BOSTON UNIVERSITY SCHOOL OF LAW

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WORKING PAPER NO. 06-08

USING SARBANES-OXLEY ACT TO REWARD HONEST CORPORATIONS

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ABSTRACT:

Sarbanes-Oxley Act offers an opportunity to reward truthful corporations and their management, offering them a competitive advantage, and relieving them from some the Act's provisions. Corporate culture plays an important role in a corporation's honest behavior. One size does not fit all in matters of corporate culture. Sarbanes- Oxley Act provisions that impose on all corporations the same internal controls and governance rules impose unnecessary costs on corporations, requiring honest corporations to change one good habit for another. The article suggests that relief from some of the internal controls rules imposed in the Sarbanes-Oxley Act might be an effective way for rewarding corporations for their honest behavior rather than punishing them.

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D R A F T

USING SARBANES-OXLEY ACT TO REWARD HONEST CORPORATIONS

TAMAR FRANKEL[•]

INTRODUCTION

Sarbanes-Oxley Act offers an opportunity to reward truthful corporations and their management. Honest corporations should receive a competitive advantage by relieving them of some provisions of the Sarbanes-Oxley Act and imposing those provisions of the Act only on rogue corporations. There are five parts to this Article. The first part of the Article poses the question: What makes an honest corporation? The general answer is: Corporate culture plays an important role in a corporation's honest behavior.

The second part poses the question: How can law reward truthful corporations? The general answer is: By threatening to punish wrongdoing, or by offering a competitive advantage to honest behavior. The third part offers guidelines for applying prohibitory and constraining laws selectively, as opposed to applying such laws generally. This part poses the question: When does it make sense to impose on all corporations the same rules? When does "one size fit all" and when should rules be imposed on corporations selectively?

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Part four examines the unique feature of the Sarbanes- Oxley Act that imposes on all corporations the same internal controls and governance rules.
Part five suggests that relief from some of the internal controls rules imposed in the Sarbanes-Oxley Act might be an effective way for rewarding corporations for their honest behavior. Such a relief would reward these corporations with a competitive advantage as compared to rogue corporations.

1. What makes an honest corporation?

Competing on merit or on image? Many American corporations are competitive, entrepreneurial, innovative and creative. When one examines some of the rogue corporations of the 1990s it is easy to see that single-minded ambitions and drive directed their creative activities to a slippery slope that led to illegal behavior. During the past thirty years, and especially during the 1990s, too many businesses competed on finding gray areas in the law, on aggressive accounting methods that led to hiding financial weaknesses, and on painting deceptive images of greater financial success. Corporations that have pushed the envelope most gained a competitive advantage over others. It is not surprising that as long as preventive and enforcement measures were weak, the number of copycat competitors that followed these kinds of innovations rose,[1] and inevitably brought about widespread fraud. Misleading images can prevail over reality for a limited period. Few corporations have lived up to their deceptive images and turned the deceptions into reality. Many did not. Their financial weaknesses could not be hidden forever. They ultimately failed, and their deceptive images were then discovered.

A one-time deceptive action rarely leads to a full-fledged rogue corporation. Neither does a one-time correction of a dishonest action produce an honest corporation. The main key to trustworthy corporations is their culture—their organizational habits.

Corporate culture is recognized in judicial findings. For example, one court fond "'the anti-union conduct 'so pervasive as to have created a corporate culture of lawlessness."[2] Culture was also emphasized in Enron Corporation's case.[3] Imposed secrecy was found

[1] "Market timing" by mutual funds advisers, and various ways to convert representation of contracts as property while hiding corporate liabilities in financial statements, are just two examples of a myriad of loopholes that were searched for, copied, and justified. See Tamar Frankel, Trust and Honesty, America's Business Culture at a Crossroad Chapter 2 (2006) (Frankel, Trust and Honesty).

[2] Dunkin' Donuts v. NALB, 361 U.S. App. D.C. 1, 12; 363 F.3d 437; 2004 U.S. App. LEXIS 6310; 174 L.R.R.M. 2746; 149 Lab. Cas. (CCH) P10,321(D.C. Cir.2004). (…While some employees may have voluntarily departed their jobs, those who remain will doubtless share this history with newcomers.' The court noted that "the record also showed that, in the words of the ALJ, there was 'a core of steady employees with whom the experience of [the companies'] unlawful conduct will remain.' Consequently,' an affirmative bargaining order is necessary to remedy the ... unfair labor practices.').

[3] In Re Enron Corporation Securities, 2003 U.S. Dist. LEXIS 7632 (2003), at 9 (the "Court found that Lead Plaintiff has stated a claim, including the pleading of facts raising a strong inference of scienter, under *§10(b)…* sitting for a length of time on the Management Committee, which was repeatedly asked to approve these deceptive devices and contrivances, would have had to be aware of or have recklessly disregarded the warning signs….approved a waiver of Fastow's [and Michael Kopper's] conflicts of interest, contrary to Enron's own Code of Conduct, and sanctioned the creation of most of the SPEs and

to be a factor in corporate culture, [4] wherein to avoid the contacts with Cuba, Cuba was referred to by 'code words'[5] When Exrox corporation could not meet Wall Street's earning expectations it began to engage in a massive accounting fraud."[6] Xerox used various accounting methods to consistently bolster its earnings, revenues and margins. These changes were systemic. They required the knowledge and involvement of many employees. Again, top management knew and supported, if not actually initiated, these accounting methods. "It is not hard to visualize a slippery slope where accounting integrity is degraded in tiny increments in the pursuit of earnings consistency. In the case of Xerox, it is troubling that the company could become so financially distressed in such a short period of time. We believe the specter of these allegations enhances the already high risk profile of Xerox . . . ." An anonymous note that alleged fraud was ignored. This response was interpreted "as a signal that Xerox had 'a culture that didn't recognize that it was not a good thing to be getting anonymous letters about fraud.'"[7]

Corporations are the creatures of habit, like the people who populate them and the society in which they operate. Culture is a social habit. It is a habit acquired and practiced by a group, whether by a family, a corporation or a country. Personal and group habits are efficient. They reduce the anxiety produced by the need to choose and make decisions. Habits produce a sense of security, knowing what the future behavior is expected and what the future behavior of others will be. Corporations are the creatures of habit because they are composed of individuals that interact the same or similar ways day by day. This expected form and substance of interaction amounts to the corporate culture.

Habitual corporate interactions are embedded not only in personal relationships but also in the processes and forms of interaction and positions of individuals that have been put in place and practiced for many years. When these processes become very rigid with repetition and time, they acquire the force of entrenched habits. The organizational culture amounts to a behavior among group-members that is assumed without debate, consideration, and thought.

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partnerships and the illusory transactions among them and Enron, all too frequently and blatantly created at critical SEC-reporting times when Enron was in danger of not "making its numbers" and artfully manipulated by acknowledged, high-risk, aggressive accounting. The complaint paints a picture of these individuals actively and knowingly participating in a corporate culture of brazen ambition toward the appearance of ever increasing success, which was simultaneously being undermined by their blatant self-dealing for personal enrichment. Their greed was rewarded by high salaries, extraordinary bonuses, and the exercise of Enron stock options or sale of company stock, the value of all of which was continuously inflated by their manipulation of Enron's financial reports. In other words, despite the repetitive patterns of fraud constituting red flags, the Management Committee repeatedly rubber-stamped the deceptive devices and contrivances and practices of SPEs abusive accounting used to move debt off Enron's balance sheet and to claim sham revenue, while providing them with lucrative returns from the alleged Ponzi scheme."

