

# Sarbanes-Oxley Five Years Later: Hero or Villain

Charles W. Murdock\*

## I. INTRODUCTION

Sarbanes-Oxley was enacted as the culmination of the outcry against the corporate scandals that came to light in the early 2000s. The mantra “business is good, government is bad” was temporarily reversed as investors lost billions of dollars and employees lost their retirement benefits. Government was called upon to act, and the notion that the market, alone, solves all problems was proven false when it was clear that companies like Enron could so easily dupe the market.

However, it did not take long for the pendulum to begin to swing back as business railed against the costs of compliance with Sarbanes-Oxley. While many projected that compliance was likely to result in very modest costs,<sup>1</sup> the actual costs mushroomed, arguably because the accounting profession overreacted.<sup>2</sup> Businesses began to call for the repeal of Sarbanes-Oxley.<sup>3</sup> Accordingly, five years after its adoption, this is an appropriate time to review the legislation and its impact, and to assess whether its benefits outweigh its burdens.

Part II of this Article briefly reviews the circumstances that led to the passage of Sarbanes-Oxley. In particular, it analyzes two high profile examples of corporate corruption, the complicity of the accounting profession, and supine boards of directors who failed to fulfill their oversight responsibility. Part III discusses the requirement that management certify the accuracy of financial statements and the efficacy of internal controls, and the requirement that auditors attest to

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\* Professor and Loyola Faculty Scholar, Loyola University Chicago School of Law.

1. Congress initially estimated the average cost of compliance for a company to be about \$91,000. *See infra* text accompanying note 99. However, actual costs ran into the millions of dollars for many companies. *See infra* text accompanying notes 100–103 (detailing the estimated low cost of compliance with Sarbanes-Oxley).

2. *See infra* text accompanying notes 121–134 (describing how costs outpaced estimates due in part to the overreaction of public accounting firms).

3. *See generally* Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of Sox Undermine the Act's Benefits?*, 39 LOY. U. CHI. L.J. 595 (2008) (examining whether criticism of SOX will prevent it from achieving its underlying goals).

the operation of internal controls. These provisions have generated the most controversy. Consequently, Part IV analyzes what arguably has gone wrong with Sarbanes-Oxley. It then discusses the interpretive guidance the SEC recently released, intended to alleviate the unnecessary burdens Sarbanes-Oxley has placed on businesses. Parts V and VI analyze the benefits of Sarbanes-Oxley and discuss how the business community has overreacted to regulation and litigation.

The Article concludes that the policy behind Sarbanes-Oxley is essential for the proper functioning of efficient capital markets. Thus, business, instead of bemoaning the Sarbanes-Oxley legislation, should adopt a new mantra: “Why Not Tell the Truth?”

## II. THE EVENTS LEADING TO SARBANES-OXLEY

Many factors contributed to the corporate corruption that led to Sarbanes-Oxley. The prime factor was corporate management’s personal greed and lust for power. However, courts and legislatures also bear responsibility for approving or adopting procedures and rules that discouraged litigation, thereby protecting management from oversight. This lack of oversight from litigation facilitated the failure to hold corporate management accountable for their actions.<sup>4</sup> Without the threat of litigation, corporate directors, accountants, and others who winked at wrongdoing became passive and supine; thus, they failed to hold corporate management accountable. While there will always be wrongdoing, one of the great failures during this period was the failure of “gatekeepers” to fulfill their responsibilities.<sup>5</sup>

Let’s take a look at Arthur Andersen. At the start of the 1990s, Arthur Andersen was regarded as a paragon of virtue. The name was synonymous with integrity. Paul Volcker, prominent financial advisor and former Chairman of the Federal Reserve, noted the irony that “[t]en or fifteen years ago Arthur Andersen was considered the class of accounting, the gold standard, how to do it, how to organize an accounting firm.”<sup>6</sup> Unfortunately, in the 1990s, Arthur Andersen was

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4. Charles W. Murdock, *Sarbanes-Oxley, Corporate Corruption, and the Complicity of Courts and Legislatures* (Sept. 7, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=1012970> [hereinafter *Corporate Corruption*].

5. See JOHN C. COFFEE, *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (2006) (explaining the rise and development of gatekeepers, those who advise and inform boards of directors, and how their failure to raise red flags about questionable practices contributed to corporate scandals).

6. *NewsHour with Jim Lehrer: Newsmaker Paul Volcker* (PBS television broadcast Mar. 12, 2002), transcript available at [http://www.pbs.org/newshour/bb/business/jan-june02/volcker\\_3-12.html](http://www.pbs.org/newshour/bb/business/jan-june02/volcker_3-12.html).

involved in major corporate frauds involving Waste Management, Sunbeam, the Baptist Foundation of Arizona, and, of course, Enron.<sup>7</sup> Thus, within about a decade, the firm went from a conservative accounting firm to one that was operating on the edge, leading to its indictment and felony conviction.<sup>8</sup>

Pushing the envelope like Arthur Andersen did is risky business. Justice Brandeis acknowledged the dangerous, yet common, tendency for humans to test the limits:

[Y]our lawyers . . . can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone . . . ; but anybody can tell you where you can walk perfectly safely within convenient distance of that precipice. The difficulty which men have felt . . . has been rather that they wanted to go to the limit rather than they wanted to go safely.<sup>9</sup>

Reams of paper have been written about Enron and Arthur Andersen,<sup>10</sup> so that matter will not be belabored here. Instead, let's look at just one transaction that illustrates the "envelope pushing" that Arthur Andersen and Enron management engaged in under the nose of a supine board of directors.

The transaction which ultimately brought Enron down is depicted in the following illustration.<sup>11</sup> If it looks complicated, that's because it was—crooks seldom operate on the "KISS" principle.<sup>12</sup>

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7. SUSAN E. SQUIRES ET AL., *INSIDE ARTHUR ANDERSEN: SHIFTING VALUES, UNEXPECTED CONSEQUENCES* 113 (Jim Boyd ed., 2003).

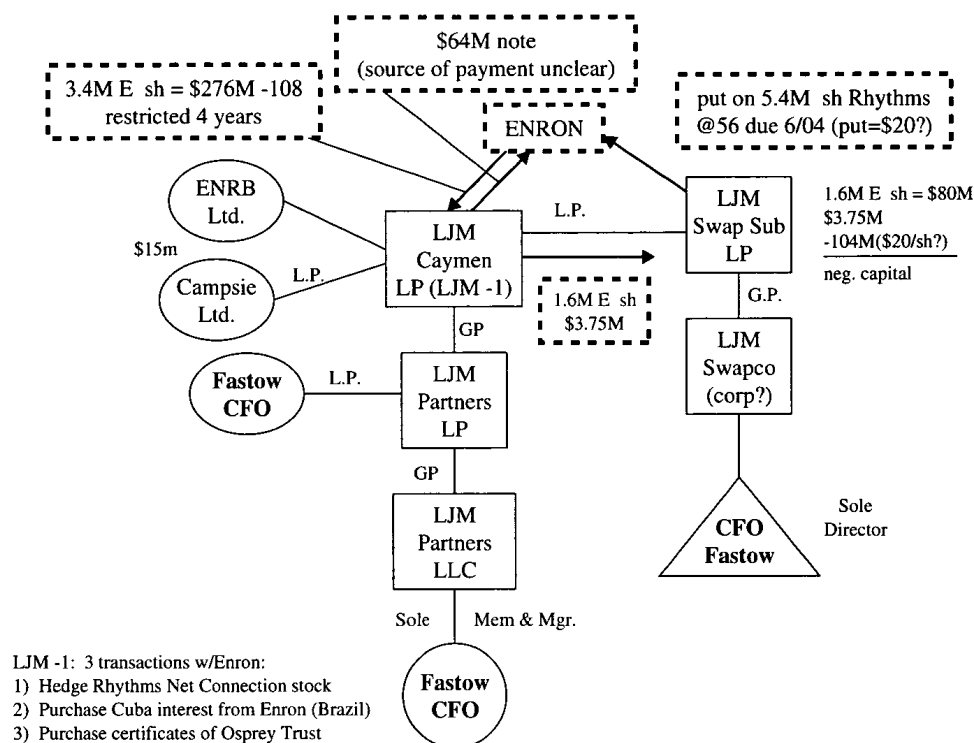
8. *Id.* (explaining the shifting values at Arthur Andersen that led to their ultimate undoing with the Enron scandal).

9. Hearings Before S. Comm. on Interstate Commerce, S. Res. 98, 62nd Cong. 1161 (1911) (statement of Louis D. Brandeis).

10. *See, e.g.*, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (a collection of articles about Enron, the business world, the legal environment, and ethics).

11. The information in the diagram and accompanying text is derived from WILLIAM C. POWERS, JR. ET AL., *REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP.* (2002), available at <http://www.broadband-span.org/downloads/powersreport.pdf> [hereinafter THE POWERS REPORT].

12. *See* Charles W. Murdock, *The Attorney as "Creator" or "Author": Attorney Liability Under Enron*, CBA RECORD, Apr. 2003, at 34 (the "KISS" principle stands for "keep it simple stupid," which is what an honest person does; in this article, the author coined the acronym "MICI," which stands for "make it complex idiot," which is what crooks employ).



Enron had acquired 5.4 million shares of Rhythms Net Connection, a private Internet broadband provider, for \$10 million, or about \$1.85 per share.<sup>13</sup> A few months later, Rhythms was taken public at \$21 per share in a hot market.<sup>14</sup> The price rose to \$69 on the first day of trading.<sup>15</sup> Enron thus had a valuable mercantile asset, but one that was very volatile. The asset was marked to market and Enron realized income or loss as the value of Rhythms stock rose or fell.<sup>16</sup> Consequently, Enron wanted to hedge the value of Rhythms.

Andrew Fastow, Enron's CFO, proposed the "hedging" transaction reflected in the diagram above.<sup>17</sup> Pursuant to this transaction, Enron transferred 3.4 million of its own shares to LJM Cayman ("LJM"), an

13. THE POWERS REPORT, *supra* note 11, at 77.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* at 78.

Enron subsidiary run by Fastow.<sup>18</sup> The shares were then worth \$276 million, but Enron placed a four-year restriction on any subsequent sale of the shares that supposedly reduced the value of the shares to \$168 million.<sup>19</sup> In exchange for the shares that Enron transferred to LJM, LJM gave Enron a note for \$64 million and LJM Swap Sub (“Swap Sub”), an LJM subsidiary also controlled by Fastow, gave Enron a put option whereby Enron could require Swap Sub to repurchase the 5.4 million shares of Rhythms stock at \$56 a share.<sup>20</sup> The put was valued at about \$20 per share, or about \$104 million.<sup>21</sup> LJM funded Swap Sub by transferring 1.6 million Enron shares, worth about \$80 million, and \$3.75 million in cash to Swap Sub.<sup>22</sup> Thus, Enron gave LJM stock worth \$168 million and received a note from LJM for \$64 million and a put from Swap Sub worth \$104 million.<sup>23</sup> In this manner, Enron supposedly hedged the value of the Rhythms stock at \$56 per share, and thus avoided having to declare a loss whenever the value of Rhythms’ stock fell.<sup>24</sup>

In order for the hedge to work, Swap Sub had to be independent of Enron so that if Enron were doing poorly, Swap Sub had an independent source of funds to draw upon to fulfill its obligations. To qualify as a supposed independent “special-purpose entity” (“SPE”), Swap Sub was required to have at least 3% equity.<sup>25</sup> Because Swap Sub had about \$84 million in assets, it needed about \$2.5 million of equity.<sup>26</sup> Fastow told the Enron Board that he invested \$1.0 million of his own money in Swap Sub, but, even if true, this would fall short of the requisite equity. Because the put obligation of Swap Sub was \$104 million, but Swap Sub had only 1.6 million Enron shares worth about \$80 million plus \$3.75 million in cash, Swap Sub was basically insolvent.<sup>27</sup>

Arthur Andersen originally signed off on this arrangement, which had the effect of protecting Enron’s income by avoiding a charge to earnings

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18. *Id.* at 80. LJM Cayman was supposed to operate independently of Enron, but Fastow’s involvement as both Enron’s CFO and manager of LJM presented a potential conflict of interest. *Id.* at 78–81. Enron’s board approved the arrangement. *Id.* at 79.

