

Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight

by R. William Ide*

I. INTRODUCTION

A. *The Enron and WorldCom Failures*

On October 16, 2001, one of the world's most acclaimed corporations, Enron, reported a shocking quarterly loss of \$618 million. Within a week, CFO Andrew Fastow was fired, and on December 2, 2001, Enron filed for bankruptcy in the wake of revelations of overstated earnings and off-balance sheet frauds. Employees lost not only their jobs, but also their retirement funds, which had been invested in Enron stock. The damage to shareholders, innocent employees, vendors, and communities from this fraudulently caused failure was devastating.¹ Arthur Andersen, the venerable accounting institution, was convicted for obstruction of justice in connection with the destruction of documents

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1. Bob Dart, *Company Collapse Leaves Toll*, ATLANTA J. & CONST., Oct. 3, 2002, at Q2.

relating to Enron, filed for bankruptcy, and, in less than a year, was out of business.²

Public shock was followed by anger and calls for action. By spring of 2002, over thirty Enron reform bills were pending in Congress; New York Stock Exchange ("NYSE") and Nasdaq Stock Market ("Nasdaq") task forces were proposing reforms;³ and the Securities and Exchange Commission ("SEC") gave notice of proposed tighter disclosure requirements.⁴ Meanwhile, the Bush administration went on record calling for tough enforcement of existing laws and promising that indictments against senior managers would be forthcoming.⁵ The atmosphere became more charged with revelations that executives at Adelphia,⁶ Tyco,⁷ and other companies⁸ had egregiously usurped company assets for personal gains. In addition, companies were announcing restatements of earnings,⁹ and by early summer, the stock market had lost \$7 trillion in value.¹⁰ Nonetheless, in the early summer, it looked as if the post-Enron reforms would be limited to (i) self-regulatory reforms by Nasdaq and the NYSE, (ii) tightened disclosure timelines and requirements by the SEC, and (iii) limited Congressional action in the regulation of accountants and the ERISA area.

Then came WorldCom. On June 25, 2002, WorldCom announced that it had improperly accounted for over \$3.8 billion in expenses during the previous five quarters, resulting in the largest earnings restatement in business history.¹¹ On July 21, 2002, WorldCom filed for bankruptcy.¹² Congress heeded the pressure to move quickly. The dikes of containment that had been successfully maintained by corporate and

2. Carrie Johnson & Peter Behr, *Andersen Convicted*, FORT WORTH STAR TELEGRAM, June 6, 2002, at 2; *Anderson Fade Away*, WASH. POST, Sept. 8, 2002, at H2.

3. See *infra* notes 62 & 64.

4. See *infra* note 61.

5. Press Release, Whitehouse, The President's Leadership in Combating Corporate Fraud, available at <http://www.whitehouse.gov/infocus/corporateresponsibility>.

6. Press Release, Adelphia Communications Corp., Adelphia Files Lawsuit Against John Rigas and Other Former Executives and Board Members of Adelphia (June 24, 2002) (on file with author).

7. Press Release, Tyco Int'l Ltd., Tyco Files Form 8-K Report on Improper Conduct of Former Management (Sept. 17, 2002), available at <http://www.tyco.com/news/ID452>.

8. Marianne Levelle et al., *Rogues of the Year*, U.S. NEWS & WORLD REP., Dec. 30, 2002, at 33.

9. Bristol Lane Voss, *Restating Strategy*, J. BUS. STRATEGY, Oct. 25, 2002, at 41.

10. John Crudele, *Spitzer Fiddled While Investors Got Burned*, N.Y. POST, Dec. 24, 2002, at 23.

11. Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3.

12. *Id.*

accounting interests, using sound policy arguments of deference to SEC and state regulatory prerogatives, gave way. As a result, Congress passed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")¹³ with little opposition, a classic example of policy giving way to politics. Policy considerations were pushed aside in the rush to provide the public with evidence that Congress had done its part in fixing the problems. Consequently, the resulting legislation is in parts disjunctive, duplicative, and lacking in regard for federalism considerations and distinctions between policy and administration.

In the months following the passage of the Sarbanes-Oxley legislation, the media attention and the political dynamics continued. The Bush administration pursued its pledge to punish the corporate wrongdoers and utilized the publicity of "perp walks" in making its arrests.¹⁴ President Bush personally met with all U.S. attorneys and Department of Justice leaders to urge more prosecutions of corporate wrongdoers.¹⁵

Meanwhile, the Attorney General of New York uncovered damning conflicts of interests by Wall Street firms in the use of analysts and their research reports to gain investment banking business and the allocation of initial public offering ("IPO") stock to CEOs for further business (referred to as "spinning").¹⁶ Public figure Martha Stewart was alleged to have profited from the sale of stock based on inside information.¹⁷ SEC chairman Harvey Pitt's style of managing his agency was not conducive to thwarting the politicalization of the corporate governance issue. On election day, the administration jettisoned Chairman Pitt, knowing that the press would be overwhelmed with other stories of greater magnitude.¹⁸ At the time of this writing, a successor has not been confirmed, leaving the SEC without a leader at a critical time.¹⁹

During the spring and summer of 2002, significant potential self-governance reforms took place. The NYSE and Nasdaq, as self-

13. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

14. See *supra* note 5.

15. *Id.*

16. Press Release, Office of New York State Attorney General, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (Dec. 20, 2002), available at <http://www.oag.state.ny.us/press/2002/dec/dec20b.02.html>.

17. See Charles Gasparino & Jerry Markin, *Merrill Aide Will Plead Guilty, Cooperate on Martha Stewart*, WALL ST. J., Sept. 26, 2002, at A1.

18. See Stephen Labaton, *In Stormy Time, S.E.C. Is Facing Deeper Trouble*, N.Y. TIMES, Dec. 1, 2002, at 1.

19. *Id.*

regulatory organizations ("SROs"), published their governance reforms.²⁰ Corporate America, through its professional associations, the Business Roundtable, and the Conference Board, also recommended progressive corporate governance reforms.²¹ At the same time, civil lawsuits were filed against management, directors, accountants, lawyers, and Wall Street firms, alleging participation in the frauds, conflicts of interests, violations of fiduciary duties, and violations of new theories of liability for corporate officials and their "gatekeepers."²² Further criminal suits and SEC enforcement actions are unfolding under new and more aggressive theories.²³

B. Navigating Sarbanes-Oxley, SEC Rules, State Law, and SRO Requirements to Create the New Paradigm for Corporate Governance

The biggest question about the many reform actions that have been and are being taken is whether they will truly make a positive difference. Advances in a civil society usually occur with laws following the will of the people in the particular area of concern. Sarbanes-Oxley and SEC regulations do provide new structure, but they do so as a political reaction to give assurance to the public that the relevant problems have been fixed. The resulting reactions to this hastily drawn legislation and the corresponding regulations are likely to be driven by an attitude of doing what is required to comply with the law and nothing more. An opportunity now exists, however, for a more positive result that could form a new paradigm for how public companies manage their affairs.

The SRO proposals are based on carefully considered proposals for better governance that institutional investors and other thoughtful leaders have been advocating over time²⁴ and are reflective of a will by some leaders in corporate America to embrace a culture of strong board involvement. This potential for self-reform offers the greatest promise for a new and stronger culture of protecting shareholder (and indeed stakeholder) interests.²⁵

20. See *infra* notes 62 & 64.

21. Press Release, Business Roundtable, Reaction to Conference Board Report on Corporate Governance (Sept. 17, 2002), available at <http://www.brtable.org/press/cfm/763>.

22. Dan A. Bailey, Size of D&O Settlements Exploding, available at <http://librarylp.findlaw.com/articles/file100127/006319>.

23. John Gibeaut, *Fear and Loathing in Corporate America*, A.B.A. J. 50 (2003).

24. See, e.g., U.S. CORPORATE GOVERNANCE PRINCIPLES (1998), available at <http://www.calpers-governance.org/principles/domestic/us/page01.asp>.

25. While this Article addresses only the situation of governance maximizing shareholder value for exchange-listed companies, stakeholder and private company values would also benefit if the new culture is achieved. See Committee on Corporate Laws, *Other*

Claims are being made that the Enron reforms will provide the greatest change in corporate governance since the enactment of the Securities Act²⁶ and Securities Exchange Act²⁷ in the 1930s. That potential does currently exist, but not because of Sarbanes-Oxley or SEC regulation. The public approach to Enron reforms is: "Do what it takes to make sure that these frauds and abuses cannot happen again." Sarbanes-Oxley and SEC actions to date respond to that approach by mandating financial reporting requirements with which management and directors must comply, by assuming jurisdiction over accountants, and by requiring lawyers to disclose fraud up the chain of command in the corporation. The overall tone of the legislation and corresponding regulations is one of directing and prohibiting actions to prevent fraud and abuse rather than improving the internal structure of governance. As a result, Sarbanes-Oxley's approach misses the dynamic of empowering independent directors to prevent abuses and also to make better decisions to increase shareholder value. If anything, some of the Sarbanes-Oxley and SEC requirements may burden the governance process and produce no corresponding value other than some minimal increase in deterrence.

On the other hand, one can sense that within the public company sphere there is a feeling that too many corporations have developed a "CEO-centric" culture, where the CEO is not subject to meaningful oversight. Consistent with this attitude, the new listing standards and "best practices" proposed by the SROs take the positive approach of seeking to set a culture of empowerment for independent directors to provide greater oversight on behalf of the shareholders. If there is sufficient commitment by directors and management to this approach, then there is indeed potential for a new positive dynamic in the boardrooms of listed companies.²⁸ The independent director empowerment approach could lead to more valuable business decisions and oversight that will in turn create greater public trust and shareholder value.

In our free market system of capitalism, it is essential that corporations have the flexibility to take risks and to fail if they are wrong.

Constituencies Statutes: Potential for Confusion, 45 BUS. LAW 2253, 2271 (1990).

26. Securities Act of 1933, 15 U.S.C. §§ 77a-77z, 77aa.

27. Securities Exchange Act of 1934, 48 Stat. 77 (codified as amended in scattered sections of 15 U.S.C.).

28. For corporations to function successfully in their markets, they must have the trust and confidence of the public. Doing what is required by the law alone will not gain the needed trust. The real issue faced by corporations is the need to set a culture that is transparent and intolerant of self-interest. See Kurt Eichenwald, *Even if Heads Roll, Mistrust Will Live On*, N.Y. TIMES, Oct. 6, 2002, §3, at 1.

Regulations should be balanced on a risk/reward scenario. In the corporate world, governance has been the province of state corporate law and subject to public scrutiny under the disclosure requirements of the federal securities laws. Parts of the Sarbanes-Oxley legislation and resulting regulatory efforts by the SEC are helpful additions to the disclosure requirements, but other parts are cumbersome intrusions into areas in which state law has greater expertise and abilities. It is the view of this Article that state corporate laws should be amended to provide that publicly traded corporations are subject to the SRO-advocated principles reflecting the empowerment of independent directors to act on behalf of shareholders in providing oversight of management. As discussed below, some of the best practices advocated by the SROs and business groups should be mandatory requirements of state law while others should be tools for measurement by the SROs, institutional investors, and state courts.²⁹

The key to meaningful reform of corporate governance is the replacement of the CEO-centric mindset, under which the board and senior managers are caught in an atmosphere of guarded acquiescence, with a new culture of true independent director oversight and collaboration with management.