[4] United States v. Brodie, No. 02-2662, (3d Cir. 2005) *403 F.3d 123, 155-56; 2005 U.S. App. LEXIS 5944 (2005) (*"The government evidence shows a corporate culture pervaded by the use of code words for Cuba, and such naturally gives rise to an inference of concealment…The one aspect of the operation that they kept secret was the Cuban connection...."

[5] Id. at 158.

[6] Russell Carlson v. Xerox Corp.Case No. 3:00CV1621(AWT) (D. Conn 2005), *2005 U.S. Dist. LEXIS 14427; Fed. ec. L. Rep. (CCH) P93,303* (allegations in the Complaint)

[7] *Id.*

Corporate culture is built on organizational and interpersonal rules and procedures. Organizations are composed of groups of people that have different personalities, histories, and lives outside the organizations.[8] Nonetheless, groups have personalities and habits of their own. These habits depend not only on particular individuals who populate the groups but also on the systemic processes of interaction among group members, and their expected behavior. Therefore, removing the leaders of a criminal organization, for example, may not necessarily affect the group's behavior. Mafia families have annihilated each other on a regular basis, but their culture and activities fundamentally remained the same.

Even though management may change or its members may go to prison, the same processes and interactions that left the door open or beckoned to violations can remain intact. Even if the members of the organization are told to avoid the violations, the old processes, like old habits, can persist. The processes and forms of which culture consists are not necessarily the ones that lead to the violations of the law, but they may be insufficient to withstand the pressures that brought about the violations, such as the drives to produce earnings (no matter how).

Corporations that developed a culture for innovative deception have acquired a habit of looking for further creativity of this type. It is not surprising that some of these corporations continued to "cook the books" even after they were required by regulators to restate their financial statements. That is because their internal procedures and the way they conducted business remained intact. The Goodyear Corporation restated its financial statements three times in six months![9] Goodyear may be an extreme example, but Huron Research has shown that a number of corporations were "repeat violators." After they corrected their financial statements once they continued to publish incorrect financial statements.[10] Presumably, their personnel simply continued to act as they were in the habit of acting. These corporations maintained their culture.

Changing the corporate culture. Changing corporate culture and the processes that compose it takes time and great effort. Organizations, like people, protect themselves against changing their habits. Even after convictions, there are people in the organization who reject change by denying that problems exist or that a wrongdoing was committed. The tendency to blame others or involve others to share the blame is strong.[11] In corporations the opportunity for blaming others or share the blame is greater than in case

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[8] *See, e.g.,* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability,* 75 MINN. L. REV. 1095, 1099 (1991) (proposing standard for corporate liability based on "assumption that organizations possess an identity that is independent of specific individuals who control or work for the organization"; which identity or "ethos" "results from the dynamic of many individuals working together toward corporate goals").

[9] Theo Francis and Timothy Aeppel, "The Red Flag Called 'Self-Insurance,'" *Wall Street Journal,* March 15, 2004, http://www.westlaw.com/.

[10] David Wessel, "Venal Sins: Why the Bad Guys Of the Boardroom Emerged en Masse,'" *Wall Street Journal*, June 20, 2002, http://www.westlaw.com/.

[11] *See* Frankel, Trust and Honesty Ch. 5.

of individual criminals. Thus, changing the underlying assumption on which people in corporations perceive others and on which people base their own actions is harder when those assumptions are habitual and unquestioning. The more entrenched the habits are, the greater the resistance to changing them would be. That is why cultural habits are followed obstinately even after it becomes evident that the habits are destroying the corporation. In sum, strong and persistent monitoring and new rules to affect the culture of a criminal corporation are crucial to their rehabilitation.[12]

Personal habits and group habits: objectives and roles. One difference between the individuals and the organization may render enforcement of organizational rehabilitation somewhat easier. This difference may facilitate enforcement by rewarding innocent corporations. The difference between individuals and corporations is that corporate objectives and the roles they play are usually more limited than those of individuals.

Persons have far more objectives than corporations. Persons may aim at more relaxation, more leisure, more money, more ego satisfaction, better spousal relationship or maintaining what the persons have and avoiding competition. The objectives of corporations are fewer. These objectives are focused on financial aims that include competitive advantage (or perhaps the attainment of a legal monopoly).

Persons play many roles: as spouses, parents, children, bosses and underlings, athletes and musicians, to name a few. Corporations offer fewer personal roles. People must know their places, their authority and the roles that they must play. They may not change their roles except according to pre-determined rules. In addition, corporate objectives are more clearly defined. Even if they act altruistically, corporate underlying goal is to advance their business. To be sure, the desires and characteristics of the people who lead and work in these organizations color the organizations. Nonetheless, within the organizations people are geared towards the organizations' goals and roles.

Changing corporate culture requires changing the procedures and the forms of interaction among the actors within the organization. Identifying the actors and the processes that relate to the objectives of a corporation may make it easier to identify the rewards that might induce corporations to lead a more trustworthy life. A competitive advantage is one of these objectives.

2. How can law reward honest corporations? The general answer is: (1) By threatening to punish rogue corporations or (2) by offering honest corporations a competitive advantage as compared to rogue corporations.

Generally, the purposes of criminal punishments in the criminal law are to punish, deter, and rehabilitate.[13] The focus of this Article is somewhat different. It seeks to find incentives to honest corporations to continue acting honest. How can law convince management that "honesty pays?" The answer is that this can be done by reducing the

[12] *Id.*
[13] See 18 U.S.C. § 3553(a)(2)(A) (1988); and also *101 Yale L.J. 2017*

costs of honest corporations and the liabilities of honest management as compared to those who violated the law.

Changing the corporate culture as part of a punishment. The status of a corporation under criminal law was, and still is, debated. After all, a corporation is a legal entity and not a person. How could it have intent and how could it suffer a prison sentence?[14] The debate on the effect of corporate criminal prosecution has continued as well. After all, the effect of prosecution must reach those who act on behalf of the corporation, and if direct personal punishment is more effective than indirect corporate punishment, why not impose the more direct and more effective punishment on corporate agents than on the corporation? Besides, the fines that a corporation might be required to pay may sometimes hurt the innocent shareholders, although if the corporation gained, the shareholders may have gained as well. Moreover, it is unclear that prosecuting the corporation will bring about a change in the corporate culture. Neither does a criminal action against the corporation assure an educational impact. Perhaps civil actions against corporations would be more effective.[15] Corporate crime and punishment has also undergone cost-benefit analyses, with various conclusions and suggestions.[16] Thus, the debate over the imposition of criminal law on corporations has not died out.

Yet, notwithstanding the differences between corporations and individuals, criminal law has been applied to corporations. Corporations have been accused of crimes, and have been punished by fines, and required to comply with other conditions to rehabilitate their organizational criminal tendencies, as if they were individuals. Prison sentences are reserved for the individuals within the corporate organizations that either committed the offenses or ordered them committed by others.[17]

The purposes of criminal law that applies to corporations is essentially the same as the purpose of criminal law that applies to individuals. The purposes, as they apply to corporations, are to rehabilitate: change the future behavior of the criminal business-corporation and satisfy the need for revenge and retribution: make the

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[14] Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, 72 N.Y.U. L. Rev. 687, 688 (1997).; Lance Cole, Corporate criminal liability in the 21st century: A new era?, 45 S. Tex. L. Rev. 147 - This article traces the evolution of corporate criminal liability and contains many references to cases and other articles. Is very good source for other articles. Arguing for fines as optimal punishment - See Richard A. Posner, Optimal Sentences for White-Collar Criminals, 17 Am. Crim. L. Rev. 409, 417 (1980); Christopher A. Wray, Note, Corporate Probation Under the New Organizational Sentencing Guidelines, 101 Yale L.J. 2017, 2021 (1992). See generally Michael K. Block, Optimal Penalties, Criminal Law and the Control of Corporate Behavior, 71 B.U. L. Rev. 395 (1991); Daniel R. Fischel & Alan O. Sykes, Corporate Crime, 25 J. Legal Stud. 319 (1996); Steven Shavell, Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent, 85 Colum. L. Rev. 1232 (1985).

