Aug. 28, 2006, at A12 ("Headlines are likely to continue to assert that stringent financial reporting and corporate governance guidelines are diminishing the prestige of a U.S. listing and driving companies to international exchanges. And yes, meeting the highest listing standards in the world does come at a price. But the benefits continue to outweigh the challenges and to drive companies toward greater efficiency, stability and long-term growth.").

101. They may also be more responsive to investor needs and concerns. *See* Ugur Lel & Darius P. Miller, *International Cross-listing, Firm Performance and Top Management Turnover: A Test of the Bonding Hypothesis* 29 (Sept. 1, 2006), *available at* http://ssrn.com/abstract=926606 (foreign firms cross-listed in the US are more likely to shed underperforming CEOs than noncross-listed firms and that "this effect is concentrated in cross-listings on major U.S. exchanges with the strongest investor protections").

102. Some of the increase may have occurred in the post-Enron environment, even without SOX. Nonetheless, SOX appears to have played a significant role. *See* U.S. GOV. ACCOUNTABILITY OFFICE, GAO-06-678, UPDATE OF PUBLIC COMPANY TRENDS, MARKET IMPACTS, AND REGULATORY ENFORCEMENT ACTIVITIES 11–12 (2006) ("Some industry observers noted that several factors may have prompted more U.S. publicly traded companies to restate previously reported financial results, including (1) the financial reporting requirements of the Sarbanes-Oxley Act, especially the certification of financial reports

The number of restatements has increased significantly since its adoption,[103] particularly among larger companies.[104] The overvaluation that resulted from the inaccurate financial statements was estimated at $63 billion on an adjusted basis.[105]

B. Audit Committees and Independent Directors

SOX made two broad changes to the audit committee structure.[106] First, it limited the committee to independent directors,[107] with the definition of "independent" substantially tougher than anything used by either the self-regulatory organizations ("SROs") or Delaware,[108] and it encouraged the committee to include directors with some degree of expertise.[109] Second, the audit committee obtained clear and expanded

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required by Section 302 and the internal controls provisions of Section 404; (2) increased scrutiny from the newly formed PCAOB through its inspections of registered public accounting firms; and (3) increased staffing and review by SEC.").

103. *Id.* at 4 ("While the number of companies announcing financial restatements from 2002 through September 2005 rose from 3.7 percent to 6.8 percent, restatement announcements identified grew about 67 percent over this period."); *see also* Reilly, *supra* note 99 (noting that 1,195 restatements occurred in 2005, up from 270 in 2001, with more than 1,300 expected in 2006).

104. *See* U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 102, at 4 ("The median size (by market capitalization) of restating companies increased from $282 million in 2002 to $672 million in 2005.").

105. *Id.* at 5 ("The market capitalization of the companies—those we were able to analyze from among the listed companies that we identified as announcing restatements of previously reported information between July 2002 and September 2005—decreased an estimated $63 billion when adjusted for overall market movements ($43 billion unadjusted) in the days around the initial restatement announcement.").

106. Section 303 also requires the adoption of rules prohibiting interference with an audit. 15 U.S.C. § 7242 (Supp. II 2002).

107. By including them as rules of the SRO, Congress dramatically reduced the possibility of private enforcement action. *See* J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE 15.04[2][g] (3d ed. 2006). If the requirements subsequently prove ineffective, the absence of this type of enforcement mechanism may provide a significant explanation.

108. In effect, directors sitting on the committee could receive no compensation from the company, directly or indirectly, other than fees. For a discussion of the Delaware definition of independence and its analytical inconsistencies, see J. Robert Brown, Jr., *Disloyalty without Limits: Independent Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. (forthcoming 2006).