19. *Id.* at 80.

20. *Id.* at 80–81.

21. *Id.* at 81.

22. *Id.* at 80.

23. *Id.* at 80–81.

24. *Id.* at 80–83.

25. See Emerging Issues Task Force, Financial Accounting Standards Board, Issue No. 90–15, Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions (1990).

26. THE POWERS REPORT, *supra* note 11, at 83.

27. *Id.* at 80–81.

if the Rhythms stock should decline in value. This approval was highly dubious, not only because Swap Sub was not a legitimate SPE since it lacked the requisite 3% capital but also because Swap Sub's assets were comprised of Enron stock. In effect, Enron was using its own stock to support the value of its stock. If the value of both the Rhythms stock and the Enron stock decreased, Swap Sub could not honor its obligation to repurchase the Rhythms stock, and the earnings of Enron would further deteriorate due to the loss incurred in marking the Rhythms stock to market. This type of circular arrangement was previously rejected in *U.S. v. Simon*, in which accountants were held criminally liable for using corporate stock indirectly to prop up the value of a corporate asset.<sup>28</sup> Two years later, Andersen claimed it became concerned about whether Swap Sub met the 3% equity test and required Enron to restate its earnings.<sup>29</sup>

This is a classic example of operating "on the edge," in fact, over the edge. The transaction used multiple entities and involved a member of Enron management who had a conflict of interest. The parties attempted to do indirectly what could not be done directly: namely, to use Enron stock to support the value of Enron stock by eliminating the mark to market risk of Rhythms stock, a mercantile asset. Twenty years earlier, in the *Simon* case, accountants went to jail for approving a similar gambit.

How did Andersen move from being a conservative, gold standard accounting firm to a sleazy one? It is an oversimplification to say that the partners were greedy and would do anything to get more business. What was the environment in which they operated, the environment that produced a "what, me worry" type mentality? Clearly, the Supreme Court's elimination of aiding and abetting liability for fraud or misrepresentations in connection with securities sales in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* contributed to this mentality.<sup>30</sup> Yet, because accountants are liable as a primary

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28. *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969).

29. THE POWERS REPORT, *supra* note 11, at 83-84.

30. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). The issue of whether aiding and abetting liability existed under Rule 10b-5 was not litigated in the courts below, nor was it initially presented to the Supreme Court on appeal. See *Central Bank of Denver v. First Interstate Bank of Denver*, 508 U.S. 959 (1993) (granting the petition for certiorari). Nevertheless, the Court directed the parties to brief this issue and, notwithstanding the fact that all eleven of the Courts of Appeal had recognized a private cause of action against aiders and abettors under rule 10b-5, the Court determined that such a cause of action could no longer be brought under rule 10b-5. *Central Bank*, 511 U.S. at 175-76.

violator for misrepresentations in audited financial statements,<sup>31</sup> even after aiding and abetting liability was eliminated they remained at risk under the securities laws for audited statements. However, *Central Bank* removed any risk of accountant liability for interim statements or for consulting services. In addition to accountants, *Central Bank* also let attorneys, investment advisors, and other professionals off the hook.<sup>32</sup>

Arthur Andersen was not alone in failing to fulfill its “watchman” or “gatekeeper” responsibilities. On paper, Enron also had a gold standard board of directors.<sup>33</sup> Similarly, the audit committee, on paper, appeared

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31. The ink was hardly dry on the *Central Bank* opinion before much of the anticipated benefit to accountants was dissipated in *Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass 1994). In *Kendall Square*, plaintiffs alleged losses as a result of the company’s material overstatements of revenue and sued several defendants, including Price Waterhouse. *Id.* at 27. The auditing firm had issued an unqualified audit opinion on the company’s 1992 fiscal results which were filed with the company’s 10K report. *Id.* The Court held that, while reviewing and approving quarterly statements does not constitute the “making” of a misrepresentation, nor does “structuring” the transactions, the cause of action could proceed “on the basis of the unqualified audit opinion,” which was a representation to the investing public. *Id.* at 28–29.

32. *Central Bank*, 511 U.S. at 164. The Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), affirmed the Eighth Circuit, noting that the Eighth Circuit had determined that “any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm.” *Stoneridge*, 128 S. Ct. at 769. The Supreme Court found that such conclusion “is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents” *Id.* The majority declined to limit the scope of *Central Bank*. For a criticism of both positions, see Justice Stevens’ dissenting opinion. *Id.* at 774 (Stevens, J., dissenting).

33. The Enron Board of Directors were: Robert A. Belfer, Chairman of Belco Oil & Gas, prior to 1986, President & Chairman of Balco Petroleum, 100% Enron subsidiary; Norman P Blake Jr., CEO of Comdisco, Director of Owens-Corning; Ronnie Chan, Chairman of Hang Lung Group (a Hong Kong development company), also director of Motorola & Standard Chartered PLC; John H. Duncan, Former Chairman of the Executive Committee of Gulf & Western Industries, Inc. and Investor, director of EOTT Energy; Wendy L. Gramm, former Chairman of the U.S. Commodities Futures Trading Commission; Ken L. Harrison, former Chairman and CEO of Portland General Electric Company; Robert K. Jaedicke, former Dean of the Graduate School of Business, Stanford University, also director Boise Cascade and California Water Service Company; Kenneth L. Lay, Enron Chairman, also Director of EOTT Energy, Eli Lilly, Compaq, I2 Technologies, and New Power Holdings; Charles A. Lemaistre, former President Emeritus of the University of Texas M.D. Anderson Cancer Center; John Mendelsohn, President of the University of Texas M.D. Anderson Cancer Center, director of Im Clone Systems; Jerome J. Meyer, Chairman, Tektronix, Inc.; Paulo V. Ferraz Pereira, Exec. V.P. of Group Bozano, former President and CEO of State Bank of Rio de Janeiro; Frank Savage, Chairman of Alliance Capital Management International, also director of Lockheed Martin and Qualcomm; Jeffrey K. Skilling, President and CEO of Enron Corp., also director of Houston branch of Federal Reserve Bank of Dallas; John A. Urquhart, Senior Advisor to Enron Chairman, former Senior Vice President of Industrial and Power Systems, General Electric Company; John Wakeham, former U.K. Secretary of State for Energy and Leader of Houses of Lords and Commons, director of a number of U.K. companies; and Herbert S. Winokur Jr., Chairman of

to be a blue ribbon committee.<sup>34</sup> The minutes of the audit committee at which the LJM transactions and Fastow's conflicts of interest were discussed illustrate how the audit committee failed to do its duty.<sup>35</sup> Set forth below is my attempt to create an agenda for the meeting to illustrate the scope of material covered:

- Call to order 1:40 p.m.
- Approval of minutes
- Current audit matters
  - Update on status (anticipate unqualified, no disagreement with management)
  - Communications required by Statement on Arbitrary Standards #61
- Opinion on internal controls (no material weaknesses)
- Observations regarding accounting procedures (financial reporting)
  - (Enron uses highly structured transactions)
- Necessity of significant judgment regarding the foregoing
- Related party transactions
- Discussion of reserves (Causey)
- Review of LJM transactions (Causey)
  - Board guidelines
  - Compliance
  - Supplemental procedures
  - Review of **each** transaction
- Legal Matters (Derrick)
- Audit Committee Report for proxy statement
- Review of proposed Audit Committee charter (Causey)
- Review of 2001 Internal Audit Control Plan (Causey)
  - Review of key business trends
  - Overview of business risk assessment

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Capricorn Holdings, Director of Penn Central (former), NATCO Group, Mrs. Fields', CCC Information Services, and Dyn Corp. ENRON CORP., ENRON ANNUAL REPORT 2000, at 56-57 (2001), available at <http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf>.

34. The Enron Audit and Compliance Committee was: Robert K. Jaedicke, Chairman, Professor Emeritus of Accounting and Former Dean, Stanford University Graduate School of Business; Ronnie C. Chan, Chairman, Hang Lung Group; Wendy L. Gramm, Former Chairman, U.S. Commodity Futures Trading Commission; John Mendelsohn, President, University of Texas M.D. Anderson Cancer Center; Paulo V. Ferraz Pereira, Executive Vice President of Group Bozano, Former President and CEO of State Bank of Rio de Janeiro, Brazil; and John Wakeham, Former U.K. Secretary of State for Energy and Leader of the Houses of Lords and Commons. *Id.* at 55-56.

35. For the full minutes, see <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/audcomp021201min.pdf>.



- Key changes from prior years
- Review of planned 2001 work and comparison with years 1998–2000
- Primary areas of emphasis in 2001 (Kitchrist)
- Discussion of shared internal control with AA
- Discussion of policies for management communication with analysts (Koenig)
  - Discussion of Enron investor relations group
  - Discussion of Regulation FD
  - Discussion of materiality
- Credit & Market Update—deferred to Finance Committee
- Adjourned at 3:15 p.m. until an executive session to approve auditors the next morning from 7:50–8:00 a.m.

This looks like an impressive agenda, both in scope and detail. Supposedly the committee reviewed **each** LJM transaction, as well as the proposed audited financial statements, the proposed internal control work, and many other items on the agenda. Now consider the LJM transaction diagram above and the accompanying explanation.<sup>36</sup> How long would it take you to understand that particular transaction?

Could these matters have been dealt with adequately in one hour and twenty-five minutes? The fact that the audit committee spent so little time on so many matters of great magnitude suggests that it was merely going through the motions. Why would this be the case? The directors of Enron were handsomely compensated.<sup>37</sup> Surely they did not intend to deceive the public. Then why were they so supine? This Article asserts that the directors were lulled to sleep by a lack of accountability in the system.

Let's take a look at another corporate fiasco that has currently been in the news involving Lord Conrad Black, Hollinger International, and former Illinois Governor James Thompson, who was the chair of the

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36. See *supra* notes 11–29 and accompanying text (detailing the LJM transaction).

37. PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., REPORT ON THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 56 (Comm. Print 2002).

The three experts at the May 7 hearing also criticized the compensation paid to the Board members, noting that \$350,000 per year was significantly above the norm and that much of the compensation was in the form of stock options which enabled Board members to benefit from stock gains, without risking any investment loss.

*Id.*

Hollinger audit committee.<sup>38</sup> While Hollinger came to light after Sarbanes-Oxley was enacted, the corruption involved highlighted the recent enactments and reflected the continued indolence of corporate directors prior to Sarbanes-Oxley.

Hollinger was another example of a supposedly blue ribbon board of directors who failed abysmally to fulfill their responsibilities.<sup>39</sup> Lord Black and his cronies took hundreds of millions of dollars as management fees from Hollinger, in connection with covenants not to compete and other ploys, such as aircraft charges, corporate apartments, automobiles, and personal staff.<sup>40</sup> In all, from 1997 through 2003, the Black group received cash compensation of \$362,606,165 and stock options of \$39,049,000 for a total compensation of over \$400 million dollars.<sup>41</sup> The table on the following page summarizes the transactions.<sup>42</sup>

The Hollinger report pointed out the failings of the Audit Committee, particularly with regard to the “outsourcing” agreement with Ravelston, a company of which Lord Black was the controlling shareholder.<sup>43</sup> The Hollinger report contained the following indictment of the audit committee:

Each of the Audit Committee members acknowledged that they never questioned the business rationale for, or fairness of, the Ravelston “outsourcing” arrangement. They also acknowledged that they did not develop or apply any comparisons or other metrics against which each year’s proposed fee could intelligently be measured. They never

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38. Lord Black was convicted of fraud and obstruction of justice, and sentenced to 6 1/2 years in prison. Tim Arango, *Black Is Sentenced to 6 ½ Years in Prison*, N.Y. TIMES, Dec. 11, 2007, at C1.

39. The audit committee was composed of Richard Burt, who was a former U.S. ambassador to Germany, Marie-Josée Kravis, a senior fellow at the Hudson Institute, and James Thompson, the former governor of Illinois. Other board members included Raymond Chambers, the chairman of the Amelior Foundation, Henry Kissinger, the former U.S. Secretary of State, Richard Perle, the Former U.S. Assistant Secretary Of Defense, Robert Strauss, the former U.S. Ambassador to the Soviet Union, and Lord Weidenfeld, the chairman of Weidenfeld & Nicholson, Ltd. RICHARD BREEDEN, REPORT OF INVESTIGATION BY THE SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF HOLLINGER INTERNATIONAL, INC. 76 (2004).

