

## IMPEDIMENTS TO COMMERCIAL RISK-TAKING

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Among the matters that those brilliant marketing people who wrote Sarbanes-Oxley had in mind, actually, was a matter in which I have spent a great deal of time in Paris over the last several years, really about six or seven years, in which a French government-owned enterprise got caught up in a massive amount of civil litigation involving billions of dollars of claims in the United States as well as parallel grand jury investigations.<sup>1</sup>

And when I first got involved in that case, I thought that, well, French business people and French government people who were involved would certainly understand the various and sundry U.S. regulatory regimes used as the basis for alleged criminal violations and civil wrongs, would understand them very well, which showed my ignorance. When I went over there, I found, however difficult it may be to go into a board room in the United States and explain the intricacies and alleged justifications for a grand jury investigation of a business, it is that much more difficult to do in Europe where many of these concepts, despite our perhaps common misconceptions of how the Europeans regulate themselves are, in fact, quite foreign to them in more than the nationalistic sense.

I was actually struck to read, in the *Wall Street Journal*, in an article about a group that was recommending to the E.U. and to European governments some regulatory changes having to do with securitized loans, for reasons that you are all aware of, this

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1. See, e.g., Martin Arnold, *Ex-Lyonnais Number Two to Plead Guilty in Executive Life Scandal*, FINANCIAL TIMES, Feb. 5, 2004, <http://www.ft.com> (search, "ex-lyonnais", then follow "Ex-Lyonnais number two to plead guilty" hyperlink) ("The Federal Reserve said Mr Bazy had agreed to plead guilty to the criminal charge of making false declarations to the Fed over the 1991 acquisition of failed US life insurer Executive Life by Credit Lyonnais, then a state-owned French bank.").

quote that came out of this group of economists and policymakers who wrote this report: “Market-driven but regulatory and supervisory authority-guided approaches are necessary for successful financial risk management. This regulation must be governed by principles and focused on maintaining levels of capital commensurate with the risks undertaken.”<sup>2</sup> It should not be based on a rigid set of rules that would stifle innovation.<sup>3</sup> I am sure many of you would join me in just wishing that some member of Congress leading a congressional committee considering legislation such as that that became Sarbanes-Oxley would stand up and make a similar statement.

I shall examine this from the workaday world that I am in on a day-in and day-out basis with business people, and how and where we are actually affects what people do and how it compares to the psyche of businessmen overseas in the environment that they expect to work in and perhaps explain a little bit of why they are rather surprised, as my French clients were, about what they may face here.

I would like to begin by looking just briefly at some very fundamental concepts and principles. I think it would do well for us as a nation, as policymakers, and as legislators to ask ourselves what the purpose of an enforcement regime is, particularly one that criminalizes conduct. What is it that it is supposed to provide? And I think the correct answer to that question is found in reminding ourselves of what is the essential role of government itself in regard to commerce. The government’s role is, or ought to be, to promote commerce. At its core, that role includes an enforcement regime that, of course, protects the means and instrumentalities that are necessary to commerce: preventing fraud on the market, protecting the engines of commerce: transportation, communication, financing, banking, honest and free markets themselves, and protecting, frankly, the integrity of courts which are necessary to the orderly resolution of business disputes.

We know that the Founders were extremely concerned that commerce should flourish, and it was in fact one of the fundamental reasons for establishing the federal government.

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2. Natasha Brereton, *Global Economy: Governments Are Urged to Make Lenders Bear Some Risk on Securitized Loans*, WALL ST. J., Nov. 13, 2007, at A16.

3. *Id.*

Hamilton wrote: "The prosperity of commerce is now perceived and acknowledged, by all enlightened statesmen, to be the most useful as well as the most productive source of national wealth, and has accordingly become a primary object of their political cares."<sup>4</sup> Sometimes today it would be hard to tell. Commerce does not exist to support government; Government exists to support commerce.

To the extent that the criminal law and other draconian enforcement methods are used to protect the means and instrumentalities of commerce, such use could be seen as consistent with the traditional purposes of both government and the use of criminal law. Criminal law, as everybody knows, traditionally has distinguished illegitimate conduct that is intentionally undertaken in violation of the law from legitimate conduct.

