Public Company Corporate Governance under the Sarbanes-Oxley Act of 2002

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PUBLIC COMPANY CORPORATE GOVERNANCE UNDER THE SARBANES-OXLEY ACT OF 2002

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I. INTRODUCTION

Following a series of corporate scandals, Congress, the Securities and Exchange Commission (SEC), and the stock exchanges proposed and adopted a variety of reforms intended to prevent future wrongdoing. While most of the reforms focus on auditing and disclosure under the federal securities acts, this paper focuses on measures that affect corporate governance. The underlying philosophy of the proposed corporate governance reforms is that the board of directors is responsible for protecting shareholders from management excesses and that independent directors are more likely to be effective in that role. This philosophy, although controversial, is not new. The Sarbanes-Oxley Act of 2002 (SOA) contains some provisions intended to improve board oversight, but, because the SOA operates mainly by amending the Securities Exchange Act of 1934 (1934 Act), its mechanism for affecting corporate governance is primarily through mandating disclosure of governance practices and policies. The stock exchanges have adopted rules that go much further, but those rules affect only those companies listed on the exchanges. Additionally, the SOA addresses primarily issues of accounting and auditing procedures and disclosure. Other factors believed to have played a part in the scandals at Enron,

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WorldCom, and others, such as executive compensation, analyst conflicts of interest, and investment banking conflicts of interest, remain largely unaddressed by this legislation.

II. BACKGROUND: THE ACCOUNTING DEBACLES OF 2001-2002

Beginning in 2001, a number of large and previously well-respected companies announced that their financial statements were inaccurate and that they had misstated their earnings by huge amounts. Enron, WorldCom, and Tyco International were the most spectacular financial disasters, but a surprising number of companies were forced to restate their financial results for a variety of reasons. This seeming epidemic of bad accounting was not unprecedented. In the last years of the 1990s, accounting scandals struck Cendant Corporation, McKesson, Rite Aid, Boston Scientific, Sunbeam, Bankers Trust, and a host of other, less well-known, companies. Nevertheless, Enron and WorldCom caught the attention of the media, the public, and the regulators and led to the passage of the SOA, the promulgation of new rules by the SEC and the stock exchanges, and the adoption of voluntary reforms by a host of companies.

It would be easier to assess the merits of the responses to the recent accounting scandals if we understood what caused them. In an attempt to explain the outbreak of financial misconduct, commentators initially focused on conflicts of interest involving independent auditors and stock market analysts, as well as on corporate governance regulation and practices.

A. Deregulation

Several commentators have suggested that the decrease in regulation throughout the 1990s led to an environment in which natural tendencies to engage in negligent or wrongful behavior went unchecked.\(^4\) The Private Securities Litigation Reform Act of 1995,\(^5\) the Securities

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Litigation Uniform Standards Act of 1998, and a number of key cases reduced the likelihood that plaintiffs in securities cases would prevail or even survive motions to dismiss. During a period (1995-1998) in which the number of SEC filings increased by twenty-eight percent and investor complaints increased by twenty percent, the SEC's budget and workforce were not increased. The number of filings the SEC was able to review declined sharply.

B. The Bubble Effect

It has also been suggested that the number and magnitude of accounting irregularities was the result of basic human nature combined with the opportunities provided by rapidly growing stock prices, and the resulting irrational optimism about the prospects of returns on stock market investments. Market participants purchased stock regardless of the merits of the issuers, and the usual checks on management provided by the market failed.

C. Laxity in the Boardroom

Several commentators have suggested that a corporate culture in which boards defer to management resulted in a lack of oversight of both management and auditors. Many outside directors are full-time executives elsewhere, serve on several boards, and consequently, are unable to spend time reviewing financial results, policies, and management performance even if they are inclined to do so. Enron's audit committee, which had been praised for comprising independent and highly-qualified directors, suffered from this restraint.