This Article advances the idea that governance should be viewed as a value generator rather than a regulatory burden. Part II begins with a discussion of the dual-purpose nature of boards of directors, highlighting the importance of the board's management oversight role and providing an overview of the basic actions that independent directors must take to provide true oversight. In part III, the Article discusses reasons why boards of directors have not successfully performed this accountability function. Part III also addresses the roles, if any, of the alleged "gatekeepers"—auditors, accountants, lawyers, analysts, and investment bankers—in corporate governance and perceived failures in their performances. In part IV, the Article addresses the reforms initiated by Congress, the SEC, and the SROs—particularly the NYSE and Nasdaq—and notes the differences between the various approaches in encouraging more director responsibility. Finally, in part V, the Article recommends amendments to the American Bar Association's Model

29. "[T]he institutional investor as the decisive owner is here to stay." PETER F. DRUCKER, *MANAGING IN THE NEXT SOCIETY* 80 (2002). As Drucker notes, CEOs and the new breed of shareholders must learn to accommodate each other's needs. Institutional investors will have increasing influence, and their advocacy of sound best practices in governance will ensure corporate boards' attention. In addition, state courts will look to such best practices in the context of fact intensive litigation as indicators of whether directors have lived up to their governance duties. *Id.*

Business Corporation Act (the “Model Act”),³⁰ the utilization of best practices, and provides a model integrating the various reforms and those best practices. It further calls for the SROs, institutional investors, and those in the corporate governance world to support this new paradigm of corporate responsibilities. While laws can help build trust, in the end, corporations must earn the trust through the creation of a culture of accountability that has buy-in from the shareholders.³¹

II. THE DUAL-MINDED BOARD OF DIRECTORS

The heart of the new culture lies in the recognition, on the part of both the board of directors and management, that they are managing an entity that belongs to the shareholders, not the senior executives or the directors. In the world of public companies, the multitude of diverse shareholders, each owning a small piece of the corporate pie, inevitably leads to remote relationships between the directors, management, and the company’s shareholders. Shareholders lack the ability to present a constant reminder to those in charge of day-to-day operations that they are the owners of the corporation and that protection and enhancement of their investment lie at the core of management’s responsibilities. For this reason, corporations are organized with ultimate authority vested in a board of directors, as reflected in corporate law statutes³² and

30. MODEL BUS. CORP. ACT (1999).

31.

[L]aw is a trust-generating institution that can serve to reinforce or help produce trust. It can serve a regulatory function by either mandating or prohibiting trust-related behaviors, or it can serve a more hortatory function by expressing trust-promoting ideals; however, it cannot eliminate the need for trust. The law’s regulatory function is simply inadequate to ensure trustworthy behavior. First, the costs of enforcement are too great to be able to police every interaction. Second, too much regulation begets untrustworthiness. One of the more curious aspects of trust is that trust reinforces trustworthiness and that distrust undermines trustworthiness. In other words, people are more likely to be trustworthy when other people trust them. The more external sanctions and restraints on individual discretion signaling distrust, the less trustworthy the behavior. This has particular implications in the context of fiduciary and asymmetric power relationships and implies that the regulatory function of the law is limited in its ability to generate trust. Law’s hortatory function is not easily enforceable, its force lying only in the actor’s sensitivity to moral suasion. Therefore, even in the presence of trust-generating institutions, trust remains a necessary ingredient in social and economic cooperation.

R. William Ide & Douglas H. Yarn, *Public Independent Fact-Finding: A Trust-Generating Institution for an Age of Corporate Illegitimacy and Public Mistrust*, U. VAND. L. REV. (forthcoming Spring 2003).

32. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2001); O.C.G.A. § 14-2-801 (Supp. 2002); MODEL BUS. CORP. ACT § 8.01 (1999).

numerous corporate charters and bylaws.³³ The board, however, is not capable of running the corporation on a daily basis. Therefore, those same statutes and organizational documents provide that the board shall appoint officers to run the day-to-day operations of the corporation.³⁴ This corporate hierarchy creates the framework for the board's dual roles—that of concern for the enterprise and that of overseer.

The first role represents our more common conception of the board as a body consulted by management to provide insight and authority on major enterprise decisions and to provide wisdom in developing what could generally be termed “corporate policy”—the big picture. In this setting, senior management is the initiator. With their intimate understanding of the daily workings of the company, members of senior management have the necessary resources to provide the board with the information it needs to make overarching decisions about the direction of the corporation. The directors then supplement this information with their own wisdom and experience to make the high-level decisions that they believe are in the best interests of the corporation and its shareholders. Once these decisions are made, senior management then has the authority and direction in its day-to-day operations to further the corporate policy developed by the board.

The second, and until recently, less recognized role of oversight is aimed at ensuring that the right senior managers have been chosen, that they are performing at satisfactory levels, and that their compensation is commensurate with performance. In this role, the board's obligation, through its oversight of senior management, is to ensure that management is properly accountable to the board and, through the board, ultimately to the shareholders. Directors who are also members of management have an inherent conflict of interest, and consequently, it is in this role that the independent directors must provide leadership for the interests of shareholders. A growing adjunct to this responsibility is the audit and compliance-related oversight being demanded of independent directors. In the foregoing areas, there is a sense that independent directors have in the past abdicated their responsibilities to management and now must assure true independent oversight.

33. *See, e.g.*, CERTIFICATE OF INCORPORATION AND BYLAWS OF DELTA AIRLINES, INC., art. IV, § 4.1 (Nov. 16, 1998); AMENDED AND RESTATED BYLAWS OF THE HOME DEPOT, INC., art. II, § 4 (Feb. 22, 1996); AMENDED AND RESTATED BYLAWS OF THE COCA-COLA CO., art. II, § 6 (July 19, 2001).

34. *See, e.g.*, DEL. CODE ANN. tit. 8, § 142 (2001); O.C.G.A. § 14-2-841 (2002); MODEL BUS. CORP. ACT § 8.41 (1999); CERTIFICATE OF INCORPORATION AND BYLAWS OF DELTA AIRLINES, INC., art. IV, § 5.1 (Nov. 16, 1998); AMENDED AND RESTATED BYLAWS OF THE HOME DEPOT, INC., art. III, § 1 (Feb. 22, 1996); AMENDED AND RESTATED BYLAWS OF THE COCA-COLA CO., art. V, § 1 (July 19, 2001).

The corporate accountability process begins with the selection of the chief executive officer. The board should be actively involved in the selection of the individual who will implement company policy, ultimately manage day-to-day operations, and be accountable to the board and the shareholders. Ensuring that the individual chosen to captain the corporate ship has the appropriate skills, experience, and personality is critical. Succession planning is also a critical need. Too often, boards have defaulted on these issues and, through inadvertence or design, effective selection and succession processes have not been in place.³⁵

Oversight means the board must also control major compensation issues. The chief executive, along with other senior executives, should be properly compensated to provide the appropriate incentives for the performance sought. There is need for further thought and debate on the appropriate long-term incentives, ranging from cash, deferred compensation, restricted stock, or options with extended vesting periods.³⁶ An important component to the foregoing is compensation tied to performance, as with incentive-based options or bonus programs.³⁷ Conversely, compensation should not reward failure to perform, as with extensive and lucrative severance packages. Ultimately, individual performance and shareholder value should be the drivers of senior executive compensation.³⁸

As part of the above tasks, the board must establish a system for monitoring corporate performance and make certain that the proper level

35. In his national bestseller, *Good to Great*, Jim Collins notes that the board has the critical role of finding a CEO who meets certain profile characteristics that can be predictive of producing significant increases in shareholder value. A failure to utilize these critical selection skill sets or a willingness to allow personal relationships to override this need will greatly harm the enterprise. See JIM COLLINS, *GOOD TO GREAT* 216 (2001).

36. See *In Plain Sight, In Plain English*, *ACROSS THE BOARD* 17 (Nov./Dec. 2002), for a summary of the report of the Conference Board's Commission on Public Trust and Private Enterprise and related observations from experts in governance and compensation. The language from well-known corporate leaders such as Warren Buffett and Andy Grove is strong and straight-forward, indicating that executive compensation has not been handled well and needs reform.

37. The use of options will continue to be the subject of debate until, over time, consensus between boards, management, and shareholder groups is reached, as there are trade-offs that cannot be evaluated in a vacuum. See Gretchen Morgenson, *When Options Rise to Top, Guess Who Pays*, *N.Y. TIMES*, Nov. 10, 2002, § 3, at 1; Daniel Altman, *How to Tie Pay to Goals, Instead of the Stock Price*, *N.Y. TIMES*, Sept. 8, 2002, § 3, at 4.

38. In addition, there is a need for more transparency in executive compensation to prevent the loss of confidence that has been produced by the hidden perks that have come to light as part of the Enron-reform environment. See Ellen E. Schultz & Theo Francis, *Well-Hidden Perk Means Big Money For Top Executives*, *WALL ST. J.*, Oct. 11, 2002, at A1.

of performance is being achieved. This monitoring function includes much more than simply confirming that stock price or net income is increasing. It involves overall monitoring of the long-term health of the organization's value drivers, including financial performance, legal and regulatory compliance, and excellence in people management.

To accomplish this oversight of corporate performance, proper systems of checks and balances must be in place. A key feature to these checks and balances is the flow of meaningful information to the board of directors regarding the overall operation of the corporation. In the 1996 case *In re Caremark International, Inc.*,³⁹ Chancellor Allen of the Delaware Chancery Court summed up this need, stating that "relevant and timely *information* is an essential predicate for satisfaction of the board's supervisory and monitoring role."⁴⁰ While noting that no information system is infallible, Chancellor Allen stated:

[I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.⁴¹

It is in this realm of information flow that the need exists for change from the old methods of interfacing between management and the board. Many CEOs have followed a practice that all communication of information to the board from senior managers would flow first through the CEO, who would then relay that information to the board. To ensure independence of thought and unvarnished perspectives, the board must have key information flowing from senior managers directly to the board, as well as to the CEO. For example, the heads of the legal, finance/accounting, human resources, and regulatory (if applicable)

39. 698 A.2d 959 (Del. Ch. 1996).

40. *Id.* at 970.

41. *Id.* Development by corporations of these information and reporting systems and oversight of these systems by the board will become increasingly important to both public and private corporations. Implementation of "disclosure controls and procedures" designed to ensure that information is "recorded, processed, summarized and reported" in a timely manner is an integral part of the SEC's new rules implementing section 302 of the Sarbanes-Oxley Act. 17 C.F.R. §§ 228-229, 232, 240, 249, 270, 274 (2002). Both senior management and the board will need to have these controls and procedures in place to support the exercise of their duties with respect to the corporation's disclosure obligations under the federal securities laws. For all corporations, public and private, however, the implementation of information systems will likely become an increasingly important aspect of the board's exercise of its informed business judgment. A board that can demonstrate that such a system is in place can better support a claim that its actions should be protected under the business judgment rule.

departments and of any major business division should regularly meet with the board or a committee of the board. In this manner, the board receives information from those more directly responsible and intimately familiar with each major corporate center and can obtain a more accurate overall picture of corporate performance and, by the same token, the chief executive's performance, independently from the chief executive. This independent source of information is imperative for the board to achieve an accurate assessment of performance and, ultimately, to protect shareholder value.

Another important governance issue is limiting the number of boards on which directors may sit. While reasonable minds can differ, there clearly is need for directors to have greater focus and spend more time on board-related matters, which should be reflected in a policy limiting the number of board seats for a director. Finally, there are efforts underway by Moody's, Standard & Poor's, Institutional Shareholder Services, and others to establish corporate governance rating systems.⁴² If they are successful, governance committees may have their agendas driven from these new sources.