But the great divide that exists today in the world of enforcement of regulation in the commercial context is that today, criminal law and other enforcement mechanisms that are equal to it in terms of severity are used to regulate what is otherwise legitimate commercial activity, such as, for example, in the environmental arena, which just so lends itself to this criticism. All would, I think, agree with the social goal of eliminating to a reasonable extent, or at least as reasonable an extent as possible, the introduction of foreign substances into the air and water that we all have to use. But the government gives people permits to do this. One is allowed to pollute in the United States. But if one pollutes too much in violation of a permitted level, then that person not only may pay a fine but, in fact, may go to jail and, if it is a corporation, it may suffer draconian consequences.<sup>5</sup>

The difference between those two, legitimately polluting under permitted level and polluting unlawfully in violation of a permit, can be measured in parts per million,<sup>6</sup> and as many know from the cases,<sup>7</sup> experts can produce reams of material on

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4. *See id.*

5. *See, e.g.*, Clean Air Act Amendments of 1990, 42 U.S.C. §7412 (2006) (imputing fines of up to \$25,000 per day per violation and imprisonment for up to 15 years).

6. *See, e.g.*, Clean Air Act Amendments of 1990, 42 U.S.C. §7511 (2006) (imposing an ambient air quality standard for ozone of between 0.19 and 0.28 parts per million).

7. *See, e.g.*, *Sierra Club v. EPA*, 314 F.3d 735, 739 (5th Cir. 2002) (where petitioners challenged an EPA ruling which concluded that no additional air quality measures were needed in the Beaumont, Texas area).

the disagreements about whether or not, in fact, a level has been exceeded.

So, what is the current situation? This trend of regulating legitimate commercial activity with criminal enforcement mechanisms and through draconian enforcement proceedings has brought us up to, in the post-Enron environment, Sarbanes-Oxley. I was on a panel the day part of Sarbanes-Oxley was marked up in front of Senator Biden's Judiciary Committee,<sup>8</sup> and the Committee had to stop the markup section of the legislation to run over to the floor of the Senate and vote for the entire bill.<sup>9</sup>

Now, does that suggest that there was a rush to judgment? I will leave it to others to reach their own conclusions.

Sarbanes-Oxley has been celebrated as a necessary response to corporate excesses. But I think it is better seen as further evidence of the loss of sight of this great divide between using enforcement mechanisms to protect the means and instrumentalities necessary to commerce and using these selfsame mechanisms to, in fact, regulate behavior. What that law does is familiar to all, and I am not going to go through it in great detail, but I will dwell for just a moment on a few terms from the statute.

Various certifications are required of executives and other professionals both within companies and outside, as part of what has come to be recognized as the Sarbanes-Oxley process.<sup>10</sup> And terminology is in use there, such as "fairly present"<sup>11</sup> the financial operations of the company, and there are "internal controls"<sup>12</sup> that are appropriate to the business, such that business leaders can assure themselves that the financial statements will be fairly representative of the company. The concept of materiality is replete throughout the law. What CEOs and others who have to certify under Sarbanes-Oxley are really

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8. *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?: Hearing Before the Subcomm. on Crime and Drugs of the S. Comm. On the Judiciary*, 107th Cong. 1-41 (2002).

9. See 148 Cong. Rec. 12504 (2002). Amendment SA 4185, which was proposed "[t]o provide for the criminal prosecution of persons who . . . defraud investors of publicly traded securities, and for other purposes," was agreed to by a vote of 97-0. *Id.* at 12508.

10. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777-78 (2002) (requiring that the CEO and the CFO of a public company certify that the company's periodic financial disclosures do not contain material misstatements or omissions).

11. *Id.* § 302(a)(3).

12. *Id.* § 302(a)(4)(A).

required to do, though, is to bet on expert opinions. And the experts themselves are very worried about their own reliability when they give those opinions, which tend to create a good deal of tension between auditors and their clients.

A subcommittee report of a group looking into this said, “There are too many sources of authoritative accounting guidance in U.S. GAAP.”<sup>13</sup> Well, that is no lie. “Preparers, auditors, and other participants,” continuing the quote, “are sometimes penalized for improving their understanding and interpretations of accounting standards over time.”<sup>14</sup>

This trend of necessity winds up causing people to become even more risk averse than they might otherwise be in a highly litigious society. Compliance risk assessments are given unnatural weight in business decisionmaking. Business leaders are more likely to make decisions without lawyers and to exclude lawyers from the early stages of business discussions because lawyers are being forced into the position of being Dr. No when it comes to innovation and the other key elements of entrepreneurial risk-taking. All of these developments collectively are having an effect—and I think these ideas are beginning to gain some traction—on our competitiveness.

A movement away from overregulated environments to environments where the impediments to entrepreneurial risk-taking are less is occurring in Europe. I read an article while I was in France on one occasion where a number of young French entrepreneurs were interviewed about why they were starting their businesses in Ireland.<sup>15</sup> And they said, “It is very simple. I do not have to deal with all of the labor requirements and the other impediments to the operation of my business in Ireland that I have to deal with in France, so I am going there.” Now President Sarkozy is trying to do something about that, and it is a sea change. Before we laugh at the French for their problems, we need to take a hard look at ourselves and where we have put ourselves today *vis-à-vis* the rest of the world in introducing impediments to entrepreneurial risk-taking.

