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Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems"

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Donald C. Langevoort*

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I. INTRODUCTION

Immediately after the passage of the Sarbanes-Oxley Act (SOX), much of the commentary was about Congress’ scatter-gun approach, firing at so many different targets at once to prompt better corporate financial reporting and disclosure. Executives, outside directors, lawyers, accountants, analysts, and others gained new obligations. For the most part, these groups now seem to have adjusted to their new regimes without all that much difficulty or lingering complaint, perhaps because the changes were never really as draconian as portrayed.

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1. Academic commentaries on SOX are voluminous, from the harshly critical (e.g., Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521 (2005)) to the mildly complimentary (e.g., Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it Just Might Work), 35 CONN. L. REV. 915 (2003)), and onto the more thoroughly supportive (e.g., Joel Seligman, No One Can Serve Two Masters: Corporate and Securities Law After Enron, 80 WASH. U. L.Q. 449 (2002)).
Today, the vocal criticism is largely reserved for just one piece of the legislation: the internal controls requirement found in section 404, which in some circles has become almost synonymous with SOX itself. Doubts about the balance of costs and benefits and whether the result will be increased de-listings and going private transactions to avoid 404's burdens have made this the portion of the Act that has encountered the most political resistance. The tone of these complaints is that 404's requirements are new, radical, and ill-considered. Until recently, at least, the internal controls requirements have received less attention from legal academics than many other salient aspects of the legislation.

Revisiting section 3.4.2 of Clark's Corporate Law ("Duty of Care as Responsibility for Systems") reminds us, however, that the internal controls story actually goes back many decades, and that many of the strategic issues that are at the heart of section 404 have long been contentious. My Article will briefly update Clark's account through the late 1980s and 1990s before returning to Sarbanes-Oxley and rulemaking thereunder by the SEC and the newly created Public Company Accounting Oversight Board ("PCAOB"). My main point builds on one of Clark's but digs deeper. Internal controls requirements, whether federal or state, are incoherent unless and until one articulates clearly for whose benefit they exist, and to what end. There are, in fact, a number of competing articulations. The failure to identify a single and coherent rationale creates significant uncertainty, which has been exploited by players in the legal, accounting, consulting, and information technology fields. Companies are probably spending more time and resources on 404 compliance than a reasonable reading of the legislation and the rules necessarily requires, heavily influenced by those who gain from issuer over-compliance. This rent-seeking compromises the political viability and substantive quality of what is at the heart a beneficial statutory reform.
II. CLARK'S COMMENTARY

Section 3.4.2 addresses the board of directors' monitoring duties with respect to potential corporate misconduct. It begins with an extended discussion of Graham v. Allis-Chalmers Mfg. Co., where the Delaware Supreme Court famously refused to impose liability on the directors for inattention with regard to illegal price-fixing behavior at the mid-manager level absent some affirmative showing that the directors were on specific notice of a problem. After critiquing the court's reasoning, Clark offers one possible justification for the result: in so far as the shareholders of the company are concerned, the extent of compliance with law is really a matter of business judgment, because ex ante a positive expected value to noncompliance sometimes exists. A monitoring model designed solely to promote compliance as such does not really fit within corporate law (i.e., shareholder protection) as commonly understood, but should instead, if at all, be connected to the legislation that imposes the underlying legal obligations.

But Clark then says that this critique does not apply with respect to one particular kind of compliance regime: internal accounting controls. "Not having such a system might very well be thought to result in a risk of injury to shareholders that no reasonable director would normally incur," and thus accounting controls present a distinguishable issue from legal compliance programs generally. At this point, his attention shifts ("ironically," he says) from state corporate law to federal law, specifically the Foreign Corrupt Practices Act of 1977 (FCPA). Enacted in the aftermath of the Watergate controversy, the FCPA added to the Securities Exchange Act a specific requirement in section 13(b)(2) that public companies both maintain accurate books and records (with no materiality or intent qualifiers) and implement a reasonable system of internal accounting controls. After commenting on how extensive the Act's potential impact is "because of its generality and apparently formless wording," Clark goes on to suggest a fairly conservative reading, tied to the accounting profession's historic understanding of the task of internal controls in the reporting process. An interesting footnote, however, acknowledges that there are many hard questions to be answered, including the extent to which controls relating to reporting blur into controls over general legal compliance or operational decision-making.

A few preliminary comments are in order. First, the subsection is a reminder of some important regulatory history. Concern about the adequacy of internal controls—and corporate accountability generally—was one of the most important issues in securities regulation in the 1970s. Because a handful of large corporations had funded the break-in of the Democratic headquarters, the Watergate scandal led directly to questions about the legitimacy of corporate managers' opaque dominion over corporate assets, especially as it related to foreign and domestic bribery and illegal political campaign contributions. An aggressive SEC enforcement program focusing on "management integrity" ensued, and

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6. CLARK, supra note 4, at 132-33.
7. Id. at 133.
8. Id. at 134.
9. Id. at 135 n.30.
10. See SEC REPORT ON QUESTIONABLE PAYMENTS AND PRACTICES, 94th Cong., 2d Sess. (1976); Ralph Ferrara et al., Disclosure of Information Bearing on Management Integrity and Competency, 76 NW. U. L. REV.
with more and more misbehavior publicized, Congress responded with the FCPA. In 1979, the SEC proposed (but later withdrew) a requirement that management evaluate and report on its internal controls on Form 10-K,\textsuperscript{11} which is the heart of what Sarbanes-Oxley now demands. These events were surrounded by controversy and criticism much like today.\textsuperscript{12}

Second, the question of definition and scope is indeed crucial, and the "formless" quality of section 13(b)(2) admits a number of possibilities. Clark suggests that shareholders are unambiguously the beneficiaries of internal accounting controls legislation, and that the Act should be construed with their needs in mind. They bear the costs, too, so that reasonableness is a key limitation. Above all, the scope of the Act should not turn into something that interferes with legitimate business judgments by company managers, whether as to operational decisions or legal compliance generally (i.e., beyond financial reporting).

This latter point will be my main interest when we return shortly to Sarbanes-Oxley and section 404. Clark has the right intuition about the interests at stake with respect to internal accounting and disclosure controls, but I think he underestimates the difficulty of identifying the optimal scope and depth of such controls. In fact, this inquiry touches on a disputed question in securities law—for whose benefit, exactly, do financial reporting requirements exist? But before we take up the question, we should move the story forward fifteen years from the time \textit{Corporate Law} was written to the onset of the Sarbanes-Oxley era.

\textbf{III. THE INTERNAL CONTROLS STORY FROM 1986 TO 2001}

If a second edition of \textit{Corporate Law} had appeared in the late 1990s, it would surely have reported on two subsequent legal developments, and perhaps a third. The first two conform reasonably well to Clark's analysis. The federal Organizational Sentencing Guidelines were developed to make clear that corporations with a reasonable compliance system would get some credit at the sentencing phase even though they were found by imputation to have violated federal law, making \textit{some} affirmative compliance system a de facto requirement for companies with reason to fear criminal prosecution. This immediately set in motion discussions about the scope, depth, and content of an appropriate compliance regime.\textsuperscript{13} To many, the Guidelines were not applied with much rigor, so that the credit that would come from a system was largely a "check the box" or cosmetic matter.\textsuperscript{14} It did, however, help create a compliance industry that assisted

\textsuperscript{555, 581-83 (1981).}
\textsuperscript{11. Statement of Management on Internal Accounting Control, 44 Fed. Reg. 26702 (proposed May 4, 1979) (to be codified at 17 C.F.R. pts. 211, 229, 240, 249).}
companies in checking the right boxes, thus moving the arts and sciences of compliance management at least marginally forward.