III. IMPEDIMENTS TO THE ACCOUNTABILITY FUNCTION

A. *The CEO-Centric Culture*

The concept of board oversight of corporate accountability is not a new one and is inherent in state corporate law, including the Model Act,⁴³ along with case law requiring directors to act as informed fiduciaries.⁴⁴ So where have corporations gone wrong? Why do corporate boards appear to be failing to perform this important function?

The principal problem is that corporate America has developed a CEO-centric culture in the boardroom. Corporate boards of directors have developed a set of behaviors in which deference to, and rubber-stamping of, CEO decision-making is the norm. How did this culture of deference develop? The CEO is the most powerful person in the corporation with the greatest access to information and with comprehensive responsibility for daily management of the business. In carrying out the affairs of the enterprise, the CEO should be in charge. It is natural that directors, in performing their enterprise role, develop a tendency to rely on the

42. See Ken Brown & Robin Sidel, *Scoring Boards On Governance Has Its Risks*, WALL ST. J., Oct. 2, 2002, at C1.

43. See O.C.G.A. § 14-2-830 (2002); N.Y. BUS. CORP. LAW § 717 (McKinney 1997); MODEL BUS. CORP. ACT § 8.30 (1999).

44. See, e.g., *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985); *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990); *Caremark*, 698 A.2d 959.

business decisions of the individual whom they believe to have the most information about and the best understanding of the corporation.

The fact that performance of the oversight function calls for a different dynamic, however, has not been clear. In providing information about the performance of the company, the chief executive is also providing information about her own performance. In the oversight situation, this creates a conflict of interest for the CEO, who has an incentive to pass along information that reflects positively on her performance, but hold back information that reflects negatively. If the board has no independent resources or sources of information, it has no means to verify the level of corporate performance. Without other sources of information, the board has a very limited view of what is actually occurring within the corporation and is therefore restricted in its ability to make truly informed decisions in the corporation's and the shareholders' best interests.

This problem is compounded if the CEO and the chairman of the board are the same individual. She then not only controls daily management, but also the body that oversees overall performance, thereby diluting the ability of the board to provide a separate source for monitoring accountability. The tendency of the board to defer to the CEO's decisions and rely solely on information she provides easily spills over from the enterprise role of the board to the accountability role. Absent a culture that makes the independent directors a separate "power source," the questioning of management decision-making or the level of corporate performance does not occur in a meaningful way.⁴⁵

A further driver of the CEO-centric culture is the standard means of selecting director nominees. The CEO often directs the selection process, and the nominees are often chosen from a group of the chief executive's friends, acquaintances, and peers. This creates a "buddy system" in which board members individually and collectively feel an obligation to the CEO and thus have less incentive to question her decisions. Furthermore, given the prevalence of CEOs on the boards of other corporations, there can be a sense among board members that questioning the decisions of a chief executive of a corporation on whose board they sit may generate unwanted questions from their own board.

Finally, the lack of incentive to question the judgment of the CEO is exacerbated by a lack of financial interest by board members in the

45. In testimony to Congress, board members of ImClone Systems admitted that they knew CEO Sam Waksal had forged signatures on a loan and a stock certificate, but took no action because he was "indispensable." He was finally forced to resign when charges of insider trading were made. See Julie Appleby, *Directors Say They Knew of Waksal's Woes*, USA TODAY, Oct. 11, 2002, at 1B.

corporations on whose boards they serve. There is a sense that in the long run, it is not their money at stake. Without an equity stake in the corporation to align their interests with those of the shareholders, directors have less personal incentive to ensure positive corporate performance.

The foregoing are the true corporate governance issues, as distinguished from other important issues that are involved in seeking to prevent the next Tyco, Enron, or WorldCom. Improving disclosure, requiring truly independent auditors, and punishing wrongdoers are important steps to provide deterrence of future frauds. They are tools that complement good governance. True corporate governance, however, focuses on creating a culture of positive dynamics between board and management that assures integrity and value-creating decisions. While there are many theories about the causes of the recent frauds and scandals, such as decline of ethics, short term financial pressures from Wall Street, and a culture of greed, the CEO-centric culture is the dynamic most directly related to the failure of boardroom oversight.

B. The Role of "Gatekeepers" in Corporate Governance

Many have decried the failure of the "gatekeepers" as a main cause of the recent failures and frauds, citing lapses by accountants, auditors, lawyers, analysts, and investment bankers. Often the concerns are expressed in the context of allegations that individual gatekeepers and their firms helped perpetuate frauds. Criminal and civil actions have been filed in those situations under laws that are adequate to punish the wrongdoers. The important question remaining, however, is whether the corporate failures can be attributed, to some degree, to the systems of regulation that exist for each gatekeeping function. If so, then such regulatory flaws need to be corrected. In addition, there are governance lessons to be learned relevant to the alleged gatekeepers, as discussed below.

The roles played by these functions are quite different, with only audit and accounting constituting true "gatekeeping" functions that have been recognized as serving corporations, with the public as a designated beneficiary of their services. As the accountants became more entrepreneurial, their lead entrée into corporations of providing audit services became a loss leader for more lucrative accounting and consulting services. The culture of cross-selling and disclosed conflicts lead to complacent audits and aggressive accounting decision-making. Sarbanes-Oxley addressed the regulatory failure in the accounting/audit function by creating the Public Company Accounting Oversight Board to install integrity and transparency into this critical governance and

disclosure tool.⁴⁶ Unfortunately, the politicalization of the Oversight Board appointment process set a disappointing tone for the inauguration of these efforts.⁴⁷ As a result, restoring credibility and the highest tone of objectivity will be that much of a longer road. In addition, the Oversight Board and audit committees must address the continued lobbying efforts by accountants to continue providing nonaudit services to audit clients.⁴⁸ The Oversight Board should take the definitive first step and prohibit such waivable conflicts. If it does not do so as a matter of good corporate governance, audit committees should not permit the conflicts created by the performance of nonaudit services to continue. It is time for audits to become a pure and unsubsidized function in order to provide the true gatekeeping role it is designed to supply.

Wall Street investment houses came under fire with revelations that analysts' recommendations were tainted by banking relationships and that clients were favored with profitable IPO allocations.⁴⁹ To fill the regulatory gap, various proposals to assure analyst independence are being pursued⁵⁰ and regulators will act to prevent future "spinning" abuse.⁵¹ Until the analyst function is uncoupled from investment banking, however, objectivity concerns will remain. If the analyst function becomes independent, then it will provide a form of "gatekeeping," but investment banking has never been designed to play that role.⁵² The governance lesson in the investment banking realm is that corporate cultures must be set that would not condone management decisions for personal gains, such as spinning or seeking to artificially maintain stock price, as reflected by recent incidences of management pressuring investment bankers to reverse proposed unfavorable analysts reports.

The basic function of lawyers in our society is to ensure the rights of individuals through counsel and advocacy.⁵³ The attorney-client

46. Pub. L. No. 107-204, § 101, 116 Stat. 750 (codified at 15 U.S.C. § 7211 (2002)).

47. See Michael Schroeder, *Arthur Levitt Finds Himself on the Outs*, WALL ST. J., Nov. 29, 2002, at A4.

48. See Cassell Bryan-Low, *Accounting Firms Are Still Consulting*, WALL ST. J., Sept. 23, 2002, at C1; Robert Luke, *Deloitte CEO Warns of "Trap" in Reforms*, ATLANTA J. & CONST., Oct. 16, 2002, at D4.

49. See *supra* note 16.

50. See *infra* note 68.

51. See Susan Pulliam, Randall Smith & Michael Schroeder, *SEC May Punish Some Executives Who Snared IPOs*, WALL ST. J., Sept. 27, 2002, at C1.

52. See Thor Valdmanis, *Mighty Merrill Lynch Bogs Down in Legal Troubles—Nation's Biggest Brokerage Firm May Be Liable to Investors for Its Ties to Enron, Tyco and ImClone*, USA TODAY, Oct. 10, 2002, at 1A.

53. While there is a tension between the zealous advocate and officer of the court roles of lawyers, those issues are related to making the adversarial system work, not third party

privilege is a vital tool that assures the client that all that is revealed to counsel is confidential and encourages the forthrightness necessary to effectively represent the client. Only in limited situations, such as rendering legal opinions, does the lawyer act for the benefit of third parties and then only at the request of the client. So the “gatekeeper” moniker is not a good fit for lawyers because the lawyer does not perform an audit-type function and must ensure client confidences to effectively ensure the rights of individuals. Yet if a client provides information to a lawyer that he will harm a third party, can the lawyer do nothing and let the crime occur? Rule 1.6 of the American Bar Association Model Rules of Professional Conduct (the “Model Rules”) allows the lawyer to reveal client confidences “to prevent . . . imminent death or substantial bodily harm.”⁵⁴ However, contrary to the attorney ethics rules in most states, the ABA Model Rules do not permit disclosure to prevent or rectify crime or fraud that was reasonably certain to result or had resulted in substantial injury to the financial interests or property of another. In the context of the vast damage done to so many people from the Enron frauds and the apparent failure of its attorneys in this regard, the public can only look askance at the ABA’s failure to address this concern. The ABA is out of step with the public and the ethics rules of many states. It is time that the ABA recognized and allowed this exception to the privilege to resolve this problem. There are similar defects with the existing ABA Model Rule 1.13, which dictates a lawyer’s obligation to report such matters up the corporate ladder.⁵⁵ These two rules must be updated.

The ABA’s failure to act promptly to update these rules in light of the many corporate scandals resulted in an unnecessary intrusion into the state regulation of lawyers in the form of section 307 of the Sarbanes-Oxley legislation. Section 307 requires the SEC to adopt rules requiring lawyers practicing before the SEC to report evidence of material violations of securities laws or breach of fiduciary duties up the chain of command within the corporation.⁵⁶ The language of section 307 is inexact and does not provide clear standards to inform the lawyer when action is necessary. Without clear and narrowly drawn standards such as “actual knowledge” or “reason to know” reportable events, the rules underlying section 307 will be awkward for lawyers to manage in their traditional role of serving the client as an advocate. Furthermore, if the standards are too broad, the lawyer will be turned into a “legal auditor,”

disclosures.

54. MODEL RULES OF PROF’L CONDUCT R. 1.6 (2001).

55. MODEL RULES OF PROF’L CONDUCT R. 1.13 (2001).

56. Pub. L. No. 107-204, § 307, 116 Stat. at 784 (codified at 15 U.S.C. § 7245 (2002)).

spending more time doing diligence to ensure that he is not violating the SEC's conduct rules than fulfilling his role as a counselor and advocate. The current rules proposed by the SEC⁵⁷ reveal the lack of expertise needed to provide the proper balance between the need for attorney-client privilege to meaningfully represent a client and the need to protect the public.⁵⁸ In crafting the final rules, the SEC should work with the ABA and the Chief Justices of the states to gain assurance that all lawyers are subject to proper regulation on these issues.⁵⁹ The SEC must understand that an independent judiciary depends upon an independent bar. Our form of democracy depends upon both, and the regulation of lawyers should be protected from federal ad hoc interference. To the extent that current regulation of lawyers at the state level is not being properly managed, the SEC should work with the ABA and the state courts to enhance that regulation rather than usurping the supervision and enforcement of conduct rules and harming this important balance of federalism.

From a governance perspective, this debate is academic given that a very practical solution is for all boards of directors to instruct their chief legal officer to require all inside and outside lawyers to report such violations to that officer, who in turn will keep the board informed. The governance learning provided in the realm of the role of attorneys is to have the chief legal officer manage evidence of crimes or substantial financial harm with the board.