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13. SEC, Advisory Committee on Improvements to Financial Reporting, Subcommittee II: Standard Setting, Report for Discussion at November 2, 2007 Full Committee Meeting, <http://www.sec.gov/about/offices/oca/acifr/acifr-sc2-report.pdf> (last visited May 20, 2008).

14. *Id.*

15. Dara Doyle, *French Like Job Climate in Ireland*, INT’L HERALD TRIB., Mar. 30, 2006, at 13.

There is empirical evidence to support the fact that the net effect of this criminalization of business regulation, as epitomized by Sarbanes-Oxley, is having that effect. Bill Donaldson observed not too long ago that Sarbanes-Oxley is creating a huge preoccupation with the dangers and risks of making the slightest mistake, as opposed to taking a reasonable approach to assessing business risk.<sup>16</sup> He said, "People are confusing business risk-taking with legal risk-taking, which is a mistake."<sup>17</sup> Even Senator Schumer, joining with Mayor Bloomberg, commissioned a report on New York City's competitiveness, for reasons that are obvious.<sup>18</sup> That report concluded that enforcement efforts have effectively criminalized conduct assumed to be permissible, causing market participants to adopt costly risk-averse behavior and bear the associated opportunity costs. Regulatory trends in the United States are actually starting to damage the competitiveness of financial institutions doing business domestically.<sup>19</sup>

Interestingly enough, in what might have seemed in the immediate post-Enron environment to be a heretical if not radical statement, another report said, "[C]riminal enforcement against companies . . . should . . . be a last resort . . ."<sup>20</sup> And a study recently conducted by the American Enterprise Institute concluded that American firms and American markets are becoming less competitive even compared to their British counterparts.<sup>21</sup>

Where do we go from here? I do not think we are totally tilting at a windmill here, but considering what leads Congress to pass something like Sarbanes-Oxley, it is very, very difficult to

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16. Adrian Michaels, *After a Year of US Corporate Clean-Up, William Donaldson Calls for a Return to Risk-Taking*, FIN. TIMES, Jul. 24, 2003, at 15.

17. *Id.* at 15.

18. Michael R. Bloomberg & Charles E. Schumer, *Introduction to MCKINSEY & COMPANY, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP* (2007), at i-ii, [http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20\\_FINAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf) (last visited May 20, 2008).

19. *Id.* at 78.

20. COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION xii (2006), *available at* [www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf); *id.* at 72-73, 84-86 (detailing further why criminal enforcement should be reserved for only the worst abuses).

21. Leonce Barger et al., *Sarbanes-Oxley and Corporate Risk-Taking* (June 18, 2007) (unpublished manuscript, *available at* [http://www.aei.org/docLib?20070615\\_LehnSOX.pdf](http://www.aei.org/docLib?20070615_LehnSOX.pdf)).

conclude, given whatever the next scandal is, which may be in mortgage derivatives, that Congress will not respond with something equally ill-advised. But what we can do to try to prevent that is to remind ourselves of some fundamental things and demand that our policymakers start looking at fundamental issues, such as the role of government in protecting the means and instrumentalities of commerce and not being involved in setting up unnecessary obstacles to commerce.

I want to observe in closing that I, sometimes when talking about this issue, have been misinterpreted because I am a defense attorney for businesses, so I would condone fraud in the marketplace and the kind of shenanigans that went on at Enron, and so forth. That is not true at all; a corrupt market cannot be, by definition, a free market. There is certainly a role for government in protecting the marketplace from fraud and fraudsters. That being said, though, when we move beyond that, when we lose sight of the fundamental distinction between protecting the means and instrumentalities of commerce and move into, however lofty the goal might be, using these enforcement mechanisms as regulatory tools, we lose sight of those things which are necessary to maintain our competitiveness.

The other thing I will say in closing is that I do not hear in the political discourse on these issues a recognition that businesses and corporations are not inherently evil. They are instead the primary employers of people and the creators of the wealth—an unparalleled wealth in human history—that our people enjoy today. A strong economy is of course essential to the health of our country, our people, and our democratic government and the institutions that it tries to promote. If we were to just simply introduce a recognition of that in the policy decisions, both at the legislative level and at the enforcement level, we would go a long way towards beginning to rein in our tendency to try to correct every human misdeed with which somebody thinks they can get away with some kind of provision in a regulation and draconian penalty that it would attach to that in the future.