7. See Coffee, supra note 4, at 1409-10.
8. See Schlesinger, supra note 4.
9. Id.
Commission on Public Trust and Private Enterprise, a blue-ribbon panel formed by the Conference Board, recently issued a report recommending corporate governance "best practices." The report noted that "strong CEOs appear to have exerted a dominant influence over their boards, often stifling the efforts of directors to play the central oversight role needed to ensure a healthy system of corporate governance." The criticism, discussed below, that the new rules place too great a burden on directors suggests that past practice did not involve extensive oversight by directors.

D. Executive Compensation.

Many commentators have suggested that the scandals of the past few years are directly or indirectly attributable to excessive executive compensation, particularly in the form of stock options or other incentive-based compensation that ties an executive’s pay to a single financial indicator—such as earnings. This led to an overall focus on short-term performance rather than long-term business growth.

III. THE SARBANES-OXLEY ACT OF 2002

Neither the SOA nor any of the rules or proposed rules promulgated thereunder mandate changes in the composition of corporate boards of directors as a whole or change liability standards or standards of behavior for corporate directors. Some of the provisions may, however, indirectly affect pre-existing state law corporate governance rules.

that audit committees at Enron, Adelphia Communications, and Qwest had notice that there were accounting problems but failed to act).

14. Id.
15. See Preliminary Report of the American Bar Association Task Force on Corporate Responsibility, 58 BUS. LAW. 189, 193, July 16, 2002. See also Joann S. Lublin, View From the Top: A CEO Discusses His Unusual Pay Package With a Shareholder Activist, WALL ST. J., Apr. 10, 1997, at R14 (noting that most of Dennis Kozlowski of Tyco International’s compensation was in the form of restricted stock, and quoting him as saying: “I’m very concerned about increasing the earnings per share because I have a vested stake in those earnings.”).
Section 301 of the SOA requires the SEC to enact rules that direct the national securities exchanges and national securities associations to require that listed companies comply with certain requirements for audit committees. These requirements apply only to companies that are listed, or that seek to be listed, on a national stock exchange, the NASDAQ National Market, or the NASDAQ Small Cap Market. Companies that file periodic reports under section 13(a) or section 15(d) of the 1934 Act but that are not listed on a national stock exchange or NASDAQ are not subject to the section 301 requirements.

Section 301 concerns both the responsibilities of an issuer’s audit committee and its composition. Specifically, the rules contemplated by section 301 require

(1) that listed companies have an audit committee of the board of directors that is

directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee;19

(2) that all members of the audit committee be “independent,” as that term is defined in the SOA (see below);20

(3) that the audit committee establish procedures for handling complaints about the issuer’s accounting, internal controls, or

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auditing and for the confidential, anonymous submission by employees of concerns about accounting or auditing;\(^{21}\)

(4) that the audit committee “have the authority to engage independent counsel and other advisors”;\(^ {22}\) and

(5) that the issuer provide necessary funds to the audit committee to pay compensation to auditors and other independent advisors.\(^ {23}\)

While the New York Stock Exchange and the NASDAQ have long required that listed companies have audit committees composed of independent directors, the definition of “independent” contained in section 301(3)(B) of the SOA is much more rigorous than previous definitions. Specifically, audit committee members may not receive any consulting, advisory, or other compensation from the issuer (other than for service as a director) and may not be an “affiliated person” of issuer,\(^ {24}\) although the SEC is given the authority to exempt certain relationships from the independence requirement. Additionally, because section 407 of the SOA requires that a company disclose whether or not it has a “financial expert” on its audit committee,\(^ {25}\) there will be significant pressure on reporting companies to ensure that they have at least one such expert on their audit committees.

**B. Sections 201, 202, and 204—Further Responsibilities of Audit Committees**

In addition to the responsibilities placed upon audit committees by section 301, section 202 of the SOA requires that the audit committee approve all audit and non-audit services performed by an issuer’s

\(^{21}\) Id. § 301(m)(4), 16 Stat. at 776 (codified as amended at 15 U.S.C.A. § 78j-l (m)(4) (West Supp. 2003)).