One final point about lawyers: A board may find situations in which it needs independent advice and investigation on matters of concern to the corporation. Outside counsel that is truly independent should be employed, and its charge should not have restrictions that prevent a full

57. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670-01 (Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

58. These are very important and complicated issues that have been debated by the ABA for decades. To turn the lawyer into a "mandatory discloser" would significantly reduce the practice of clients confiding in their lawyers, which would impact fundamental freedoms of the individual. As a practical matter, many of the states have already adopted the "significant financial harm" exception. On balance, the process of working through the right balance has been successfully accomplished with very thoughtful wordings of ABA Model Rules that are designed to ensure minimal unintended consequences. The words in section 307 do not have such contexts, and clearly, the needed balancing of considerations was not involved in the drafting of this legislation.

59. Judges and lawyers view the proposed regulations as the exact opposite of what is needed. Instead of adopting a narrow interpretation of section 307 to provide for "up the chain reporting," the proposed rules take an expansive interpretation that will chill the attorney-client privilege and violate established federalism principles. It is anticipated that the ABA and the Conference of State Chief Justices will strongly urge significant changes to the proposed regulations and a narrow interpretation of section 307.

and complete analysis of the issues. This was the problem with the Enron special investigation that failed to reveal the fraud. The American Arbitration Association (“AAA”) has established its Independent Fact-Finding Service to make such services available through a panel of qualified fact-finders.⁶⁰ The rules that it has adopted for this program are helpful guides to ensure the needed independence. As advanced in the discussion below on amendments to state law, use of an independent fact-finder by a board should provide a safe harbor for directors.

IV. THE REGULATORY RESPONSE

In response to the recent crises in corporate America, Congress, the SEC, and the SROs have all developed new rules and regulations to rectify some of the more blatant failures of corporate accountability and to re-establish investor confidence in public corporations. The SEC and SROs, particularly the NYSE and Nasdaq, began the charge in early to mid 2002 with the issuance of proposed rules by the SEC and proposed corporate governance listing standards by the SROs. For the most part, the SEC avoided issues of strict corporate governance and focused on disclosure.⁶¹

In late May and early June, Nasdaq and the NYSE both announced that they would be making recommendations to their respective boards of directors for the adoption of additional corporate governance listing standards. Although Nasdaq was the first to propose new rules, the actual rules published were primarily limited to addressing shareholder approval of stock option plans, a more restrictive definition of independence for board members, and audit committee approval of related party transactions.⁶² Nasdaq indicated, however, that it planned to examine

60. For more information about the AAA’s Independent Fact-Finding Service, see <http://www.adr.org/index2.1.jsp?JSPssid=15721>.

61. The SEC focused on better corporate disclosure, issuing releases containing proposed rules on accelerated corporate disclosure of major corporate events and of relationships between corporations and their senior executives, in addition to proposing shorter time frames for filing periodic reports such as annual reports on Form 10-K and quarterly reports on Form 10-Q. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42914-01 (June 25, 2002) (to be codified at 27 C.F.R. pts. 228, 229, 240, 249); Form 8-K Disclosure of Certain Management Transactions, 67 Fed. Reg. 19914-01 (Apr. 23, 2002) (to be codified at 17 C.F.R. pts. 230, 239, 240); Acceleration of Periodic Report Filing Dates and Disclosure Concerning Web Site Access to Reports, 67 Fed. Reg. 58480-01 (Sept. 16, 2002) (to be codified at 27 C.F.R. pts. 210, 229, 240, 249).

62. *See* Press Release, NASDAQ, NASDAQ Submits First Round of Corporate Governance Rule Changes to the SEC; Announces Plan for Additional Issues for Review

additional requirements, including requiring a majority of independent directors on corporate boards, an independent compensation committee, expanded audit committee authority, continuing education for directors, and increased use of codes of conduct.⁶³

The NYSE, however, took a more definitive first step, publishing on June 6, 2002 the recommendations of its Corporate Accountability and Listing Standards Committee.⁶⁴ These recommendations included a comprehensive set of new listing requirements focusing on the importance of the role of independent directors in corporate governance.⁶⁵ The proposals included a requirement for a majority independent board under a much more stringent definition of independence; regular meetings of the independent directors outside of the presence of management directors; independent compensation, nominating/governance, and audit committees, each with increased authority (particularly the audit committee); shareholder approval requirements for equity-based compensation plans; and mandated corporate governance guidelines and codes of conduct.⁶⁶

Before the SEC or SROs could take any action on their respective proposals, however, the WorldCom scandal erupted and Congress stepped into the fray. Stressing to the American public the high importance it placed on corporate accountability, particularly financial accountability, Congress passed and, on July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002.⁶⁷ A large portion of the Act focuses on the establishment of the Public Company Accounting Oversight Board and related oversight of the accounting profession.⁶⁸

This Month, available at http://www.nasdaqnews.com/news/pr2002/ne_Section02_121.html (June 5, 2002).

63. *See id.*

64. *See* NEW YORK STOCK EXCHANGE, CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE REPORT (June 6, 2002), available at <http://www.nyse.com/about/home.html?query=/about/report.html>.

65. *Id.*

66. *Id.*

67. Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-7266 (2002)).

68. Congress focused primarily on the financial and accounting aspects of the recent corporate scandals and sought to put better systems in place to ensure accurate and complete reporting of financial information. Furthermore, much of the act addresses those persons who are generally viewed as external validators of corporate performance, or "gatekeepers," as discussed above in part III. These gatekeepers are supposed to provide external monitoring of corporate performance through review of financial disclosures, legal matters, and market performance, respectively. However, as suggested by the various reforms aimed at the systematic behavior of these gatekeepers, they too have failed in their monitoring function. For accountants and investment banks in particular, a lack of independence has interfered with their ability to act as monitors. The provisions of the

Title III of the Act addresses corporate responsibility, particularly focusing on audit committee responsibilities and the responsibility of the chief executive officer and chief financial officer for financial reporting and disclosure, including review and certification of internal controls to ensure that such disclosure is accurate and complete.⁶⁹

Sarbanes-Oxley Act clearly address various means of ensuring auditor independence, including the prohibition of many “nonaudit” services that tend to impair the independent judgment of the auditor. Pub. L. No. 107-204, § 201, 116 Stat. at 770 (codified at 15 U.S.C. § 78j-1(g) (2002)). Both the SROs and the SEC have been addressing reforms with respect to investment banking firms and particularly conflicts of interest on the part of analysts within those organizations. *See* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45908, *available at* <http://www.sec.gov/rules/sro/34-45908.htm> (May 10, 2002) (approving NYSE and Nasdaq rule changes with respect to analyst conflict of interest rules); Regulation Analyst Certification, 67 Fed. Reg. 51510-01 (Aug. 8, 2002) (to be codified at 17 C.F.R. pt. 242) (proposing Regulation Analyst Certification, which would require certain certifications and disclosures by analysts in connection with companies for which they provide research reports). With respect to lawyers, section 307 of the Sarbanes-Oxley Act requires the SEC to promulgate rules setting forth minimum standards of conduct for attorneys practicing before the SEC, including requirements to report evidence of material violations of securities laws or breaches of fiduciary duties to the chief legal or executive officer of the company and, if such officer does not appropriately respond, to the board, the audit committee, or a committee of independent directors. These requirements are in contrast to proposals of the American Bar Association Task Force on Corporate Responsibility, which is recommending amendments to Rules 1.13 and 1.6 of the ABA’s Model Rules of Professional Conduct. The ABA proposals are more carefully crafted to take into account traditional ethical requirements of lawyers and relate to all attorneys, not just those who represent public companies. *See* Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002).

69. Section 301 of Sarbanes-Oxley addresses audit committee obligations, amending section 10A of the Securities Exchange Act of 1934 to provide requirements for committee membership and to enhance the functions of the audit committee. Pub. L. No. 107-204, § 301, 116 Stat. at 775-77 (codified at 15 U.S.C. § 78f (2002)). This section requires that all members of the audit committee be independent directors, defining independence very narrowly to mean that these directors may neither accept any consulting, advisory, or other compensatory fees from the company (other than in their capacity as directors or committee members), nor be affiliated with persons of the company or any of its subsidiaries. “Affiliated person” is defined in section 3(19) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2002), by reference to the definition of “affiliated person” under the Investment Company Act of 1940, 16 U.S.C. § 80a-2(a)(3). Section 2(3) of the Investment Company Act states:

“Affiliated person” of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting Securities of such other person; (B) any person 5 per centum

With respect to additional corporate governance obligations for executive officers, Sarbanes-Oxley creates two separate certification requirements for chief executive officers and chief financial officers.⁷⁰

or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Id. § 80a-2(a)(3).

With respect to enhanced audit committee authority, section 301 provides that the audit committee is directly responsible for the appointment, compensation, and oversight of the auditing firm employed by the company to prepare and issue audit reports. Pub. L. No. 107-204, § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78f(m)(2)). This responsibility includes the authority to hire and fire auditors and is enhanced by the provisions of sections 201 and 202 of the Act requiring the committee to pre-approve all audit and nonaudit services. Pub. L. No. 107-204, §§ 201, 202, 116 Stat. at 771-73 (codified at 15 U.S.C. §§ 78j-1(h), (i)). Another important monitoring function of the audit committee under section 301 is the requirement that the committee establish confidential and anonymous procedures for dealing with complaints and concerns regarding accounting, internal accounting controls, and auditing matters. Pub. L. No. 107-204, § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78f(m)(4)).

70. Section 906 requires CEOs and CFOs to make a written statement certifying that financial statements comply with periodic reporting rules of the Securities Exchange Act of 1934 and that the information in the reports fairly presents, in all material respects, the financial condition and results of operations of the company. This provision institutes severe criminal fines or imprisonment of CEOs and CFOs for knowing or willful false certifications. Pub. L. No. 107-204, § 906, 116 Stat. at 806 (codified at 18 U.S.C. § 1350) (2002).

Section 302 of Sarbanes-Oxley requires the company's principal executive officer and principal financial officer, who are generally the CEO and CFO, to provide certifications with respect to the company's Form 10-K and Form 10-Q filings. The CEO and CFO must attest to the fact that they have reviewed these reports and, based on their knowledge, there are no material misstatements or omissions in the filings and the financial information in these filings provide a fair representation, in all material respects, of the company's financial condition and results of operations. In addition to certifying the content of the reports, however, the CEO and CFO must also certify that they are responsible for establishing and maintaining internal controls and have designed such controls to ensure material information is made known to them on a timely basis. Furthermore, they must certify that they have evaluated the effectiveness of these controls within the last ninety days and presented the results of the evaluation in the filing along with any changes made since that evaluation. Finally, the officers must disclose to the audit committee and independent auditors any significant deficiencies in the design, operation of, or weaknesses in the internal controls, along with any fraud involving persons with a significant role in those controls. Pub. L. No. 107-204, § 302, 116 Stat. at 777 (codified at 15 U.S.C. § 7241 (2002)). *See, e.g.*, Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46427, available at

After the enactment of the Sarbanes-Oxley Act, the SEC issued a final rule, released on August 29, 2002, that implements the certification requirements in section 302 of the Act.⁷¹ This certification and information collection process is having an impact today as a stark reminder that the signers could be subject to the “perp walks” that are still occurring. The unknown is whether, as time passes, the certification requirement and corresponding threat of liability will be a deterrent to future financial reporting failures.