[15] Steven C. Bennet, Book Review: Cullen, William J. Maakestad & Gray Cavender, Developments in the Movement Against Corporate Crime. Corporate Crime Under Attach: The Ford Pinto Case and Beyond, Francis T., *65 N.Y.U.L. Rev. 871(1990)* (citing the argument in the reviewed book)

[16] Darryl K. Brown, Cost-Benefit Analysis in Criminal Law, *92 Calif. L. Rev. 323* (2004)

[17] See e.g. n.8 *See, e.g., In the Face of Rising Oil Prices,* ECONOMIST (U.S. ed.), Sept. 24, 2005 (LEXIS, News Library, Curnws File) (noting prison sentences given to officials at Tyco International, WorldCom, and Adelphia Comminications).

wrongdoer pay for its crimes; satisfy the need for revenge and signal that wrongdoing gets its just deserts; and deter: affect the future behavior of both rogue corporations and others that have not committed wrongs or have not been caught committing wrongs but may waiver on this score. The signal shows the cost of such illegal behavior and may deter those corporations from such actions.[18] As in the context of individuals, these objectives have a societal and a future aspects--to reduce the incidence of wrongdoing.

Corporations that have misbehaved are subject to a number of discretionary punishments, in addition to the punishments meted out by criminal law. They can obtain suspended prosecution; they can obtain suspended sentences; they can settle with the prosecutors or regulators, and they can be placed under probation. All these measures are tailor-made for the wrongdoers. The following is a bird's eye description of each of these measures.

Changing corporate culture through settlements in exchange for suspended prosecution. Regulators and prosecutors have used suspended prosecution to deliver serious warnings to suspected organizations and to impose on them burdens. A growing number of companies have settled potential charges of accounting fraud by agreeing to a form of corporate probation in order to avoid criminal prosecution in exchange for good behavior in the future.[19] The corporations agree to the settlement terms because the mere charges can have serious consequences, for example, adversely affecting their reputation in the Untied States and sometimes abroad.[20]

The prosecutors are interested in such deferred prosecutions as well. With 300 open fraud investigations, the Federal Bureau of Investigation began "using the deferred

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[18] WAYNE R. LAFAVE, CRIMINAL LAW (4th ed. 2003) (purpose of criminal punishment: (1) Prevention (also called particular deterrence) - § 1.5(a)(1), at 26-27 ("to deter the criminal himself . . . from committing further crimes"); (2) Restraint - § 1.5(a)(2), at 27 (to protect society from persons deemed dangerous by isolating them); (3) Rehabilitation - § 1.5(a)(3), at 27-28 (to "rehabilitate" individual so he will not commit more crimes); (4) Deterrence (also called general deterrence) - § 1.5(a)(4), at 28-29 (to deter others); (5) Education - § 1.5(a)(5), at 29 (to educate others, by the attendant publicity, that a certain activity is not acceptable); (6) Retribution - § 1.5(a)(6), at 29-31 ("it is only fitting and just that one who has caused harm to others should himself suffer for it"); See also Rationale for corporate liability against a corporation, from 1 CHARLES E. TORCIA, WHARTON'S CRIMINAL LAW § 49, at 319 (15th ed. 1993) ((1) it may be difficult or impossible to ascertain the identity of the individual who committed the act in question; (2) "the individual may be outside the jurisdiction" ; (3) shareholders may be on guard; (4) officers may supervise employees properly)).

[19] Bloomberg, CFO.com, January 5. 2005.

[20] Section 9, Investment Advisers Act of 1940, 15 U.S.C. §80b-9 (2005) (revoking the registration of an adviser subject to criminal prosecution, and authorizing the SEC to exempt the adviser from such a revocation). Corporations that have sought and received "deferred prosecution" include Computer Associates International Inc., American International Group Inc., PNC Financial Services Group Inc., and AmSouth Bancorp. And "we're going to see a lot more of these," said Robert Giuffra, an attorney with Sullivan & Cromwell who headed an internal probe into accounting fraud at Computer Associates. Bloomberg, CFO.com, January 5. 2005. The most recent company to agree to these arrangements is Time Warner. The company agreed in December 2004 to pay $510 million to settle government probes into whether its America Online unit improperly booked advertising sales. Under the terms of the deferred prosecution, the Department of Justice will dismiss charges if the company cooperates with prosecutors and doesn't engage in similar fraud for two years. Said U.S. Deputy Attorney General James Comey, "If AOL fails to comply with the agreement, the deal is off, and they are in a world of trouble." Id.

prosecution option much more frequently."[21] Such suspended prosecution is desirable when the prosecutors' budget is tight; when the case is not strong enough; when the violations are not sufficiently serious; when the violators could recruit significant counter-pressures by political and business allies. These considerations are not applicable to every case, and there are questions about the fairness and efficacy of the bargains. These settlements may include requirements for restructuring the organizations. But critics question the efficacy of the restructuring long-term for lack of monitoring and enforcement.[22]

Changing corporate culture through settlements after the start of legal proceedings.[23] Prosecutors are guided by a number of considerations regarding settlement. The more important are (1) the severity of the offense; (2) the cost of conducting the prosecution; (3) the chances of successful prosecution; (4) The effect of a verdict on the others in the same position as the defendants; (5) The defendants' cooperation in the investigation, and leading to other wrongdoers and their prosecution. These considerations apply to individuals as well to corporations. The considerations might have greater weight if large corporations and thousands of documents are involved, and the cost of the prosecution may be higher.[24] Importantly, many settlements include

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[21] Id. Timothy Coleman, senior counsel at the Justice Department. "We think it's a good tool for use in prosecuting large corporations with lots of employees and lots of stakeholders."

[22] *See, e.g,* John E. Stoner, *Corporate Criminal Liability for Homicide: Can the Criminal Law Control Corporate Behavior?,* 38 Sw. L.J. 1275, 1288 (1985):

> If a court mandates internal restructuring of a corporation, some means for assuring that the corporation follows the court's orders is necessary. The court in effect would have to become a corporate watchdog, constantly monitoring those corporations acting under court orders. Overburdened courts cannot place themselves in such an untenable position.

[23] The incentives of corporations to settle at some stage in the proceedings are greatly affected by insurance. Insurance will not be paid if the defendant corporations were found guilty. That payment would be against public policy. To put more "bite" into settlements, the SEC is considering making as a condition to settlement a requirement that payments by insurance companies will be excluded. The payments would therefore have to come from the corporate coffers or the assets of the individual accused. Brian McGee, SEC May Extend Ban on Using Insurance to Pay Fines, WSJ Reports, Bloomberg News, June 16, 2003 Settlements and the agreed upon fines, however, do not mean the end of the claims against the corporations. They may mean the beginning of claims by other regulators and by injured investors. Thus, Pimco Corporation paid $18 million before the SEC sued it. Siobhan Hughes, Dow Jones Newswires, SEC Nets Another Fund Settlement, Wall St. J. Sept. 14, 2004. Then it settled with the SEC settlement by paying $50 million. SEC order in the matter of PSA Fund Management LLC, PEA Capital LLc, PA Distributors LLC. File NO. 3-11661 http://www.sec.gov;litigation/ Salso the W. St. J. Sept. 14, 2004. Tami Luhby, and Pradnya Joshi, Mutual funds have new safeguards after investors withdrew billions from tainted firms, September 5, 2004 (the following mutual fund companies have settled or agreed to settle with state and federal regulators: Alliance Capital $600 million; Bank of America (Nations Funds) $675 million; Bank One $90 million; Franklin Advisers, $50 million; Janus Capital $226 million; MFS $350 million; Pilgrim Baxter $100 million; Putnam $110 million; Strong Financial $175 million. Total: $2.394 billion. SEC; New York State Attorney General's office, Fund Companies. Because most settlements allow the accused to avoid admitting having done anything wrong, the payments in full or in part are covered by insurance.

