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Act of 2002 were aimed at preventing corporate abuses after Enron and a spate of corporate scandals.

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Independent directors, audit committees, and other reforms of the Sarbanes-Oxley Act of 2002 were aimed at preventing corporate abuses after Enron and a spate of corporate scandals.

Schipani

Have independent directors made a difference? Not nearly enough, according to evidence presented in a forthcoming law journal article by Michigan Ross Professors Cindy Schipani and Nejat Seyhun, along with post-doctoral research scholar **S. Burcu Avci.**

They show that class-action lawsuit settlements and amounts have not abated since

happening," says Schipani, Merwin H. Waterman Collegiate Professor of Business Administration and professor of business law. "And, according to the metrics we analyzed, there's even complicity."

Lawsuits and Abnormal Returns

The authors base their conclusions and reforms on empirical evidence.

They examined the number of class-action settlements of $10 million or more for claims of financial fraud. There's been no significant decrease in the number of lawsuits nor the amounts paid out since Sarbanes-Oxley.

Seyhun

"It was probably unreasonable to expect that directors, who aren't really privy to day-to-day affairs of the company, have enough information or incentive to prevent or find complex and hidden fraud," says Seyhun, Jerome B. & Eilene M. York Professor of Business Administration and professor of finance.

The authors also studied abnormal returns on executive and director stock option grants, which suggest manipulation. The common types of manipulation are backdating, spring-loading (delaying announcement of positive news until after options are granted), and bullet-dodging (releasing negative news before option grants.)

Option grant data from Thomson Reuters was divided into three periods — pre-Sarbanes-Oxley (1996-2002), scandal period (2002-2006), and the post-scandal period (2007-2015). Their analysis showed the manipulation techniques led to extra returns for management of 9.2 percent, 14.9 percent, and 4.1 percent in the three eras, respectively.

For outside directors, the extra returns were 7 percent, 10.3 percent, and 7.5 percent,

- Limit multi-class shareholder structures with unequal voting rights. The parent company of Snapchat recently did an IPO with zero shareholder voting rights.
- Make shareholder bylaws that pass proxy voting binding on the board of directors.
- Require directors receive a majority of the shareholder vote, not merely a plurality.
- Require that any director who doesn't receive a majority vote resign from the board.

"The board system is broken," says Schipani. "While it's very important for corporate governance, it doesn't serve the monitoring role well. It makes more sense for boards to focus on strategy, helping management solve problems, and be the group of very bright people management can turn to for guidance. It's hard to do that and be the cop on the beat. We think it's time for a different structure."

The full paper is available online.

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