Could Sarbanes-Oxley discourage honest corporate officers and entice dishonest ones?

'Left Behind' after Sarbanes-Oxley

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Soon after the enactment of the Sarbanes-Oxley Act of 2002, William Donaldson, then the chairman of the Securities and Exchange Commission, worried that the new law would drain away some of the "risk-taking zeal" of American entrepreneurs. He observed that the law had "unleashed batteries of lawyers across the country" and one predictable result would be "a huge preoccupation with the dangers and risks of making the slightest mistake."

With a few years' experience of life under Sarbanes-Oxley, three economists at the University of Pittsburgh put Donaldson's prediction to the test. In a study released in June 2007 using United Kingdom companies as a benchmark, Leonce Bargeron, Kenneth Lehn, and Chad Zutter concluded that corporate risk-taking had indeed declined. American companies, they found, have reduced expenditures on research and development, increased holdings in low-risk investments, and proven significantly less willing to test the IPO waters.

To many readers of *Regulation*, this vignette may be filed in the already ample folder labeled "Laws That Had Dismal Consequences Completely Unsurprising To Any Sensible Observer." But the simple story becomes somewhat more complicated when we consider another report, the "2007 Oversight Systems Report on Corporate Fraud," that sounds a jarringly discordant note. According to a national survey of certified fraud examiners, three-quarters of the respondents reported their impression that institutional fraud is *more* prevalent today than before Sarbanes-Oxley. Notwithstanding the draconian penalties now in place for corporate fraud, only 3 percent of the examiners felt that fraud is less prevalent.

Taken together, these reports present a puzzle: how can there be less risk-taking but more fraud? Surely, one would expect, as the overall amount of business activity declines, so too would the level of fraud. If entrepreneurs are really parking capital in low-risk ventures — that is, if entrepreneurs are less entrepreneurial and more akin to what we might call "bean counters" — one would predict that there would be less, and not more, business fraud. In this article, we propose a solution to this puzzle by focusing on the question of who has been "left behind" managing publicly-traded corporations in the aftermath of Sarbanes-Oxley.

The "Left Behind" from our title is an allusion to the series of novels that are based on the religious doctrine of Rapture — that is, the doctrine that believers will, "in the twinkling of an eye," be taken body and soul into heaven. Left behind here on earth, according to this view, will then be the unbelievers and the unrighteous. Likewise, albeit on a rather more mundane note, we propose to ask whether, in the wake of criminal laws such as Sarbanes-Oxley, certain kinds of corporate executives may decide to flee the scene and, if they do, what sort of men and women will be left behind. We suggest that there may not only be growing numbers of risk-averse "bean counters," there may also be an emerging class of entrepreneurs whom we call "swashbucklers." These men and women have no special regard for the strictures of the criminal law and they may thrive in the post-Sarbanes-Oxley world.

SARBANES-OXLEY

As is now widely known, Sarbanes-Oxley dramatically escalated penalties for white-collar crimes. For example, the maximum penalty for securities fraud is now 30 years imprisonment. But Sarbanes-Oxley did not simply increase penalties; it also con-

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This article condenses a longer paper forthcoming in the *American Criminal Law Review*.

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tinued a nearly century-long trend in American law that has diluted a *mens rea* or "guilty mind" requirement for various criminal offenses. To take just one example, consider the notorious certification provision that requires corporate executives to certify that all financial filings "fairly represent *in all material respects* the financial condition and results of the operations of the issuer." As Professor Pamela Bucy has written, "Avoiding chicanery is not enough; a corporate officer will go to prison for failing to tell about all possible financial problems." Suffice it to say, more and more activities potentially fall within the scope of the criminal law; and whether they actually do seems to be left ever more unpredictably to the ex post discretion of prosecutors and juries.