[24] *See, e.g.,* Ben White & Peter Behr, *Citigroup, J.P. Morgan Settle Over Enron Deals,* WASH. POST, July 29, 2003, at A01 (noting that prosecutor "stopped short of pursuing criminal charges . . . because it would have been difficult to prove that any individual acted with intent to commit fraud").

enforcement mechanisms, such as are used in the case of probation, discussed in the next section.

Changing corporate culture by probation. Probation has been rarely applied to corporations until very recently.[25] Courts have had the power to place corporate defendants on probation – in addition or as an alternative to other punishments.[26]

The Sentencing Commission, however, has only recently paid more attention to issues of corporate probation. Hence, the field is relatively new and growing.[27] For corporate crimes, probation guidelines aim at three remedies: mandatory restitution, community service, and rehabilitation by compliance programs.[28] Yet, critics note that probation has proved disappointing,[29] while others are concerned that some of these guidelines would lead to "over-deterrence," and apply to cases of negligent but unintentional behavior.[30] Yet, no corporation was rewarded for reorganizing and creating a more law-abiding culture. [31] As of the effective date of Chapter 8 of the United States Sentencing Guidelines in November 1991, courts are required to place the defendant organization on probation if any one of eight factors exists.[32]

Increasingly, criminal punishments have included required mechanisms to change corporate culture. Procedures for decision making and compliance have been put in place or revamped. This has become the focus especially in the large corporations, and

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[25] United States v. J. C. Eherlich Co., Crim. No. 73-0451-K., March 14, 1974 (D.C. Ill). (corporate defendant was convicted of violating statute prohibiting discharge of refuse into navigable waters and was placed on probation. Defendant corporation appealed. The Court of Appeals held that corporations are subject to statutory provisions authorizing court to suspend imposition or execution of sentence and may be placed on probation. The court held, however, that order requiring corporation to set up and complete program within 45 days to handle oil spillage into soil and/or stream and authorizing appointment of special probation officer in event the conditions were not complied with was unreasonable and in excess of court's authority. Reversed and remanded for imposition of sentence).

[26] 18 USC § 3561. The terms of the Guidelines are set forth in Appendix A.

[27] Appendix A contains a more detailed description of the Guidelines.

[28] 18 U.S.C. § § 3551-3742 (2000); 28 U.S.C. § § 991-998 (2000).

[29] Shayne Kennedy, Probation and the Failure to Optimally Deter Corporate Misconduct, *71 S. Cal. L. Rev. 1075 (1998)(citing* V.S. Khanna, Corporate Criminal Liability: What Purpose Does it Serve?, *109 Harv. L. Rev. 1477, 1497* (1996), listing costs associated with reputational sanctions (1) no one benefits from corporation's lost reputation, but someone is damages by a cash fine; (2) the cost of a social stigma is hard to determine, but must be calculated to establish an optimal penalty; (3) because of inaccurate evaluation of social stigma reputational penalties will result in over- and underdeterrence; (4) corporations can limit the effect of a social stigma by generating positive publicity; and (5) only firms with a good reputation will be affected. Hence, cash fines are more efficient. Consequently, the Guidelines need to be rewritten in a manner that aligns the use of probation with the tenets of optimal penalty theory)

[30] Mark A. Cohen, Criminal Law: Environmental Crime and Punishment: Legal/Economic Theory and Empirical Evidence on Enforcement of Federal Environmental Statutes, *82 J. Crim. L. & Criminology 1054* (1992).

[31] Kendel Drew and Kyle A. Clark, Twentieth Survey of White Collar Crime: Corporate Criminal Liability, *42 Am. Crim. L. Rev. 277* (2005) (at least in "2002, no organization earned a reduction in its culpability score for having an effective compliance program.").

[32] See U.S.S.C. § 8D1.1

especially if their activities are spread around the globe. Internal policing must substitute for external policing, and culture is the backbone of enforcement of any book of rules.

Revocation of Licenses and Registration. Many corporations cannot function without licenses (e.g., broker dealers) and registration (e.g., investment advisers). The revocation and suspension of a license or a registration indirectly imposes a fine, which includes lost profits and the cost of keeping the business. Needless to say, suspension is may tarnish the licensee's reputation for honesty. However, this punishment does not necessarily require rehabilitation.

3. The other way: Rewarding honest corporations by offering them a competitive advantage

What remedy would provide a corporation with incentives to behave legally, and offer a monitoring process or mechanism to ensure proper behavior? Such a remedy should contain at least two components: a positive incentive to behave, and a monitoring of future activities.

Offering the corporation a competitive advantage as compared to rogue corporations. When a rogue corporation is punished, the corporations that have not been found to have committed a wrong are rewarded by the distinction: After all, they have not been punished while their competitors have been punished and have paid fines, depleting their assets and their reputation. These punishments offer benefits to their honest competitors. Even corporations that are slated for prosecution are at a competitive disadvantage and pay significant fines not to be prosecuted. Others wait for prosecution and bear the cost of probation and restructure or the suspension of their licenses temporarily or permanently. All these costs that are visited on criminal corporations put the honest corporations at a competitive advantage. This is as much as criminal law can offer honest corporations.

Rewarding leadership. Because corporate leadership greatly affects corporate culture, rewarding leadership for honesty would logically be a good place to start. Similar considerations apply to corporate employees as well. Yet, rewarding for honesty is more complicated than rewarding for producing something tangible. It is, after all, a reward for *not doing* a tempting wrong (taking more money than is due) or for doing something a less tempting right (avoiding a misleading impression of success).

Besides, leadership has a strong influence on the how much money and benefits it receives. Thus, an additional monetary reward for honesty might not be as valued, especially if a little dishonesty might produce far more money. Further, law cannot easily reward leadership or employees without drawing the monetary rewards from either the country's treasury or the shareholders pockets (or hurting the employees and communities). If the shareholders wish to reward their leadership they can do so on their own. It is doubtful whether taxpayers should pay for management's honesty.

It is doubtful whether honesty should be rewarded with money. A direct monetary reward for honesty is unseemly. Honesty should be considered the rule and not the exception. One does not reward people for not killing others, just as one should not reward people for not stealing from others. This kind of reward undermines the value of self-limitation and self-control in the face of temptation.

In addition, other motivations may affect the managers' behavior. When managers demand higher pay in the millions, their motivation is usually not the need for money but the desire for prestige and distinction.[33] Money is the signal or symbol of success and importance. Therefore, management's reward for honesty should provide the same kind of satisfaction by means other than direct monetary compensation.

Should honest corporations be rewarded with a medal of honesty? There are differences between not punishing and awarding a medal of honesty. In the first case, not punishing is a negative assertion rather than a positive one. In addition, the receipt of the medal of honesty is more conspicuous. Further, there may be more corporations that have not been punished than those who might receive a medal. A medal of honesty, however,

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[33] Frankel Trust and Honesty, Chapter 6 (Oxford University Press 2006)

is a symbolic gesture that does not contribute to the bottom line in the balance sheet of the corporation, and that is what most corporations, their investors and their personnel want. After all, this is their main purpose for being. In addition, there is something unbecoming for a corporation to advertise that it is honest. This is what is expected of every business (even if it the reality is somewhat different).

