The Federalization of Corporate Law

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By Norwood P. Beveridge

LLP. Baron's independent auditors and one of the largest and most distinguished accounting firms in the world, was convicted in 2002 of criminal obstruction of justice in the Earnings investigation by the Securities and Exchange Commission (SEC). Although the conviction was later reversed by the United States Supreme Court for error in the jury instructions, this case too late to save the accounting firm, which has gone out of business in a welter of litigation. The Sarbanes-Oxley Act of 2002, passed with great haste by the U.S. Congress and signed by the President in July of 2002, has been followed by an interminable long trail of final and proposed rules and regulations issued by the new Public Company Accounting Oversight Board, the SEC, and the self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers.

There exists a general impression that we are experiencing an unprecedented crisis in corporate governance and that the federal government has seized control of the law of management of publicly held companies to the exclusion of the states. The truth is otherwise. The disastrous investor losses that accompanied the failures of these huge companies were the result of deliberate financial and accounting fraud, not as such a failure of corporate governance in the sense that a proper exercise of care by the company board of directors would necessarily have prevented it. The federal reforms enacted by Congress address primarily the problems of auditing and controlling audits to be put into place and monitored by corporate executives, the auditors, and the legal profession, but the law of corporate governance is still basically state law, supplemented and not replaced by the federal statute.

II. Historical Background and Perspective

Looking back on the last four decades of the Twentieth Century, we can see that each decade was marked by drastic corporate scandals and securities market frauds, all of which have some features in common with the current crop, and the lessons to be learned from this history is that blame cannot be rested upon the corporate board of directors alone even primarily. Furthermore, the federal government is not the obvious source of any solution to the problem in truth, it has been a part of the problem.

In the 1960s, corporate conglomerates such as Gulf and Western, Ling-Temco-Vought, and International Telephone and Telegraph were in vogue. The excesses that accompanied the bull market and the tender offer merger and acquisition boom of the 1960s resulted in new federal securities legislation and culminated in the stock market crash of 1973. The end of the decade saw the criminal conviction of auditors from Lybrand, Ross Bros. & Montgomery, independent auditors for the holding company, Vending Machine Corporation, and from Peat, Marwick, Mitchell & Co., independent auditors for the National Student Marketing Corporation. The Council of the American Law Institute began work on a proposed Federal Securities Code in 1964.

The decade of the 1970s was overshadowed by the resignation in 1974 of Richard M. Nixon, the President of the United States, amid the Watergate investigation. However, there was no shortage of corporate scandals, such as the Equity Funding scandal and the continued abuse of Investor Overseas Services by Robert L. Vesco. Most dramatic was the procession of corporate confessions by hundreds of U.S. compa- nies of improper or 'securities' payments to domestic and foreign governments and politicians that led to the enactment of the Federal Corporate Feudal Practices Act of 1977. There were crises for increased federal control of large public companies, and the American Law Institute began its Corporate Governance Project in 1975.


The 1990s began with the collapse of the Bank of Credit and Commerce International in 1991, and the exposure of illegal manipulation of the government bond market by Salomon Brothers in the same year. Congress addressed what it saw as an easy way for securities fraud litigation in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998. Limited preemption of state securities laws was enacted in the National Securities Markets Improvement Act of 1996. Throughout the decade there was a series of financial frauds and failures, including those at the savings and loan corpora- tions, Sunbeam Corporation, and Lazard Technologies, that might have provided an indication of more the same if anyone of having been paid any attention.

It would not be reasonable to expect that all financial frauds involve essentials of the same kind, and it is frequently one of the hallmark of a fraud that no one can quite understand how the scheme works, but at least in the early stages, it demonstrably does work. This was certainly true of the famed South Sea Bubble in England in 1720 and the Mississippi Company of John Law in France in the same year. Charles Ponzi, for example, in 1920 was quite willing to explain his business plan for making huge gains by arbitrage in international postal coupons, but no one could quite understand how the scheme worked.

I am not a lawyer, nor have I ever taken a law course at any level, and I have never worked for any law firm. In that sense, I am an outsider to the legal profession, and I do not pretend to have any expertise or knowledge in the area of securities law. However, I do have a broad interest in law and economics, and I have always been fascinated by the way in which legal rules and regulations can shape the behavior of individuals and institutions in ways that can have profound effects on the economy. I hope that my work will add to the understanding of how the law affects the behavior of people and institutions, and I believe that this understanding can help to inform the development of better laws and regulations.

In my view, the problem of corporate fraud is more than just a matter of individual greed and corruption. It is a problem that has implications for the whole economy, and it is one that requires a coordinated approach involving both legal and regulatory measures. In this regard, I believe that the law has a role to play in preventing fraud and ensuring that those who are found guilty are held accountable for their actions. I also believe that it is important for the legal profession to work closely with other stakeholders in the economy, such as businesses and financial markets, to ensure that the law is effective in promoting transparency and accountability.