The second major development was the Caremark case,\(^\text{15}\) Chancellor Allen's thoughtful discussion of the continued vitality of Graham under Delaware law. Times have changed, he said (noting the Guidelines in particular), so that it was no longer reasonable for directors to act as if compliance monitoring is something reserved for responding to danger signs that happen to appear. The board therefore has some affirmative obligation of compliance monitoring. Caremark has been the subject of extensive commentary, which need not be repeated here. Many have noted the acoustic separation in the opinion—rhetorically, it is a strong wake-up call to directors, but with very little liability threat behind it.\(^\text{16}\) Only "sustained and systematic indifference" to compliance by the board would breach the duty (and by this time, section 102(b)(7) of the Delaware Code was in place so that there would still be no duty of care liability threat for directors in the majority of companies with exculpation clauses in their charters, at least in the absence of bad faith).\(^\text{17}\) I suspect that a second edition of Corporate Law would have mildly applauded Caremark as a matter of law because it follows Clark's critique of Graham quite closely; even though it makes legal compliance a corporate law issue, its liability threat is restrained enough to leave ample room for business judgment on the specifics of compliance design.

The third development is somewhat more subtle, and brings us back to financial reporting and internal controls under federal law. After noting the anxiety over the breadth of section 13(b)(2), Clark observes that as of the mid-1980s, "the SEC has done little to substantiate those fears."\(^\text{18}\) That is an understatement. In fact, in the face of threatened political backlash from the business community made more salient by the election of President Reagan and a Republican Senate in 1980, the SEC made an unusual formal statement in 1981 pledging to read the law narrowly, from which it never deviated.\(^\text{19}\) From then on, the accounting controls provisions were essentially only raised in enforcement actions when there was evidence of actual misreporting by the issuer, so that any controls failure claim was largely surplusage.

But there is a back story. In the face of continuing examples of financial misreporting, especially among banking institutions, the SEC continued to express concern about financial misreporting and made further changes to upgrade the quality of disclosure in 10-Ks and 10-Qs. In the mid-1980's, a private sector initiative led to the creation of the so-called Treadway Commission on Fraudulent Financial Reporting,

\(^{15}\) In re Caremark Int'l Inc., 698 A.2d 959 (Del. Ch. 1996).


\(^{17}\) More recently, the bad faith doctrine has developed so as to make exculpation clauses arguably less potent. See McCall v. Scott, 239 F.3d 808 (6th Cir. 2001), modified, 250 F.3d 997 (6th Cir. 2001) (applying Delaware law); Hillary Sale, Delaware's Good Faith, 89 CORNELL L. REV. 456, 482-84 (2004). But see In re Walt Disney Co. Deriv. Litig., No. Civ.A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 19, 2005) (narrowing the scope of good faith duty).

\(^{18}\) CLARK, supra note 4, at 134.

chaired by a newly departed SEC Commissioner, which made a series of recommendations to address problems in the internal controls environment. In 1988 the SEC again formally proposed requiring management to evaluate and report on its internal controls,\(^\text{20}\) though once again the proposal was never implemented. Instead, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) committed to develop a private sector framework that would give more substance to what good internal controls should be. Its report, *Internal Controls: An Integrated Framework*, was released in 1992,\(^\text{21}\) and now plays a significant role under Sarbanes-Oxley. The sponsoring organizations were the major institutions in the accounting industry, including the American Institute of Certified Public Accountants.

By the mid-1990s, the devolution of financial reporting quality, which had been worrisome for at least two decades, seemed to accelerate. The reasons for this deterioration are multi-faceted and have also been extensively discussed elsewhere.\(^\text{22}\) They include (at least) the sustained bull market, which made investors pay less attention to issuer credibility; judicial and legislative developments making private securities litigation harder to bring; a reduction in SEC fiscal and political resources; conflicts of interest in the accounting profession and elsewhere; and financial innovation, technological innovation, and the explosive growth of options-based executive compensation, each of which provided further motive and opportunity for financial misreporting. Out of this came Enron, Worldcom, and Sarbanes-Oxley.

IV. SARBANES-OXLEY AND THE ARCHITECTURE OF INTERNAL CONTROLS

Although section 404 is the focus of most attention, there are actually two provisions in Sarbanes-Oxley that impose internal controls obligations. The other, section 302, is actually the more elaborate, requiring CEO and CFO certification of the issuer's 10-Ks and 10-Qs.\(^\text{23}\) Section 302 says that, in addition to certifying the accuracy of the disclosures, the officers must also affirm that they are responsible for internal controls; have designed such controls to ensure that material information is brought to their attention; have evaluated its effectiveness in the last 90 days; have presented in their report their conclusions about its effectiveness; and have discussed in the report any changes in internal controls during the period under review, including corrective actions. By contrast, section 404 simply insists that each 10-K contain management’s assessment of internal controls, and—crucially—requires the independent auditor to attest to and

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\(^\text{23}\) See Lisa Fairfax, Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act, 55 RUTGERS L. REV. 1, 56-58 (2002). Section 302 is one of two certification provisions; the other is section 906, a criminal provision, which does not refer to internal controls.
The SEC's initial implementation of the rules was quick, even though there were inconsistencies in the statutory formulation to address. Section 302 speaks of "internal controls," whereas section 404 refers to "internal controls over financial reporting." Recognizing that there was a subtle but substantive distinction here, the Commission stated in new Rule 13a-15 that issuers had to design and implement two separate but overlapping control systems. The first—"disclosure controls and procedures"—is designed to elicit information from throughout the organization for management to make timely and accurate decisions as to required disclosure of any sort under the securities laws. Reporting on these disclosure controls and procedures is mandated in Item 307 of Regulation S-K. The second—"internal controls over financial reporting"—deals with assuring that financial reports are prepared in accord with generally accepted accounting principles. It is reported pursuant to Item 308 of Regulation S-K. Perhaps unfortunately, nearly all of the business community's attention has focused on the latter, because it is the one that must be audited pursuant to section 404 (and Item 2-02 of Regulation S-X) and because Item 308's reporting instructions are more elaborate, including the explicit duty to disclose material weaknesses and the warning that management cannot conclude that its controls are effective if there are one or more unremedied material weaknesses.

Evaluating internal controls of either kind requires that a benchmark be available against which to compare the effectiveness of any given system. As to internal disclosure controls, there is no guidance in the text of the rules. For internal controls over financial reporting, Rule 13a-15(c) requires an evaluation based on a "suitable, recognized control framework established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." According to the SEC, the only body that clearly meets that test is COSO, whose "Integrated Framework" has thus become the de facto standard.

Completing the relevant set of rules is Auditing Standard No. 2 (AS-2) of the PCAOB, which was created by Sarbanes-Oxley to regulate the public company audit process and has the specific statutory authority to set audit standards. AS-2 defines auditor obligations with respect to the review and evaluation of management's internal controls over financial reporting (not the broader "disclosure controls and procedures"). As a result, it also sets de facto standards with respect to management's own evaluation.