Not surprisingly, some corporate executives are reporting job dissatisfaction and linking this dissatisfaction to changes in the legal regime. The regulatory apparatus has become so detailed and invasive and penalties for violations, even of a technical nature, have become so punitive that many executives have waved the white flag. According to a 2006 issue of *Business Week*, many hotshots of American industry are leaving publicly traded corporations for "the money, freedom and glamour of private equity." In addition, as a result of Sarbanes-Oxley, some private corporations have decided not to go public and some public corporations have decided to go private. Small investors should lament both of those developments. The corporations they are able to invest in are less likely to attract top managerial talent, and in addition it means that, by contracting the number of publicly traded corporations, their investment options become relatively more limited. Sarbanes-Oxley should be a boon to rich and well-placed individuals and institutions that can invest in alternative asset classes like private equity.

When Outback Steakhouse's long-time and much-praised CFO Bob Merritt resigned in April of 2005, he criticized the multiplying regulations that have made his professional life such a misery: "Because I'm a business-development oriented person, and administration is not my strength, I believe there are other people out there who can do a much better job at managing in this environment than I."

Merritt's suggestion, seconded by several others in the journalistic and academic community, is that entrepreneurial-minded executives are leaving and their places are being taken by risk-averse persons who delight in the minutia of regulatory compliance. To be sure, this is part of the story. But our argument is that the truth may be more complex. Sarbanes-Oxley and similar criminal laws may trigger an adverse-selection cascade in which the best entrepreneurs are driven away from heavily regulated, publicly traded markets. Soaring penalties for corporate crimes and dilution of a *mens rea* requirement could have the paradoxical consequence of creating *more* corporate crime and not, as the standard story goes, less. And the reason is that a form of adverse selection is now operating in which some of the best or most instinctively law-abiding entrepreneurs are fleeing the scene, leaving the less wholesome sorts behind.

SWASHBUCKLERS, BEAN COUNTERS, AND IDEAL ENTREPRENEURS

One can imagine the competition for corporate control as waged by three human "types" — the swashbucklers, the bean counters, and the ideal entrepreneurs. What distinguishes those three types from each other is their attitudes toward risk, and in particular their attitudes toward business risks on the one hand and legal compliance risks on the other.

First, consider the ideal entrepreneur. His willingness to flee from or embrace risk depends on the nature of the risk confronted. On the one hand, when the risk entails compliance with the criminal law such as the avoidance of any environmental spillage that might give rise to criminal liability, the ideal entrepreneur is risk-averse. He will, therefore, incur significant costs to ensure that no spillage will occur.

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On the other hand, when the issue is a business decision such as whether to open a new factory, the ideal entrepreneur is risk-neutral. This means that ideal entrepreneurs prefer risky undertakings with high expected returns to safe endeavors with lower returns. To take an example, imagine that one project has a certain rate of return of 5 percent, and a second project has a three-fourths chance of a -20 percent return and a one-fourth chance of a 100 percent return. As individuals, being risk-averse, we are likely to choose the first project. But as a shareholder, we would want the managers of our corporation to choose the second option (with an expected return of 10 percent) to the first (with a guaranteed return of 5 percent). This is because, as investors, we can hedge against risk by owning a diversified stock portfolio. John Maynard Keynes famously referred to entrepreneurs' "animal spirits," but it is possible that what we mistake for irrational exuberance is really just the best entrepreneurs' ability to coolly crunch the numbers and pick risky projects that are more profitable than safer ones.

Much of the standard law-and-economics scholarly literature on white-collar crime assumes that the best corporate managers' risk-neutrality bleeds over into decisions about compliance with the criminal law. That assumption may be

faulty. In fact, society demands that the very same corporate managers who are risk-neutral with respect to business decisions be risk-averse when confronted with the criminal law. Professor (formerly Judge) William Allen has written:

> [C]orporate directors will not direct management to calculate the costs and benefits of compliance with criminal law. Nor will their lawyers advise them that they may safely do so. The pedagogic message of criminal sanctions is "take all necessary steps to avoid the proscribed act."

The ideal entrepreneur hears that message. For him, it is better to comply with the criminal law than chance getting caught, however remote the possibility. He pays the certain costs of compliance rather than risk being convicted of a crime, even when a purely rational (or risk-neutral) individual might violate the law or not invest in precautions. After all, the low probability of detection and conviction may render the expected penalty less than the cost of compliance. For example, if the actual fine for violating a criminal law is $10,000 but the rate of detection is 10 percent and the rate of conviction is 10 percent, then the expected fine is only $100. If the cost of complying with the criminal law — either the value of the time spent reviewing an issue with an accountant or the cost of installing a special filtration device to prevent any environmental spillage — is $200, then the purely rational, or risk-neutral, response is to break the law. When it comes to the criminal law, however, the ideal entrepreneur has taken his altar vows simply to obey, thus removing compliance issues from the ordinary mix of variables that are subject to a cost-benefit analysis.