In conclusion, I hope that my work will contribute to the ongoing effort to understand and address the problem of corporate fraud. I believe that by doing so, we can help to ensure that the economy remains a force for progress and prosperity for all.
understand how he made money with the scheme.

There have been numerous other spec- tacular undiscovered financial frauds in the nation's history, such as the exposure in 1938 of the President of McKesson & Robbins, F. Donald Conant, whose real name was Philip Music, a twice convicted felon, or the amazing exposés of the crooked King Kresse, whose racket came to light after his suicide in Paris in 1932.28 An examination of these and other financial frauds shows that the common elements of a corporate fraud may include the following:

- Self-dealing and manipulation by top corporate management.
- New and poorly understood financial techniques or business plans.
- Extraordinary and notorious success of the business model.
- Ineffectiveness or corruption of high government officials.
- Ineffectiveness or complicity of company Board of Directors.
- Ineffectiveness or complicity of company attorneys.

III. The Law of Corporate Government

Since the beginning of the nation's history, business corporations have been chartered primarily by the states, not by the federal government.29 State general incorporation statutes were common by the mid-nineteenth century.30 Since a large part of corporate law is statutory, there has been primarily a statute that governs a state-created corporation.31 Under the internal affairs doctrine, applicable state law of a corporation generally has been the state law of the state of incorporation.32 The federal government has chartered businesses corporations, notably the federal thrift and thrift institutions such as the Second Bank of the United States, which led to a United States Supreme Court holding that such powers were within the implied as well as the express powers of the Congress under the Constitution.33 The federal government also has on occasion chartered other types of corporations such as the Union Pacific Railroad.34 For a federally-chartered corporation such as a national bank, obviously its charter is governed by federal law.35 While there have been over the years a number of proposals to require federal licensing or federal incorporation of large publicly-held corporations, for a variety of reasons this has never been seen as a practical or appropriate approach.36 In light of the experience with the Union Pacific Railroad, which led to the notorious Credit Mobilier scandal in 1873, it should be obvious that federal incorporation is not a guarantee of effective corporate governance or freedom from corporate fraud.37 This has more recently illustrated by the farce over improper accounting by government agencies (such as the Enron Corporation) such as the Federal Home Loan Mortgage Corporation.38 Apart from statutes, a good deal (if not most) of important corporate law is judge-made common law. Un til 1938, the federal courts made a good deal of corporate common law.39 However, by 1938 federal law was declared by the United States Supreme Court declared that in that year there no longer exists any general federal common law.40 Since that time, the Supreme Court has established what may be called the Corporate Doctrine, under which corporations are deemed to be creatures of state law and therefore governed by state, not federal law, with respect to their internal affairs.41 This is so even where a shareholders' derivative suit is brought changing violations of federal law.42 The Supreme Court has also declined to create federal common law with respect to the duty of care of directors of a federally-chartered corporation, even where a federal statute established minimum standards of care for those directors.43

IV. The Federal Role

Of course, it is obvious that the federal government has found ways of dealing with the economic power of large corporations, through the federal antitrust laws and direct regulation by federal administrative agencies, and through the federal labor laws and tax laws, as well as extensive other social legislation. The federal securities laws, the SEC, and the self regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers have imposed significant regulation on the securities markets and the governance of publicly held companies. In a federal system of government, it is quite presum ptive not to expect federal intervention in matters of national importance, and it is clear that the investment rights and sav ings of millions of public shareholders is of national importance. The question therefore is to assess the extent of intervention and threatened intervention by the federal government with respect to state regulation of corporate governance.

There is no general agreement on the actual or appropriate role of federal intervention. To some observers, it seems that the federal government is the chief regulator of corporate governance.44 Others believe that the threat of federal intervention has substantially reduced federal/state law differences.45 The Supreme Court has also declined to create federal common law with respect to the duty of care of directors of a federally-chartered corporation, even where a federal statute established minimum standards of care for those directors.46

V. The Sarbanes-Oxley Act of 2002 Covers But Does Not Preempt the Field

There is no doubt that the Sarbanes-Oxley Act (the Sarbanes-Oxley Act) casts a wide net over all significant actors in the financial and securities mar ket, including the public company's officers and directors, independent auditors, counsel, securities analysts, and credit rating agencies.47 The Act includes the provisions discussed below.