Rewarding the corporation rather than its management. I conclude that honest corporate management should not be rewarded by direct payment. For management and other employees alike a direct appropriate reward should be in terms of prestige and highlighted distinction. Indirectly, however, profits for the corporation can provide strong incentives to act honestly. For example, corporate reputation for honesty is valuable in the market and may lead to a more profitable corporation, and indirectly to profits for its management as well as its employees.

Another type of rewarding honest corporations is in the form of bestowing on corporations competitive advantages. These reward the business of the corporation. Such advantages indirectly benefit management and corporate employees in terms of prestige and self-worth and in terms of indirect monetary rewards that do not carry the disadvantages of direct money payments. These benefits inure to the shareholders, employees and other stakeholders in the corporations, including managements. Further, giving honest corporations a competitive advantage over dishonest corporations can be achieved by law.

In sum, an optimal reward for an honest corporation is indirect rather than direct payment to management and employees. This reward can be presented by a competitive advantage to the business of the corporation.

3. When does it make sense to apply the same rules to all corporations under a principle that "one size fits all," and when should rules be imposed on corporations selectively?

When costly regulation is imposed on all corporations that are natural competitors honest corporations do not gain a competitive advantage over those who have violated the law. In some situations these honest corporations bear higher costs than rogue corporations bear. Who then benefits from such rules?

Advantage of regulations that apply to all corporations. Rules that apply to all corporations offer advantages. First, they make it easier for the regulators to supervise the subjects of the regulation. The regulators include not only government regulators and examiners but also the internal police within large organizations, that is, compliance officers, comptrollers, and accountants. Second, generally applicable rules that relate to accounting principles make it easier for investors to compare the financial statements of various corporations. This, as well as clear general accounting rules that apply to all corporations may perhaps strengthen public-trust in the information that corporations offer the public. Besides, general rules provide a level playing field for competitors. All these reasons point to the benefits of rules that apply to all similar actors. However, in

certain contexts, such general rules impose high costs on honest corporations. In these circumstances the rules may reduce, if not eliminate, the benefits of general rules that apply to all.

Disadvantages of regulations that apply to all. By definition, regulations that apply to all are over-inclusive and under-inclusive. The regulations might fail to address problems that arise in some corporations, while reduce the reliability and honest behavior of other corporations. Much depends on the nature and coverage of the regulation.

For example, Congress has imposed disclosure requirements on corporations that issue securities to the public. The law required the SEC to provide the details of disclosure. On the one hand the duty to disclose should be general. On the other hand, corporations have different histories and different degrees of transparency. Some have been around for decades. Others have just issued their first initial public offering. The SEC has been adjusting the disclosure forms to reduce if not eliminate over and under inclusiveness as well as the regulated corporations' costs. To be sure, this adjustment creates a competitive advantage for large and well-known corporations as compared to small and unknown corporations. On the other hand, small corporations are exempt from obligations so long as the main objective of protecting investors is achieved. Thus, while the disclosure requirement applies to all corporations that offer their shares to the public, the detailed requirements are fashioned and tailored to accommodate particular types of corporations, and thereby reduce the over and under inclusiveness.

When some corporations have violated the law while others did not, it makes no sense to punish all by fines or restrictions. Criminal law, settlements of suspended prosecution, or sentencing by settlements or probation apply to those corporations that violated the law or were about to be prosecuted for violations. These are traditional preventive regulations. The basis for preventive regulation is general, but the application of these rules is specific to those corporations that were shown to have violated the rules. The general rules usually include prohibitions, such as the prohibition of fiduciaries to engage in conflicts of interest transactions, and requirements, such as the requirements for prospectuses in a public offering and corporate internal accounting.

Courts and regulators fashion punishments to fit the corporations that have violated the law. They do so by settlements before or after the beginning of criminal proceedings, and by punishments, probation, and suspension of licenses after judgment. In addition, regulators are sometimes authorized to fashion appropriate rules for particular actors as well as class of actors by relieving them from the constraints of the law, usually subject to new and different constraints.

Preventive measures concerning internal governance. Internal corporate governance has acquired increasing importance. That is because corporations have become larger and have spread their influence and transactions all over the world. The larger and less penetrable corporations are, the stricter the legal requirements for strong corporate governance are going to be. Such corporations must have effective internal private police because neither the markets nor the government enforcement mechanisms

can enforce on them the law.[34] Strong private police will also not be effective unless the culture of the corporations, that is, the processes and rules by which the members of the corporations interact, are oriented toward honesty.

Thus, if corporations have installed internal policing and established a culture of honesty they are likely to operate honestly. Any rogue actor within such a corporation will be caught and punished. The detection of such a person is just as important as the punishment to prevent a movement of copycats that may change the expectations of the corporate community and thereby its culture. Many corporations have applied and enforced such preventive mechanisms, and have operated honestly.

4. The Sarbanes-Oxley Act

When the 1990s frauds came to light Congress and regulators reacted by imposing new laws. The Sarbanes Oxley Act that imposes on all corporations the same internal controls and governance rules. Congress substituted more specific rules for laws that were open to broader interpretations. That is because the corporations and their lawyers have interpreted the rules in ways that subverted the purposes of the rules. Hence, specific prohibitions offered less maneuvering space for those who sought to violate the spirit and purposes of the rules.

In addition, the Sarbanes-Oxley Act of 2002 (the Act)[35] imposed strict duties on corporations and their management. The Act is criticized for the costs it imposes. These costs were equated to fines, thereby affecting innocent corporations and their shareholders. In addition, the Act directly affects top management. The Act poses for management new, and to some extent novel, liabilities. In this respect the Act is quite unique.

The Act generally applies to all corporations, whether or not they were found guilty, or suspected, of violating the law. The question is whether all of the Act's provisions are appropriate for "one size fits all" structure. In order to apply the tests discussed above, a summary of the Act is necessary. Then I can demonstrate which of the Act's provisions should apply to all corporations and which should apply only to corporations that were found to have violated the law, or are strongly suspected of having violated the law.

Governance provisions. The audit committee. The Act intrudes into the governance of publicly held corporations. It requires public corporations to establish independent audit committees[36] responsible for "the appointment, compensation, and oversight of the work" of the corporations' auditors.[37] The audit committees must establish procedures for addressing complaints.[38] The committees should have authority

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[34] Mutual funds: Compliance-internal police. General
[35] Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.
[36] *Id.* § 301, at 776 (codified at 15 U.S.C. § 78j-1(m)(3)) (Supp. II 2003)).
[37] *Id.* § 301, at 776 (codified at 15 U.S.C. § 78j-1(m)(2)) (Supp. II 2003)).
[38] *Id.* § 301, at 776 (codified at 15 U.S.C. § 78j-1(m)(4)) (Supp. II 2003)).

to engage independent counsels and other advisers deemed necessary.[39] The corporations must provide appropriate funding to the auditors and the audit committees' advisers.[40] The SEC is required to prescribe rules regarding management assessment of the corporations' internal controls.[41]

Auditors. Auditors are also subject to new requirements. The Act requires auditors to attest to, and report on, the management's assessment of internal controls,[42] and the SEC must propose and issue appropriate rules regarding improper influence in the conduct of audits.[43]

Principal executive officers. Under the Act, the SEC should require the principal executive officer(s) and principal financial officer(s) of the issue to provide an appropriate certification in each annual or quarterly report filed under section 13(a) or 15(d) of the 1934 Act.[44] The chief executive officer and chief financial officer will forfeit to the issuer-corporation certain bonuses and profits, if the "issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws."[45] Further, "[I]t is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation."[46]

The Act generally prohibits a director or an executive officer of an issuer-corporation from certain trading during pension fund blackout periods,[47] and prohibits issuers from making certain personal loans to any director or executive officer.[48] Further, the Act requires disclosures of certain transactions involving directors, officers, and certain 10 percent beneficial owners[49]