40. *Id.* at 106, tbl. 3.

41. *Id.*

This does not include the many additional financial benefits that Hollinger’s former senior management extracted for affiliated entities, including (i) the CanWest management and termination fees to Ravelston; (ii) the Hollinger revenue generating assets transferred to Horizon and Bradford; (iii) the NP Holdings loss carryforwards sold to Ravelston; and (iv) the scores of millions in below market loans to HLG.

*Id.*

42. *Id.*

43. *Id.* at 133.

**HOLLINGER INTERNATIONAL**  
**Summary of Compensation Received by the Black Group**

	2003	2002	2001	2000	1999	1998	1997	Total
Management Fees (1)	\$26,036,000	\$24,868,000	\$30,707,000	\$38,012,000	\$40,300,000	\$32,000,000	\$26,506,000	\$218,429,000
Non-Compete / Unauth Pymts (2)	—	—	11,267,548	63,724,383	15,200,000	—	—	90,191,931
Salaries & Bonuses	982,106	995,032	2,647,853	5,188,347	910,247	689,906	667,734	12,081,225
Directors / Article Fees / Other	389,509	463,641	468,822	538,561	485,938	441,192	359,514	3,147,177
Moffat Mgmt "Broker" Fee	—	—	—	—	—	—	—	*
Personal / Home Staff	321,130	318,486	208,066	196,798	199,059	127,380	31,731	1,402,650
Aircraft Charges (3)	4,747,947	6,016,364	6,476,182	6,466,616	—	—	—	23,707,109
Corporate Apartments	148,281	142,212	134,700	2,609,000	187,951	998,215	125,793	4,346,152
Roosevelt Papers	—	—	8,000,000	33,000	—	141,625	737,200	8,911,825
Automobiles	153,229	131,923	85,398	18,546	—	—	—	389,096
<b>TOTAL CASH</b>	<b>\$32,778,202</b>	<b>\$32,935,658</b>	<b>\$59,995,570</b>	<b>\$116,787,250</b>	<b>\$57,283,194</b>	<b>\$34,398,318</b>	<b>\$28,427,972</b>	<b>\$362,606,165</b>
Stock Options (4)	8,318,000	8,390,000	9,364,000	5,241,000	3,216,000	3,551,000	969,000	39,049,000
<b>TOTAL COMPENSATION (5)</b>	<b>\$41,096,202</b>	<b>\$41,325,658</b>	<b>\$69,359,570</b>	<b>\$122,028,250</b>	<b>\$60,499,194</b>	<b>\$37,949,318</b>	<b>\$29,396,972</b>	<b>\$401,655,165</b>

(1) Amounts paid to Ravelston, RMI, Black-Amiel and Moffat as reported in Hollinger proxy statements. 2003 management fee figure obtained from Hollinger. Management fee disclosures in Hollinger proxy statements for some years do not match 10-K disclosures; impossible to reconcile without access to Ravelston records, which have been withheld from the Special Committee.

(2) Includes \$16.55 million in unauthorized non-competive payments to HLG in 1999 and 2000, which indirectly benefited Black and his fellow Ravelston shareholders by subsidizing an entity in which Ravelston held a 78% ownership interest.

(3) Paid directly by Ravelston prior to 2000 — hence these costs were still funded by Hollinger in those years through the management fee paid to Ravelston. Amounts shown in table relate to both business and personal use of corporate aircraft by Black and Radler, because flight logs do not clearly indicate the purpose of most flights. As discussed later in this report, however, the Special Committee's review of flight destinations indicates that Black and Radler used the corporate jets extensively for personal travel without reimbursing the Company.

(4) Source: F.W. Cook & Co. Valued using binomial model and Hollinger's FAS 123 assumptions for the respective years.

(5) This does not include the many additional financial benefits that Hollinger's former senior management extracted for affiliated entities, including (i) the CanWest management and termination fees to Ravelston; (ii) the Hollinger revenue generating assets transferred to Horizon and Bradford; (iii) the NP Holdings loss carryforwards sold to Ravelston; and (iv) the scores of millions in below market loans to HLG.

\* Hollinger paid \$900,000 in "broker" fees to Moffat Management in 1999. This amount was disclosed as management fees in Hollinger's 2000 proxy and, accordingly, is included in Management Fees above.

asked for any information about Ravelston: its size, scope of business, revenues/profitability, clientele, employee list, compensation schedules, or anything else. They never asked if the payment of annual management fees to Ravelston was causing Hollinger to incur costs greater than it would incur if the Company simply hired Black, Radler and other needed Ravelston personnel directly. And they never sought to base the annual fee on a performance component, such as a percentage of Hollinger's EBITDA.<sup>44</sup>

Director Marie-Josée Kravis, a member of the audit committee, was not aware that Black's compensation through Ravelston was set by the audit committee.<sup>45</sup> According to the Hollinger Report, "Kravis' observation that the Audit Committee didn't negotiate the management fees appears consistent with the record, but this appears to be due to complacency and neglect by the Committee, and not because another committee was taking on such negotiations."<sup>46</sup> The other members of the audit committee, and the board itself, deferred to Governor Thompson as the chair of the committee.<sup>47</sup> Thompson declared that, "his pre-Audit Committee meetings with Radler were brief, and they were usually held over lunch or coffee."<sup>48</sup> He acknowledged that he never asked for any analysis supporting the fee proposal, but believed such an analysis was unnecessary "because the proposed fee never changed much from year-to-year."<sup>49</sup> Thus, the committee that was supposed to oversee the compensation arrangement deferred to the chairman's judgment. The chairman, however, failed to fulfill his responsibilities, and in the end the company lost hundreds of millions of dollars.

What leads to such passivity? Part of it is structural bias. These directors think alike and are social confrères.<sup>50</sup> Another part of it is a lack of any concern for, or fear of, the consequences for a failure to fulfill their responsibilities.

Judge Veasey of the Delaware Supreme Court, while still in private practice, ridiculed the notion of structural bias in arguing that courts

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44. *Id.*

45. *Id.* at 136.

46. *Id.*

47. *Id.* at 134.

48. *Id.*

49. *Id.*

50. See Charles W. Murdock, *Corporate Governance: The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 104-09 (1993), reprinted in 36 CORP. PRACTICE COMMENTATOR 61 (1994-95) [hereinafter *Corporate Governance*] (discussing how members of committees have biases which affect their decision making).

should always defer to the judgment of the board of directors in the context of special litigation committees. He stated:

Those who are chosen as outside directors of publicly held corporations are generally persons who have distinguished themselves in some other capacity. Chief executive officers of other corporations seem to be especially prized as outside directors. Generally speaking, then, outside directors tend to be men and women who have considerable investments in reputation but who have invested most of their human capital elsewhere. The structural bias argument asks us to believe that outside directors generally are more willing to risk reputation and future income than they are to risk the social embarrassment of calling a colleague to account.<sup>51</sup>

I responded:

The concept of structural bias primarily recognizes the unconscious elements of decision making. It proceeds on the basis that members of the committee are not evil but biased. Bias is not used here in a negative or pejorative sense; rather it is used in the sense of inclination or predisposition.<sup>52</sup>

I should have added that the likelihood of risking future income is quite remote, given the United States Supreme Court decisions insulating directors and officers from litigation.<sup>53</sup>

The two examples of director dereliction in Enron and Hollinger evidence little desire to call colleagues to account and certainly do not inspire confidence that the board of directors will keep a watchful eye on management. Yet the dominant thrust of judicial decisions is essentially blind deference to boards of directors. If there is no one looking over your shoulder, why worry?

### III: SARBANES-OXLEY AND ITS KEY PROVISIONS

For a while, however, everyone was worried. The uproar over Enron and the other corporate scandals of the period led to the enactment of the Sarbanes-Oxley Act and, even more surprisingly for the George W. Bush administration, a determination to increase the budget of the

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51. Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW 503, 535 (1989).

52. See *Corporate Governance*, *supra* note 50, at 104 (explaining structural bias as a function of predisposition).

53. See *Corporate Corruption*, *supra* note 4, at 30–61 (documenting the Supreme Court's and Congress' complicity in the escalation of massive corporate fraud).

Securities and Exchange Commission to give it the manpower to curb corruption.<sup>54</sup>

However, it did not take long for enthusiasm for regulation to wane, at least in the corporate management arena. By 2004, a survey of CEOs found that a majority of them believed that overregulation was a bigger threat to the growth of their companies than was global terrorism or currency fluctuations.<sup>55</sup> This demonstrates both the bias and the myopia of corporate management. More recently, a study by Korn/Ferry reported that over half of directors in the United States believe that the Sarbanes-Oxley regulations should be repealed or overhauled.<sup>56</sup>

So what is the story? Is Sarbanes-Oxley good or evil? And, if there are problems, does the fault lie in the legislation or in how the legislation has been interpreted or exploited? Let us start by looking at the legislation itself.

From the standpoint of corporate integrity and reliable financial reporting, the key provisions of Sarbanes-Oxley are Sections 302, 404, and 906. Section 302 requires that the principal executive officer and the principal financial officer certify in each annual or quarterly report filed under the securities laws that the officer has reviewed the report, that it contains no false or misleading information, and that the financial statements “fairly present in all material respects the financial condition and results of operations of the issuer.”<sup>57</sup> In addition, the signing officers must certify that they are responsible for establishing and maintaining internal controls, that they have evaluated the effectiveness of such controls, and that they have disclosed to the auditors and the audit committee any problems with such controls.<sup>58</sup>

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54. The appropriations for the SEC increased every year from \$356,074,000 in fiscal year 1999 to \$904,846,000 (requested) in fiscal year 2007. SEC ANNUAL REPORT 208 (1999); SEC ANNUAL REPORT (2007), available at <http://www.sec.gov/about/annrep.shtml>.

55. Floyd Norris, *Too Much Regulation? Corporate Bosses Sing the Sarbanes-Oxley Blues*, N.Y. TIMES, Jan. 23, 2004, at C1.

A survey of global chief executives released by PricewaterhouseCoopers at the World Economic Forum found that 59 percent viewed overregulation as a significant risk or, worse, one of the biggest threats to the growth of their companies—far more than viewed global terrorism or currency fluctuations as posing major risks.

*Id.*

56. Press Release, Korn/Ferry International, Majority of Board Directors Feel Sarbanes-Oxley Regulations Should Be Repealed or Overhauled (Feb. 23, 2006), available at [http://www.kornferry.com/Library/Process.asp?P=PR\\_Detail&CID=1419&LID=1](http://www.kornferry.com/Library/Process.asp?P=PR_Detail&CID=1419&LID=1).

57. 15 U.S.C.A. § 7241(a)(3) (West Supp. 2006).

58. 15 U.S.C.A. §§ 7241(a)(4), (5) (West Supp. 2006).

Section 906 put some teeth in the requirement that the CEO and CFO certify that the financials fairly present the condition and operations of the company. The Section provides criminal penalties and imprisonment if an officer knowingly or willfully certifies false information.<sup>59</sup>

Section 404 requires that each annual report filed by a reporting company must contain the report on internal controls, which sets forth the responsibility of management to establish and maintain such controls, as well as an assessment of their ineffectiveness.<sup>60</sup> In addition, the auditor for the company is required to attest to and report on the assessment made by management.<sup>61</sup>

This Part focuses on objections to Sarbanes-Oxley. It first looks at the criticism directed towards Section 302 of the Act and demonstrates that its requirements are, in fact, reasonable. It then examines the impact Section 302 has had on recent litigation. Next, this Part deals with Section 404, the more controversial section of Sarbanes-Oxley. It discusses the initial expectations regarding the impact of Section 404.

#### A. *Section 302: Management Certification of Financials*

While much of the rancor directed towards Sarbanes-Oxley has focused upon Section 404, dealing with management's responsibility for internal controls, Section 302 has also been criticized for allegedly expanding the net of liability. In railing against overregulation, the McKinsey Report, commissioned by Mayor Michael Bloomberg of New York City and New York Senator Charles Schumer, characterized the U.S. legal system as punitive, stating:

[L]iability is not limited to corporate entities but also extends to individuals, even if they are only remotely involved in the US markets. For example, Section 302 of the Sarbanes-Oxley Act specifically imposes personal liability on corporate executives for failing to comply with the act. The recent extraterritorial application of other US statutes has made even clearer the personal threat that US laws can present.<sup>62</sup>

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59. 18 U.S.C.A. § 1350(c) (West Supp. 2006).