A. Regulation of Attorneys Practicing Before the SEC

Just as it appeared that the SEC had given up the battle to control the securities bar, section 307 of Sarbanes-Oxley directed the SEC to promulgate minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers.48 The SEC's proposed rules drew heavy fire from the organized bar (and the Conference of Chief Justices) for the inclusion of a provision requiring counsel to notify the SEC if a perception of law violation was reported to the company's chief legal officer or chief executive officer and board of directors was not corrected. This "noisy withdrawal" provision was not included in the final rules adopted January 23, 2003, but it was withdrawn not withdrawn. The final rules are now in force, and they require reporting within the corporation up the ladder, but a noisy withdrawal and notice to the SEC is permitted, not required.49 The former SEC Chairman had stated that the SEC has not decided to adopt or to withdraw the mandatory noisy withdrawal rule.50

B. Regulation of Independent Auditors

For the first time in history, section 101 of the Act creates a Public Company Accounting Oversight Board (Board) to oversee the audit of public companies and  

29. See Colin E. Clark, Corporations in America (1980).
31. See 2 James Donovan Davis, Primary in the American Bar on Economics (2nd ed. 1921).
to register and discipline public accounting firms. The Board is composed of five members serving staggered five-year terms, two (and only two) of whom shall be certified public accountants. Under section 103 of the Act, the Board has authority to establish and maintain standards, qualifications and ethics for certified public accountants. Under sections 108 and 109 of the Act, generally accepted accounting principles (as opposed to professional auditing standards) may be set by the Financial Accounting Standards Board (FASB), an industry group, but FASB will in the future be funded by fees payable by public company issuers. In order to ensure auditor independence, section 201 of the Act prohibits (Independent Auditors) from providing nonaudit services, including bookkeeping, systems design, appraisal, actuarial, internal audit, management, investment banking, legal, or other services that are determined by the Board. Under section 202 of the Act, other nonaudit services must contain (with certain minimum exceptions) be approved by the issuer's audit committee in advance. Under section 203, audit partners must be rotated after five years.

C. Regulation of Public Company Governance

Under section 301 of the Act, the SEC is ordered to direct the national securities exchanges and national securities associations to prohibit the listing of securities of any issuer not having an audit committee of the board of directors (committee) in compliance with the requirements of the Act. These requirements include: (i) all members of the committee must be independent, defined to mean not an affiliate of the issuer or any subsidiary and not accepting any consulting or advisory or other fee for services from the issuer; (ii) the committee must establish a complaint procedure for the receipt of confidential or anonymous communications regarding questionable accounting or auditing matters; (iii) the committee must have authority to engage counsel and other advisors; and (iv) the committee must have funding for the independent auditors and committee advisors.

Section 302 of the Act requires the SEC to issue rules mandating the principal executive officer and the principal financial officer to certify in each annual or quarterly report (filed under section 13(a) or 15(d) of the Securities Exchange Act of 1934) that a number of things, including that the report does not contain any material misstatement or omission and that it fairly presents the financial condition and results of operations of the issuer. Section 302 also requires the Chief Executive Officer and the Chief Financial Officer to certify that they have reviewed the effectiveness of the issuer's internal controls within the past ninety days and to present and disclose to the auditors and audit committee any significant deficiencies or fraud. Furthermore, under section 404 of the Act, the annual report to the SEC of the issuer must have an internal control effectiveness report by management, and its assessment must be reported on by the issuer's independent auditors.

VI. The SEC's Proposed Securityholder Director Nominations Rules

Perhaps the most controversial proposal by the SEC has been the proposed rules that would allow public shareholders of reporting companies to nominate individuals for election to the board of directors and to have those nominees included in management's proxy statement. This proposal has not been adopted, but it has generated over 9,000 comment letters, which are available on the SEC's web site.

The proposal would provide that upon the happening of either of two triggering events, a more than five percent shareholder for more than two years would have the right to nominate one or more independent candidates for the board (one if eight or fewer board members, two if more than eight and less than twenty, and if twenty or more). The triggering events would be: (i) withholding of more than thirty-five percent of the votes cast for any board nominee of the management; or (ii) a more than fifty percent vote by shareholders on a proposal by a more than ten percent shareholder for one year to allow shareholders' nominations in management's proxy statement. The American Bar Association opposed the proposed rule as beyond the SEC's authority and unwise in principle and effect. The SEC proposal on director nominations by public shareholders is not required by Sarbanes-Oxley; it was an initiative of the SEC, which split on the wisdom of its adoption. The SEC has also adopted rules requiring mutual funds to have a Chair and at least seven-five percent of the members of the board of directors independent of the investment advisor. These rules have been upheld by the Court of Appeals for the D.C. Circuit in a suit brought by the U.S. Chamber of Commerce as properly within the authority of the Commission, although the court also held that the procedures followed failed the Administrative Procedure Act.

VII. Conclusion

It remains to be seen what further developments we may expect in this area of law. Congress does not appear inclined to enact further legislation, and the SEC has been divided, with changes in personnel. The federal courts, as discussed, will not be receptive to creating a parallel universe of federal corporate law to challenge the states. It appears that state law will continue to be paramount with regard to corporate governance, with the exception of some requirements under federal law, at least for the time being.