24. There is some reason to suspect that the most useful information for disclosure purposes is not the financial reports but risk disclosure, such as that which should be disclosed in the MD&A, and conflict of interest transactions. Although some contingencies and conflicts are reflected in the financials, that kind of disclosure is normally found elsewhere—hence outside "internal controls over financial reporting" but in "disclosure controls and procedures." 


because management’s failure to adhere will result in a qualified or otherwise adverse auditor opinion. And because the SEC’s internal controls rules do not address either the breadth or depth of the required controls system in any great detail, AS-2 is now the most authoritative guidance on the subject. It should be read closely by anyone interested in corporate or securities law.

AS-2 is expansive with respect to both the breadth and depth of the internal controls audit. As to breadth, the audit process reaches every input that goes into the process of financial reporting, as well as the mechanisms for translating those inputs into the financial reports. That, of course, includes all base-level data generated by daily business operations, but also extends well into the corporate governance process. Paragraph 24 emphasizes that the scope extends to controls over potential misappropriation of assets, the company’s risk assessment policies, its code of ethics and conduct, the extent of internal monitoring, and its procedures for whistle-blowing. And in a directive probably not yet fully appreciated by corporate scholars, paragraphs 55 through 59 require the auditor to evaluate the effectiveness of the audit committee of the issuer’s board of directors as part of the control environment, including whether “the right questions are raised and pursued with management and the auditor.” Paragraph 59 says that ineffective oversight by the audit committee is at least a significant internal controls deficiency and a strong indicator of a material weakness, which in turn would require disclosure of the audit committee weakness if not corrected.

That internal controls (and the audit thereof) must operate broadly has long been understood. The much more difficult question is how deep they must go. This is the familiar problem raised by Clark: how much independent evaluation of the quality and integrity of the inputs and their processing must occur? Put bluntly, how much trust in normal information flow is permissible, or when must there instead be extensive detective work—“corporate espionage,” to borrow the phrase from Graham—to uncover negligence or deliberate noncompliance? Before Sarbanes-Oxley, it was commonly understood that an audit’s assessment of internal controls was not a fraud prevention device as such, but rather simply a way of gaining confidence in the company’s numbers. The limited depth of the standard assessment of the control environment reflected this. The question now is to what extent Sarbanes-Oxley requires a deeper dig. The costs associated with internal controls come largely in the answer to this question.

AS-2 starts off with the standard assertion: internal controls must provide “reasonable assurances,” not absolute certainty. Hence, there is a judgmental element. Perhaps the key sentence in the entire standard, however, then comes in paragraph 9: a significant deficiency in controls arises when there are one or more flaws in the control system such that “there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential.”28

Something is considered remote only when the chance of its occurrence is “slight”—a more than remote risk, then, is anything more than a slight one. According to paragraph 10, a material weakness is one or more significant deficiencies that create a “more than

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28. AS-2, supra note 26 para. 9 (emphasis added). Paragraph 9 then says that something is “inconsequential” if a reasonable person would conclude, under the circumstances, that it “would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion . . . that misstatement is more than inconsequential.” ld. (emphasis added).
remote” likelihood that a material misstatement in the financials will not be prevented or detected. In sum, some combination of what AS-2 calls “preventive controls” and “detective controls” must reasonably address any such “more than remote” risk. That, obviously, demands substantial depth because there are countless risks relating to the financial reporting controls environment that could meet the more-than-remote test, and thus require some level of attention.

V. INTERPRETING “REASONABLE ASSURANCES”

In light of the foregoing, it should not be surprising that there has been substantial uncertainty as to what the new internal controls rules require. The puzzling questions go to both scope and depth. As to scope, for example, does an internal controls system have to incorporate a compliance system with respect to federal and state laws affecting how the company does business (the problem posed in Graham and Caremark)? Both the SEC and PCAOB have said not as such, but then take much of that back by acknowledging that noncompliance with federal or state law may create contingent liabilities or risks that may, under the circumstances, have to be accrued in the financials, described in a footnote to the financials, or disclosed elsewhere, such as in the MD&A portion of the 10-K or 10-Q. If there is a more than remote risk relating to the financials, then there is a possible connection to be considered. And even if not with respect to the financials, management must still worry about the separate (albeit unaudited) “disclosure controls and procedures” certification and reporting obligations, which presumably require a system for gathering forward-looking information relating to risks the company faces. In other words, a failure to have a compliance system to detect violations of law could, under the right circumstances, be an internal controls failure.

But again, depth is the bigger issue. How much inquiry, double-checking, and surveillance is necessary to come to a reasonable assurance as to the control environment in light of the “more than remote” risk standard? The remainder of this Article will largely be commentary on that question. As noted above, everyone seems to agree that this involves judgment, not mechanics, and presumably the judgment is of the conventional sort: the level of depth should not generate more cost than benefits, and there should be no less costly way of gaining those benefits. It would be trite simply to say that costs and benefits are hard to quantify, and may often use incommensurable measures. That is true, but already well understood as a generality. My points are more specific to the internal controls context.

A. Managerial Incentives

The starting point is to consider management’s own incentives. Keep in mind that

29. Obviously, the materiality standard here provides some protection from the need to dwell on small matters. However, the materiality standard employed contains both quantitative and qualitative elements, which make it difficult to ignore small matters simply because they are small. See SEC Staff Accounting. Bulletin No. 99, 64 Fed. Reg. 45150-01 (Aug. 19, 1999) (codified at 17 C.F.R. pt. 211); JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 580-82 (5th ed. 2006).

there are two separate but related objectives built into the internal controls requirement. One is to bring material information to management's attention, the other to permit monitors like auditors or board audit committees to verify the quality of the information flow and processing by management.

Why would managers ever choose a system of less-than-perfect information from below?31 The easy answer, of course, is that internal controls and verification procedures are very costly, a subject to which we turn shortly. But if costs are the only issue, then we might want to trust management's judgment on the right balance.

Principal-agent problems are another obvious possibility. Senior managers might choose to under-invest in monitoring the activities of subordinates for a variety of selfish reasons. Not knowing might create legal or reputational protection that comes with "plausible deniability,"32 or be a trade with subordinates: granting them some degree of autonomy (and thus the ability to conceal their own self-serving behavior) in return for their political support or their assistance in helping the higher-ups keep hidden what they wish. We should not push this too hard, however; plainly, knowledge is power for senior managers33 and too much ignorance of what happens below is dangerous.

The agency cost issue becomes much clearer when we see internal controls not simply as a way of moving information upwards but simultaneously permitting its external verification. Managers no doubt want some opacity within their own sphere of activities to conceal risky or opportunistic behavior, so strong internal controls are a threat. Muddying their own informational environments (e.g., relying on informal information networks rather than formal ones34) may be the price for gaining the desired autonomy. Here, the incentives to conceal are much the same as the incentives to mislead, a subject that has received ample attention from both lawyers and economists.35

A third category falls somewhere in between. A familiar concern is that informational and control needs vary over the life cycle of the firm—the management structure that works in making a start-up successful or a small company grow may be deficient as applied to a large and successful enterprise. There is a cognitive problem here because such change is hard to see from within, so that the original structure stays in place too long without modification simply because the managers are paying attention to

31. This is not the same question as why managers do not voluntarily disclose information; management presumably would want to know more than it might choose to disclose.