109. SOX does not require financial expertise. Instead, the Commission must issue rules requiring reporting companies "to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least [one] member who is a financial expert, as such term is defined by the Commission." 15 U.S.C. § 7265 (Supp. II 2002). The Commission codified the requirements in Item 401 of Regulation S-K. *See* SEC Regulation S-K, 17 C.F.R. § 229.401 (2005). The NYSE now requires financial expertise on the audit committee. *See* NYSE, Inc., Listed Company Manual § 303A(7) (2006). At least among

jurisdiction, receiving "direct" responsibility "for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer"[110] and a guarantee of "appropriate funding." [111]

It is hard, from a common sense perspective, to see the harm in requiring greater independence[112] and expertise on the audit committee.[113] Those opposing the changes have focused on studies suggesting that director independence generally, and on the audit committee specifically, does not increase shareholder value or reduce the probability of financial statement wrongdoing.[114]

The studies illustrate the weakness of resolving all issues by relying upon off-the-shelf economic analysis. The studies generally pre-date SOX ,[115] and focus on the role of independent directors. SOX, however, did more than require independence. It provided for expertise, mandatory jurisdiction, and guaranteed funding. Studying one aspect of SOX without considering the impact of the others renders the whole approach suspect.[116] Moreover, the studies have an inherent

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Fortune 500 companies, the presence of financial expertise has become ubiquitous. Alix Nyberg Stuart, *Can You Spot the Finance Expert?*, CFO MAG., Sept. 2005.

110. *See* 15 U.S.C. § 78j–1(m) (Supp. II 2002). The requirements were to be implemented as mandatory listing standards by the exchanges.

111. *See* Ribstein, *supra* note 42, at 369.

112. Some have tried. *See* Romano, *supra* note 7, at 1530 (surveying studies and suggesting that "independent boards do not improve performance and that boards with too many outsiders may, in fact, have a negative impact on performance").

113. One of the silliest is the notion that the pool of eligible directors will somehow get smaller. *See* E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 IOWA J. CORP. L. 441, 448 (2003) ("Two things are likely to happen. One is the near certainty that the Enron fallout and Sarbanes-Oxley will shrink the universe of willing and qualified candidates who would agree to be elected as directors."). It is another way of saying that by making the job harder and increasing the work load, some will have less interest in serving on the board, a fair enough statement. That there will not be an adequate pool of possible directors does not at all follow from that conclusion and, in fact, may make room for greater diversity. *See* Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 805 ("More specifically, reform measures that require corporations to have more independent directors can have a positive impact on the number of directors of color.").

114. Romano, *supra* note 7, at 1529–33.

115. *Id.* at 1604.

116. This is particularly important since common sense suggests that independence in isolation will not automatically have a positive impact on companies. The term generally applies to persons not under the control of the CEO. *See* Brown, *supra* note 108. The mere absence of a particular type of relationship does not in any way guarantee the presence of other qualities necessary for effective management. Thus, independence alone does not necessarily mean the director will have the knowledge or force of personality to act in an

weakness.[117] Neither the definition used by Delaware[118] nor the exchanges[119] truly ensures independence. The studies, even those attempting to compensate for some of these deficiencies,[120] suffer from comparable flaws.[121]

In any event, companies have implemented the requirements, and some opportunities exist to study how things are working in practice. Since the adoption of SOX, the number of financial restatements from large public companies has increased significantly.[122] Presumably, at least some of the increase resulted from the newly reconstituted audit committees.

C. Executive Loans

The restriction on executive loans is perhaps the most obvious categorical prohibition in the Act. Section 402 of SOX imposes an almost absolute ban[123] on extensions of credit to executive officers and

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independent fashion. There may be some specific circumstances where independence alone has value. For example, the insertion of independent directors might prove beneficial to a board viewed by the market as excessively under the control of an underperforming CEO. Of course, this effect could also occur by the replacement of captive independent directors with less captive ones or incompetent directors with competent ones.

117. Some evidence indicates the approach may be working and directors may be acting in a more independent fashion. *See* Alan Murray, *Leash Gets Shorter for Beleaguered CEOs*, WALL ST. J., Aug. 23, 2006, at A2 ("The firing of a CEO used to be a rare event—even the worst of them often managed to cling to power with remarkable tenacity. In the past two years, however, CEO firings have become commonplace.").