Turning now to the swashbucklers: they are risk-neutral with respect to both business decisions and legal compliance issues. For them, criminal laws are just another cost of doing business, no different from Chinese imports or recalcitrant unions. Just as the decision whether to open a new store at a particular location has its financial risks, so too does the decision whether to declare properly the latest financial reports to the SEC. This group of entrepreneurs subjects all choices facing the company they manage to the same amoral cost-benefit analysis.

Finally, there are the bean counters. As opposed to swashbucklers and ideal entrepreneurs, bean counters are thoroughly risk-averse people — not only with respect to legal compliance matters but also in business decisions. Were public corporations ever to become dominated by such persons — utterly lacking in "animal spirits," but whose delight is the crossing of t's and dotting of i's — then the result would surely be economic stagnation.

As we consider the competition for corporate control waged by these three human "types" — the bean counters, the swashbucklers, and the ideal entrepreneurs — the optimal environment, from society's perspective, is one that allows the ideal entrepreneur to thrive. Unlike the bean counters, he is engaged in wealth-generating activity; unlike the swashbucklers, he is hard-wired to comply with the criminal law even at substantial cost.

STATE OF MIND

One difficulty is that the criminal law imposes costs on the ideal entrepreneur not borne by the swashbuckler. In order to comply with the criminal law, the ideal entrepreneur incurs precaution costs that the swashbuckler does not. As long as those precaution costs are greater than the expected penalties, the ideal entrepreneur will generate lower returns than his swashbuckling counterparts. Boards of directors will prefer managers who systematically generate higher returns, and so it would seem that ideal entrepreneurs would be driven away and replaced by swashbucklers.

There must be some mechanism for warding off the problem of adverse selection. As Professor Jeffrey Parker pointed out in a seminal article 15 years ago, the *mens rea* requirement traditionally played that role.

Mens rea is the Latin term for the mental state needed to convict someone of a crime. One did not, at common law, ordinarily incur criminal liability for mere negligence; the prosecution needed to show that the defendant possessed a "guilty mind" or, as Blackstone wrote in his *Commentaries*, a "vicious will." The common law adage was that "the act does not make a person guilty unless the mind is also guilty." American common law and constitutional law embraced that view through the 19th century. *Mens rea* was both a substantive requirement and a constitutional guarantee; there were virtually no strict liability crimes.

That began to change during the New Deal. The U.S. Supreme Court upheld the conviction of the manager and president of a company that had shipped adulterated and mislabeled drugs in interstate commerce even though the president did not personally know of the violation. The Court in *United States v. Dotterweich* admitted that the statute might visit hardship upon those whose "consciousness of wrongdoing [is] totally wanting," but when "[b]alancing [the] relative hardships, Congress has preferred to place it upon those who have at least the opportunity of informing themselves of conditions imposed for the protection of consumers." Using what purported to be a cost-benefit analysis, the Court suggested that the cost of imprisoning the innocent was less than the benefit accrued to the public and, given that these modern statutes were for the "public welfare," it was reasonable to eliminate any requirement of *mens rea* for a criminal conviction.

Emboldened by this precedent, Congress has over the past several decades enacted hundreds of criminal laws, all nominally designed to secure the public welfare. There are now over 4,000 federal offenses that carry a criminal penalty, and obviously countless more state crimes. Only a tiny fraction of those crimes existed as common law; overwhelmingly, the crimes are regulatory in nature.

Some criminal statutes preserve a shorn remnant of a *mens rea* requirement: they require knowledge of the relevant act, but not knowledge that the relevant act was illegal. Under such statutes, the prosecution has only to prove that the act was done "knowingly" but not "willfully." For example, 16 U.S.C. § 707, which criminalizes the sale of migratory birds, requires the prosecution to prove that the defendant knew that he was selling a migratory bird, but not that he knew that such a sale was illegal. Although the old adage that ignorance of the law

is no excuse makes sense when the law prohibits murder or rape — it is fair to assume that anyone other than a sociopath understands that those acts are wrong — regulatory crimes do not necessarily involve any such transparent wrongness.