60. 15 U.S.C.A. § 7262(a) (West Supp. 2006). *See infra* text accompanying note 95 for the full text of this Section.

61. 15 U.S.C.A. § 7262(b) (West Supp. 2006).

62. MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, CITY OF NEW YORK AND U.S. SENATE, SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 76-77 (2007), available at [http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20\\_FINAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf)

So how great is this threat? What do we expect from CEOs and CFOs with respect to the financial statements that their company promulgates to the public? Is it satisfactory for someone like Jeffrey Skilling, CEO of Enron, to be able to disclaim any knowledge of what was going on in his company?<sup>63</sup>

In order to assess how reasonable or unreasonable the provisions of Section 302 are, it might be helpful to look at the regulations promulgated pursuant to Section 302, which set forth the certification that the officers are required to give.<sup>64</sup> But rather than look at the certification itself, let's look at its negative. In other words, what would the antithesis of the required certification look like? I suggest it might look something like this:

I, [identify the certifying individual], certify that:

1. I have [*not*] reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report [*may*] ~~does not~~ contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, [*may or may not; I really don't know*] fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are [*not*] responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. [*Not*] Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to

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63. *The Financial Collapse of Enron—Part 2: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Energy and Commerce, 107th Cong. 91 (2002)* (testimony of Jeffrey K. Skilling, CEO, Enron).

64. To get to the actual language which the certification must follow requires a bit of mental gymnastics. You first need to go to Rule 13a-14, which will send you to form 10-K, Item 15, which will then take you to Item 601 of Regulation S-K. 17 CFR § 229.601.



- ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- b. *[Not]* Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. *[Not]* Evaluated the effectiveness of the registrant's disclosure controls and procedures and *[we have no]* ~~presented in this report our~~ conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. *[Not]* Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a. *[We have no idea whether there are]* All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. *[We have no idea whether there has been]* Any fraud, whether or not material, that involves management or other employees who have a

significant role in the registrant's internal control over financial reporting.<sup>65</sup>

If management of a company filed the foregoing certification, would anyone buy stock in such a company? Why then cannot corporate management assert the positive, since the negative is unacceptable?

Do we not expect management to review the financial statements it promulgates to the public? Note that the certification speaks only about what management knows, not what management *should* have known. If there are material misstatements or omissions *known* to management, would we not expect them to be corrected or disclosed? Does not management have a responsibility to maintain internal controls and should not these controls be such that they ensure that *material* information is brought to the attention of senior management? And should not management be interested in whether or not the controls are working? Why have controls if they are not effective? If there are *significant* deficiencies or *material* weaknesses, should not the auditors and the audit committee be informed?

One reason that management does not like these provisions is that, at least with respect to financial statements, management cannot escape responsibility for financial statements by employing the requirement in the Private Securities Litigation Reform Act ("PSLRA") that a plaintiff plead misstatements and scienter with particularity.<sup>66</sup> PSLRA placed a

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65. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (§ 302 codified at 15 U.S.C.A. § 7241 (West Supp. 2006)) (changes by author).

66. With respect to pleading with particularity, Section 21D(b)(1), 15 U.S.C.A. § 78u-4(b)(1) provides as follows:

In any private action arising under this chapter in which the plaintiff alleges that the defendant:

(a) made an untrue statement of a material fact; or

(b) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

15 U.S.C. § 78u-4(b)(1) (2000). In addition, with respect to scienter, Section 21D, 15 U.S.C.A. § 78u-4(b)(2) provides as follows:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (2000).

huge obstacle in the way of securities fraud plaintiffs by requiring specific, particular details of the alleged fraud to be in the complaint in order for the suit to proceed<sup>67</sup>—without the benefit of discovery.<sup>68</sup> Section 302 facilitates the particularity requirement for certain situations. It identifies for potential liability particular persons, who make particular representations, based upon particular actions.

*In re OCA, Inc. Securities and Derivative Litigation*<sup>69</sup> illustrates the impact that the Section 302 certification can have on the outcome of litigation. In the *OCA* case, the CEO, CFO, and COO were sued on the basis that they had misled investors by overstating the company's assets, which were in the form of patient receivables, and concealing material shortcomings in the company's internal controls.<sup>70</sup> Paradoxically, the company was in the business of providing financial, operational, marketing, management, and other business services to dental practices.<sup>71</sup> The situation was akin to the cobbler's children having no shoes.

In their complaint, the plaintiffs relied heavily upon the Section 302 certifications in three quarterly reports and upon three confidential witnesses. In all the quarterly reports, the CEO and CFO certified that the financial reports fairly presented the company's condition. In the first quarterly report in question (May 20, 2004), they certified that they:

- (i) had designed or caused to be designed "disclosure controls and procedures" to ensure that they were made aware of material information relating to the company; (ii) had evaluated the effectiveness of OCA's disclosure controls and presented in the quarterly report their conclusions about the effectiveness of those disclosure controls; (iii) had disclosed any material change in the company's internal controls over financial reporting that occurred

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67. See *Harris v. Ivax*, 182 F.3d 799, 803 (11th Cir. 1999) (noting the PSLRA's heightened pleading standard, which requires specific facts sufficient to create a strong inference as to the state of mind of the officers involved in submitting the allegedly fraudulent statement); *In re Midway Games*, 332 F. Supp. 2d 1152, 1155 (N.D. Ill. 2004) (describing the purpose of the PSLRA to discourage claims of "fraud by hindsight"); *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1306 (N.D. Ga. 2006) (noting that the PSLRA contemplates pleadings which allege facts concerning the time, place, and contents of the alleged fraudulent actions rather than conclusory allegations); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 984 (9th Cir. 1999) (holding that the plaintiff failed to meet the requirements where his allegations merely "suggested" an inference of deliberate recklessness, but failed to document the contents of the alleged fraudulent reports or the persons who wrote and reviewed those reports).

68. 15 U.S.C. § 78u-4(a)(3)(B)(iv)(2000).

69. No. 05-2165, 2006 WL 3747560 (E.D. La. Dec. 14, 2006).

70. *Id.* at \*1-2.

71. *Id.* at \*1.

during the most recent fiscal quarter; and (iv) had disclosed to OCA's auditors and its audit committee any significant deficiencies or material weaknesses in the company's internal financial reporting controls and any fraud, whether or not material, involving management or other employees who have a significant role in the company's internal financial reporting controls.<sup>72</sup>

The quarterly report also reported in a cursory manner that Ernst & Young, the auditors, had identified a number of material weaknesses in the company's internal controls, but that the company was taking a number of steps to improve its controls.<sup>73</sup>

The company later terminated Ernst & Young and engaged PricewaterhouseCoopers as the successor auditor.<sup>74</sup> On June 7, 2005, the company announced that it would further delay its 2004 annual report and that it had determined that it had materially overstated its reported patient receivables for each of the first three quarters.<sup>75</sup> The company also announced that the Board of Directors had appointed a special committee to investigate allegations that altered data had been provided to the company's auditor.<sup>76</sup> In the wake of this announcement, the stock of the company fell by more than 38%, and PricewaterhouseCoopers resigned five months later.<sup>77</sup> Later, OCA went into bankruptcy.<sup>78</sup>

In their motion to dismiss, defendants argued, first, that the plaintiffs had not alleged any actionable false statements by them and, second, that plaintiffs had not alleged acts sufficient to establish a strong inference of scienter.<sup>79</sup> The court dismissed the claim against the COO because he had not signed any of the public filings with the SEC and had not been involved in any of the press releases.<sup>80</sup> However, the court

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72. *Id.* at \*3 (internal quotation marks omitted).

73. *Id.* The weaknesses included:

- (i) increased automation in determining patient revenue and patient receivables; and
- (ii) steps to improve communication between operations and financial accounting, such as appointing a CFO with operations experience and forming a committee with representatives from the operations, financial accounting, and legal departments to discuss and assess pending litigation. The company also stated that it intended to hire additional financial accounting staff and to engage outside consultants to advise management on additional improvements to internal controls.

*Id.*

74. *Id.* at \*2.

75. *Id.* at \*6.

76. *Id.*

77. *Id.* at \*7.

78. *Id.*

79. *Id.* at \*10.

80. *Id.* at \*12.

noted that the CEO and CFO had each signed the certifications. Since the company had acknowledged in its June 7 communication that patient receivables were overstated by material amounts, the court determined that plaintiffs had adequately pleaded misleading statements by the two senior officers.<sup>81</sup> Under PSLRA, and prior to Sarbanes-Oxley, the action probably would have been dismissed.

The existence of these Section 302 certifications also helped plaintiffs meet their burden to plead scienter with particularity. The court stated:

[A]llegations of the following circumstances, when considered together, are sufficient to raise a strong inference of scienter as to Palmisano, Sr. [the CEO] and Verret [the CFO]: (1) the importance of OCA's patient receivables asset; (2) the severity of OCA's internal control problems; (3) the relationship of the internal control problems to the overstatements of the patient receivables asset; and (4) the Sarbanes-Oxley certifications executed by Palmisano, Sr. and Verret.<sup>82</sup>

Further supporting the plaintiffs' claims, confidential witnesses had testified to numerous complaints from patients that their payments had not been credited against their balances owed and that these problems were brought to the attention of their superiors.<sup>83</sup> In addition, the CEO, who was a certified public accountant, had helped to develop the company's accounting systems.<sup>84</sup> The court took this all into account when deciding whether the plaintiffs had adequately alleged an inference of scienter.

In so deciding, the court reviewed various commentators discussing how the Section 302 certification can help a plaintiff establish scienter.<sup>85</sup> The commentators argued that if a corporate officer certifies the company's financial reports, and later the company reveals that the reports contained material false statements, a plaintiff could establish that the officer knew about the false statements or was reckless in not knowing about the false statements in one of two ways.<sup>86</sup> First, the company's disclosure controls, mandated by Sarbanes-Oxley and certified as effective in the Section 302 certification, would have alerted the officer to the false statements.<sup>87</sup> Second, if the disclosure controls

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81. *Id.* at \*12.

82. *Id.* at \*17.

83. *Id.* at \*18.

84. *Id.*

85. *Id.* at \*21.

86. *Id.*

87. *Id.* at \*22.

were inadequate, then the officer knew they were inadequate or was reckless in not knowing.<sup>88</sup> Either way, based on the Section 302 certification, the officer could be charged with the requisite state of mind at the pleading stage.<sup>89</sup>

However, the court declined to hold that a Sarbanes-Oxley certification, “without more,” would support a strong inference of scienter.<sup>90</sup> It did conclude, however, that in this case, the “something more” was present. The certifications, coupled with the substantial problems with receivables and the failure to respond to the serious control problems, could support an inference of scienter.<sup>91</sup> The court focused on the fact that the officers certified that they had designed and evaluated the internal controls and that those controls were effective.<sup>92</sup> Moreover, the officers also certified that they had disclosed all significant deficiencies and material weaknesses in the internal control system to the auditors and the company’s audit committee.<sup>93</sup> However, in connection with its resignation, PricewaterhouseCoopers had reported that the company had not responded to the serious accounting irregularities and control problems, but rather had submitted altered records to the auditors.<sup>94</sup>

The *OCA* case demonstrates the potential impact of a Section 302 certification on the outcome of securities litigation—absent the officers’ certification of financial reports in that case, the defendant’s motion to dismiss probably would have been granted, allowing the defendants to escape liability easily.

*B. Section 404: Management Assessment of Internal Controls and Auditor Attestation of Such Assessment.*

Section 404 of Sarbanes-Oxley has generated the most controversy because of the incredible costs involved in complying with it. Calls for its modification or repeal have reached a crescendo. Before reviewing the complaints about Section 404, let us first look at the language of the provision:

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88. *Id.* at \*22.

89. *Id.* at \*21.

90. *Id.* at \*22.