In addition to the requirements above, there are four other changes in responsibilities and disclosures that reflect the corporate governance concerns of the Act. Section 402 of Sarbanes-Oxley sets out prohibitions on loans made from the company to corporate officers and directors.⁷² Under section 403, the Act requires the SEC to adopt rules implementing accelerated filing of reports by directors, officers, and principal stockholders, reflecting their transactions in the company’s securities.⁷³ Section 404 requires the SEC to adopt rules requiring public companies to include an internal control report in their Form 10-K.⁷⁴ In the internal control report, management must state their responsibility for establishing internal controls and assess the effectiveness of those controls.⁷⁵ The company’s independent auditors must attest to and report on this assessment.⁷⁶ Finally, in direct response to the decline in financial accountability, section 406 of Sarbanes-Oxley requires each public company to adopt a code of ethics for its senior financial officers or to disclose why they have not done so.⁷⁷

<http://www.sec.gov/rules/final/33-8124.htm> (Aug. 29, 2002).

71. The SEC release requires that corporations put in place disclosure controls and procedures, including a recommendation that the corporation form a disclosure controls committee to create an internal information processing system whereby information is made readily available on a timely basis to assist the CEO and CFO in making their required certifications and to assist the corporation in making required disclosures. See *Certification of Disclosure in Companies’ Quarterly and Annual Reports*, Exchange Act Release No. 34-46427, available at <http://www.sec.gov/rules/final/33-8124.htm> (Aug. 29, 2002). The SEC expanded on this release in a subsequent release that proposes to add the concept of “internal controls and procedures for financial reporting” to the certification and disclosure requirements of the initial release. See *Proposed Rule: Disclosure Required by sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002*, Proposed Exchange Act Release No. 34-46701, available at <http://www.sec.gov/rules/proposed/33-8138.htm>.

72. Pub. L. No. 107-204, § 402, 116 Stat. at 787-88 (codified at 15 U.S.C. § 78m(k)).

73. *Id.* § 403, 116 Stat. at 788-89 (codified at 15 U.S.C. § 78p (2002)).

74. *Id.* § 404, 116 Stat. at 789 (codified at 15 U.S.C. § 7262 (2002)).

75. *Id.*

76. *Id.*

77. *Id.* § 406, 116 Stat. at 789-90 (codified at 15 U.S.C. § 7264 (2002)).

Following the enactment of Sarbanes-Oxley, both Nasdaq and the NYSE took additional steps. Their respective boards approved the proposed listing standards, modified somewhat to avoid any conflicts with the provisions of Sarbanes-Oxley and, in Nasdaq's case, expanded to include additional and more comprehensive proposals more in line with the NYSE proposals. On August 16, 2002, the NYSE published its "final" proposals and indicated that they had been forwarded to the SEC for its approval.⁷⁸

The central theme of the NYSE proposals for new corporate governance listing standards, which will be codified in a new section 303A of the Exchange's Listed Company Manual, is the enhanced role of the independent directors. The very first provision in the NYSE proposals requires that each listed company have a majority of independent directors on its board of directors.⁷⁹ In addition to addressing the independent directors as a group, the NYSE proposals require listed companies to establish audit, nominating/corporate governance, and compensation committees that are comprised solely of independent directors. Each of these committees must have a publicly disclosed written charter that sets out that individual committee's purpose, goals,

78. Corporate Governance Rule Proposals (Aug. 16, 2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf. At the time of this writing, both the Nasdaq and NYSE proposals (with the exception of those relating to shareholder approval of equity-based compensation plans) are still in proposed form and are reportedly being negotiated between the SROs and the SEC.

79. *Id.* For a director to be considered "independent," the board has to affirmatively determine that the director has no material relationship with the listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company. The board's determination of independence must be disclosed in the company's annual proxy statement. Certain relationships are affirmatively deemed to preclude independence, including employment by the company or by an auditor of the company, being part of an interlocking directorate in which an executive officer of the company serves on the compensation committee of another company that concurrently employs the director, and having an immediate family member in any of the foregoing relationships (although in the case of employment by the company, only if the family member is an officer). Each of these relationships is subject to a five-year "cooling-off period," during which time the individual is not independent. Furthermore, nonmanagement directors, which may include directors who do not qualify as "independent," must meet regularly at executive sessions without management present to serve as a check on management. The nonmanagement directors must select a presiding director or develop a method of selection of such a director for each meeting and disclose either the one director or the selection process. These directors must also disclose a method for interested parties to communicate directly with the director chosen to preside over the meetings or with the committee as a whole.

and responsibilities, and each is responsible for undertaking annual committee performance evaluations.⁸⁰

The NYSE proposed rules contain two other principal corporate governance requirements. The first is aimed at increasing shareholder control over equity compensation plans by requiring each listed company

80. *Id.* Similar to Sarbanes-Oxley, NYSE proposals focus much of their attention on the audit committee, requiring an increase of audit committee authority and responsibility. Members of the audit committee must not only be independent, but must also meet the tightened definition of independence provided in section 301 of Sarbanes-Oxley. Pub. L. No. 107-204, § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78f(m)(3)). To maintain the independence of audit committee members, their compensation is limited to directors' fees, either in the form of cash or equity. The proposed rules indicate that the committee's purpose must be, at a minimum, to assist board oversight of (i) the company's financial statements, (ii) compliance with legal and regulatory requirements, (iii) the outside auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and outside auditors. In connection with this purpose, the committee has extensive duties and responsibilities. Under its enhanced functions, the audit committee will have the sole authority to hire and fire independent auditors and to approve any significant nonaudit relationship with the independent auditors. The committee must annually review a report by the outside auditors describing issues relating to the firm's internal quality control procedures and its independence, and adopt policies for hiring employees or former employees of the outside auditor. The committee must also discuss the company's financial statements and other financial disclosures with management and the outside auditors, and meet separately with management, the outside auditors, and the personnel in charge of the company's internal audit function to discuss accounting and audit-related matters. The committee must internally discuss earnings releases, financial information and earnings guidance provided to analysts and rating agencies, and the company's risk assessment and risk management policies. Finally, the committee must report regularly to the entire board.

The NYSE proposals charge the nominating/corporate governance committee with identifying and developing criteria for qualified nominees for director and selecting, or recommending that the board select, these nominees for election at the next annual meeting of shareholders. The committee then oversees the evaluations of the board and management. In addition, the nominating/corporate governance committee must develop and recommend a set of corporate governance guidelines to the board. The corporate governance guidelines must address an array of subjects, including director qualification standards, director responsibilities, director access to management and independent advisors, and director compensation.

The compensation committee's role under the NYSE proposals is to discharge the board's responsibilities relating to compensation of the company's executives. The committee's duties and responsibilities are primarily twofold. The committee must make recommendations to the board of directors with respect to incentive compensation plans and equity-based plans. More importantly, however, the committee must review and approve corporate goals and objectives relevant to the chief executive officer's compensation, evaluate the CEO's performance in light of those corporate goals and objectives, and set the CEO's compensation level based upon that evaluation.

to permit shareholders to vote on such plans, with limited exceptions.⁸¹ The second, the requirement that the company adopt a code of business conduct and ethics for directors, officers, and employees, is focused on providing appropriate behaviors throughout the organization. The code of business conduct and ethics must address a number of subjects including conflicts of interest, usurpation of corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, legal and regulatory compliance, and internal reporting of any illegal conduct. As with committee charters and the corporate governance guidelines, this code must be publicly available. Furthermore, any waivers of the code for officers or directors must be approved by the board or a board committee and must be publicly disclosed.⁸²

Nasdaq, while not yet issuing final proposals, published a summary of its proposed new listing standards and began the process of preparing final proposals and discussing those proposals with the SEC.⁸³ While

81. This proposal has been separated from the other proposed listing standards and has been published by the SEC for public comment, with the comment period expiring October 29, 2002. At the time of this writing, the proposal had not yet been approved by the SEC. See NYSE Rulemaking: Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Shareholder Approval of Equity Compensation Plans and the Voting of Proxies, Exchange Act Release No. 33-46620, available at <http://www.sec.gov/rules/sro/34-46620.htm> (Oct. 8, 2002).

82. *Id.*

83. The summary indicates that the new listing standards would encompass a number of new corporate governance provisions, which have been approved by Nasdaq's board of directors. See Summary of NASDAQ Corporate Governance Proposals, available at http://www.nasdaq.com/about/Corp_Gov_Summary091302.pdf (Sept. 13, 2002). The summary has been updated on several occasions as various rule proposals have been drafted and forwarded to the SEC.

Nasdaq, like the NYSE, proposes to increase board independence by requiring that the board be composed of a majority of independent directors. Nasdaq would also strengthen the definition of independence by requiring a threshold determination of independence by the board and excluding, among others, the following persons: directors with any family member who is employed, or has been employed, as an executive officer by the company, or any parent or subsidiary; former partners or employees of the listed company's outside auditor; directors who received payments in excess of \$60,000 from the company or its affiliates, excluding compensation for board service; directors who are partners, controlling shareholders, or executive officers of any entity to which the company made or from which the company received payments exceeding the greater of \$200,000 or five percent of the recipient's gross revenues; and any director who is part of a compensation committee interlock. These exclusions are subject to a three-year "cooling-off period," unlike the five-year period for the NYSE proposals. The Nasdaq proposals also require the board to have regularly convened executive sessions of independent directors.

Independent director status is also important to director nominations and CEO compensation. The Nasdaq proposals require independent director approval of director nominations either by an independent nominating committee or by a majority of the

similar to the NYSE proposals, there are some differences in the respective standards. There is no apparent reason, however, for the SROs to have varying governance listing standards. It is assumed that the SEC, in negotiation with the SROs, will push the SROs to adopt uniform standards that meet the greater governance requirements of the NYSE's proposals.

The requirements and perspectives of Sarbanes-Oxley and the NYSE and Nasdaq proposals differ. The former is designed with a disclosure focus while the latter seek to put the independent directors in charge of accountability to shareholders. Some of the independent director concepts can be found in existing state laws, but not with the procedural rigor provided by the SROs. As discussed in more detail below, melding the foregoing independent director concepts into uniform state law applicable to all publicly traded companies would provide a coherent path to reach the next paradigm in which independent directors take the lead with meaningful oversight.

independent directors. Independent director approval of CEO compensation is also required either by an independent compensation committee or by a majority of the independent directors meeting in executive session.

Similar to Sarbanes-Oxley and the NYSE proposals, the Nasdaq proposals seek to empower the audit committee by increasing its authority and responsibility. Nasdaq would require that the audit committee consist of at least three independent directors, and all audit committee members, independent or otherwise, are prohibited from receiving any compensation other than payment for board or committee service. Under the Nasdaq proposals, the audit committee has the sole authority to appoint, determine funding for, and oversee the outside auditor, in addition to approving all permissible nonaudit services. The audit committee or a comparable body of the board of directors is required to review and approve all related-party transactions. The audit committee will also be responsible for establishing confidential and anonymous procedures for dealing with complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters.

Other Nasdaq proposals include a requirement for shareholder approval for the adoption or material alteration of all stock option plans; a prohibition on company loans to officers and directors; and a requirement that all companies adopt and make publicly available a code of conduct addressing, at a minimum, conflicts of interest and compliance with applicable laws, rules and regulations. Any waivers of the code for officers and directors must be made by the independent directors and must be publicly disclosed. The proposals also include a requirement for shareholder approval for the adoption or material alteration of all stock option plans. As with the corresponding NYSE proposal, this proposal has been published by the SEC for comment, with the comment period ending November 1, 2002. At the time of this writing, the proposal had not yet been approved by the SEC. *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc. Relating to Shareholder Approval for Stock Option Plans or Other Arrangements, 67 Fed. Reg. 64173-01 (Oct. 17, 2002).