It may be said in response that, in a complex world, people are expected to inform themselves of regulatory crimes and they have a duty to conform their actions to the law. But the modern criminal law has the approximate clarity of a late Henry James novel. There are the dozens, and possibly hundreds, of criminal laws that represent what one might call de facto strict liability — that is, ambiguously defined terms, uncertain enforcement strategies, and steep penalties. Even a person without a "vicious will," indeed even someone earnestly desiring to abide by such laws, might run afoul of their strictures. To illustrate the shift in the law away from *mens rea*, consider two cases involving the Clean Water Act (CWA). This law has resulted in criminal liability — and prison sentences — for people whose crimes seem to have been ones of, at most, garden-variety negligence.

The first case is *United States v. Hanousek* (1999), in which the defendant, an employee of a railroad company, hired an independent contractor. The contractor's negligent use of a backhoe resulted in a broken oil pipeline, which then resulted in an oil spill. Despite the multiple degrees of separation between the defendant and the spill, the defendant was nonetheless criminally charged with violating the CWA. He was convicted and sentenced to six months in jail. The Ninth Circuit affirmed the conviction, holding that "a public welfare statute may subject a person to criminal liability for his or her ordinary negligence without violating due process."

In the second case, *United States v. Hansen* (2001), the government successfully prosecuted three managers of a chemical plant for illegal discharges, and the Eleventh Circuit affirmed. The court of appeals' lengthy recitation of the facts makes clear that the company, which teetered on, and eventually collapsed into, bankruptcy was aware of various operational problems and made efforts, sometimes vigorously, sometimes not so vigorously, to address them. One of the defendants, Alfred Taylor, was not even a manager for part of the relevant period. By the government's own statement of the case, he made diligent efforts to alert management to difficulties and to remedy them. Although Taylor would eventually resign in protest over the company's failure to take action sooner to address the problems, federal prosecutors charged him with a few dozen criminal violations, including conspiracy to commit environmental violations. Remarkably, the prosecution cited Taylor's protests as evidence of his knowledge of the criminal discharges. Taylor was convicted and sentenced to five years in prison.

By the government's own account, Alfred Taylor took seriously the demands of the criminal law and strove, within the confines of a financially strapped company, to comply. But this was not good enough. In the future, will the Alfred Taylors of the world bother to make efforts to improve the compliance

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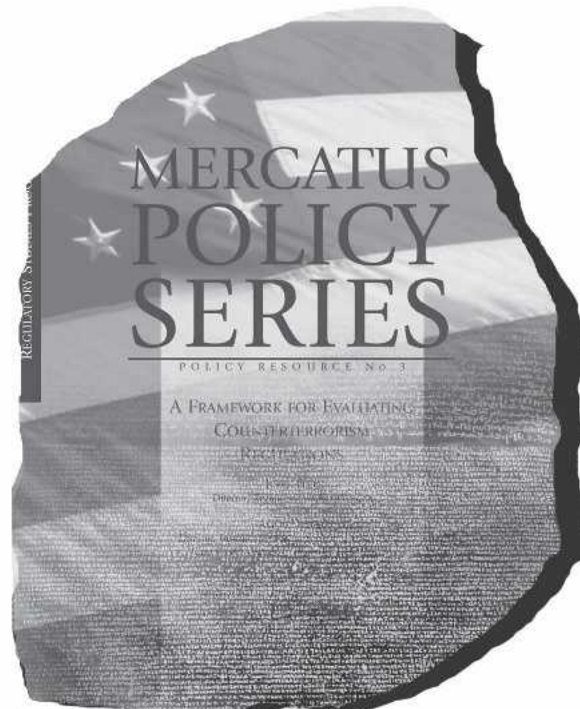

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records in such companies — or will they simply flee? And who will be left behind to take their place?