91. *Id.*

92. *Id.* In two of the quarterly reports, these certifications had waffled about the effectiveness of internal controls, but the court stated that such “doubletalk” itself reflected a conscious evasion of the truth. *Id.*

93. *Id.*

94. *Id.*

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by . . . the Securities Exchange Act of 1934 . . . to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.<sup>95</sup>

On its face, the provision does not appear terribly earthshaking. Management has long been required to put a system of internal controls in place.<sup>96</sup> All Section 404 would seem to require is that management

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95. Sarbanes-Oxley Act of 2002 § 404 (codified at 15 U.S.C. § 7262 (Supp. 2006)).

96. The Foreign Corrupt Practices Act, enacted in 1977, added section 13(b)(2), 15 U.S.C.A. §78m (b) (2), to the 1934 Act. The relevant material provides as follows:

(2) Every issuer which has a class of securities registered pursuant to section 781 of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall—

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to

acknowledge its responsibility for establishing an internal control system and assess its effectiveness.<sup>97</sup> In addition, the auditors are then required to attest to and report on such assessment.

Congress certainly did not believe that Section 404 would be a major problem. The committee report stated:

[T]he Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees. High quality audits typically incorporate extensive internal control testing. The Committee intends that the auditor's assessment of the issuer's system of internal controls should be considered to be a core responsibility of the auditor and an integral part of the audit report.<sup>98</sup>

Furthermore, in the SEC's release adopting the internal control rules, the SEC estimated that the average annual cost to public companies over the initial three years of compliance would be \$91,000 and that there would be "a direct correlation between the extent of the burden and the size of the reporting company, with the burden increasing commensurate with the size of the company."<sup>99</sup>

Unfortunately, history has demonstrated that the SEC expectations did not accord with experience.

#### IV. WHAT WENT WRONG WITH SARBANES-OXLEY?

The cost of compliance with Sarbanes-Oxley has gone through the roof. A Korn/Ferry study in 2004 reported an average implementation cost of \$5.1 million.<sup>100</sup> The next year, Deborah Solomon from the *Wall Street Journal* reported that compliance for an individual company can

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any differences.

Furthermore, Section 302 establishes the requirement that management have a system of internal control. Sarbanes-Oxley Act § 302. The signing officers must create such a system that "material information is . . . made known to such officers . . ." *Id.* In addition, Section 302 requires that management evaluate the effectiveness of the control system, report their conclusions, and disclose to the auditors and the audit committee "significant deficiencies" and "material weaknesses" in the system. *Id.* Like Section 404, on its face, this appears to be a rather ordinary course type responsibility.

97. Sarbanes-Oxley Act § 404, 15 U.S.C.A. 7262 (West. Supp. 2006).

98. S. REP. NO. 107-205, at 31 (2002).

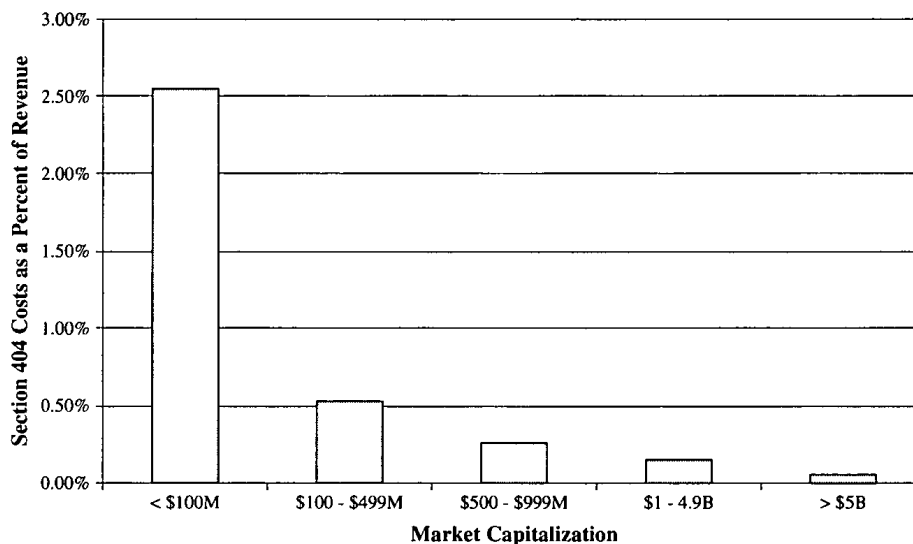
99. Management's Report on Internal Control, Exchange Act Release No. 33-8238, 68 Fed. Reg. 36,636, 36,655 (June 18, 2003).

100. Press Release, Korn/Ferry International, Price of Regulatory Compliance Skyrockets, According to Board Directors Worldwide (Nov. 22, 2004), [http://www.kornferry.com/library/Process.asp?P=PR\\_Detail&CID=840&LID=1](http://www.kornferry.com/library/Process.asp?P=PR_Detail&CID=840&LID=1); see also John Berlau, *A Tremendously Costly Law: Sarbanes-Oxley, Three Years After its Unfortunate Passage*, NAT'L REV., Apr. 11, 2005, at 39 (positing that the costs to businesses of implementing Sarbanes-Oxley has caused a decline in productivity, new jobs, and innovation in the general business world).



range from a few hundred thousand dollars to more than \$8 million, depending on the company's size.<sup>101</sup> However, the most serious impact has been on smaller companies. The *Final Report of the Advisory Committee on Smaller Public Companies* reported that, for companies with a market capitalization between \$75 million and \$700 million, second-year implementation costs will average approximately \$900,000.<sup>102</sup>

The chart below<sup>103</sup> shows implementation costs as a percentage of revenue for companies with different market capitalizations and demonstrates the greater impact of implementation costs on smaller companies.



Source: American Electronics Association (AeA) Report entitled Sarbanes-Oxley Section 404, The Section of Unintended Consequences and Its Impact on Small Business (Feb. 2005).

How is it that reality could be so different from expectations?

101. Deborah Solomon, *Critics Say Sarbanes-Oxley's Costs Are Too High*, PITTSBURGH POST-GAZETTE NOW, Oct. 17, 2005, <http://www.post-gazette.com/pg/05290/590143.stm>.

102. ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, SEC, FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO UNITED STATES SECURITIES AND EXCHANGE COMMISSION, 32-33 (2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf> (last visited March 8, 2008) [hereinafter ADVISORY COMMITTEE REPORT].

103. *Id.* at 33.

Last year, a majority of directors surveyed believed that Sarbanes-Oxley should be repealed or overhauled.<sup>104</sup> However, the problem is not with the statute, but rather with its implementation. The SEC's Advisory Committee on Smaller Public Companies ("Advisory Committee") has noted that "[t]here [has] been little attempt to tailor, or 'scale,' regulation to address the manner in which smaller companies operate."<sup>105</sup> In other words, those in the accounting industry essentially adopted a "one-size-fits-all" approach to fulfilling their responsibilities to attest to and report on management's assessment of its internal controls.<sup>106</sup> As a result of testimony adduced at its hearings, the Advisory Committee concluded that "implementation of AS2 has resulted in very rigid, prescriptive audits as a result of onerous AS2 requirements."<sup>107</sup>

In addition, the scope of auditor review has gone far beyond what is necessary to ensure the integrity of financial reporting. As one chief financial officer pointed out:

Currently, companies are documenting, testing and auditing nearly all business processes and their related controls. However, the act was intended to focus solely on controls over financial reporting. The Public Company Accounting Oversight Board and the audit industry have interpreted the act very broadly, to include nearly every activity within the company.

For example, companies are required to document, test and audit their controls over the hiring process, personnel reviews and executive management meetings/minutes. These areas have little or no relationship to the company's financial statements. This broadening of the scope of the Sarbanes-Oxley Act is why the effort and cost has been so much larger than anticipated.<sup>108</sup>

The absurdity of the implementation of Section 404 is documented in commentary and testimony sought by the Advisory Committee. One respondent stated:

We have been forced to identify 2500 controls for a company with only 12–15 job categories. To measure the risks involved (700 in our

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104. Press Release, Korn/Ferry International, Majority of Board Directors Feel Sarbanes-Oxley Regulations Should be Repealed or Overhauled (Feb. 23, 2006), [http://www.kornferry.com/Library/Process.asp?P=PR\\_Detail&CID=1419&LID=1](http://www.kornferry.com/Library/Process.asp?P=PR_Detail&CID=1419&LID=1).

105. ADVISORY COMMITTEE REPORT, *supra* note 102, at 31.

106. *Id.* at 32.

107. *Id.*

108. David Sanakaran, *Ask the Experts: CFOs Balancing Act*, SMALL TIMES, June 8, 2005, available at [http://www.smalltimes.com/articles/article\\_display.cfm?ARTICLE\\_ID=270093&p=109](http://www.smalltimes.com/articles/article_display.cfm?ARTICLE_ID=270093&p=109).

case), categorize them and design and document that many controls is completely unmanageable. That is 200 controls per job type. This is an auditor's dream, but just a dream. It is not function[al], practical or useful.<sup>109</sup>

Consider also the prepared statement of Donald S. Perkins, the chairman of Nanophase Technologies, addressed to the Advisory Committee.<sup>110</sup> Nanophase is a corporation that had total revenues of approximately \$5.2 million in 2004.<sup>111</sup> In 2005, its three largest customers accounted for approximately 83% of the company's revenue.<sup>112</sup> The company has a market capitalization of \$120 million, but only fifty-three employees,<sup>113</sup> three of whom are professionals in finance and accounting.<sup>114</sup> According to Mr. Perkins, in 2004 the company spent \$259,000 and over a thousand hours on Section 404 compliance.<sup>115</sup> The Sarbanes-Oxley expenses amounted to approximately 5% of sales.<sup>116</sup> Perkins explained why this kind of effort was absurd for his company:

In an environment as small as ours, redundant controls are inherently inefficient if not impossible. The CFO signs every check and approves every purchase order in excess of fifteen hundred dollars. The CEO signs every check over ten thousand dollars and approves every purchase order over five thousand. I or another board member signs off on any purchase of equipment which would be in this case 250 thousand dollars or more. We have a total of seven people responsible for the administration of the small company, but we may need to add somebody if we are to follow the pressures brought on to us by Sarbanes-Oxley.<sup>117</sup>

The CFO of the company testified that, while the process may have had some advantages, "it was kind of swatting flies with a

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109. SEC, Responses to ACSPC Request for Public Input, question 10, identified as 08/03/2005 01:39:17, available at [http://www.sec.gov/info/smallbus/acspc/acspc\\_rpc10.htm](http://www.sec.gov/info/smallbus/acspc/acspc_rpc10.htm) [hereinafter Responses to ACSPC Request].

110. DONALD S. PERKINS, STATEMENT TO SEC ADVISORY COMMITTEE (Aug. 9, 2005), available at <http://www.sec.gov/rules/other/265-23/dsperkins080905.pdf>.

111. Nanophase Technologies Corp., Annual Report (Form 10-K), at F-6 (Mar. 14, 2005) (Form 10-K), available at [http://www.nanophase.com/pdf/NanophaseAnnualReport\\_2005.pdf](http://www.nanophase.com/pdf/NanophaseAnnualReport_2005.pdf).

112. *Id.* at F-23.

113. *Id.* at 9.

114. RECORD OF PROCEEDINGS, ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, SEC, at 81 (Aug. 9, 2005) (statement of Donald S. Perkins, Chairman of the Board of Directors of Nanophase Technologies Corp.), available at <http://www.sec.gov/info/smallbus/acspc/acspctranscript080905.pdf> (last visited Feb. 22, 2008).

115. *Id.* at 81, 87.

116. *Id.*

117. *Id.*

sledgehammer.”<sup>118</sup> In a company of the size and complexity of Nanophase, it would be cheaper to hire retired FBI agents to sit on the shoulders of the three accounting professionals than to go through the expense to which the company was subjected.