32. See generally Larry D. Browning & Robert Folger, Communication Under Conditions of Litigation Risk: A Grounded Theory of Plausible Deniability and the Iran-Contra Affair, in THE LEGALISTIC ORGANIZATION 251 (Sim Sitkin & Robert Bies eds., 1994) (discussing the accountability of conduct when actions are taken deliberately because of the risk of litigation); John C. Coffee, Beyond the Shut Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099 (1977) (discussing models for reforming the common law of corporate misconduct).

33. For a recent case noting the depth of senior management's access to information, see Nursing Home Pension Fund Local 144 v. Oracle Corp., 380 F.3d 1226, 1230-32 (9th Cir. 2004) (holding that the Private Securities Litigation Reform Act was designed to eliminate frivolous sham actions and not actions of substance). On senior management's ability to exploit lack of communication below, see Lawrence Mitchell, Structural Holes, CEO's and Information Monopolies—the Missing Link in Corporate Governance, 70 BROOK. L. REV. 1313 (2005).

34. See infra notes 79-87 and accompanying text.

more pressing matters.\textsuperscript{36} Once this happens, correctives become much more expensive, and then resisted for both economic and cognitive reasons.

The latter two explanations, at least, suggest that Clark is right in his intuition that internal accounting controls ought not be left completely to managerial business judgment. A faithful board of directors would thus be expected to insist on something more, and the law might need to compensate if we fear that the board on its own might not do enough. Hence, we turn from whether the law should prompt the implementation of a workable controls system to how the law should seek the right balance between costs and benefits.

\textit{B. Costs}

Measuring the costs of internal monitoring is something I have written about in some detail elsewhere,\textsuperscript{37} and I do not want to repeat myself. Some of the out-of-pocket costs associated with an internal controls system are easily identified in terms of audit fees, manpower, or hours spent by line, compliance, and audit personnel. Harder to quantify are the opportunity costs and the distractions. AS-2 makes clear that controls and their audit will often be intrusive—for example, an observation of mail opening and cash processing that may lead to inquiries and explanations from relevant personnel and the assurance that good documentation is being created.\textsuperscript{38} Paragraph 96 gives an illustration of overseeing how sales managers review and investigate unusual invoices, which may require not only having the manager explain, but also then corroborate those explanations, which may generate the need for further explanation and recordkeeping.

The more abstract cost question is one that particularly interests Clark in \textit{Corporate Law}. He responds to Graham-like arguments against a duty to monitor that relate to the effect on employee motivation and morale by admitting that it may cause discomfort to employees who do not like to be watched. But it is a discomfort that may necessarily attend all efforts at supervision and control and the cost seems warranted in light of widespread reports of corporate illegality. Moreover, no rational employee should feel personally insulted by an impartial system of internal controls applicable to all the corporation’s employees.\textsuperscript{39}

Perhaps so as a normative matter, but the social science research treats this conclusion as

\begin{itemize}
\item \textsuperscript{37} See Donald C. Langevoort, \textit{Monitoring: The Behavioral Economics of Corporate Compliance with Law}, 2002 COLUM. BUS. L. REV. 71, 93-100 (examining social and cognitive psychology conclusions regarding legal compliance and employee monitoring).
\item \textsuperscript{38} AS-2, supra note 26 para. 93.
\item \textsuperscript{39} CLARK, supra note 4, at 131-32.
\end{itemize}
at least debatable in terms of its impact on internal efficiency and productivity. Close monitoring can have perverse effects on the sense of trust (and, implicitly, the psychological contract), perhaps crowding out loyalty and commitment. It may also affect aggressiveness and risk-taking. The fact that many organizations deliberately give key employees or teams a wide degree of autonomy (subject only to ex post peformance measures), even when stricter monitoring is technologically feasible, suggests that there is likely some inchoate motivational cost to introducing a high-powered control system; my sense is that it may be a serious one. We shall return to a specific example later.

C. Benefits

We can now agree with Clark on two points: internal accounting and disclosure controls cannot be left to management's business judgment, and they are costly. The law is right to intervene and require that the board and management invest in controls so long as the benefits justify the costs. That brings us to the hardest question in this exercise: assessing the benefits, so that we have a way of knowing when the costs have become excessive. Here again, Clark sees the issue, raising a question as to whether shareholders necessarily benefit from strict compliance systems generally, but then suggesting that they are clear beneficiaries of the kind of internal accounting controls required by the FCPA, at least if the Act is reasonably interpreted. My sense is that there is much more to think about. Without doubting that hard questions come in quantifying the benefits (if any) of a given system or control mechanism, the more basic problem comes in identifying what kinds of benefits—indeed, benefits to whom?—we are searching for in the first place. The more benefits and beneficiaries we find, the greater the costs that might seem justified and thus required by the rules.

1. From Shareholders to Investors

The dominant corporate law claim is that the issuer's current shareholders are its principal (perhaps only real) beneficiaries, and Clark seems to assume this contention in his analysis of the duty of monitoring. With respect to securities regulation, however, the analysis is much more complicated. As many have pointed out, existing shareholders will often suffer rather than benefit from truth-telling and hence prefer less-than-full transparency ex post. To be sure, opacity has its costs as well, assuming that the market

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41. See Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. PA. L. REV. 1735 (2001) (discussing the effects of monitoring as applied high up in the organization).

42. Elsewhere, Clark does explore other formulations. See CLARK, supra note 4 § 16.2.

43. See Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 VA. L. REV.
penalizes opacity efficiently, so there are incentives favoring a commitment to transparency ex ante. This result creates a significant trade-off for current shareholders, so that there will not necessarily be unqualified support for high investments in internal controls that might expose bad news that would lead to a reduction in the value of their shares. In part, it will be a question of the liquidity needs of shareholders and how frequently the corporation taps the capital markets. Research in financial economics suggests that there are clientele effects—long-term shareholders demand less extensive transparency and disclosure, while those who trade more frequently (especially actively managed institutional investors) want more transparency—and corporate behavior in fact tracks these preferences based on which category dominates.

The same point arises from the conflict between debt and equity. It may be in shareholders' interest to leverage the company fairly aggressively, assuming favorable interest rates. Because debt holders must largely protect themselves, indentures and loan agreements build in prophylactics, allowing for protective action or adjusting terms when there is a change in financial condition. Typically, these protections use GAAP-denominated accounting measures as triggers, or perhaps rely on the rating agencies, which in turn rely heavily on the accounting. Under these circumstances, equity-holders may at any given moment prefer something other than faithful adherence to GAAP and would consider burdensome any internal financial controls system that made it more likely that debt holders would renegotiate or cut off the supply of cheap funds. In fact, a careful look at many episodes of financial misreporting (including Enron) suggests that they were heavily motivated by the desire to preserve access to the debt markets by not triggering protective covenants or rating downgrades. As with other kinds of noncompliance, equity holders would benefit were the scheme to succeed. So here again the benefits to shareholders of internal controls that produce more accurate financial reporting are mixed.