\(^{22}\) Id. § 301(m)(5), 16 Stat. at 776 (codified as amended at 15 U.S.C.A. § 78j-l (m)(5) (West Supp. 2003)).

\(^{23}\) Id. § 301(m)(6), 16 Stat. at 776 (codified as amended at 15 U.S.C.A § 78j-l (m)(6) (West Supp. 2003)).


auditor.26 If such services are not approved by the audit committee, their performance is a prohibited activity under section 201.27 Any approved non-audit services performed by an issuer’s auditor must be disclosed in the issuer’s periodic reports under section 13 of the 1934 Act.28 Section 204 of the SOA requires that an issuer’s auditor report to the audit committee “all critical accounting policies and practices,”29 all alternative accounting treatments discussed with management, and other “material written communications” between the auditor and management.30 Sections 201, 202, and 204 apply to any issuer required to conduct an audit under the securities acts.

C. Section 407—Disclosure of Audit Committee Financial Expert

Section 407 of the SOA directs the SEC to adopt rules requiring that a company disclose whether it has a financial expert on its audit committee, and if it does not have an expert, an explanation as to why it does not.31 This requirement applies to all reporting companies, even if not listed, and thus it applies to companies that are not necessarily required to have a financial expert on their audit committees.32

The definition of financial expert under section 407 is left to the SEC, which is instructed to consider, in formulating its definition,

32. Existing NYSE listing standards require that at least one member of the audit committee have “accounting or related financial management expertise.” See New York Stock Exchange Listed Company Manual § 303.01(B)(2)(b), available at http://www.nyse.com/listed/listedcomanual.html (last visited Nov. 2, 2003). The NASD requires that audit companies of NASDAQ companies have at least one member who has “past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual’s financial sophistication. . . .” See NASD Manual, Marketplace Rule 4350(d)(2)(A), available at http://www.nasd.com/pdf-text/nasd_manual.pdf at p. 682 (last visited Nov. 2, 2003). Those rules have been made more strict following passage of the SOA. See infra Section IV.B.
whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

(1) an understanding of generally accepted accounting principles and financial statements,
(2) experience in—

(A) the preparation or auditing of financial statements of generally comparable issuers; and
(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions. 33

In response to the mandate directed by section 407, the SEC has adopted a number of rules 34 incorporating the attributes of section 407, but with some modifications. First, the rules require that an audit committee financial expert have an understanding of generally accepted accounting principles and the ability to assess the general application of such principles” in connection with accounting policies. 35 In addition, an audit committee financial expert may have acquired his or her expertise through “preparing, auditing, analyzing, or evaluating” financial statements of similar complexity to the issuer’s. 36 The SEC also provides further guidance on who may qualify as an audit committee financial expert. 37

35. Id. at 9.
36. Id.
37. Id. at 9-15.
The SEC's rules require that a company not only disclose whether or not it has a financial expert on its audit committee, but also the expert's name and whether or not he or she is "independent," as that term is defined in the SOA. Furthermore, the rules require that the company disclose the person the full board of directors has identified as the financial expert. The SEC stated in the Release proposing the Section 407 rules that it believes that the full board is "best-equipped" to make that determination; and by requiring this disclosure, the rules in effect require that the full board, rather than management or the audit committee itself, act to identify the expert. The SEC also stated that a board may not rely solely on the fact that an individual has previously served on an audit committee or has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer. Rather, the board must consider whether such persons have "the requisite attributes and the right mix of education and experience."

The SEC has not adopted rules, or otherwise provided guidance, relating to an issuer's disclosure about why it does not have a financial expert on its audit committee. It remains to be seen whether issuers that are not listed, and therefore not required to have a financial expert on their audit committees, will be pressured to name such an expert by the disclosure requirement.