118. For a discussion of the problems with the approach used by Delaware in determining independence, see Brown, *supra* note 108.

119. The exchanges do not, for example, deal with the impact of personal relationships.

120. While studies of audit committees have attempted to identify independent outside directors and use a definition similar to the one in SOX, *see* Romano, *supra* note 7, at 1530–31, the data presumably suffers from the limits imposed by the public disclosure system. Thus, the proxy rules only require the disclosure of relating party transactions to the extent exceeding $60,000. As a result, not all arrangements will necessarily be disclosed. Moreover, sometimes companies do not properly disclose all required information about the potential conflicts of directors. *See In re* Disney, Exchange Act Release No. 50,882 (Dec. 20, 2004) (admin. proc.) (failing to disclose certain director relationships).

121. *See* Clark, *supra* note 95, at 300 (discussing independent director studies and noting that "independent directors may not be truly independent, because whatever the formal procedures, they are de facto selected by management, and they have insufficient personal incentive to act very independently").

122. *See* U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 102, at 114.

123. Some have suggested that Congress should consider more narrow categorical prohibitions designed not to exclude all loans. *See* Jayne W. Barnard, *Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act*, 31 OHIO N.U. L. REV. 325, 353–56 (2005) (proposing that Congress study particular abuses arising in the

directors,[124] although it is also one of the easiest to circumvent.[125] The provision amounted to a direct intrusion into state fiduciary duties. Because loans sometimes benefited the corporation[126] and sometimes did not,[127] the matter had traditionally been left to the discretion of the board of directors.[128] After SOX, this was no longer the case.

The provision was inserted into SOX in response to a number of abuses associated with loans to CEOs of large public companies. These loans demonstrated a fundamental weakness in the development of fiduciary obligations. As with any self-interested transaction, loans to directors or officers on the board were examined under the duty of loyalty.[129] The test mandated that the transactions be fair to the corporation. Fairness in the context of a loan was not a particularly difficult standard. In general, it was enough to show that the terms of the loan compared favorably to those made by "unrelated lenders."[130]

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context of executive loans and consider amendments); *see also supra* note 56 and accompanying text.

124. 15 U.S.C. § 78m(k) (Supp. II 2002).

125. Some have complained that the provision will inhibit stock ownership by executive officers and directors by prohibiting stock loans. *See* Ribstein, *supra* note 42, at 373 ("The problem with this regulation is that such loans have the potential benefit of encouraging insider ownership of company stock, which tends to align their interests with those of the shareholders."). This criticism ignores the fact that the company can, of course, give the officer or director the shares directly or derivative securities such as stock appreciation rights, in both cases obviating the need for any loan.

126. Thus, Romano is correct in noting that the provision "is a blunderbuss approach that prohibits all loans, whether or not they are useful in facilitating the shareholders' objective of providing a sought-after incentive effect." Romano, *supra* note 7, at 1540. Of course, so does every categorical rule that affects shareholder objectives.

127. The WorldCom loans to Bernie Ebbers, for example. DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM., INC. 292–93 (Mar. 31, 2003) ("We believe these loans and guaranties were contrary to the interests of WorldCom and its shareholders. Indeed, we do not understand how the Compensation Committee or the Board could have concluded that these loans were in the best interests of the Company or an acceptable use of more than $400 million of the shareholders' money. These decisions reflected an uncritical solicitude for Ebbers' financial interests, and an insufficient focus on the shareholders' interests.").

128. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 971–72 (2003) (labeling section 402 as the "type of limitation that more traditional minds might think should flow from the chartering states, rather than from the federal government").

129. *See* Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1211 (2004).

130. *See* Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987).

Delaware courts, however, eliminated the requirement of fairness, replacing it with process.[131] The transaction only needed to be approved by a board consisting of a majority of independent and disinterested directors.[132] Once done, the loan would be reviewed under the business judgment rule,[133] rendering the actual terms of the transaction largely irrelevant.