From an orthodox corporate law perspective, therefore, one could say the right balance between opacity and transparency varies over time and among issuers, which would suggest that too strict a system of required internal controls is often inefficient. Securities law, however, does not treat the issuer's existing shareholders as the primary beneficiaries of investment in high quality disclosure; it is as much, and probably more,
concerned with outside investors who are deciding whether to buy company securities.\textsuperscript{48} To this group, the benefits of transparency are clearer, although ex ante even future shareholders might opt for a regime of less-than-full candor if, on average, corporate profitability is enhanced by the ability to keep some kinds of secrets.\textsuperscript{49}

My point here is simply that measuring the benefits to investors from investments in internal controls depends on which investors one is considering, and what is good for one group (e.g., debt or outside investors) may not be for another. Securities regulation adopts a strong bias in favor of transparency—seeking share price integrity—notwithstanding this divergence. As a result, contrary to what Clark suggests in his comments on the FCPA, the traditional corporate law standard of existing shareholder interests is probably not the right baseline for assessing the benefits of internal controls. Internal accounting control requirements are designed to produce positive externalities for non-shareholder investors, something that necessarily alters the appropriate cost-benefit mix. Perhaps the most important message here is to point out something of a philosophical inconsistency in the Sarbanes-Oxley reforms. Many of the reforms assume that corporate governance strategies, such as having more independent directors (or independent director control over the audit committee), naturally lead to more candid disclosure. But if independent directors are responsive mainly to the current generation of shareholders in contrast to debt holders or outside investors, then that will not necessarily be the case.\textsuperscript{50} In terms of internal controls, the beneficiaries of a strong system will include (and may be dominated by) outside investor interests, to whom neither the directors nor management have any loyalty. Sarbanes-Oxley seeks to conscript directors into a more public-regarding role than a regime based on shareholder wealth maximization would produce on its own.

Finally, there is a very different kind of problem in measuring the benefits to investors from strong internal controls. Although the Sarbanes-Oxley rules contemplate both disclosure and accounting controls, disproportionate attention—generated largely by the audit requirement in section 404—has been devoted to the latter. Even if we assume that the purpose behind securities regulation is the promotion of market price integrity, we should ask about the relationship between accounting disclosure and securities prices.\textsuperscript{51} One of the subtly troubling aspects of Sarbanes-Oxley is the extent to which it devotes extraordinary attention and resources to enhancing GAAP compliance when many economists and others wonder just how significant accounting statements are in the rational formation of stock prices, as opposed to other kinds of information and disclosure.\textsuperscript{52} In fundamental value terms, one year’s (or one quarter’s) earnings have


\textsuperscript{50} See generally Bratton, supra note 44.

\textsuperscript{51} See CLARK, supra note 4, at 752-53. See also Langevoort, supra note 22, at 24-28; Stephen Penman, \textit{The Quality of Financial Statements: Perspectives from the Recent Stock Market Bubble}, 17 ACCT. HORIZONS 77 (Supp. 2003). For an interesting perspective see Alfred Rappaport, \textit{The Economics of
limited predictive value. Pursuing this inquiry thoroughly would take us too far afield, but obviously share value relates to the future, not the past, and accounting metrics miss much of what is of value even in assessing the current financial condition of the company. To the extent that internal financial reporting controls are purportedly justified in terms of share price accuracy, the question is how much value is added by marginal increases in the quality of balance sheets, income statements, and statements of cash flow. Some, to be sure, but it is hard to say much more than that, yet determining the optimal level of investment in internal accounting controls depends on a more precise answer.


The foregoing “share price integrity” account is the conventional story. But some securities law theorists dissent from the view that the benefits of disclosure mechanisms accrue to investors in terms of better pricing. Most of these rely fairly heavily on strong claims of market efficiency. We have already noted the possibility that market efficiency diminishes (or in particularly strong versions, eliminates) the tension between short- and long-term investor interests, at least ex ante. If we take efficiency seriously enough, it can also lead to different conclusions about the benefits, or lack thereof, of disclosure requirements.

As Clark himself points out in a different chapter of Corporate Law, market efficiency has profound implications for disclosure policy, though neither he nor many serious contemporary scholars conclude that there is no role at all for mandatory disclosure. There is a plausible argument that whatever the scope of mandatory disclosure, the market will price the residual risk of fraud or inaccurate disclosure fairly well. If so, diversified investors should be indifferent to whether there is high quality disclosure or not. This has led scholars like Merritt Fox to argue that the real benefits from disclosure are not so much to investors but to the process of capital allocation among firms—honest firms have a more credible claim to economic resources when there is full disclosure, which thus generates positive externalities for the economy as a whole. My point here is not to agree or disagree but simply to observe that allocative

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54. Obviously, the debate over efficiency is too heated to delve into here. That securities prices may deviate, perhaps considerably, from fundamental value is today more widely accepted even among financial economists than it was when Clark wrote Corporate Law. See, *e.g.*, Symposium, *Revisiting the Mechanisms of Market Efficiency*, 28 J. CORP. L. 499 (2003) (articles discussing recent developments in financial economics). For a vigorous expression of the consequences in terms of shareholder and investor protection, see Michael Jensen, *The Agency Costs of Overvalued Equity*, 10 EUR. FIN. MGMT. 549 (2004). Obviously, even relaxing assumptions about efficiency does not by itself justify heavier regulation if one doubts how well regulators will do their jobs.
efficiency might present an additional or different set of benefits against which to assess the costs of an internal controls system.

A more deregulatory view, which Paul Mahoney has advocated, agrees that the market can protect the properly diversified investor from the risk of inaccurate pricing as such. What still needs to be controlled, however, are agency costs, because insider abuses misappropriate resources and operate as a dead-weight social loss. While agency law is largely the domain of state corporate law, the securities laws—properly read in historical context—can be seen as an effective supplement. This fact has important implications for the design of the disclosure regime, which should not strive for breadth and completeness, because those costs are unnecessary, but simply target those situations where transparency specifically helps overcome principal-agent problems. Here, presumably, the benefits of an internal controls system would be measured by (and largely limited to) how well it helps monitor and control the behavior of the firm’s senior managers. This kind of system would be far narrower than what is contemplated by something like AS-2, though the PCAOB’s standard plainly has an agency cost element embedded in it. This vision is the one that comes closest to justifying internal controls in terms of the interests of the issuer’s current shareholders, because they unambiguously do benefit from efficient controls on agency costs.

3. Stakeholders and Social Licenses

So far, we have assumed that the intended beneficiaries of disclosure and internal controls are investors and/or the economy. And that, surely, is the received wisdom. But there may be more to it than that, and hence different kinds of benefits that might justify additional investment in internal controls and be included in the benchmarking.

The question of whether securities regulation was designed for the benefit of non-investor constituencies as well as investors is an interesting one, as Cindy Williams has shown. Regardless of one’s impression of the history, non-investor interests today play a significant political role in the formulation of securities law policy and thus might also count as beneficiaries of the internal controls rules. If so, then those benefits may need to be added to the calculus.

AS-2 is fairly clear that there is something to this theory. Paragraph 6 says, for example, that government regulators are specific beneficiaries of required internal controls, and in Appendix E the PCAOB observes that accurate financials are important to a broad range of groups: “the board of directors, management, employees, investors,

59. As to identifying other public interests, we know that organized labor and public pension funds take an interest in securities regulation policy designed to enhance managerial accountability and better corporate social responsibility, and probably not simply because of concern about workers’ savings and retirement benefits. That which decentralizes managerial power and creates more transparency and accountability can potentially make it more subject to external stakeholder influence. In light of the well-documented impact of the financial scandals on company employees, we cannot rule at least this effect out of bounds in terms of Sarbanes-Oxley’s statutory purpose, and hence the scope of its intended benefits.
lenders, customers and regulators." That breadth of beneficiaries, it notes, is underscored by its statutory mandate, which is "to protect the interests of investors and further the public interest."