Financial reporting. The Act requires financial reports under 1934 Act to "reflect all material correcting adjustments that have been identified by a registered public accounting firm." In addition, the SEC must to issue rules that require issuers to (1) Disclose off-balance sheet transactions and regarding *pro forma* information,[50] and (2) Disclose, "together with periodic reports required pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934, …whether or not, and if not, the reason therefore, [the issuers have] adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions."[51]

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[39] *Id.* § 301, at 776 (codified at 15 U.S.C. § 78j-1(m)(5)) (Supp. II 2003)).
[40] *Id.* § 301, at 776-77 (codified at 15 U.S.C. § 78j-1(m)(6)) (Supp. II 2003)).
[41] *Id.* § 404(a), at 789 (codified at 15 U.S.C. § 7262(a) (Supp. II 2003)).
[42] *Id.* § 404(b), at 789 (codified at 15 U.S.C. § 7262(b) (Supp. II 2003)).
[43] *Id.* § 303(d), at 778 (codified at 15 U.S.C. § 7242(d) (Supp. II 2003)).
[44] *Id.* § 302, at 777-78 (codified at 15 U.S.C. § 7241 (Supp. II 2003)).
[45] *Id.* § 304(a), at 778 (codified at 15 U.S.C. § 7243(a) (Supp. II 2003)).
[46] *Id.* § 1001, at 807.
[47] *Id.* § 306(a), at 779-80 (codified at 15 U.S.C. § 7244(a) (Supp. II 2003)).
[48] *Id.* § 402(a), at 787-88 (codified at 15 U.S.C. § 78m(k) (Supp. II 2003)).
[49] *Id.* § 403, at 788-89 (codified at 15 U.S.C. § 78p(a) (Supp. II 2003)).
[50] *Id.* § 401, at 785-87 (codified at 15 U.S.C. §§ 78m(*i*)-(j), 7261 (Supp. II 2003)).
[51] *Id.* § 406(a), at 789 (codified at 15 U.S.C. § 7264(a) (Supp. II 2003)).

The SEC must also revise the regulations on "matters requiring prompt disclosure on Form 8-K (or any successor thereto). to require issuing corporation to immediately disclose a change in or waiver of the code of ethics,[52] and to disclose, "together with periodic reports required pursuant to sections 13(a) and 15(d) of the Securities Exchange Act of 1934…whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the [SEC]"[53]

Issuers must disclose "on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations" as the SEC requires.[54]

The SEC must adopt rules to address conflicts of interest involving securities analysts and research reports, and elaborating on what the rules must include[55] In addition, SEC rules should require securities analysts, brokers and dealers to disclose conflicts of interests, and elaborating on what must be disclosed.[56] Attorneys are not left out of the Act. The Act requires the SEC to set out standards of professional conduct for attorneys representing issuers.[57]

The Act establishes criminal penalties for the destruction, alteration, or falsification of records in federal investigations and bankruptcy;[58] for the destruction of criminal audit records;[59] for defrauding shareholders of publicly traded companies,[60] and for corruptly tampering with a record or otherwise impeding an official proceeding.[61] Criminal penalties are imposed on chief executive officers and chief financial officers that knowingly or willfully sign false certification of periodic financial reports.[62]

Accounting provisions. The Act establishes a new Public Accounting Oversight Board, and has set out its duties and the conditions for membership. The Board is authorized to establish auditing, quality control, and independence standards and rules.[63] It reports to SEC annually.[64] Only a registered firm may prepare an audit report for an issuer. There are requirements for application for registration; and for members' periodic

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[52] *Id.* § 406(b), at 789 (codified at 15 U.S.C. § 7264(b) (Supp. II 2003)).
[53] *Id.* § 407, at 790 (codified at 15 U.S.C. § 7265 (Supp. II 2003)).
[54] *Id.* § 409, at 791 (codified at 15 U.S.C. § 78m(*l*) (Supp. II 2003)).
[55] *Id.* § 501(a), at 791-92 (codified at 15 U.S.C. § 78*o*-6(a) (Supp. II 2003)).
[56] *Id.* § 501(b), at 792-93 (codified at 15 U.S.C. § 78*o*-6(b) (Supp. II 2003)).
[57] *Id.* § 303(d), at 784 (codified at 15 U.S.C. § 7245 (Supp. II 2003)).
[58] *Id.* sec. 802(a), § 1519, at 802 (codified at 18 U.S.C. § 1519 (Supp. II 2003)).
[59] *Id.* sec. 802(a), § 1520, at 802 (codified at 18 U.S.C. § 1520 (Supp. II 2003)).
[60] *Id.* sec. 807, § 1348, at 804 (codified at 18 U.S.C. § 1348 (Supp. II 2003)).
[61] *Id.* § 1102, at 807 (codified at 18 U.S.C. § 1512(c) (Supp. II 2003)).
[62] *Id.* sec. 906, § 1350, at 806 (codified at 18 U.S.C. § 1350 (Supp. II 2003)).
[63] *Id.* § 103, at 755-57 (codified at 15 U.S.C. § 7213 (Supp. II 2003)).
[64] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750-53 (codified at 15 U.S.C. § 7211 (Supp. II 2003)).

reports to the Board.[65] In addition the Board must enforce the rules. It must conduct inspections as specified in the Act,[66] and set procedures for investigations and disciplinary proceedings.[67] The SEC oversight of Board under the Act, includes the authority to amend and approve the Board's rules[68] The Act sets criteria for SEC's recognition of "generally accepted" accounting standards,[69] and limits situations of accountants' conflicts of interest,[70] as well as prohibits improper influence on the conduct of audits, in violation of SEC rules.[71]

5. The Sarbanes-Oxley Act contains a number of unusual features

The Sarbanes-Oxley Act significantly intrudes on internal governance of publicly held corporations. The Act applies to all financial institutions, even those that are specially regulated, such as banks and mutual funds. It covers internal accounting and structural internal governance, as well as imposing liabilities on top management backed by criminal sanctions.

The Act applies equally to rogue corporations and corporations that have not been found to have violated the law. The bad guys would receive the medicine they deserved, and the good guys would receive it as well, even though they did not deserve it. Honest corporations did not benefit from their honest behavior. They were punished as if they had violated the law. While accounting has traditionally been generally applied, the structural rules that the Act imposes have not. Thus, the Act raises the issue of inappropriate "one size fits all" in internal governance and management's liability and its costs.

Should these structural provisions apply to all corporations? The Act might deter corporations that are or would have planed to defraud. Or it might not. Will the provisions in the Act make it easier for the SEC to supervise misbehavior and make it easier for investors to compare corporations with more certainty? The answer is far less certain. On the one hand, these provisions might strengthen the public's trust in corporate America. On the other hand, the forced changes in the internal structures of corporations that have not violated the law may be counter-productive.