As Enron, WorldCom, and other major scandals indicated, massive fraud is not possible without corruption at the top. In any company, the danger always exists for management to override the controls in place. Thus, in effect, one of the most important internal controls is to protect whistleblowers<sup>119</sup> with a strong whistleblower policy.<sup>120</sup>

Some of the outlandish costs associated with Section 404 compliance are not a problem of government regulation, but rather a problem within the business community; namely, the accounting profession. One respondent to the Advisory Committee commented about the lack of control his company had with respect to using appropriate judgment in determining which areas were high risk or low risk:

How to categorize this lies not in the hands of our company or the SEC, but in the hands of our CPAs, who are by nature going to erro[rs] on the side of being excessively cautious right now to avoid the potential of being the next Arthur Andersen. No one knows our risks better than we do, yet a third party that comes on site for two or three weeks a year has all the power to tell us that lower level risk items require treatment as high risk areas . . . .<sup>121</sup>

An article in the *National Review* was even more critical of the accounting profession. In commenting upon an ad in the Wall Street Journal supporting Sarbanes-Oxley, the author stated:

The expensive ad was not paid for by a pension fund or another group representing the investors the law was intended to serve: Its sponsor was, rather, PricewaterhouseCoopers, the multi-billion-dollar accounting firm making a bundle in fees for doing all the audits the law has ended up requiring of business. By creating so many hurdles for public companies, the law has birthed a golden goose for those who audit them. And ironically, despite the media and legislative clamor to “get” the big accounting firms after Enron imploded, it’s the

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118. *Id.* at 81 (statement of Jess Jankowski, Chief Financial Officer of Nanophase Technologies Corp.).

119. *See* Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. § 1514A (West, Supp. 2006) (discussing whistleblower protections for employees).

120. The whistleblower policy of Nanophase is an excellent example. Nanophase Technologies Corp. Whistleblower Policy, [http://www.nanophase.com/investor\\_relations/whistleblower.asp](http://www.nanophase.com/investor_relations/whistleblower.asp).

121. Responses to ACSPC Request, *supra* note 109, at question 10, identified as 08/16/2005 13:19:29.

Big Four accounting firms that have turned out to be the big winners from Sarbanes-Oxley.<sup>122</sup>

Hopefully, both the furor over the excessive expense and the “cover your back” approach of the accounting profession will be moderated now that the SEC has published Interpretive Guidance (“Guidance”) regarding management’s evaluation of internal control.<sup>123</sup> The SEC also published amendments to its rules (“Amendments”) to clarify that a company in compliance with the interpretive guidance will satisfy management’s evaluation requirement.<sup>124</sup> The Amendments defined the term “material weakness” and revised the requirements for the auditor’s attestation report.<sup>125</sup> These changes were intended to make management and auditors’ evaluations of internal control over financial reporting more effective and efficient.<sup>126</sup>

The SEC’s Guidance is organized around two main principles, which seem to respond to many of the objections surrounding the accounting

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122. Berlau, *supra* note 100, at 39.

123. Management’s Report on Internal Control Over Financial Reporting, Exchange Act Release No. 33–8762 & No. 34–54,976, 71 Fed. Reg. 77,635, 77,635 (Dec. 27, 2006) [hereinafter *Interpretive Guidance*]. The Release set forth the following summary:

We are proposing interpretive guidance for management regarding its evaluation of internal control over financial reporting. The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. The proposed guidance is intended to assist companies of all sizes to complete their annual evaluation in an effective and efficient manner and it provides guidance on a number of areas commonly cited as concerns over the past two years. In addition, we are proposing an amendment to our rules requiring management’s annual evaluation of internal control over financial reporting to make it clear that an evaluation that complies with the interpretive guidance is one way to satisfy those rules. Further, we are proposing an amendment to our rules to revise the requirements regarding the auditor’s attestation report on the assessment of internal control over financial reporting.

*Id.*

124. *Id.*

125. Amendments to Rules Regarding Management’s Report on Internal Control Over Financial Reporting, Exchange Act Release No. 33–8809 & No. 34–55928, 72 Fed. Reg. 35,310, 35,313 (June 27, 2007) [hereinafter *Amendments to Rules*]. The Release summarizes its effect as follows:

We are adopting an amendment to our rules to clarify that an evaluation which complies with the Commission’s interpretive guidance published in this issue of the Federal Register in Release No. 34–55,929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer’s internal control over financial reporting. We are also amending our rules to define the term material weakness and to revise the requirements regarding the auditor’s attestation report on the effectiveness of internal control over financial reporting. The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors.

*Id.* at 35,310.

126. *Id.*

profession's current approach to auditing a company.<sup>127</sup> The first principle focuses on allowing management, not accountants, to determine what risks exist for a material misstatement in financial records and the seriousness of the risk.<sup>128</sup> The Guidance suggests a process for evaluating risks, which uses "a top-down, risk-based approach," designed to encourage efficiency.<sup>129</sup> The Guidance does not require management to identify every control in a process; thus, management can focus on those that it believes are adequate to control the risk of a material misstatement.<sup>130</sup> "[I]f management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of other controls is required."<sup>131</sup>

The second organizational principle uses management's assessment of risk to determine the extensiveness of the controls and evaluations in each area.<sup>132</sup> This allows management to focus more on the areas it determines are high risk for inaccuracies, thus conserving resources in areas that pose less of a threat.<sup>133</sup> As a result, "companies of all sizes and complexities will be able to implement [the] rules effectively and efficiently."<sup>134</sup>

According to the SEC's Amendments, it intended that the Guidance would "significantly lessen" pressure on management to rely heavily on auditing standards in conducting its evaluation of internal controls over financial reporting.<sup>135</sup> Those auditing standards had resulted in excessive testing and documentation, which greatly increased the cost of implementing Sarbanes-Oxley.<sup>136</sup> Thus, the Guidance should assist management in avoiding excessive costs and in determining how best to evaluate its internal controls.<sup>137</sup> The Amendments stated:

Through the risk and control identification process, management will have identified for testing only those controls that are needed to meet the objective of [internal control over financial reporting] (that is, to provide reasonable assurance regarding the reliability of financial

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127. *Interpretative Guidance*, *supra* note 123, at 77,635–36.

128. *Id.*

129. *Id.*

130. *Id.* at 77,639.

131. *Id.*

132. *Id.* at 77,632.

133. *Id.*

134. *Id.* at 77,639.

135. *Amendments to Rules*, *supra* note 125, at 35,316.

136. *Id.*

137. *Id.*

reporting) and for which evidence about their operation can be obtained most efficiently. The nature and extent of procedures implemented to evaluate whether those controls continue to operate effectively can be tailored to the company's unique circumstances, thereby avoiding unnecessary compliance costs.<sup>138</sup>

The Amendments also defined "material weakness" as a deficiency, or a combination of deficiencies, in internal controls such that "there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis."<sup>139</sup> The use of "reasonable possibility" in effect is an intermediate approach between "more than remote" and "reasonable likelihood." Finally, the Amendments determined that the company's auditor must only express one opinion on the company's internal controls. This would be a direct opinion on the effectiveness of such controls.<sup>140</sup> Prior to the amendments, letters expressed two separate opinions: one on the effectiveness of a company's controls and another on management's assessment of such effectiveness.

These policy pronouncements would seem to respond to the concerns previously discussed.

## V. THE BENEFITS OF SARBANES-OXLEY

While much criticism has been directed at Sarbanes-Oxley, there is substantial data to indicate that there have also been significant benefits. Some of the benefits are arguably quantifiable, but others, such as a change in tone at the top levels of management, are more amorphous.<sup>141</sup> One clear trend is that, immediately following the enactment of Sarbanes-Oxley, there was a dramatic increase in the number of financial restatements filed by public companies. This trend is illustrated by the graph on the following page:

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138. *Id.*

139. *Id.* at 35,313.

140. *Id.* at 35,315.

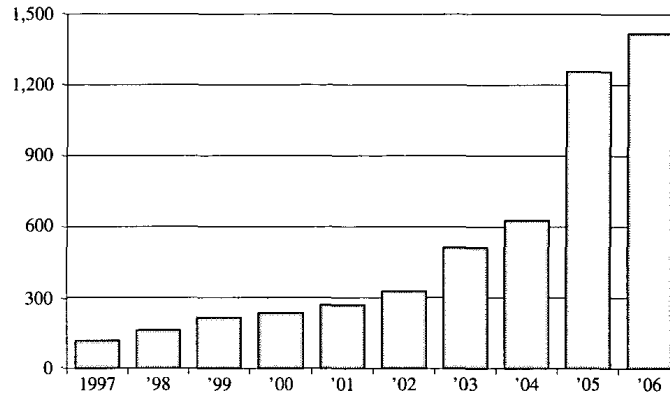
141. *See, e.g.*, COMMITTEE ON PUBLIC MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON PUBLIC MARKETS REGULATION (2006) [hereinafter INTERIM REPORT]. The Interim Report stated:

Critics stress high compliance costs—which totaled an estimated \$15–20 billion for issuers in 2004—while supporters emphasize the intangible, or indirect, benefits from Section 404 implementation. In particular, supporters note a changed 'tone at the top' among public companies when it comes to financial reporting, with a higher level of engagement from audit committees, CEOs, and CFOs on accounting issues. They also note that many of the control weaknesses uncovered in the early years of Section 404 implementation have led to significant improvements in the control environment.

*Id.* at 115–16. The Committee on Public Markets Regulation is an independent, bipartisan committee composed of twenty-two top corporate and financial leaders. *Id.* at vii.

**(RE)STATING THE CASE**

The rapid rise in filings by U.S. public companies



Source: *Say Again?*, CFO MAGAZINE, Apr. 2007, Glass, Lewis & Co. (2003-6) and Huron Consulting (1997-2002)

In discussing the upsurge in restatements in 2003 and 2004, a report by the Huron Consulting Group (the “Huron Report”) opined:

The intense focus brought by Section 404 and its requirements for the management of public registrants to thoroughly document, test and take responsibility for the effectiveness of their company’s safeguards for quality financial reporting has resulted in an unprecedented period of scrutiny on how registrants produce financial results for investors.<sup>142</sup>

The Huron Report also noted that 15% of the 2004 restatements were by “repeat filers” who had reported erroneous information on more than one occasion since 1997.<sup>143</sup> In addition, the number of companies reporting errors in at least three of the prior annual periods rose to nearly 40%.<sup>144</sup> If a company files restatements for multiple periods, that suggests the company has “flawed accounting policies, practices and errors occurring over a period of time, as opposed to one-time errors.”<sup>145</sup> Thus, Sarbanes-Oxley has brought increased attention to the

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142. Press Release, Huron Consulting Group, New Report by Huron Consulting Group Reveals Financial Restatements Increased at Record Level in 2004 (January 20, 2005), available at <http://www.huronconsultinggroup.com/article.aspx?articleId=143>.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*



way in which companies conduct their accounting, forcing necessary changes that might have otherwise gone unnoticed.

The Business Roundtable even acknowledged that Sarbanes-Oxley has done some good. Thomas Lehrner, a spokesman for the Business Roundtable, stated, "There is without question greater accountability in the board room . . . . In the minds of the investing public, [the Sarbanes-Oxley requirements] are important safeguards, and I think they are."<sup>146</sup> Officials at a publicly traded company that spent \$2.5 million and 10,000 hours of employee time opined that the costs were excessive, but acknowledged that the company was now a better-run business.<sup>147</sup> They stated, "[d]irectors meet more often without executives present. Multiple ombudsmen field employee complaints. Ethics training is more rigorous."<sup>148</sup> The CEO of the company now requires his lieutenants to take more responsibility for their results and concluded, "[I]nvestors are better protected because Sarbanes-Oxley regulations have been put in place."<sup>149</sup>

The Interim Report attempted to conduct a quantitative analysis of whether the benefits of Sarbanes-Oxley outweigh the costs.<sup>150</sup> It used two approaches. One was based on a 2006 GAO study that analyzed the market responses to announcements of a financial restatement by comparing the stock price the day before the announcement with the stock price at a point in time thereafter.<sup>151</sup> The Interim Report concluded that the benefits approximate cost.<sup>152</sup> However, it may have understated the benefits because it used the price from the day before the restatement was announced, whereas companies may have announced an intent to restate at a previous point in time. In addition, the news may well have leaked into the market.

The second approach was to use a cost of capital analysis based on two different studies that examined the impact of disclosure by firms that reported internal control deficiencies.<sup>153</sup> One study found a Sarbanes-Oxley benefit to be \$85–255 billion, whereas another study

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146. Joan S. Lublin & Kara Scannel, *Critics See Some Good from Sarbanes-Oxley*, WALL ST. J., July 30, 2007, at B1.

147. *Id.*

148. *Id.*

149. *Id.*

150. INTERIM REPORT, *supra* note 141, at 118–30.

151. *Id.* at 120–24.

152. *Id.* at 120–26.