There is also something more diffuse but maybe just as influential. Social norms seemingly have shifted in the last thirty-five years in the direction of expecting greater transparency and accountability from institutions that have significant political, economic, or social power, whether public or private. Institutions (and their leaders) that inappropriately conceal or dissemble are punished more harshly in the news media and in markets of various sorts, as well as in the courts. This idea of "social license" has interesting behavioral effects, both inside and outside the organization. In the aftermath of Enron and Worldcom, I suspect, there was a palpable public demand to respond to overreaching by economic elites by building more public accountability into large corporations. In this sense, Sarbanes-Oxley was not simply investor protection but a backlash against the exercise of power in a way that violated emerging social expectations about the governance of institutions that strongly affect peoples' lives and wealth. One indication that this contention is more than an academic abstraction is the common impression that Sarbanes-Oxley also sets legal standards for private companies, not-for-profits, non-governmental organizations (NGOs) and government agencies. It does not, at least not by its terms. But to the extent that it is a reflection of broader social expectations about institutional governance, leaders of those kinds of institutions would have reason to pay attention. If so, then the benefits of internal controls even in public companies might not be measured simply by reference to standard investor metrics.

VI. EFFECTS

To be clear about the foregoing, I am not making any normative claim that section 404 or other internal control requirements growing out of Sarbanes-Oxley should be interpreted in accord with any one of these possibilities about who is supposed to benefit and in what ways. Rather, my point is simply that a "reasonable assurance" judgment predicated on assessing likely costs and benefits is fruitless unless one defines fairly clearly what benefits are to be considered, and in light of the foregoing discussion, the possible benefits are so expansive as to justify (and thus require) almost limitless

61. Id. para. E6.
62. This, of course, is a major theme in recent work on the blurring of the public-private boundaries. E.g., Jody Freeman, The Private Role in Public Governance, 75 N.Y.U. L. REV. 543 (2000) (describing increased reliance on private action in regulatory behavior).
65. Consistent with my discussion infra, I will concede here that some of this impression is the result of influence activity by interested parties. See, for example, the Sarbanes-Oxley publications page of the PricewaterhouseCoopers website (www.pwcglobal.com), which contains numerous materials with titles such as "Sarbanes-Oxley: How Will it Affect Nonprofits and Higher Education?"
costs. That normative ambiguity begets uncertainty in how to comply.

At first glance, one might predict that companies would take advantage of this ambiguity by construing the requirements in a narrow and self-serving way. But section 404, at least, requires auditors to attest, which gives the audit firms significant leverage. In conventional economics terms, the likely prediction would then be a Coasian bargain between auditors and managers whereby control audits become more expensive but preserve managerial autonomy in the most sensitive places. In particular, auditors might focus their attention on time-consuming and revenue-generating tasks like operational documentation and testing, but not the places where the risks of managerial opportunism are greater. There is indeed anecdotal evidence of something like this happening.

That assumes, however, that managers and auditors are free to arrive at their self-serving bargain. Sarbanes-Oxley (and corporate and securities law generally) restrains this conduct in a number of ways: first, by interposing others, such as independent directors on the audit committee, the company’s lawyers, etc., inside this process, so that an opportunistic conspiracy is more difficult to sustain; second, and more powerfully, by creating a much harsher criminal and civil liability threat if noncompliance is detected by the SEC or federal prosecutors.

Managers can try to blunt these effects by lobbying Congress and the regulators to back off of any aggressive enforcement. Lobbying is how the accounting provisions of the FCPA were rendered impotent for so long, and there is evidence that this effort is to some extent currently underway. This approach, however, may be risky, especially if I am right about the gradual creep of social norms and expectations about institutional behavior. When the discovery of cheating generates strong public and media attention, it is hard to protect the cheaters; the tendency instead is for business people to tolerate aggressive (perhaps even over-aggressive) tactics against a few unfortunate “bad apples” lest further reform efforts build. And post-Sarbanes-Oxley, the tactics can indeed be harsh. So there is reason for insiders to be anxious even when the signals from regulators are momentarily friendly. The lingering fear might produce a relatively high level of compliance.

But even this story doesn’t capture all the likely effects of the uncertainty. Corporate officers and directors have little direct familiarity with the law, especially as to something as complicated as Sarbanes-Oxley. Precisely because of their ambiguity, the internal controls provisions have to be interpreted for them, along with the level of enforcement risk. What has ensued has been an aggressive level of rent-seeking by those in a position to gain from an inflated construction of the Act’s requirements, especially as to internal controls. This inflation of the law’s threat is likely not in bad faith. Given how


67. The internal controls requirements are not directly enforceable via private securities litigation, although there may be some “backdoor” mechanisms under both federal and state law that internal control failures lead to private liability. See Lewis D. Lowenfels & Alan R. Bromberg, Implied Private Actions Under Sarbanes-Oxley, 34 SETON HALL L. REV. 775, 800-04 (2004).

open-ended the rules are, a person and group can readily construe them broadly (and in professional contacts influence their peers to do the same) and come to believe in their interpretation, which makes them all the more persuasive when transmitting their message to the business community.

Auditors are certainly one group that—assisted by the SEC and the PCAOB—has read the internal controls rules broadly and benefits considerably from doing so. Audit fees are up sharply, and given the highly concentrated nature of the market for public company audit services, profits presumably are as well. Although Sarbanes-Oxley severely limits the non-audit services independent auditors can provide the issuer, there remain some—risk management is one area—and so there still may be room for ancillary fees. As we have just noted, auditors have considerable regulatory bargaining power vis-à-vis the issuer and its management to extract such rents, which is a considerable irony given how much of the blame for the financial scandals was directed at the accounting profession.

Attorneys have particular dominion over how the law is read and hence the power to skew it in the direction of professional self-interest.69 Many law firms aggressively offer Sarbanes-Oxley compliance advice and implementation. Particularly interesting here has been the extent to which non-corporate/securities lawyers have seized on the Act’s internal controls requirements. Many specialty areas (e.g., foreign trade, tax, health care) have argued that expensive structural enhancements to the clients’ legal compliance efforts are needed to be “Sarbanes-Oxley compliant.”

Management consultants are active, too, including many specialists in ethics, compliance, and internal controls who have been in the market ever since the Organizational Sentencing Guidelines and Caremark first bumped up the threat risk more than a decade ago. And perhaps the most intriguing group of all to seize on the Act are information technology professionals, who naturally see internal controls as largely an information technology-based task and offer hardware, software, and expertise to redesign those portions of the issuer’s technology infrastructure to assist with information security and surveillance.70

Some of these interest groups are outsiders (like law firms, consultants, and software vendors), but note that much of the rent-seeking influence activity will come from inside the issuer. Information technology, internal audit, compliance, and legal services departments, among others, can compete for internal resources using Sarbanes-Oxley as leverage. This collective effort by those who stand to gain from internal controls compliance can overwhelm the natural inclination by managers to go easy on internal controls. Again, the auditors’ leverage is clear, and the legal profession can gain managers’ attention by amplifying the signals about executives’ personal liability risks if they do not build a thorough enough system. Given the absence of any real enforcement


70. See Eric Bellman, One More Cost of Sarbanes-Oxley: Outsourcing to India, WALL ST. J., July 14, 2005, at C1 (describing a company’s difficulties in deciding which parts of their operations it could outsource while staying in compliance with the new law).
thus far we do not really know how strictly the rules will really be enforced, but there are still enough signals from regulators that internal controls are still a priority item, and we are still too close in time to the scandals and the legislation for even sympathetic regulators to back off too visibly. The most predictable response by managers, then, is herd behavior—looking around at what peers are doing and conforming so as not to stand out as a tempting liability target. This effect means that once rent-seekers succeed in getting one company to “upgrade,” others can be sold more easily on the need to do the same.