The use of the business judgment rule, while never fully explained, was hard to justify.[134] For one thing, the courts did nothing to exclude the interested influence. The interested director could participate in the discussion and vote on the matter. It was enough that a "majority" of the board be independent and disinterested.

More importantly, the business judgment rule was an over-inclusive protection designed to encourage managerial risk-taking.[135] As such, the approach allowed some instances of mismanagement to go unpunished.[136] The logic behind the presumption did not apply where the transaction was motivated not by risk-taking but by self-interest.

The poster child for the consequences of this approach was the loans and guarantees made to Bernie Ebbers, the CEO of WorldCom. The total amount ultimately exceeded $400 million and occurred at a time of financial difficulty for WorldCom. Two of the three members of the

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131. *See* Brown, *supra* note 108.

132. *See id.*

133. The only significant exception was a transaction between the company and a controlling shareholder. In those circumstances, approval by independent directors shifts the burden of proof, with shareholders having the burden of proving the unfairness of the transaction. *See id.*

134. Approval of a conflict of interest transaction by a majority of independent and disinterested directors apparently purged the disloyal taint and justified the application of the business judgment rule. *See id.* In fact, however, the conflict was still very much present. The approach used by Delaware did not guarantee that in fact the directors making the decision were independent. Nor did it even require that the conflict be removed from the deliberation process. So long as approved by a majority of independent directors, the interested party could participate in the discussions and even vote on the matter.

135. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1299 n.43 (2001) ("When it took that step, the law reflected the policy concern that an overly aggressive approach to enforcing the duty of care could deter risk-taking and discourage service on corporate boards by qualified candidates."); *see also* George W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*, 75 NW. U. L. Rev. 96, 135 (1980) (stating that the business judgment rule "insulate[s] from liability directors who have made mistaken decisions resulting in corporate losses, notwithstanding their good faith and exercise of due care").

136. Thus, liability may not be imposed for negligent mismanagement. Delaware courts require at least a showing of grossly negligent mismanagement. *See* Brainbridge, *supra* note 14, at 562–63. In fact, the standard is probably higher.

compensation committee[137] had extensive interaction with Ebbers and, while meeting the NYSE definition of independent, were considered "poor choices" to represent the interests of the corporation.[138] The loans were made on highly favorable terms[139] and involved an assumption of risk "that no financial institution was willing to assume."[140]

Nonetheless, so long as they were approved by directors who met the state law definition of independent[141] and otherwise conformed to the duty of care, a decidedly low standard,[142] the loans were beyond challenge.[143] Ebbers ultimately defaulted and most of the loans remain uncollected.[144]

Had the board retained the obligation to show the fairness of the loans, they probably never would have occurred. At a minimum,

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137. As one report concluded: "The Compensation Committee of the board seemed to spend most of its efforts finding ways to enrich Ebbers, and it certainly did not act as a serious outside watchdog against excessive payments or dangerous incentives." Richard C. Breeden, Corporate Monitor, Restoring Trust: Report to the Hon. Jed S. Rakoff on Corporate Governance for the Future of MCI, Inc. 25 (Aug. 2003).

138. *Id.* at 28 n.27 ("Both Kellett and Bobbitt appeared to satisfy the 'independence' standards for directors of the time, and might well satisfy current definitions used by the New York Stock Exchange ("NYSE") and NASDAQ. However, both men had received millions of dollars worth of WorldCom stock when Ebbers acquired predecessor companies. Both men had been involved in business with Ebbers for years, and both owed a substantial portion of their net worth to his actions. This made them uniquely poor choices to represent the interests of WorldCom's shareholders in exercising oversight responsibilities over Ebbers. As demonstrated by their actions in extending stockholder loans to bail out Ebbers' personal debts, both men seemed to be more solicitous of Ebbers' wishes than shareholder interests.").