Sarbanes-Oxley Act raised a chorus of objectors against the general applicability of the Act. Some are strongly complaining about the costs, and the power of the

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[65] *Id.* § 102, at 753-55 (codified at 15 U.S.C. § 7212 (Supp. II 2003)).
[66] *Id.* § 104, at 757-59 (codified at 15 U.S.C. § 7214 (Supp. II 2003)).
[67] *Id.* § 105, at 759-64 (codified at 15 U.S.C. § 7215 (Supp. II 2003)). The Act clarifies the status of foreign firms. *Id.* § 106, at 764-65 (codified at 15 U.S.C. § 7216 (Supp. II 2003)).
[68] *Id.* § 107, at 765-68 (codified at 15 U.S.C. § 7217 (Supp. II 2003)).
[69] *Id.* § 108, at 768-69 (codified at 15 U.S.C. §§ 77s(b), 7218 (Supp. II 2003)). See also *Id.* § 109, at 769-71 (codified at 15 U.S.C. §§ 78m(b)(2)(C), 7219 (Supp. II 2003)) regarding the board's funding.
[70] *Id.* § 201, at 771-72 (codified at 15 U.S.C. §§ 78j-1(g)-(h), 7231 (Supp. II 2003)); *Id.* § 202, at 772-73 (codified at 15 U.S.C. § 78j-1(*i*) (Supp. II 2003)); *Id.* § 203, at 773 (codified at 15 U.S.C. § 78j-1(j) (Supp. II 2003)); *Id.* § 204, at 773 (codified at 15 U.S.C. § 78j-1(k) (Supp. II 2003)); *Id.* § 206, at 774-75 (codified at 15 U.S.C. § 78j-1(*l*) (Supp. II 2003)).
[71] *Id.* § 303(a), at 778 (codified at 15 U.S.C. § 7242(a) (Supp. II 2003)). Exemptive provisions are listed in Appendix B.

accountants to invent new systems that benefit only them. Others believe that the Act is not sufficiently strict. They ask whether corporate America has already forgotten Enron's lessons.[72] They argue for a level playing field among all corporations.

The obvious solution is to apply the strict laws to the corrupt but not to those who are not. The solution, however, seems to undermine the principle that rules should apply to all. They ought to apply equally. This view is true, but not completely. No rule applies equally to everyone. Rules may make distinctions and define the persons or organizations to whom they apply. A public offering of securities involves far more onerous rules than a private placement. We may argue about the definitions, their specificity, and the lines we wish to draw, but that argument is not unique to the idea that corrupt organizations should be subject to stricter rules and those who are not should be relieved of the rules. It applies to every rule. The principle of equality under the rule of law applies only to those who are of the same species to whom the rule applies.

Perhaps in this case a level playing field should not be maintained, just as a level playing field is not maintained when criminal corporations are fined while honest corporations are not. Honest corporations that bear the cost together with those who violated the law may well reconsider whether honesty pays. While they understand that accounting rules must apply to all, with few exceptions the rules that require internal restructuring and impose criminal risks on top management might not require a "size fits all" rule.

Honest corporations may maintain a culture of honesty in many ways. Corporate culture may depend on the personality of top management, on the corporation's history or on its core business and many other factors that contributed to its particular organizational structure and habits of interaction. Forcing such honest corporations to restructure has a double effect. It destroys the honest culture. It imposes enormous costs of changing the culture. And it creates a justified resentment that questions the value and reward for honesty. Thus, imposing the Act on corporations that were not found dishonest may undermine the culture of honesty that they maintained.

Sarbanes Oxley Act can be used to reward honest corporations by offering them a competitive advantage. This article is based on the assumption that competitive advantage is one of the strongest motivations of management. Just as competitive advantage might motivate management to violate or allow the violation of the law[73] it might also motivate management to strictly adhere to the law. To be sure, fines and imprisonment can deter. But that need not be all.

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[72] See e.g., Shaheen Pasha, Corporate Compliance Rules Challenged, CNN Money.com March 22, 2006. (claimants in a court case argue that the Act is unconstitutional).

[73] This type of violation is usually kept secret not only to hide it from the authorities but also to hide it from competitors. But as the competitors find out about the violation their management feels constrained to do the same. In such situations people justify their following this route by "What can I do? Everyone does it. If I do not, I will go bankrupt." Besides, "someone else is to blame for my misbehavior, and finally, this is not misbehavior. So many corporations do the same. It cannot be wrong." Frankel, Trust and Honesty Chapter 3.

The Act offers a unique opportunity to provide a competitive advantage to corporations that did not violate the law. Relief from the requirement to change the corporate culture and from the costs that it entails offers significant competitive advantage to honest corporations. Thus, not only is a relief from the Act justified, but it also provides a social benefit by offering an incentive to maintain internal corporate honest cultures.

Special rules are designed for the wrongdoers. Corporations and individuals that are prosecuted for violations of the law are subject to special rules. Some of these rules are negotiated with the prosecutors. Some of these rules are imposed by the courts, for example, the rules relating to probation. Some rules are imposed by special committees such as parol committees. The Securities and Exchange Commission may establish rules for particular applicants for exemptions. These exemptions change the laws for the applicants and impose on them different specialized restrictions. Therefore, we do have rules that apply to a class of persons and yet, under certain circumstances, are changed for some members of the class but not for others. In fact, settlements with prosecutors are not governed by equal rules. The prosecutors have broad discretion to agree to different settlement terms with different corporations that are accused of the same wrongs. Further, repeat violators may bear under the law different punishments, and some discretion is vested in the courts as well as in the prosecutors as to the extent of the punishments.

The principle that under certain circumstances, a law may apply to some corporations but not to others of the same species is part and parcel of our legal system. There is nothing new or innovative about this principle, except in one respect. Different applications of rules to corporations of the same species or to individuals who fall into the same class usually relate to the punishment of those who violated the rules. Within the class of corporations to whom a rule applies all must be treated equally, until they are shown to have violated the rule. It is then and only then that the corporations receive different treatments.

In fact, punishments are far more unequal than the standard of the violation. The rule applies to all. Violators, however, are treated differently, not only from those who did not violate the rules but also from each other. It may well be that the uncertainty about the punishment is another deterrent to obey the law. In addition, there is a justification for the differences. After all, the circumstances of each violating corporation may differ. For example, the chances of their repeating the wrongs, such as the changes in leadership, structure, and personnel, may be different, and therefore the deterrent aspect of the punishment may differ. This justifies different treatment of the wrongdoers. Therefore, even after a violation occurs, it seems that there are not precedents for applying the law differently to the violators. The differences appear within the realm of punishment.

Even the differences that apply to the future behavior concerning internal controls and alike are triggered only within the realm of punishment. They belong to the probation and parol categories. There is no precedent to a general rule, that is, the law on the books,

that would be triggered only after a wrong was committed, and triggered automatically to all violators alike. Thus, it seems that an automatic and clear application of a rule after a violation or an event limits the discretion of the government prosecutors rather than expands it. Arguably, such a rule would also reduce the deterrent effect of the punishment because it would be applied like the amounts of a fine, and have a limit. A cost benefit analysis may then be even more inviting than it is today.

However, rules that catch in their net only corrupt corporations differ somewhat from other punishments. Such rules are not prohibitory. They impose additional duties on all corporations and their leaderships. The Sarbanes-Oxley Act contains such rules. It restricts the behavior and structure of organization and their management. It does not leave any corporations free to behave as they did before. Its rules would have the salutary effect of distinguishing the violators from the non-violators, and allow those who did not violate the law to advertise that fact. These corporations could show that the government did not apply the stricter rules to them, and benefit from lower costs and government controls.

The objection to the proposed approach is that it will allow corporations to "leverage" the law to their advantage. The answer is that this is the precise result which the proposed approach should achieve. Let every corporation leverage the law to avoid violation. There could be no better result than when the proposal creates for corporate management an incentive to ensure that the corporations steer away from the stricter rules. There could no better result if the management takes advantage of the situation and advertises the fact that it is not subject to the stricter rules.

Another argument against this proposed approach is that a corrupt management, which may be the most affected by the rule, would simply take greater care to hide legal violations in order to avoid this new additional burden. The answer to this argument is that as compared to prison sentences and enormous fines, in addition to bad publicity and its attendant financial disasters that may follow, the applicability of stricter rules would not trigger greater efforts to hide the wrongs.