153. *Id.* at 124–25.

found no impact on cost of capital.<sup>154</sup> These latter two analyses seem contradictory and inconclusive at best.

In addition to the restatement data, there is compelling evidence that companies have been manipulating earnings, something that is less likely after Sarbanes-Oxley began requiring top management certification. Former SEC Chairman Arthur Levitt spotlighted this problem during his tenure. He stated that “we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion.”<sup>155</sup> Given the frequency with which Chairman Levitt raised this issue, the problem could hardly be a surprise to anyone.

Chairman Levitt focused on five of what he considered the “more popular” techniques to manufacture earnings.<sup>156</sup> The first was the “Big Bath” restructuring charges in which a company overstates the charges

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154. *Id.* at 124.

155. Arthur Levitt, Chairman, SEC, The “Numbers Game,” Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt> [hereinafter Levitt, The “Numbers Game”]. The theme of declining integrity in financial reporting has been repeated on many occasions. *See, e.g.*, Arthur Levitt, Chairman, SEC, A Financial Partnership, Remarks Before the Consumer Federation of America (Nov. 16, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch227.htm>; Arthur Levitt, Chairman, SEC, Partnership for Public Trusts, Remarks at the American Institution of Certified Public Accountants (Dec. 8, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch230.txt>; Arthur Levitt, Chairman, SEC, Keeping the Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds, Remarks at Mutual Funds and Investment Management Conference (Mar. 22, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch261.txt>; Arthur Levitt, Chairman, SEC, In the Best Interests and Beneficiaries: Trust and Public Funds, Remarks at the 1999 Annual Meeting of the Council of Institutional Investors (Mar. 30, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch263.htm>; Arthur Levitt, Chairman, SEC, Remarks to Committee of Economic Development of New York (May 19, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch278.htm>; Arthur Levitt, Chairman, SEC, An Essential Next Step in the Evolution of Corporate Governance, Remarks at the Audit Committee Symposium (June 29, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch289.htm>; Arthur Levitt, Chairman, SEC, Corporate Governance in Global America, Remarks to the American Council on Germany (Oct. 7, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch302.htm>; Arthur Levitt, Chairman, SEC, Quality Information: The Lifeblood of Our Markets, Remarks at the Economic Club of New York (Oct. 18, 1999), *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm>; Arthur Levitt, Chairman, SEC, Remarks at the Economic Club of Washington (Apr. 6, 2000), *available at* <http://www.sec.gov/news/speech/spch362.htm>; Arthur Levitt, Chairman, SEC, The Public’s Profession, Remarks at the Fall Council of the American Institution of Certified Public Accountants (Oct. 24, 2000), *available at* <http://www.sec.gov/news/speech/spch410.htm>.

156. Levitt, The “Numbers Game,” *supra* note 155 (characterizing all five as accounting “gimmicks”).

so that earnings will take a one-time hit; later, those charges are converted into earnings when the charges turn out to be less than reserved against.<sup>157</sup> The second was “creative acquisition accounting” in which companies classify part of the acquisition price as in process research and development so the amount can be written off in a one-time charge.<sup>158</sup> The third is the “Cookie Jar” reserve approach, which involves utilizing unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs.<sup>159</sup> In this approach, the company stashes accruals in cookie jars during the good times to utilize in bad times by reducing recognized expenses because of the accruals already made.<sup>160</sup> The fourth technique involves revenue recognition.<sup>161</sup> This has been a fairly common problem.<sup>162</sup> It involves recognizing revenue before sale is complete, before the product is delivered, or when the customer still has options to terminate or delay the sale.<sup>163</sup>

The fifth technique involves misusing the concept of materiality. Chairman Levitt set forth the following model:

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157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. See, for example, the company’s actions in *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1309 (N.D. Ga. 2006). Paragraph 20 of the complaint alleged:

To induce SPC’s customers, including Best Buy, Menards, Wal-Mart, Kmart, Shopco, and Toys R Us, to order unwanted product and to pull sales forward into earlier quarters, SPC gave its customers deeper discounts, longer payment terms, and credits towards future purchases. The highest levels of management at SPC engaged in this channel-stuffing.

*Id.*

Also, paragraph 34 of the complaint provided additional detail:

According to a former national account manager, K-mart stores had on average between 52 to 100 weeks of Rayovac batteries, with some stores holding 250 weeks of C and D batteries. This same witness stated that Wal-Mart had 30–50 weeks of product in inventory and even though everyone knew in January 2005 that Wal-Mart’s inventory levels and weeks on hand were way up, SPC continued to offer Wal-Mart incentives to take additional product because “we needed to make the numbers.” Wal-Mart’s inflated inventory was confirmed by a former sales analyst, employed at SPC during the Class Period, who recalled at least “30 weeks on hand” and stated, “We all knew what was going on, we front loaded the stores in August and September 2004 for the Christmas holiday.” This witness reiterated that executive-level management handled every aspect of the Wal-Mart account because the Company was so dependent on this relationship.

*Id.* at 1309–10.

163. Levitt, The “Numbers Game,” *supra* note 155.

[S]ome companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that's the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly . . . "It doesn't matter. It's immaterial."

In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don't matter.<sup>164</sup>

The Interim Report argued that the SEC should define materiality in terms of a 5% pre-tax income threshold.<sup>165</sup> The assumption is that a less than 5% error in earnings would be immaterial and of no concern to investors. As Chairman Levitt pointed out, however, missing an earnings projection by a penny can have a multimillion dollar impact on market capitalization. Moreover, there is a huge difference between a company reporting flat earnings versus 5% growth, particularly when the market is expecting 5% growth. The effect on value is compounded because earnings will be less, and the price-earnings multiple could well be reduced also.<sup>166</sup>

Lest there be any question as to whether earnings manipulation is prevalent, *CFO Magazine* reported that financial executives can use "allowable discretion" to boost or lower earnings by a few percentage

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164. *Id.*

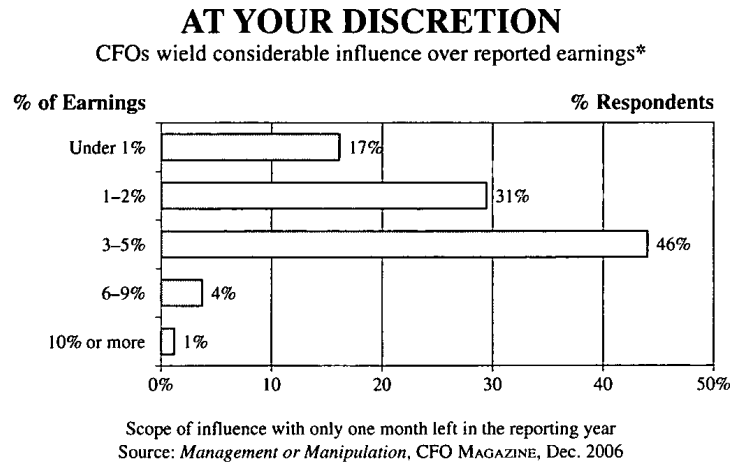
165. INTERIM REPORT, *supra* note 141, at 131. The report recounted:

For many years, the rule of thumb was that, in determining the scope of an audit, a potential error exceeding five percent of annual pre-tax income would be considered material. In evaluating a misstatement, an error that exceeded ten percent of pre-tax income was considered material, while the materiality of an error between five percent and ten percent of pre-tax income was assessed, based on various qualitative factors.

*Id.* at 128.

166. The capital asset pricing model posits that the discount rate is equal to the risk-free rate plus beta times the spread between the market return and the risk-free rate:  $DR = RFR + \beta(MR - RFR)$ . The capitalization rate is the discount rate minus the growth rate.  $CR = DR - G$ . Thus, the larger the growth rate, the lower the capitalization rate. The capitalization rate is inversely proportional to the price-earnings multiple. Thus, the larger the growth rate, the higher the price-earnings multiple. See SHANNON P. PRATT, ROBERT F. REILLY & ROBERT P. SCHWEIHS, *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 244-45 (4th ed. 2000) (discussing multiples of economic variables).

points.<sup>167</sup> The magazine conducted a survey in which they asked CFOs how much discretion they could use to affect reported earnings.



The results of the survey, set forth in the chart below, show that almost half of the CFOs could boost or lower earnings 3–5%, a change that could have a huge impact on investors.<sup>168</sup>

In commenting upon the situation, the magazine stated:

And the methods involved don't require a Ph.D. in finance. Operational levers include such time-honored tactics as delaying operational spending, accelerating order processing, and driving the sales team harder. Accounting steps, which are less common, include changing the timing of an accounting charge and adjusting estimates, both of which can be permissible under [Generally Accepted Accounting Principles].<sup>169</sup>

On a positive note, thus far in 2007, the number of accounting restatements has decreased.<sup>170</sup> This may indicate that executives are playing less loosely with their financials, possibly because the

167. Don Durfee, *Management or Manipulation?*, CFO MAG., Dec. 1, 2006, at 28 (stating CFOs can influence reported earnings by three percent or more).

168. *Id.*

169. *Id.*

170. See Lublin & Scannel, *supra* note 146, at B3 (noting that the number of companies with restatements fell to 698 from 786 in the first six-months of 2007).

certification requirements in Sarbanes-Oxley have pushed management toward placing a greater emphasis on internal controls.

#### VI. THE BUGABOO OF OVER-REGULATION AND EXCESSIVE LITIGATION

Sarbanes-Oxley has become the focal point of criticism about increased enforcement costs, perhaps undeservingly. Many of Sarbanes-Oxley's critics may have exaggerated the impact of its regulations and blamed it for recent excessive litigation. It may be that there is more litigation because there is more fraud, and that there is more fraud because of our focus on short-term results. The focus on short-term results may be partially because management has an incentive to manipulate short-term results to hype executive compensation.

A conservative journal lamented the enactment of Sarbanes-Oxley on the basis that it "goes against a 30-year trend of general economic deregulation under Republican and Democratic presidents."<sup>171</sup> But perhaps deregulation is part of the problem. Enron certainly exploited, or rather over-exploited, deregulation.<sup>172</sup>

The Interim Report, in addition to raising concerns about Sarbanes-Oxley Section 404, was also generally critical of the regulatory and litigation burden affecting U.S. markets.<sup>173</sup> With respect to Rule 10b-5, which governs liability for material misstatements or fraud in connection with the sale of securities and is often the basis for holding directors and officers liable, the report argued that "the SEC should attempt to provide more guidance, using a risk-based approach."<sup>174</sup>

On the other hand, with respect to regulation of the securities industry, the report argued for a principles-based approach. Since "a principles-based regime gives regulated firms less guidance about expected behavior, the SEC and the SROs must be sensitive to this heightened ambiguity."<sup>175</sup> In other words, management says, "Don't provide us with specifics when you regulate us, but when we do something wrong, grant us absolution because the regulation was amorphous."

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171. Berlau, *supra* note 100, at 39.

172. See generally BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003) (discussing Enron's abuses of securities law and regulations).

173. See INTERIM REPORT, *supra* note 141, at 5, 9-15, 59-70, and 71-92 (discussing the adverse impact of securities litigation on American markets).

174. *Id.* at 8, 80.

175. *Id.* at 8.

In point of fact, Rule 10b-5 is a principles-based approach. In effect, it says that it is a sin both to lie and to tell half-truths.<sup>176</sup> This has been, and should continue to be, the basic ethic of the securities laws. However, the Interim Report demonstrates how business wants to have it both ways. From a regulatory standpoint, business wants to be cut some slack. On the other hand, with respect to litigation that ensues when business has breached the basic ethic of the securities laws, it wants to constrain investors and their lawyers.

The Interim Report lamented the costs borne by business from enforcement of the securities laws and contrasted them with lesser costs in the United Kingdom or Europe. Although the Interim Report admits that one of the strengths of the U.S. market may be the tough administrative enforcement of securities laws, it believed that “the penalties have grown disproportionately large relative to their deterrent benefit.”<sup>177</sup> The Report compared the total monetary penalties for securities violations in the United States to those in the United Kingdom during the year 2004.<sup>178</sup> In the United States, administrative penalties totaled approximately \$4.7 billion, and private class actions totaled \$3.5 billion.<sup>179</sup> In comparison, private class actions do not exist in the United Kingdom, and the administrative penalties only amounted to approximately \$40.5 million.<sup>180</sup> The report emphasized that directors and officers’ (“D & O”) insurance costs in the United States are six times higher than in Europe.<sup>181</sup>

There could be a reason why enforcement costs are so much higher in the United States than in Europe. For one thing, Europe does not yet seem to match the United States in the scope and frequency of securities fraud. Consider the table of class action settlements incorporated in the Interim Report:<sup>182</sup>

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176. For example, the second clause of rule 10b-5 provides that it is unlawful:

To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

17 C.F.R. § 240.10b-5 (2007).

177. INTERIM REPORT, *supra* note 141, at 11.

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.* at 76.