MORAL HAZARD

The *mens rea* requirement, as we suggested earlier, played a crucial sorting function in warding off the problem of adverse selection. One might, in this respect, liken the problem faced by prosecutors to that traditionally faced by insurance companies. Those charged with the enforcement of the criminal law, just like insurance companies, face a heterogeneous pool of people. Some are good drivers, while others are not; some cherish obedience to the law (such as the ideal entrepreneur), while others do not (such as the swashbuckler).

A sorting mechanism can distinguish the groups. Insurance companies look at driving records, identify the safe drivers, and then reward them by charging lower premiums. Safe drivers then choose to remain in the pool. Likewise, at least traditionally, the *mens rea* requirement had provided a sorting mechanism for those enforcing the criminal law. The machinery of justice would only be brought to bear against those who had formed a specific intent to commit whatever harm occurred. The law-abiding could demonstrate their good intentions by pointing to the precautions they had incurred; even if some bad result had come to pass, no penalties would attach. Law-abiding individuals could thus continue to engage in the regulated activity. In effect, *mens rea* helped the law's enforcers sort those determined to comply with the law (such as the ideal entrepreneurs) from those indifferent to the strictures of the criminal law (such as the swashbucklers).

When insurance companies are no longer able to distinguish safe from unsafe drivers and price their premiums accordingly, they will likely charge rates that will force the best drivers out of the pool. Likewise, when the criminal law regulating certain spheres of activity is stripped of a *mens rea* requirement, law-abiding ideal entrepreneurs will no longer be able to signal their intent to comply with the law. Some may respond by exiting the regulated activity altogether.

This should hardly be surprising. In the realm of tort law, many scholars have argued that the current product liability regime stifles the entrepreneurial spirit. Some new products will not be brought to market and other useful ones will be discontinued in the face of a strict liability tort regime that overpunishes mistakes. Exit from a sphere of activity should be even more pronounced when entrepreneurs face potential criminal liability. Thus, the crucial, though sometimes neglected, point is that the movement away from a *mens rea* criminal law regime will induce some individuals to over-invest in precautions and still others to abstain from the activity completely.

LEFT BEHIND

Lawmakers need to consider the kind of entrepreneurs driven away when the law regulating corporate crime is stripped of a *mens rea* requirement and becomes one of, in effect, strict liability. We suggest a form of adverse selection is apt to occur — a variation of Gresham's Law in which those reckless of the criminal law will drive away those respectful of the law.

To return to the puzzle posed at the beginning of this article, here is our suggested solution: Sarbanes-Oxley has caused some ideal entrepreneurs to flee American publicly traded corporations, either for the greener pastures of Europe or private equity. And perhaps a growing number of those left behind are both the bean counters (who are less inclined to seek out risky ventures) and the swashbucklers (who are not easily deterred by the criminal law).

With each new "corporate scandal," Congress will be spurred to further action. A few centuries ago, Jean-Baptiste Colbert, the architect of the French regulatory state under Louis XIV, was determined to enforce the cotton industrial codes and, to that end, oversaw the execution of dozens of entrepreneurs who had violated them. Similarly, the archives of the Old Bailey are replete with tales of smugglers sentenced to death. Is it possible that one day Congress will impose life imprisonment and even the death penalty for regulatory infractions?

If it did, one could be sure that most ideal entrepreneurs would have long ago fled the scene. The swashbucklers who would remain at the helm of publicly traded corporations would not be deterred easily, much like the English smugglers who continued to operate regardless of the death penalty. Either throwing caution to the winds or crunching the numbers, the swashbucklers discount even the most punitive statutory penalties because of a perceived low rate of detection and conviction.

As every increase in criminal penalties more thoroughly drives away the ideal entrepreneurs, the swashbucklers more completely dominate the field, engaging in ever more risky activity, earning ever larger profits, which in turn more thoroughly drives out both the ideal entrepreneurs and even the bean counters. The ultimate irony is that the indeterminate widening of the scope of white-collar criminal law, and the penalties that attach for its violation, may drive away the very people most susceptible to being deterred by the criminal law. Those "left behind" are truly the unrighteous: those who are not — and, absent absurdly draconian penalties, cannot be — deterred. R

Readings

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