V. REACHING THE NEW PARADIGM OF GOVERNANCE THROUGH
INDEPENDENT DIRECTORS EMPOWERED BY STATE LAWS

Sarbanes-Oxley and the SEC have provided meaningful enhancements to financial disclosure through accelerated reporting, improved regulation over accountants, and enhanced corporate reporting processes. The SROs have shown the way to shift from a CEO-centric culture to oversight by independent directors, but they do not oversee all public companies, they do not have an extensive history in the many nuances of governance, and their threat of delisting is an inadequate enforcement mechanism. There are governance federalization advocates pushing to have the SEC assume jurisdiction over corporate governance on the grounds that there is no viable alternative to fill the perceived vacuum. This would be a mistake. The 3-2 votes of the SEC Commissioners implementation of Sarbanes matters and the proposed rules under section 307 of Sarbanes-Oxley demonstrate how governance can become political in the hands of the SEC.⁸⁴

The existing state law regime of governance is the best foundation on which to build the needed clarity of independent directors' obligations to assure accountability by management to shareholders. Independent state judiciaries have demonstrated the expertise and detachment from political quick fixes. The Delaware decisions in particular have shown the flexibility of balancing needed corporate risk taking with management accountability. For the free market system to succeed, some corporations need to fail under the risk/reward scenario, but at the same time the line must be always drawn with management putting shareholder's interests above their own. State statutes and decisions have recognized the needed flexibility in providing both remedies and the ability of shareholders to access them. State law provides the broad perspective required when determining whether proper governance is being provided, and state laws are better equipped to provide realistic policing.

The present lack in state governance laws does not lie in their ability to hold independent directors accountable after the fact; it lies in their failure to assure that independent directors follow oversight processes such as those now proposed by the SROs. To achieve the new paradigm, state laws should explicitly adopt the independent director principles and continue as the guardian of corporate governance.⁸⁵ It is proposed

84. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670-01 (Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

85. Amending the Model Act would provide an effective means to lead states to amend

that the underlying legal basis for independent director oversight of management be confirmed by amendments to the Model Act, requiring all listed companies to meet the below discussed independent director requirements, plus providing a safe harbor by using independent fact-finding. In addition, compliance would be supported through required governance disclosure to monitor compliance with the below-discussed best practices and any variances from them.

Abdication by state law would be unfortunate. The established governance expertise exists in state law. Over many years, the states have crafted thoughtful balances between ensuring accountability and allowing market economy demands to reward or punish management decisions. Reform from within is the best opportunity for a new paradigm, and state law is the best enabler. Absent state corporate law aggressively clarifying through case law or statute the requirement for independent director processes, the claimed vacuum may well be filled by federal preemption. Section 307 of Sarbanes-Oxley and the SEC proposed rules thereunder exemplify how quickly historic understandings under federalism principles can be cast aside.

A. Proposed Amendments to the Model Act and Best Practices

As noted earlier, as companies become public and grow, shareholders, directors, and management no longer know each other. Governance in private companies is much more responsive to shareholders as, typically, the shareholders are also the directors and their money is at stake. Accordingly, it is with public companies that the change is needed, and it is proposed that the Model Act and state statutes be amended to provide a definition of “independent director” and to apply independent director governance provisions to public companies.⁸⁶ The basic

their corporate laws. The Model Act has currently been adopted as state law in forty-four states and is followed in varying degrees by other states. Amendments to the Model Act are typically adopted by states that have already adopted the entire Act. Concerns that states would not adopt the changes but would instead compete by racing to the bottom in governance are out-dated. In light of the current environment and the sophistication and activism of institutional investors, this result is unlikely. The alternative of defaulting to eventual federal preemption is unattractive from a policy point of view and would not be in the best interests of corporations. Finally, the criticism that states' court systems are of varying quality is not a practical concern, as the states in which most public companies are incorporated have created fair and meaningful guidance on governance duties. Institutional investors have been vocal in advocating the principle that good governance enhances shareholder value, and their continued monitoring, in tandem with state law, can provide needed support for the transition from a compliance mindset in corporate governance to a proactive value generator.

86. See MODEL BUS. CORP. ACT §§ 1.40 and 8.02 (1999). For states like Delaware that prefer to act through case law, there is a need for a signal that the case law exists to

governance scheme would be to take the most vigorous of the NYSE and Nasdaq proposals and the recommendations of governance-thought leaders and convert them into state law principles.⁸⁷ The Model Act amendments would provide that independent directors constitute a substantial majority of the board. Board committees consisting solely of independent directors would be required to oversee compensation, nominating/governance, and audit.⁸⁸ The scope, charge, and powers of these committees would be as described above in part IV.

On a few important issues, the SROs pulled back on implementing the new culture, but the Model Act amendments should not. The board's culture and perspective should focus on collaboration on enterprise matters and oversight of management. To take the full step in converting from today's CEO-centric culture to this new paradigm, the amendments should require that the board chair be an independent director. The job description of the chair would be to facilitate oversight and collaboration, not to be involved in enterprise operations, which would remain under the CEO's control. This change will be difficult for many CEOs during the period of realignment, but if implemented

require the independent directors to provide management oversight. Articles, speeches, or new opinions are needed where statutes are not amended to give the needed assurances of the new oversight culture.

87. The Corporate Laws Committee of the ABA's Business Law Section is in the process of developing a White Paper on *Uniformity in Corporate Reform Through Changes to the Model Business Corporations Act* [hereinafter the "White Paper"]. The initial draft of the White Paper proposed many of the revisions to the Model Act discussed in this article, including requiring: (i) a majority of the directors to be independent based on a codified definition of "independent director;" (ii) an independent chairman of the board; (iii) mandatory nominating/governance, compensation and audit committees populated solely with independent directors; and (iv) mandatory prior shareholder approval of significant conflict of interest transactions for directors and officers. These requirements would apply only to "public corporations," which would be specifically defined to mean any corporation with a total market capitalization in excess of \$100 million at the end of the previous fiscal year and which has securities registered under section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") or is required to file reports under section 15(d) of the Exchange Act. The initial draft also proposed including a director's duty of candor in Model Act Section 8.30, Standards of Conduct for Directors, which would require a director, with limited exceptions, to disclose to other directors information within the director's knowledge that would be relevant to decisions made by the board. The duty of candor is aimed at preventing the situation reflected by Enron and other recent scandals in which outside directors were not informed by inside directors of material information, resulting in the outside directors' claim that they were unable to exercise effective oversight through no fault of their own. I favor this approach. The initial draft may well fail to carry the day in light of strong feelings that case law, not prescriptive statutes, is the more desirable approach.

88. See MODEL BUS. CORP. ACT §§ 1.40 and 8.02.

properly, a well-organized and thoughtful oversight structure will be at work for the benefit of all.

The amendments should go beyond existing state law and the SRO provisions by providing that related party transactions involving substantial sums must be approved by shareholders.⁸⁹ The risks of abuse and lack of credibility outweigh the benefits of leaving this approval to directors with subsequent disclosure. Such transactions should not occur except in extraordinary circumstances, and such circumstances would justify the time and expense of shareholder approval.

For a board to provide independent oversight, it must have access to the perspectives and information of senior managers without CEO involvement. This is discussed below under best practices, but the amendments should require that a chief legal officer, in the form of either inside or outside counsel, be designated for the corporation and, at least annually, that individual should meet in executive session with the independent directors. While lawyers understand that the client for a chief legal officer is the corporation, many boards and CEOs do not currently view the chief legal officer's representation in that way. The amendment would make this fact clear, and the executive sessions would complement the requirements of section 307 of Sarbanes-Oxley and Rule 1.13 of the ABA Model Rules.

What is the director to do when she becomes aware of a potential problem within the corporation in which management may have some involvement? What if there are only rumors and it is not clear if the flag being waved is really red? The Model Act should be amended to provide a safe harbor for directors in such situations. The current Model Act provides that board members may reasonably rely on management and outside experts.⁹⁰ There should be more specific comfort in the above situation when the facts are not clear. The amendments should provide that the board may rely on an independent counsel investigation of facts reported to it by the independent counsel. Independence should be defined as a lawyer or firm that does not regularly perform legal work for the corporation and one that is investigating the facts without restrictions from the client on the scope of the inquiry.⁹¹ As mentioned

89. The initial draft of the White Paper would require mandatory approval for any transaction in excess of \$500,000. *See supra* note 51.

90. *See* MODEL BUS. CORP. ACT § 8.30.

91. This definition would prevent the situation that arose in the Enron scandal in which Enron hired its outside counsel to perform an investigation into the surfacing allegations of impropriety, but provided the outside counsel with limited access to information. As a result, the "investigation" failed to effectively address the problems.

above, the American Arbitration Association has an independent fact-finding program that suggests rules and definitions to ensure the needed independence.⁹²

There are other practices that should be followed by most corporations. To allow flexibility for warranted exceptions, which must be explained by disclosure, these practices should be listed as best practices to be monitored by the SROs, institutional investors, and state courts when reviewing allegations of director failings. Although discussed in more detail under the integrated model below, they are basically as follows: Management should meet periodically in executive session with the independent director committees, i.e., internal auditor and CFO with the audit committee, chief compliance officer with the audit committee, chief human resources officer with the compensation committee, and chief governance officer with the governance committee. The chief legal officer would have the statutory duty to meet with the independent directors and in some situations might also fulfill the compliance and governance roles.

The staff functions of finance, human resources, audit, legal, and, where applicable, others should be free-standing and not imbedded in the business units to assure a system of independent reporting to the function head and the board. Too often, fiefdoms are created within business units when these oversight functions are not allowed to report issues of importance up the line to senior management and the board.

Directors should be subject to high quality education and training about the business and critical governance matters. In addition, there should be an annual planning process in which the board is given thorough briefings and the ability to give input on the upcoming annual budget. This process would include a review of all critical assumptions and potential risks facing the enterprise.

In addition to rigorous review of CEO performance by the board, board members should be evaluated by the governance committee on a regular basis. The board should also undertake a macro-level review of how the corporation's governance system is working, including an assessment of the adequacy of information furnished to the board and the meaningfulness of items put on or omitted from the board agenda.⁹³

92. See *supra* note 60.

93. There are some reform proposals that are not recommended at this time. Certain institutional investors advocate such issues as giving shareholders better access to the proxy process to provide their own nominees for election as directors, repealing provisions in corporate charters permitting staggered boards, requiring term limits for directors, and requiring rotation of board or committee members. These issues are more related to the takeover issues that arose in the 1980s than to this Article's focus on producing a new

B. The Board Empowerment Corporate Governance Model

The following model integrates the requirements and proposals described above, along with recommendations and best practices, to establish a culture of board empowerment designed to produce meaningful collaboration on enterprise matters and effective oversight of management. The first step in developing a system to support a culture of corporate accountability is to ensure that those in charge of monitoring accountability are themselves independent and therefore capable of undertaking such a role. The resounding theme of the proposed model is board independence. The existing laws and listing standards will establish the minimum standards. However, the board should evaluate whether a more stringent definition of independence, whether that of another SRO or of an organization such as the Business Roundtable⁹⁴ or the Council of Institutional Investors,⁹⁵ would provide a better benchmark against which to measure independence. The definition adopted should be included in the board's corporate governance guidelines (discussed below) and other documents addressing the structure and responsibilities of the board. To provide a true culture of oversight, the chairman of the board should be one of the independent directors.⁹⁶

Once overall board composition has been addressed, the board should, at a minimum, populate three board committees that are vital to the board's accomplishment of its oversight function: the nominating/governance committee, the compensation committee, and the audit committee. Each has a distinct role in the protection of corporate accountability, as discussed in more detail below. All committee members should be independent, with the audit committee meeting any additional independence requirements of section 301 of the Sarbanes-Oxley Act,⁹⁷ as further interpreted by the SRO listing standards.

culture of board empowerment. If this culture does appear, many of these issues may not seem as important to institutional shareholders.