<b>Ten Largest Securities Class Action Settlements Since 1995</b>		
<b>Rank</b>	<b>Issuer</b>	<b>Maximum Asserted</b>
1	Enron	\$7,160.5 Million
2	WorldCom	\$6,156.3 Million
3	Cendant	\$3,528.0 Million
4	AOL Time Warner	\$2,500.0 Million
5	Nortel Networks	\$2,473.6 Million
6	Royal Ahold	\$1,091.0 Million
7	IPO Allocation Litigation	\$1,000.0 Million
8	McKesson HBOC	\$960.0 Million
9	Lucent Technologies	\$673.4 Million
10	Bristol-Myers Squibb	\$574.0 Million

These companies were sued in connection with securities transactions in the United States.<sup>183</sup> Eight of them are U.S. companies; Nortel is Canadian, and Royal Ahold is Dutch.<sup>184</sup>

These figures not only add to the cost of securities litigation, but also impact the cost of D&O insurance in United States. It may be that we have a litigious culture because there is so much fraud in the United States.

Another aspect of our culture that may lead to high enforcement costs is the obsession with short term results and stock prices. As Chairman Levitt has stated:

While the problem of earnings management is not new, it has swelled in a market that is unforgiving of companies that miss their estimates. I recently read of one major U.S. company, that failed to meet its so-called “numbers” by one penny, and lost more than six percent of its stock value in one day.

I believe that almost everyone in the financial community shares responsibility for fostering a climate in which earnings management is on the rise and the quality of financial reporting is on the decline. Corporate management isn’t operating in a vacuum. In fact, the different pressures and expectations placed by, and on, various participants in the financial community appear to be almost self-perpetuating.

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183. *Id.*

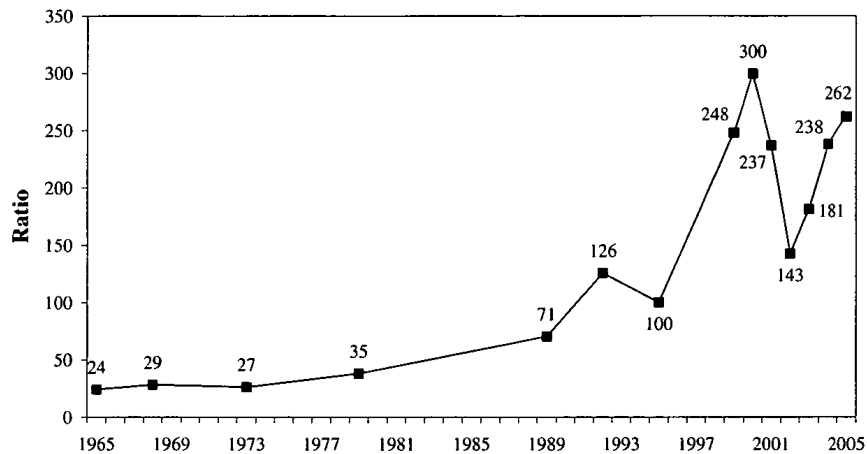
184. *Id.*



This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way.<sup>185</sup>

Another cultural obsession—that of the CEOs in their endless quest to make more money—also drives securities fraud and raises the cost of securities litigation. The chart below demonstrates the almost exponential rise in pay for CEOs, driven largely by stock options, which in turn creates a focus on short-term results.

**Ratio of CEO to average worker pay, 1965–2005**



Source: Economic Policy Institute (analysis of *Wall Street Journal/Mercer* (2006)).

Figure from Mishel, Lawrence, Jared Bernstein, and Sylvia Allegretto, *The State of Working America 2006/2007*. An Economic Policy Institute Book, Ithaca, N.Y.: ILR Press, an imprint of Cornell University Press, 2007.

The above chart, while it shows a dramatic rising trend in the ratio of CEO pay to worker pay, may actually be conservative. *Fortune* and *Money* recently reported that, in 2006, the ratio of CEO pay to worker pay was 364, down from 411 times in 2005.<sup>186</sup> The report stated that the record was 525 times in 2000.<sup>187</sup> The 2000 figure squares with a

185. Levitt, The “Numbers Game,” *supra* note 155.

186. Jeanne Sahadi, *CEO pay: 364 Times More Than Workers*, CNNMONEY.COM, Aug. 28, 2007, [http://money.cnn.com/2007/08/28/news/economy/ceo\\_pay\\_workers/index.htm](http://money.cnn.com/2007/08/28/news/economy/ceo_pay_workers/index.htm).

187. *Id.* The report did acknowledge, however, that such comparisons are not precisely “apples-to-apples” because of a recent change in 2007 in measuring CEO options. *Id.*

*BusinessWeek* report that compared CEO compensation in United States to that of other countries.<sup>188</sup>

CEO Compensation as a Multiple of Employee Compensation	
Country	Multiple
United States	531
Hong Kong	38
Britain	25
Thailand	23
China	21
France	16
Sweden	14
South Korea	11
Japan	10

It appears that executives in other countries are starting to catch up to the largesse of United States pay in this decade.<sup>189</sup> As overseas compensation increases, however, so also may incidents of overseas financial fraud.<sup>190</sup>

188. Eric Wahlgren, *Spreading the Yankee Way of Pay*, BUS. WK., Apr. 18, 2001, [http://www.businessweek.com/careers/content/apr2001/ca20010419\\_812.htm](http://www.businessweek.com/careers/content/apr2001/ca20010419_812.htm).

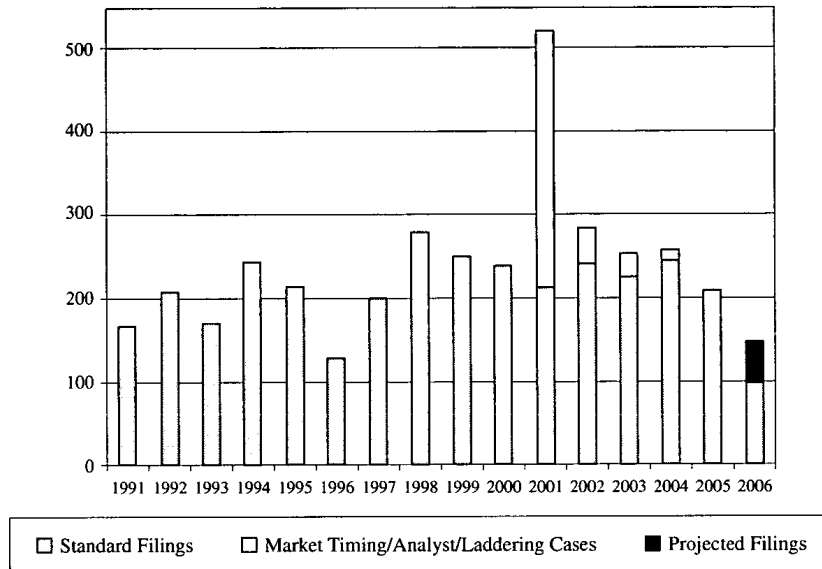
189. See Michael Hennigan, *Executive Pay and Equality in the Winner-take-all Society*, FINFACTS IR, Aug. 7, 2005, available at [http://www.finfacts.com/irelandbusinessnews/publish/article\\_10002825.shtml](http://www.finfacts.com/irelandbusinessnews/publish/article_10002825.shtml) (discussing the increasing pay gap between executives and other employees worldwide).

190. See Mark S. Willis, Esq. & Robert M. Roseman, Esq., *Global Markets, Global Fraud: What We Can Learn From "Europe's Enron"* (May 2006), [www.srk-law.com/CM/WhatsNew/IPE\\_CA.pdf](http://www.srk-law.com/CM/WhatsNew/IPE_CA.pdf), which states:

Fraud can happen anywhere in the world, particularly as securities markets increase the trend toward globalisation. After the Parmalat scandal shook the financial world, the press quickly dubbed it "Europe's Enron"—making it painfully obvious that major corporate fraud could no longer simply be considered an American phenomenon.

Indeed, the current chairman of the US Securities and Exchange Commission, Christopher Cox, made this point in his first major speech to the public: "For more than a year after Enron, the WorldCom, Health South, Global Crossing, Qwest, and Tyco scandals made it appear that financial fraud was a uniquely American problem. But this dubious distinction was shattered when the Vivendi, Royal Dutch/Shell, Parmalat and other European frauds emerged." Recent events have only added to this list of financial high jinks, as non-US-based companies such as DaimlerChrysler, Convergium, Royal Ahold and Repsol are now names that many investors also associate with securities fraud.

In point of fact, as the table below illustrates,<sup>191</sup> there has been a downward trend in securities litigation in the United States after the enactment of Sarbanes-Oxley.<sup>192</sup>



Source: *Recent Trends in Shareholder Class Action Litigation*, Todd Foster et al., NERA.

In seeking to explain this trend, the Interim Report offered the following explanation:

First, the stock market rose for most of 2005 and 2006, reducing the number of sudden stock price drops that might have fueled securities litigation. The 2006 indictment of Milberg Weiss, once dominant in representing class plaintiffs, may also have affected the filing rate. The indictment may have deterred other firms from filing lawsuits, and it may have become more difficult for those firms that did still wish to file securities class action lawsuits to find or use “professional” plaintiffs—that is, plaintiffs who are (probably) paid to participate. Finally, it is possible that the lower filing rate reflects the success of the 2002 Sarbanes-Oxley legislation in curbing managers’ incentives to recognize income prematurely or engage in other dubious accounting manipulations.<sup>193</sup>

191. INTERIM REPORT, *supra* note 141, at 77.

192. *Id.* In the chart, the Market Timing cases refer to Mutual Fund Trading and the Analyst cases refer to analysts trading stock they knew were over-valued.

193. *Id.*

It is very difficult for the business community to acknowledge that regulation may have some positive effects. The Interim Report first focuses on a rising stock market and second on the indictment of a plaintiff's lawyer. Only then does it acknowledge that Sarbanes-Oxley may have curbed managerial market manipulation.

The pattern reflected in the chart above does not show any correlation to a rising or falling stock market. Moreover, while Milberg Weiss was indicted in 2006, the downward trend started a year earlier. Rather than being the least likely of the possibilities, it is highly probable that requiring the CEO and CFO to certify the company's financials and the existence of an internal control system, coupled with increased auditor scrutiny, is responsible for a decrease in fraudulent activity.

## VII. CONCLUSION

It is universally recognized that information drives the market. The securities acts reflect a policy of disclosure. However, it is also universally recognized that "garbage in equals garbage out." The corporate scandals that led to the adoption of Sarbanes-Oxley demonstrated that much of the information fed to the markets was garbage—fraudulently manufactured garbage.

Enron and its ilk were not isolated occurrences. CFOs have acknowledged that they have the ability to manufacture earnings. The upsurge in restatements following the enactment of Sarbanes-Oxley, amounting to thousands of restatements, compels the conclusion that the market has not been receiving accurate information.

When a corporation releases financial information to the public, do we not expect the CEO and CFO to stand behind such information? Further, do we not expect that management would put in place internal controls to assure that the financial information disseminated to the market is reliable? How else can a market fulfill its price setting function?

Business was entitled to rail against the compliance costs associated with Sarbanes-Oxley. However, these outrageous costs stemmed not from the legislation, but from the egregious excesses of the accounting profession in supposedly fulfilling its assessment responsibility. Now that the SEC has debunked the accounting profession's approach to auditing internal controls, costs should normalize.

With respect to the outcry of business toward regulation and litigation, there is a very simple and cost effective response: "Why Not Tell the Truth?" Justice Brandeis observed that sunlight is a great disinfectant. If we focus on telling the truth, rather than obfuscating

financial results, we can have the best of all worlds: an efficient market and minimal litigation.