139. BERESFORD ET AL., *supra* note 127, at 292 ("The Company did not have a perfected security interest in any collateral for the loans for most of the time period during which they were outstanding."); *see also id.* at 304–05 ("Ebbers was not required to make regular payments; rather, payments were required only on the Company's demand, and no payments were demanded. The promissory notes provided that the interest charged to Ebbers would be equal to the fluctuating rate of interest charged under a WorldCom credit facility, almost always the lowest rate available to WorldCom at the time, and a rate of interest lower than that of Ebbers' other outside loans. Moreover, this rate was lower than the average rate WorldCom paid on its other debt.").

140. *Id.* at 292.

141. WorldCom was incorporated in Georgia. The company eventually changed its name to MCI and reincorporated in Delaware. This analysis assumes the Delaware standard applies.

142. *See* Brehm v. Eisner, No. 411, 2006 Del. LEXIS 307, at *54–58 (Jun. 8, 2006).

143. As one report concluded: "[W]e do not understand how the Compensation Committee or the Board could have concluded that these loans an acceptable use of more than $400 million of the shareholders' money." BERESFORD ET AL., *supra* note 127, at 32.

144. Some of Ebbers' assets were seized and sold to pay down the loan. The company filed an action in the Bankruptcy Court seeking a judgment for the full amount due under the note. *See* MCI Corp., Form 10-K/A (Jan. 5, 2006) (filed with the SEC).

fairness would have required commercially reasonable terms. With the decision subject to the business judgment rule, the terms and fairness of the transaction hardly mattered.

It was this void that Congress entered in banning executive loans by public companies.[145] Thus, the issue is not whether the prohibition results in inefficiencies or additional costs, but whether these consequences are more costly and inefficient than the approach employed under Delaware common law.

IV. CONCLUSION

Contractarians add a valuable perspective on corporate law, particularly the insight into the usefulness of enabling rules over mandatory rules.

The approach, however, has no presumption in practice.T[146] In addressing reform, adherents must make the affirmative case that the costs of any particular provision outweigh the benefits. Relying on weak empirical data about costs while understating benefits will be unconvincing. So will criticisms of a categorical approach solely because it is categorical. Defending the status quo without addressing its weaknesses will lack credibility.

This has been particularly true in the context of SOX. It is true that the Act was adopted in a political flurry, precipitated by scandal. None of that changes the fact that, in the aftermath of Enron and WorldCom, there were serious problems with the U.S. system of disclosure and governance. WorldCom succeeded in understating expenses by $10 billion, Enron in creating an $80 billion Potemkin village, and these were only a few of the extraordinary financial scandals during the period.[147] While there may be an "optimal amount of fraud,"[148] nothing

145. The consensus European approach seems to favor categorical rules in some cases. *See* ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 22, at 20 (noting that "abusive self-dealing should be prohibited").

146. Some would disagree with this. *See* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 IOWA J. CORP. L. 657, 721 (1996) ("When a firm and a union representing its workers contract for strategic participation, the basic economic principle of voluntary exchange allows us to assume that the agreement is mutually beneficial. No such presumption, however, attaches to strategic participation imposed by government fiat.").

147. For a convenient list, see David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 65–67 (2003).

148. Carney, *supra* note 3, at 141 (quoting Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 67 (1973)).

about the Enron-WorldCom era seems optimal; suggestions to turn back the clock are myopic.[149]

Similarly, asserting that Delaware corporate law is, in general, the most efficient does not automatically require the conclusion that everything done within the state results in greater efficiency.[150] In the context of the duty of loyalty, the approach of the Delaware courts has been to more or less eliminate the fairness analysis from conflict of interest transactions.[151] The result is that conflict of interest transactions are not subject to serious limits. SOX tried to undue part of this approach.

The permanent effects of SOX may eventually become clear enough and susceptible to isolation to permit assessment. That day has not yet arrived.

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149. *See* Romano, *supra* note 7, at 1529 ("The central policy recommendation of this Article is that the corporate governance provisions of SOX should be stripped of their mandatory force and rendered optional for registrants.").

150. *See* Bebchuk et al., *supra* note 26, at 1789.

151. *See* Brown, *supra* note 21, at 335.

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