D. Section 406: Code of Ethics Disclosure

Section 406 of the SOA directs the SEC to adopt rules requiring that a company disclose whether it has adopted a code of ethics for senior

40. Id. § II (A)(2), at 8-9.
41. Id. § II (A)(2), at 9.
42. Martin Lipton of Wachtell, Lipton, Rosen & Katz is reported to advise clients who do not have a qualified financial expert on their audit committees to state that the Board has selected directors for the audit committee "based on the Board's determination that they are fully qualified to monitor management and our internal accounting operations and the independent auditors and are fully qualified to monitor the disclosures of the company to that end that they fairly present the company's financial condition and results of operations." The company can also point out that the audit committee has the authority to hire advisors to assist it in carrying out its duties. See Sarbanes-Oxley Act Question of the Week, CORP. COUN. WKLY. (BNA), Nov. 20, 2002, at 355.
financial officers, and, if it has not done so, why not.\textsuperscript{43} The SOA also directs the SEC to adopt rules to require prompt disclosure on Form 8-K of any changes to or waiver of the code of ethics.\textsuperscript{44} The SOA defines a "code of ethics" to be

such standards as are reasonably necessary to promote--

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with applicable governmental rules and regulations.\textsuperscript{45}

Pursuant to section 406, the SEC has adopted rules that expand the coverage of that section. First, the new rules relate to codes of ethics not only for senior financial officers, but also for a company's "principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions."\textsuperscript{46} In addition, the term "code of ethics" is broadened to include not only the three prongs quoted above but also "[t]he prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and [a]ccountability for adherence to the code."\textsuperscript{47}

Any company that does not have a code of ethics that includes standards encompassing each of these items, even if it has a code of ethics, would not be able to affirm that it has the type of code contemplated by the rules, and would be subject to the requirement that it explain why it does not have such a code.\textsuperscript{48}

\textsuperscript{44} Id. § 406(b), 16 Stat. at 789 (codified as amended at 15 U.S.C.A. § 7264(b) (West Supp. 2003)).
\textsuperscript{45} Id. § 406(c), 16 Stat. at 789-90 (codified as amended at 15 U.S.C.A.§ 7264(c) (West Supp. 2003)).
\textsuperscript{46} Section 406 Release, supra note 34, § II (B)(1), at 18.
\textsuperscript{47} Id. § II (B)(2)(C), at 19.
\textsuperscript{48} Proposed Section 406 Rules, supra note 39, § II (B)(2), at 1, § II (B)(3), at 17.
A change to a company’s code of ethics, or a waiver of the code for any officer covered by the code, must be reported within two business days on Form 8-K or posted on the company’s internet website.\footnote{Section 406 Release, supra note 34, § II (B)(5), at 20-21.}

E. Executive Compensation Under Sarbanes-Oxley

The SOA contains only one provision relating to executive compensation, section 402. This section makes it unlawful for an issuer to “extend or maintain credit” or otherwise lend money to a director or executive officer, with limited exceptions for housing loans or loans in the ordinary course of business.\footnote{Sarbanes-Oxley Act of 2002, Pub. L. No. 207-204, § 402(k)(1), 16 Stat. 745, 786 (2002) (codified as amended at 15 U.S.C.A. § 78m (k)(1) (West Supp. 2003)).} This will eliminate the practice of executives borrowing from the company to purchase company stock.\footnote{This practice has the advantage of enabling executives to acquire stock which thereby aligns their interests with those of other stockholders. However, it has the disadvantage of linking the personal solvency of the executive to the stock price. See Lublin, supra note 13 (noting that at that time CEO Kozlowski owed Tyco International $11 million for taxes on his restricted stock and usually spent his annual bonus on interest payments).}