94. See The Business Roundtable Principals of Corporate Governance, *available at* <http://www.brtable.org/pdf/704.pdf> (May 2002).

95. See The Council of Institutional Investors Corporate Governance Policies, *available at* http://www.cii.org/corp_governance.htm (Mar. 25, 2002).

96. When the chairman and CEO are the same person, there is no effective distinction between the board and management. Consequently, the board cannot effectively serve as an independent monitor of management's performance and shareholder value. To protect the board's ability to fulfill this fundamental role, the two primary sources of power within the organization, the chairman and the CEO, should be separated. See Joann S. Lublin, *Splitting Posts Of Chairman, CEO Catches On*, WALL ST. J., Nov. 11, 2002, at B1.

97. Pub. L. No. 107-204, § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78f(m)(3)).

Furthermore, each committee should have a charter, which is publicly available, that defines the committee's duties and responsibilities. The public nature of these documents permits shareholders and investors to evaluate the basic structure of the corporation's system of governance as embodied by these three independent committees. In addition to the public charters, each of the committees should also have a set of guidelines that establish basic operating procedures and are flexible enough to permit frequent updating as necessary to adjust those procedures to meet the needs of the committee and the company.

A primary role of the first of these committees, the nominating/governance committee, is assisting the board in the evaluation and implementation of an effective independent board structure. This committee should be the entity responsible for identifying director nominees and for ensuring that the nominees meet the appropriate criteria for directors of the company, whether or not they are independent. Senior management and the CEO, due to their intimate understanding of the needs and operations of the corporation, should provide input into determining the criteria for board membership. However, the ultimate decision with regard to the identity of the nominees should be made by the committee, who should then recommend those nominees to the full board for approval.⁹⁸ The board, not the CEO, would then make the offer to the nominee. By removing the selection of director nominees from the realm of the CEO and senior management, the corporation can avoid the problem of the appearance, and perhaps practice, of cronyism plus reliance on the chief executive for one's position on the board as discussed in part III above.

The nominating/governance committee should develop and recommend a set of corporate governance guidelines for full board adoption. These guidelines should set forth the basic qualifications, duties, and responsibilities of directors, including procedures for selecting board and committee members, independence requirements, size and structure of committees, procedures for meetings, director education and compensation, and annual performance evaluations of the board and its committees.⁹⁹ The adoption of these guidelines is an important step in establishing a culture of accountability. They provide a road map for

98. Final approval of the nominees may be made by the committee if the board has delegated such authority to the committee in accordance with applicable state corporate law. Companies should verify that the corporate law of their state of incorporation permits such delegation before attempting to do so.

99. A more appropriate location for committee specific procedures may be in individual committee guidelines, which can address the procedures best suited for accomplishing the duties of the respective committee.

implementing board structure, a fundamental aspect of that culture. They should not simply regurgitate minimum requirements of law and regulation, but should instead represent a thoughtful analysis of the governance structure that would best serve the corporation and its shareholders. Once the guidelines are in place, the committee must monitor the board's progress to make sure they are followed and updated as the terrain changes. Furthermore, by making these guidelines public, the company gains credibility with shareholders, particularly larger institutional shareholders, by providing them with a concrete means of evaluating the company's governance structure.

The nominating/governance committee should also help infuse the culture of board independence into the regular meetings of independent directors. These meetings provide an important forum for the independent directors to discuss enterprise issues and to exercise their oversight function. Ensuring the flow of the right information to the independent directors and meaningful agendas for these meetings is critical. In addition, the independent directors should assure total perspective by meeting in executive session without the presence of interested directors and the CEO. Such meetings also provide the opportunity to obtain the views of management members other than the CEO to obtain a better picture of corporate operation and performance. These meetings should be regularly scheduled, to avoid any stigma being attached to the calling of a meeting. If the chair of the board is not independent, a lead director should be designated as chair to coordinate the meetings and ensure that they are productive. The chairman of the nominating/governance committee, as the individual most responsible for monitoring corporate governance compliance, would be a logical person to lead these meetings. In connection with these meetings, the independent directors should develop procedures for interested parties to make their concerns about the corporation known, as required by the NYSE proposals. These procedures could include publishing meeting dates and times and permitting interested parties to meet with the directors before, during, or after the meeting. The directors could, alternatively, designate a person, potentially the lead director, as a contact person for interested parties and provide a means for contacting that director. These procedures provide an additional means for shareholders to play an important role in corporate monitoring by providing them with direct access to those responsible for corporate oversight.

As discussed in part II, the board must make sure that the appropriate person is in the position of CEO. Here again, the governance committee plays an integral role. In connection with its corporate governance guidelines, the committee should develop criteria for CEO selection and performance review, both as a part of its role in monitoring

current senior management and in developing policies regarding succession planning. These criteria will vary from company to company based on the business needs of the organization and will, therefore, benefit from the input of senior management. As with the criteria for the selection of directors, however, the final criteria should be approved by the independent committee members to avoid any likelihood of management self-perpetuation. The criteria should assist the governance and compensation committees in evaluating the performance of the current chief executive, keeping in mind at all times the central charge of protecting shareholder value. The criteria should also assist the chief executive, providing a benchmark against which to measure his own performance. To the extent that the current CEO is consistently not meeting the performance criteria, the succession planning aspect comes into play, and additional criteria should exist to assist the governance committee in selecting a new chief executive officer.

Essential to the selection and retention of the appropriate CEO is how the corporation compensates that individual to provide the proper incentives for performance and to reward that performance. It is the responsibility of the compensation committee to address this issue. Factors that the compensation committee should review in determining the level of compensation, both for the CEO and other members of senior management, should include a review of current compensation, including incentive-based compensation, and how it correlates with performance achieved in the past year; compensation paid by comparable companies; and the level of executive compensation compared to average employee compensation throughout the corporation. The committee's major challenge is in providing long-term incentives, which play an important part in protecting and enhancing shareholder value. Part of the problem with executive compensation in the recent past has arisen from short-term incentives created by equity compensation, particularly stock options, with a short vesting period. This form of compensation gives the executive the incentive to take actions to increase stock price in the short run, permitting her to exercise the option and immediately sell the stock to benefit from the spread between exercise and market price. The short-term stock price increase and the actions taken to create that increase, however, may not be in the best interests of the corporation from a long-term perspective and may in fact harm both the corporation and the interests of the shareholders. Properly structured equity compensation, however, can be an important part of executive compensation because it directly aligns the executive's interests with that of the shareholders. Compensation committees should give more independent thought to these issues and should explore forms of equity compensation with a more long-term perspective, such as deferred compensation,

restricted stock grants that vest over an extended period, and performance-based option grants.¹⁰⁰ Each of these forms of compensation ties the executive to the company and its performance for a longer period of time, encouraging her to strive toward enhanced long-term performance, which ultimately is the primary concern of the shareholders.

In determining the appropriate types and level of compensation, the committee should turn to an independent compensation consultant retained by the committee, not by management. As noted in the NYSE proposals,¹⁰¹ one of the important prerequisites for assisting the compensation committee in achieving the appropriate level of compensation is its sole authority to retain, terminate, and approve fees and retention terms for a compensation consultant.¹⁰²

The heart of the board's oversight and accountability function rests in its active monitoring of executive performance in light of overall corporate performance and in its protection of shareholder value. Each of the three board committees discussed herein, along with the nonmanagement directors as a group, have a valuable role to play in the monitoring process.

As described above, the nominating/governance committee must monitor both the composition and efficacy of the board itself, along with its committees, to ensure that they are carrying out their responsibilities in an effective manner. An important part of this process lies in assuring that each director receives the appropriate orientation and continuing education to foster and maintain their understanding of the requirements of their dual roles. The new culture must begin with the board itself and should be instilled from the day directors become board members and regularly throughout their term.

This culture must go beyond the board, however. All members of the organization must recognize the importance of fostering corporate performance and the vital role that compliance with laws, regulatory requirements, and systems of best practice developed by the board play in cultivating that positive performance. An effective method of disseminating this message is through the corporate code of conduct. The nominating/governance committee should therefore develop, with the

100. *Id.*

101. *See supra* note 78.

102. *Id.* If the consultant is hired by management and takes its direction from management, then the forms of compensation used are likely to be those that most benefit management, not the company or the shareholders. If, however, the consultant's instructions come from an independent compensation committee charged with the responsibility of providing the proper incentives to foster long-term growth and protection of shareholder interests, the resulting compensation is more likely to focus the executives on their accountability to the shareholders.

assistance of management, a code of conduct that reflects and clearly articulates the company's policies regarding the respect for and protection of the corporation's best interests. The provisions of the code would include compliance with legal requirements; prohibitions of conflicts of interest with the corporation and taking corporate opportunities for personal gain; the importance of confidentiality and fair dealing; and the reporting of activities that are illegal, unethical, or otherwise in violation of the code. As with the corporate governance guidelines, for the code of conduct to be effective it must reflect more than the minimum requirements. The governance committee should monitor compliance with the company's code of conduct and, if necessary, review and approve (pursuant to a very high standard) any waivers of that code for officers and directors. As required by the proposed SRO listing standards, both the code of conduct and any waivers for directors and officers should be publicly disclosed, thereby providing the shareholders with an additional valuable tool for monitoring and evaluating their investment.

In addition to overseeing compliance with the code of conduct, the governance committee should also generally monitor the performance of the chief executive and other members of senior management based on the performance criteria established on the evaluation and selection of the chief executive officer.¹⁰³ This review should be performed at regular intervals, at least twice a year, both to provide for a general performance review and to act in the committee's succession planning role, if the need should arise. Similarly, the compensation committee should monitor CEO and executive officer performance in light of those performance criteria. Based on the level of achievement of those criteria, the compensation committee should adjust senior management's compensation accordingly. The compensation committee has the additional challenge of setting director compensation. Post-Enron, directors are subject to greater risks, duties, and demands on their time as part of their board service.¹⁰⁴ They should be compensated accordingly.¹⁰⁵ Further, some board committees, such as the audit committee, will be asked to do even more. While a uniform base compensation for directors is still appropriate, when additional demands are placed on

103. See *supra* note 80.

104. There is continued uncertainty in the director and officer insurance market which has led some potential director candidates to decline board nominations. See Tamara Loomis, *The Risky Business of a Directorship*, CORPORATE COUNSEL, Nov. 2002, at 122.

105. *Pay of Directors Likely to Rise as Greater Time is Required*, ATLANTA J. & CONST., Nov. 3, 2002, at Q5.

certain directors, they should be paid for meeting them.¹⁰⁶ The stock-versus-cash issue for director compensation should be resolved consistently with the determination on the best way to align the CEO's pay with the long term interests of shareholders.

The third committee, the audit committee, plays a very critical and currently highly visible role in the corporate oversight and accountability process. While the responsibility of the audit committee has steadily increased in recent years, both the Sarbanes-Oxley Act and the SRO proposals have greatly expanded the committee's duties, as described in part IV above. The primary role of the audit committee is oversight of the company's accounting and financial reporting process, including oversight of the preparation of financial statements and the performance of internal and external auditors. These areas are crucial gauges of corporate performance and the primary means for shareholders and the investing public to monitor that performance. As such, the audit committee's effective and informed oversight of these areas is critical to the board's accountability function.