Although describing this activity as rent-seeking sounds cynical, this description does not necessarily indicate whether the net consequences are good or bad. If, as suggested earlier, management lacks sufficient incentives to implement internal financial reporting controls on its own, then some push is needed and an assist from even self-interested actors may be useful. Plainly, many innovations will be an improvement on the status quo. But even when controls move in the proper direction, there may still be a misallocation of control resources. The budgetary push will be for resource-intensive efforts—spending on new technology, legal services, audit routines, and documentation. The SEC and PCAOB have recently expressed concern that internal controls efforts have become “bottom up” rather than “top down,” focusing on routines and details deep within the organization without enough attention to their overall strategic significance. Such labor-intensive formalism is not surprising given the interests of those paid to implement the systems, but doesn’t necessarily add the most value.

While this “bottom-up” focus does give some cause for pessimism, it should still be tempered. Again, many changes will be bona fide improvements, and gradually, managers under competitive pressure will learn to push back against those that are patently wasteful, especially (as I predict) if the rules are not aggressively enforced. In addition, I suspect that there will be some subtle but positive externalities with respect to the norms of corporate accountability. As sociologist Lauren Edelman and her colleagues have documented in their wide-ranging studies of corporate implementation of equal employment opportunity regulation, compliance programs create the opportunity for social norms to take deeper root inside the organization, competing with (though probably never fully displacing) narrower conceptions of the firm’s self-interest.

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of this behavior is a result of rent-seeking—in the employment area, the laws empowered human resource and compliance professionals, who then negotiated a larger place for adherence to social expectations about due process and the right to be heard. Even though there was too much formalism here, too, once such norms found a place inside the firm, they became difficult to push aside entirely. Employees’ sense of fair firm behavior shifts, and expectations increase.

Though there are surely differences of degree in the social norms underlying employment opportunity and managerial accountability, this may be Sarbanes-Oxley’s legacy as well. One competitive pressure that companies face is the need to attract and keep a motivated workforce. Employees who are pressured to violate social norms that they consider legitimate react with reduced motivation, exit, and, occasionally, subversion in the form of whistle-blowing or otherwise. If I was right earlier that expectations about institutional transparency and accountability are increasing, it will become harder for managers to enlist cooperation by subordinates in an effort to cheat. Sometimes the internal corporate culture will be strong enough to generate powerful rationalizations, especially if the subordinates have a stake in the cheating as well (e.g., Enron), but such strong cultures are probably the exception, not the rule.

To be sure, this cultural shift in expectations pre-dates Sarbanes-Oxley and would have an effect even in the absence of any legislation. The added impact of the Act and its rules is two-fold. Together with the extraordinarily salient events surrounding it—particularly the implosion of companies like Enron, with so much collateral damage—it is first a memorable objective lesson in the dangers of lack of accountability and an expression of support for newer norms of institutional governance. Second, it forces a redesign of the architecture of internal controls that brings the processes more into the open, with the involvement not only of compliance and audit professionals but a wider variety of mid-level personnel inside the firm. The corporate sightlines are bound to be better. AS-2 is clear, for example, that the system must be open and attentive to expressions of employee doubts about the integrity of information or procedures. This open architecture means that there will be greater transparency inside the firm, which will make it harder to hide things from those outside.

My sense, then, is that Sarbanes-Oxley will have some positive pay-off in terms

74. The work of Tom Tyler particularly emphasizes the role of employees’ perceptions of social norms, fairness, and entitlements as a constraint on what employers can demand. See, e.g., Tom R. Tyler & Peter Degoe, Trust In Organizational Authorities: The Influence of Motive Attributions on Willingness to Accept Decisions, In Trust In Organizations: Frontiers of Theory and Research 331 (Roderick M. Kramer & Tom R. Tyler eds., 1995).


78. AS-2 supra note 26 para. 24. Whistle-blower protection is also enhanced by various provisions of Sarbanes-Oxley.
of corporate transparency and accountability generally, in addition to the specific improvements in the quality of financial reporting. Whether the costs will be worth it depend, as we have discussed, on whom we specify as the intended beneficiaries of the legislation. I am ambivalent so far as benefits to investors are concerned, especially in light of the extensive rent-seeking to influence the design of the controls, but slightly more optimistic if we take into account the broader social externalities.

VII. SURVEILLANCE, NETWORKS, AND AN ASIDE ABOUT CORPORATE LAW'S APPENDIX A

One curiosity in Clark's Corporate Law is Appendix A: “A Special Note on Hierarchies.”\(^79\) It is a fifteen page frolic and detour, replete with intricate graphics, drawing from a wide range of social sciences (even archeology and anthropology) about the comparative evolutionary fitness of hierarchical systems in the management of organizations. It is mainly about information networks. For all its fascinating detail, it makes a fairly simple and intuitive point: that the hierarchical form of authority, which corporate law endorses by so centralizing power in the board of directors, is an efficient mechanism for managing network information flow in a complex organization.\(^80\) So far as I can tell, this line of reasoning relates back to only one page in the main body of the treatise.\(^81\)

The underlying idea, however, connects closely to Sarbanes-Oxley, because internal controls are about hierarchies and information flow within organizations. Appendix A focuses on formal information networks and their relationship to authority, and suspect that these networks are what most internal controls designers pay attention to as well. By contrast, I want to shift attention to informal networks—the communication routes that emerge, often spontaneously, among officers, directors, managers, and employees.

Since 1986, this has been a major academic research project, largely among sociologists doing research in organizational behavior. Some of the work is highly qualitative, other fairly mathematical.\(^82\) The underlying idea is that individuals develop lines of communication through which information flows separately from formal processes, and that certain individuals will develop higher quality networks than others by connecting to different places inside and outside the firm. A variety of techniques can be used to identify individuals who possess traits, positions, or experiences that make them particularly well-connected.\(^83\) (As we all realize deep inside, it is who you know, not just what you know). Some interesting work along this line relates to boards of directors: there is reason to suspect that firms benefit in many ways by having directors

\(^{79}\) CLARK, supra note 4, at 801-16.


\(^{81}\) CLARK, supra note 4, at 24.

\(^{82}\) E.g., Kathleen Carley, A Comparison of Artificial and Human Organizations, 31 J. ECON. BEHAV. & ORG. 175 (1996) (comparing and contrasting computational models of network behavior). The more quantitative approach to the sociology of network behavior has been popularized in DUNCAN 1. WATTS, SIX DEGREES: THE SCIENCE OF A CONNECTED AGE (2003). For a law-oriented use of networks material, see Mitchell, supra note 33.