In addition, the deterrent effect of the approach is not for corporations committed to corrupt practices, but for those who are not sure about what to do. The approach is aimed at corporations and their management that view corrupt and financial successful competitors and wonder whether they to should follow that path. The answer, however, is that even for these hesitant corporations, why would stricter rules deter more than fines and imprisonment? Besides, the response is that the approach is designed to provide corporations and their management with a tangible and on-going benefit for staying on the right path. Fines are a one-time pain and may be covered by the wrongful acts. Imprisonment may lead to new management. But imposing on-going costs and restructure on a corporation is long-term and far more costly. In the mean time those corporation that are not subject to the stricter rule gain a competitive advantage.

An additional benefit of the proposed approach is that it allows for an evaluation of new rules that are not based on experience. The Sarbanes-oxley Act is a good example.

The costs of the Act have not been verified before it was passed. If the approach suggested here would have applied, then the Act would have been passed as it did, but would have applied only to corrupt corporations and their management.

7. The Questions.

Many questions arise in connection with the proposed rule.

What would be the triggering event on which the law would apply? This question is crucial and the answer must be the most unambiguous.

Who should decide whether to apply the stricter law? For example, should such a law apply to all corporations but allow regulators to exempt corporations that were not covered by the triggering event, or should relief be determined by some private sector gate-keeper such as lawyer or an accountant, or should the corporation itself be free to determine that the law does not apply to it, unless it decides to seek approval by the regulator?

Should the relief from the Act be automatic?

As always, the devil is in the details.

The Triggering Event

The question of applicability of a rule is not new or unique. For this proposal just as for any rule, to work well the triggering event should be as unambiguous as possible, and or be connected to another already established triggering event, such as a guilty verdict. Otherwise, duplicative and high costs may be connected to the applicability of the approach. Besides, if the applicability of a stricter rule is likely to be viewed as a punishment under criminal law, the presumption of innocence would apply with all its rigor.

What kind of event should trigger a stricter rule? One possibility is to define the event by a particular wrong or wrongful acts as proven in the court. However, the specification of such wrongs may lead to pressures to bargains with prosecutors to avoid the specified wrongs. The result would be to award prosecutors with additional power in their negotiations with corporations and management. But this is not the intent or design of the proposed approach. A "softer" version of the same method is to provide it as a model for the prosecutors on which to negotiate. They could negotiate the application of the particular stricter rule in toto or in part. Thus, Sarbanes-Oxley Act could become a new punishment and a basis for negotiations between the prosecutors and corporations and management as to the punishment. This, too, is not precisely the purpose for which the approach is designed. Similarly, if the stricter rule is added as a possible punishment to be meted by the court, the parties might negotiate a settlement before the court passed the sentence. A rule based on principles does not resolve the problem. In short, the

question is not merely what violations would lead to an application of the strict rule but who should decide whether the violations have occurred.

The nature of the violations that could trigger the stricter rule should relate to the substance of the stricter rule. A violation of the Act should trigger the applicability of all its provisions. In the ,future legislators might consider such stricter rules when the legislation applies to corporations and management.

I believe that every corporation that has been held to have violated the laws covered by the Act should automatically be subject to the provisions and requirements of the Act. Further, suspended sentences, which today do not include supervision, should automatically include the applicability of the Act. In addition, settlements, which today include various compliance restructuring requirements should include the applicability of the Act at the discretion of the prosecutors. The reason is that settlements usually include compliance mechanisms and restructuring that may be more suitable to the particular corporations. In addition, if the SEC determines to eliminate the contribution of insurance to settlements in full or in part, then perhaps a relief from the act may help cover some of management's losses. Admittedly, this is a speculation that requires further empirical research. Any corporation whose license was revoked or suspended should be subject to the Act automatically. If, however, the license is suspended then the authority that suspended the license may after giving its reasons, relieve the licensee or registrant of the applicability of Act, with or without conditions.

Who should decide whether to apply the stricter law? One possibility is to retain the status quo and have the law apply to all corporations, but authorize regulators to exempt corporations that were not covered by a triggering event. Another possibility is that relief from the applicability of the Act would be determined by a private sector gate-keeper such as an organization of lawyers or accountants. Yet another possibility is to define the triggering event and allow corporations to determine whether the law applies to them, unless they decides to seek a determination by the regulators.

Should the relief from the Act be automatic? In the accounting area relief has been mostly exemptive in individual cases. In the disclosure area, relief has been usually general. Why not allow for an automatic exclusion of all non-violating corporations from the Act's provisions concerning corporate governance? Why not automatically apply the Act's governance provisions if the corporation is accused of violations that are covered by the Act? The exclusion would send a message: "If you behave, you are exempt."

Arguably, increased liability of corporate management would deter a management that is inclined if not actually planning to defraud, even though they were not caught. Yet a possible reaction of innocent corporations may undermine the purpose of the Act. As noted, corporations that were not found to have violated the law might rethink the benefits of honest behavior. Beside, the prohibitions on fraud are on the books. The Act requires a change of culture that is costly as was argued above.

If these concerns are significant, then instead of an automatic exclusion the Act could be amended to provide an exemption from the Act if the corporation can show that it has complied with the relevant laws for a number of years, for example, 5 years. A regulatory agency, such as the banking, insurance, or Securities and Exchange agencies could then determine whether an exclusion or exemption is merited. The amended Act can then provide the principles and timing under which the agencies will be required to exempt. Such an exemption may also serve to provide a competitive advantage to the particular corporation.

Should SOX automatically apply at any stage of criminal proceedings? There are good arguments that it should, especially in light of the proposal of the SEC to preclude from settlements the payment of insurance to cover the settlement costs and fines. Such preclusion is quite serious and can result in strong resistance to settle. What role would the applicability of SOX play in settlement negotiation? If it is automatically applied, it might be used as an alternative to the requirements for eliminating insurance. Or it could be imposed either at the discretion of the prosecutors or at the discretion of the accused corporation. Unlike a fine, which the insurance company or the corporation would pay, lack of insurance or the imposition of the Act are alternatives by focusing on management, and imposing on it either payment or future liabilities. The applicability of the Act is this case must be discretionary, to be an alternative to the elimination of insurance. I would, however, vote for the automatic application of the Act, and the retention of the insurance. My vote is influenced by the fact that the applicability of SOX may offer a competitive advantage to honest corporations, as well as a helpful measure to rehabilitate the culture of the accused corporations.

Should probation include an automatic application of SOX or should the court have the discretion to apply the Act? Discretion regarding probation is vested in the courts. Presumably, the court could evaluate whether the Act is an appropriate added requirement for probation. In addition, probation involves a measure of monitoring and supervision, arguably making the applicability of SOX unnecessary, or too burdensome. On the other hand, SOX contributes to heightened awareness of top management and to a change in the corporate culture, which is one of the main purposes of probation. There may be benefit in applying and standardizing this part of the probation process. I would vote for applying SOX automatically to any probation order, and vesting the court with the power to relieve the accused corporation of SOX or part of SOX.

Conclusion

The Sarbanes-Oxley Act can help re-establish a culture of honesty within a corporation by continuously reminding management of the issue, and rendering legal compliance and honest accounts as part of its decision making. However, the Act applies to honest corporations and to institutions that are highly regulated such as banks and other financial institutions. The Act raises the costs for all corporations, whether rogue or honest. The Act does not offer honest corporations a competitive advantage, and robs them of their ability to demonstrate that they have behaved well.

One important purpose of corporate criminal punishments should be to reward honest corporations by offering competitive advantages. In addition to preventing corporations from competing on fraud, corporate criminal law should focus no only on changing the culture of rogue corporations, but also on rewarding honest corporate culture. Exemptions from some onerous provisions of the Sarbanes-Oxley Act offers a good opportunity for such rewards.