The Sarbanes-Oxley Act stresses the audit committee's supervision of the audit process and the services provided by the independent auditors to ensure auditor independence. These features can be seen in the provisions requiring the committee to have sole authority to hire and fire the independent auditors¹⁰⁷ and to pre-approve all services provided by the independent auditors.¹⁰⁸ The NYSE and Nasdaq proposals incorporate similar requirements. By undertaking these tasks, the audit committee helps to ensure that another independent monitor of the corporate accountability process, the external auditor, also properly performs its role. If the external auditor is retained by the committee, the auditor can provide an additional check to management because it is not reliant on management for its audit engagement. This independence from management is strengthened by audit committee pre-approval of all services provided, restriction of such services to audit, and very limited nonaudit services. As noted above, the committee should carefully consider whether the provision of any nonaudit services is consistent with the auditor's independence. Once the external auditors are independent, they provide an important source of information and knowledgeable review to assist the audit committee in its

106. The NYSE corporate governance proposals reflect this concern, acknowledging the need to increase director compensation in light of increased responsibilities.

107. Pub. L. No. 107-204, § 301, 116 Stat. at 776 (codified at 15 U.S.C. § 78(f)(m)(2)).

108. Pub. L. No. 107-204, § 202, 116 Stat. at 772 (codified at 15 U.S.C. § 78h-1(i) (2002)).

oversight of the corporation's financial performance and, correspondingly, the performance of senior management.

The audit committee's role goes far beyond auditor supervision, however. As highlighted in the SRO proposals, the audit committee must review the company's financial disclosures and ask probing questions of management and the internal and external auditors regarding the contents of those disclosures. The committee must discuss the corporation's major risks and the policies for managing those risks. They must also discuss the critical accounting policies and practices used by the company with management and the external auditor. Each of these responsibilities implicates the audit committee's financial reporting oversight function.

Beyond the realm of oversight of financial reporting, the audit committee also is responsible for addressing the underpinnings of that reporting and the structures that ensure that the reporting is accurate, complete, and timely. Consequently, an important part of the audit committee's function includes meeting separately with the external auditor, the internal auditors (if any), and management to discuss issues raised in the audit, including any problems or disagreements encountered or alternate methods of treating financial information. The audit committee should also review and discuss the procedures followed and performance of each of those three players in the audit process. In the area of monitoring the company's internal controls, the audit committee must review the annual report of the CEO and CFO with respect to those controls and, on a quarterly basis in connection with the certification requirements of section 302 of the Sarbanes-Oxley Act, discuss with those officers any deficiencies in the design or implementation of internal controls or weaknesses in those controls and any fraud involving anyone with a significant role in those controls.¹⁰⁹ Finally, the audit committee must develop and should oversee procedures for dealing with complaints or concerns relating to accounting, internal accounting controls, or audit matters, including confidential, anonymous submission procedures for employees. Each of these areas assists the committee in its monitoring function by ensuring the proper flow of information both within the company and to the committee.

This monitoring of information flow is not just a function of the audit committee, however. As noted above in part II, information flow is a key

109. There will be a natural tendency for the CEO and CFO to shift satisfaction of the certification responsibilities onto the audit committee, which would be inappropriate and inconsistent with the committee's monitoring function. The audit committee does, however, have the oversight responsibility to review reports on internal controls and to ensure their adequacy.

feature of the monitoring function performed by all of the committees and by the board as a whole and provides necessary support to the board's exercise of its business judgment. As Chancellor Allen indicated in *Caremark*:

[C]orporate boards may [not] satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.¹¹⁰

While an important source of this information is the CEO, with his broad knowledge of the corporation, in order to assure accountability, the board and its committees must also have access to information about the company that does not come from the CEO, the primary person that the board seeks to evaluate and monitor.

To put the appropriate information systems in place, the board should look at the overall structure of the corporation. First of all, the senior officer for each of the major operating departments should provide reports regularly to the board and, if necessary, a board committee. These reports will provide the board or the committee with insight into company operations from the persons immediately responsible for those operations. Furthermore, such information will come from a source other than the CEO, providing the board with alternate viewpoints on corporate performance.

A more extensive structure is needed within the various "service" functions of the corporation such as finance/accounting, legal, regulatory/compliance, and human resources. Reporting within the function should be directed upstream to the head of the respective function, as opposed to the head of the business unit that is served by the function. The chief officer of the respective function, although reporting to the CEO within the corporate hierarchy, should also be required to provide regular reports to the board or one of its committees as appropriate.

For example, if a corporation has an attorney on staff who primarily serves the manufacturing department, that lawyer should report to the chief legal officer, not the head of the manufacturing department. While the attorney's decisions and actions would be made with input from the head of the manufacturing department, the relationship with the manufacturing department would be a "client" relationship. The chief

110. 698 A.2d 959, 970 (Del. Ch. 1996).

legal officer, not the head of the manufacturing department, would make critical legal decisions, would supervise the activities of the attorney, and would ultimately be the person to whom the attorney is accountable. The chief legal officer is then aware of the important legal issues within the organization and is able to inform the board of these issues on a regular basis.

This structure provides four important benefits to both the communications process and the corporation's systems of checks and balances. First, this process helps to ensure that the necessary information flows through the corporation to the appropriate members of senior management. This information flow is an integral part of the disclosure controls and procedures required by the new SEC rules implementing section 302 of the Sarbanes-Oxley Act.¹¹¹ Second, it ensures that the member of

111. New rules promulgated under section 302 of Sarbanes-Oxley require the company to maintain "disclosure controls and procedures." Pub. L. No. 107-204, § 302, 116 Stat. at 777 (codified at 15 U.S.C. 7241). The new SEC rules define "disclosure controls and procedures" as:

[C]ontrols and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. "Disclosure controls and procedures" include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

See Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46427, *available at* <http://www.sec.gov/rules/final/33-8124.htm> (Aug. 29, 2002). The SEC recommends that an issuer create a management committee with responsibility for considering the materiality of information and for determining disclosure obligations on a timely basis. In addition to the responsibilities suggested by the SEC, the disclosure committee should help the CEO and CFO audit the disclosure controls and procedures process to ensure it is working properly and should take the necessary action to improve the disclosure process. For example, the committee (or a designee or chairperson of the committee) should prepare a detailed timetable and checklist covering all aspects of the disclosure process for a specific report and should prepare guidelines that specify the responsibilities of the committee members and employees involved in the disclosure process. The committee should report to the CEO and CFO, who have the responsibility for designing, establishing, maintaining, reviewing, and evaluating the company's disclosure controls and procedures. It is crucial that the CEO and CFO have direct involvement with the design and review of the disclosure controls and procedures process because they will have to provide a certification to that effect. Additionally, the disclosure committee should meet with the audit committee to discuss any judgment calls either committee had to make and to discuss significant disclosure items like Management's Discussion and Analysis of Financial Condition and Result of Operation. Recommended committee members include the principal accounting officer or the controller; the general counsel or other senior legal official with responsibility for disclosure matters; the

senior management with the most experience in and responsibility for the respective service function, whether it be legal, finance/accounting, human resources, regulatory/compliance, or otherwise, is either making or aware of critical decisions within that function.

Third, the fact that the service provider (the attorney, the accountant, the compliance officer, etc.) is accountable to the chief officer in their service department rather than the managers of the operating departments that they serve results in more independent decision-making by those service providers. The service provider is not influenced by concerns that she is beholden to the manager of the operating department and can therefore make a decision that the manager may not like without fearing a negative effect on his employment. Furthermore, the service provider is free to make a decision that, while perhaps not in the best interests of the manager or the particular operating department, is in the best interests of the corporation and its shareholders, thus providing an important aspect of the corporation's checks and balances.

Fourth, as noted above, the upstream reporting process provides a source of information to the board and its committees in addition to that of the CEO. Consequently, the board obtains more than one viewpoint on the operations of the corporation and independent verification of the performance of the company and of the chief executive.

Given the importance of the flow of information to the board and its committees in assisting them in fulfilling their accountability function, in addition to their decision-making function, a logical route for the communication of information from the service departments to the board and its committees would be as follows:¹¹²

- The chief legal officer, who will likely have a key role in various aspects of corporate governance including not just

principal risk management officer; the chief investor relations officer (or an officer with equivalent responsibilities); and such other officers or employees, including senior officers associated with the company's business units, and employees involved in the preparation of the company's disclosure reports, as the company deems appropriate.

112. The process described herein is not meant to imply that these individuals should cease reporting to the CEO or that the corporate chain of command should somehow eliminate the CEO as the direct (or indirect, as appropriate) superior of these officers. In fact, such a procedure would undermine the CEO's ability to perform his duties because the flow of information to the CEO is just as vital as it is to the board, as noted in Chancellor Allen's statement in *Caremark* discussed *supra* at note 110 and as reflected in the new SEC rules discussed in *supra* note 61. In order to provide the appropriate checks and balances to ensure sufficient corporate performance, accountability to the shareholders, and the protection of shareholder value, however, the board must have a source of information about the company that comes from someone other than the chief executive officer. The procedures described herein provide that information source in a practical and efficient manner.

legal matters, but also compliance with various reporting requirements and the code of conduct, should meet regularly with the entire board, the nominating/governance committee, and the audit committee.

- The chief financial officer, who plays a vital role in the company's financial reporting process, should regularly meet with the entire board and the audit committee.
- The director of human resources should regularly meet with the compensation committee.
- The chief compliance or regulatory officer (if someone other than the chief legal officer) should regularly provide reports to the entire board, the audit committee, and depending on the areas of compliance monitored by the officer, possibly also the governance committee.

In addition, each of these individuals should also regularly meet with the independent directors in their executive sessions to discuss any matters that the independent directors as a group wish to address outside of the presence of the CEO and other members of management.

VI. CONCLUSION

There can be a very positive future for corporate governance post-Enron. A new paradigm of independent director empowerment leading to active and thoughtful exercise of the enterprise and accountability board functions would be a true source of added value to corporations. There is a sense in the air that thought leaders in the corporate world believe that the "CEO club" days must go and that the independent director model is the wave of the future. For this model to be sustained, the applicable regulatory and legal regimes must fall in line. The SROs and the SEC are not equipped to support the sought-after positive culture of empowerment, but state law is. Existing state case law already calls for much of the new model, but state corporate statutes are not sufficiently specific. Amendments setting forth the responsibility of independent directors combined with existing case law on director duties will provide shareholders with adequate remedies if they sense proper oversight has not been exercised by a board.

The task before the board of directors is not an easy one and is one that can no longer be thought of as a relatively simple ride on the coat tails of the CEO. Serving on a board of directors and particularly on the audit committee and the other committees has become a difficult and time-consuming job in which the directors must maintain an active role. The key, however, for these directors is remembering that monitoring corporate accountability is an equally important role to their enterprise role. Furthermore, vital to that monitoring function is the understand-

ing that a culture of accountability must be developed throughout the organization and structures put in place to foster behaviors that reflect that culture instead of the CEO-centric culture that has reigned in the past. Creating such a culture may require an extensive overhaul of the corporation's current systems of governance and of the structure of its board and will result in additional cost to the corporation to implement these changes. Developing the new culture and putting in place supporting structures, combined with disclosure of the documents (such as corporate governance guidelines, codes of ethics, and committee charters) reflecting that culture and those structures, should go a long way toward restoring public trust in the corporation and, once more widely implemented, the market as a whole. Furthermore, despite initial costs and inefficiencies inherent in developing the culture, the ultimate goal is improved corporate performance and increased shareholder value. The achievement of this goal is attainable for corporations if directors and management rise to the occasion. The upside of so acting is a rich environment in which directors, in collaboration with management, actively tackle critical enterprise issues and provide thoughtful oversight of the performance of management. The key to moving to such self-governance without further federal intrusion is winning the culture battle one corporation at a time.