\(^{83}\) See generally Ajay Mehra, The Social Networks of High and Low Self Monitors: Implications for Workplace Performance, 46 ADMIN. SCI. Q. 121 (2001).
with certain network affiliations.\textsuperscript{84}

Intuitively, internal controls might well reach into the informal as well as the formal network, which brings us to a point about surveillance and the “corporate espionage” that Graham mentioned and Clark discusses. Surveillance technology has evolved considerably, and with the advent of e-mail and other forms of digital communication as primary network mechanisms, one could go quite deeply into the informal network. This idea was emphasized in the aftermath of the public release by the Federal Energy Regulatory Commission of a massive number of intra-firm e-mails from Enron during the time period before the implosion. This release of emails has allowed researchers to identify Enron’s boundary-spanners and generate time-series images of the frequency, direction, and intensity of communications, graphically portraying an increase in anxiety well before the scandal became public.\textsuperscript{85} Commentators have noted the obvious: to the extent that technology would allow surveillance of internal e-mails and other digital communications on a real time basis, one might learn something of interest as to risks and problems in a more timely fashion than via other forms of internal controls.\textsuperscript{86} In fact, this conclusion is essentially what governmental intelligence systems try to do in the counter-terrorism area.\textsuperscript{87}

That leads to an interesting Sarbanes-Oxley thought experiment. Assume that this technology were available at reasonable cost, and would elicit material information. What would be the effect on internal behavior? The privacy issues are obvious; to me, this thought experiment tests nicely our predictions with respect to the costs associated with corporate monitoring and surveillance. Clark is right that employees expect some degree of monitoring, so long as it is done evenly and fairly. But there is probably a line beyond which the intrusion provokes reactive behavior and does diminish motivation, crowd out trust, and chill communications. Autonomy is a powerful motivator, for both individuals and groups. Without knowing where that line is, I would guess that the risks associated with overly intrusive internal controls are at least more than remote.

\textbf{VIII. CONCLUSION}

As Clark suggests, Congress was correct to decide that an internal financial reporting controls requirement benefits both investors and society (i.e., that market forces alone do not suffice with respect to the integrity of information gathering and processing inside the firm). The problem with Congress’s reformulation of this requirement in Sarbanes-Oxley is not the idea but the execution: by making a reasonableness standard the only touchstone for compliance in the face of severe liability risk, the idea itself offers

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\textsuperscript{84} See Ranjay Gulati & James Westphal, \textit{Cooperative or Controlling? The Effects of CEO Board Relations and the Content of Interlocks on the Formation of Joint Ventures}, 44 \textit{ADMIN. SCI. Q.} 473 (1999) (greater connectivity among directors leads to easier formation of joint ventures). On CEOs, see Michael McDonald & James Westphal, \textit{Getting By with the Advice of their Friends: CEO’s Advice Networks and Firms’ Strategic Responses to Poor Performance}, 48 \textit{ADMIN. SCI. Q.} 1 (2003).

\textsuperscript{85} Jana Diesner et al., \textit{Communication Networks from the Enron E-Mail Corpus}, 11 \textit{COMPUTATIONAL & MATHEMATICAL ORG. THEORY} 201 (2005).


\textsuperscript{87} Though not on this particular strategy, both Cunningham and Backer, \textit{supra} note 3, note the similarities between Sarbanes-Oxley and government counter-terrorism efforts.
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no readily identifiable stopping point for deciding when the costs outweigh the benefits. The potential benefits are significant but diffuse, as are so many of the costs. Seizing on this uncertainty, many who stand to benefit from expenditures on internal controls have amplified Sarbanes-Oxley's risks and demands, and pressured risk-averse managers and directors into significant—and not always value-adding—investments. Some good is done, including architectural renovations that create a more open internal design and hence less opportunity for abuse, but many of the specific expenditures are wasteful, increasing paperwork burdens and second-guessing of stable routines.

The problem is that nothing in the statute or the rules permits easy separation of the valuable from the rent-seeking, and the political dynamics in the implementation of the regulation, at least initially, favored the accountants and lawyers. More recently, the regulators have sensed the problem and encouraged a more strategic, top-down approach to compliance—which is to say, one less obsessed with the details of the firm's informational infrastructure. 88 That is good, but still lacking in any well-articulated theory of internal controls.

To me, the right theory takes us back to why we need legal intervention in the first place, that is, why we don't trust managers' business judgment on internal controls? The main reason is the principal-agent problem, the other is the concern that old systems that once worked under different circumstances become locked-in. If so, then the appropriate legal intervention would be one that targets these problems closely—focusing the management report and external audit on those points within the system where there is a particular risk that agency problems or path dependencies lead to flawed financial reporting. That is a much tighter instruction than what we find in AS-2, which sends management, lawyers, consultants, and auditors on a labor-intensive trek throughout the firm in search of more-than-remote risks to address, and makes it likely that the reaction will be additional personnel and paperwork.

A tightened focus would leave a larger portion of internal controls to management's discretion, but this is not to say that it is out of the law's shadow entirely. Actions against the company itself if the deficiencies lead to bad reporting have an impact on senior executives, even if they did not know or recklessly disregarded the truth. 89 Moreover, there are some negligence-based remedies that the SEC can pursue (e.g., cease and desist) in the face of overly careless choices, which also have significant reputational effects. And there are provisions like section 304 of Sarbanes-Oxley—my favorite provision—that authorize the recapture of bonuses, incentive compensation, and insider trading profits of the top managers of the issuer anytime there is a restatement of the financials due to personal misconduct, without specifying whose misconduct it has to be. 90

88. See supra note 72. SEC Commissioner Paul Atkins has called for a wholesale revision of AS-2 based on these concerns. See Atkins Sees PCAOB Audit Standard as Root of 404 Implementation Issues, 38 Sec. Reg. & L. Rep. (BNA) 827 (May 8, 2006).


90. A reading of section 304 that requires that the executives themselves have committed the misconduct would be odd, because there are ample restitutionary remedies already in that case. If the section is construed to have significance, it would be read to recapture more-than-baseline compensation when misconduct occurs...
A focus on agency cost temptations would raise sensitivities, of course. A well-designed system that uses agency cost incentives to determine where to allocate surveillance resources could not be left in managers’ hands (it really should be under the audit committee’s direction), and would have to give serious consideration to the situational pressures—varying over time and circumstances—that make continued success hard to sustain. A high stock price becomes a danger sign, as would a series of successful quarters that outperform even “stretch” expectations, not necessarily a reason for a celebratory round of bonuses and options for the high achievers.

Perhaps that would be such a focus’ political undoing. We have to acknowledge that the implementation of the internal controls requirement on a costly, bottom-up basis is not only the product of rent-seeking by compliance advocates but a convenient way of deflecting attention away from things that are more sensitive. But this redirection is necessary if internal controls are to have their desired pay-off. Good policy should shift in this direction, but also be prepared with additional enforcement tools to respond to the foreseeable discomfort and resistance.

under the executives’ watch.

91. See generally Jensen, supra note 54.
92. See Langevoort, supra note 3, at 316.
93. This point is also made by Alles & Datar, supra note 3, at 132, observing that because section 404 does not distinguish well between the routine and the diagnostic, it “creates the potential danger that those implementing 404 will focus more on the former, which are conceptually simpler if more numerous and mechanical to implement, as opposed to the latter that require a fundamental rethink of incentive structures, power relationships and the firm’s culture.” Id.