Corporate Law and the current financial crunch

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The current state of the US economy and measures taken and those proposed to be taken have led me to address the issue of federal regulation of corporations. The fall of Lehman brothers, Madoff’s ponzi schemes, AIG and Bear Sterns recently (and WorldCom, Adelphia and Enron, earlier on) has highlighted the loop holes in regulatory oversight by State and federal agencies.

The government’s refusal to bail out Lehman was made partly because at the time it was viewed as questionable public policy to use tax payer’s money to bail out private companies but more important the view that doing so creates a moral hazard; the incentive for those companies to take excessive risks with the knowledge that the Government will save them should things go wrong. Lehman’s demise set off tremors throughout the financial system. The uncertainty surrounding its transactions with banks and hedge funds exacerbated a crisis of confidence. That contributed to credit markets freezing, forcing governments around the globe to take steps to try to calm panicked markets.

I have chosen to opine on this issue partly because I am an attorney who has worked in a regulatory body (Central bank) and currently in regulatory compliance in a financial institution.

The essence of this article is federalizm versus State law in the regulation of corporations and the increased over lapping regulatory supervision of the various federal and state entities. The issue is whether the federal government should be allowed to encroach into a state territory of corporate regulation. stricter government regulation of corporations simply means that instead of trying to create the incentives for private sector actors to do the right thing, the government has the power to simply demand that
they do the right thing, or at least, they not do the wrong thing.

We read in various media of the current administration’s plans to ask congress
to expand powers that would let the treasury secretary to seize hedge funds and other
non-bank financial companies whose failure would imperil the economy. The plans to
expand treasury authority would represent a major shift from the current model of
financial regulation in which independent agencies have oversight powers. In addition to
seize non-bank companies, the administration will ask for tools to prevent failures,
guaranteeing losses, buying up assets, or taking a partial ownership stake in troubled
companies. Those powers would let the government break contracts, such as those that
promised $165 million in bonuses to AIG employees.

The article reminds me of a statement made by a Delaware Supreme Court Chief
Justice in the wake of corporate scandals and Congress’ subsequent adopting of Sarbanes
Oxley Act of 2002. He said “If we don’t fix it, Congress will, but I hope they’ve gone
as far as they’re going to have to go”1 To some, Sarbanes-Oxley and other federal
rules represent an ill advised advance in the “creeping federalization of corporate law”
(now “bailouts”). To others; they think that a realistic threat of federalization is
necessary to ensure the robust development of corporate law at state level.

In the present federal system of corporate law, state governments set the rules governing
the relationships among the primary participants in the corporate enterprise; Directors,
officers and investors. Each state has its own corporate statute and a corporation may
incorporate under the laws of any state, regardless of whether it owns assets or conducts
operations in that state. Corporate federalists have argued that national

1 What’s Wrong with Executive Compensation? A round table moderated by Charles Elson, Harv. Bus.
regulation would disrupt this competition process because the federal government would enjoy monopoly power, nullifying the ability of competitive forces to advance optimal legal rules.\(^2\) That is why opponents of national level regulation argue that such regulation would not likely do better than state law in the protection of shareholders as Congress is just as susceptible to business lobbying as state legislatures.\(^3\) But those on the other side say that federal engagement provides voters throughout the country an opportunity to persuade Congress to preempt those state law provisions that lack popular support. This dynamic allows investors to influence state corporate law, if only indirectly.

A posture of absolute federal deference to state regulators would deprive citizens of this power enhancing management’s dominance of the state regulatory process.\(^4\) Examining the Sarbanes-Oxley\(^5\) Acts impact on the development of state corporate law offers an opportunity to evaluate whether the threat of federal preemption actually works the way corporate federalists predicted. The corporate scandals involving Enron, WorldCom, Adelphia and others evoked broad public dissatisfaction with the existing corporate regulatory regime.\(^6\) As a result, Congress and other federal regulators were compelled to address the perceived problems.\(^7\) This popular pressure for more extensive corporate regulation was significant, as it empowered Congress to encroach significantly on traditional state law terrain. Eventually, Congress approved the enactment of the Sarbanes-Oxley Act of 2002 in to law. Sarbanes-Oxley represents an amalgamation of

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\(^3\) id at 230
\(^4\) Renee M. Jones: Rethinking Corporate federalism in the era of corporate reform, Corporate practice commentator see fn.4 at 16
\(^5\) Sarbanes- Oxley Act ,2002
reform proposals since the Enron debacle first came to light. The Act reformed regulation of the accounting industry, enhanced securities law disclosure requirements, created a number of new white collar crimes, and enhanced criminal and civil penalties for corporate fraud.

It is not only the Sarbanes Oxley that has changed things for Directors corporate control. We have the New York Stock Exchange rules, NASDAQ rules, and recommendations from various private organizations that set the standard for a state of the art. The private organizations are the conference Board, the business round table, the Higgs report in the United Kingdom and the American Bar Association reports.

The proposal to establish a new Federal consumer financial protection agency to police abuses in the mortgage markets is meeting increasing resistance. But nearly everyone agrees that the performance of the credit rating agencies during the subprime bubble was abysmal, for instance-they blessed even the most dubious securitizations.

Allowing states to continue to regulate corporations appears to offer some benefits over a purely federalized scheme yet states should not enjoy exclusive authority in this realm, congress can influence state corporations without pre-empting it entirely. Therefore a practical resolution for corporate reform seems to be closer congressional scrutiny of corporate regulation, aided by limited preemption when

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9 Sarbanes-Oxley Act section 101-08
10 Id. section, 302, 401-09
11 Id. section, 802, 906, 1102-07
12 Id. section, 305, 804, 1105
14 Restoring trust in America’s Business Institutions; by Margaret M. Blair & William W. Bratton Sloan project on Business institutions at the Georgetown law centre, conference proceedings pg. 62
necessary to correct the states propensity to place the interests of managers above other corporate constituents in crafting corporate law.\textsuperscript{15}

The widespread corporate governance scandals revealed in the late 2001 through 2002 and more recently Lehman Brothers, AIG, Bear Sterns, Madoff’s Ponzi schemes, have prompted broad scrutiny of corporate law and launched Congressional hearings on corporate reform. In summary, allowing states to continue to regulate corporations appears to offer some benefits over a purely federalized scheme. Yet because congress can influence state corporate law without preempting it entirely, a practical resolution for corporate reform seems to be closer Congressional scrutiny of corporate regulation, aided by limited preemption when necessary to correct for states’ propensity to place the interests of managers above other corporate constituents in crafting corporate law.

\textsuperscript{15} Id.