IV. NEW STOCK EXCHANGE RULES: NYSE AND NASD

Even before the enactment of the SOA, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) were discussing changes to the requirements for companies listed on the exchange or on NASDAQ. The NYSE and NASD have each adopted rule changes, approved by the SEC, addressing shareholder approval of stock option plans and other corporate governance matters.\footnote{The NYSE rule changes are available on the Internet at http://www.nyse.com/finalcorpgovrules.pdf [hereinafter NYSE Final Rules]. A summary of the NASDAQ rule changes is included in NASD and NYSE Rulemaking: Relating to Corporate Governance, Rel. No. 34-48745; File Nos. SR-NYSE-2002-33, SR-NASD-2002-77; SR-NASD-2002-80; SR-NASD-2002-138, SR-NASD-2002-139, and SR-NASD-2002-141, available at http://www.sec.gov/rules/sro/34-48745.htm [hereinafter NASD Rule Release].}

A. Shareholder Approval of Stock Option Plans

Both the NYSE and the NASDAQ have changed their listing requirements to require that all equity compensation plans for employees
be submitted for shareholder approval.53 There are exceptions only for inducement options, plans relating to mergers and acquisitions, and tax qualified and excess benefit plans.54 In addition, the rules have provisions requiring shareholder approval for “material revisions” to plans and for repricing of options in some circumstances.55

B. Corporate Governance

Both the NYSE and the NASDAQ have adopted new listing standards requiring that issuers have boards of directors composed of a majority of independent directors.56 The definitions of “independent” in the new rules vary somewhat but are much stricter than previous rules.57

In addition to the requirement that boards be composed of a majority of independent directors, the new listing standards give those directors special responsibilities. For example, the independent directors must meet separately from the other directors to nominate new directors and approve executive compensation.58 Furthermore, the independent directors must meet without management at regularly scheduled intervals.59 This rule is intended to empower the independent directors to serve as a “more effective check on management.”60


54. Id.

55. Id.

56. NYSE Final Rules, supra note 52, §303(A)(1); NASD Rule Release, supra note 52, at 1.

57. At Disney, for example, several directors previously considered independent failed the new tests, including two who received compensation for services and three who have immediate family members employed by the company. See Bruce Orwall, Disney Board Braces for Impact of New Independence Rules, WALL ST. J., Aug. 12, 2002, at B1; NYSE Final Rules, supra note 52, § 303(A)(2); NASD Rule Release, supra note 52, at 1, 2.

58. The independent directors must meet in executive session to approve compensation for the issuer’s chief executive officer. The CEO may participate with the independent directors in determining compensation for other executive officers. NYSE Final Rules, supra note 52, § 303(A)(5b)(ii)(A); NASD Rule Release, supra note 52, at 14.

59. NYSE Final Rules, supra note 52, § 303A(2); NASD Rule Release, supra note 52, at 14.

60. This has been a highly controversial requirement. Most independent directors approve of the practice, but management representatives have objected to it. See, e.g.,
Both the NYSE and the NASDAQ rules also include rules for audit committee members that conform to the requirements of the SOA described above: audit committee members must receive no compensation from the issuer other than for board or committee service, and at least one member must have financial expertise. They also, however, require that all members of the audit committee be financially literate (able to read and understand financial statements).

V. THE SOA—GOOD, BAD, OR EMPTY?

Since the adoption of the SOA, many lawyers and other commentators have criticized its provisions for increasing the burden on directors, especially audit committee members, thus making it unreasonably difficult for companies to find qualified individuals to serve on boards and committees, especially the audit committee. In addition, some commentators have expressed concern that the new responsibilities of some board committee members may increase the potential liabilities such directors face and act as a further disincentive to board service. Others have criticized the new rules for establishing an adversarial relationship between a board and management.

A. Unreasonable Burdens?

Some commentators have suggested that the SOA and the SEC rules impose unreasonable burdens on audit committee members. Public
company audit committees have long been responsible for overseeing an issuer’s audit and financial reporting policies.\textsuperscript{68} The attention that President George W. Bush and former FBI and CIA director William Webster received for service on the audit committees of companies with irregularities in their financial reporting is evidence that even under pre-existing law, audit committee members were expected to exercise oversight of the financial reporting process.\textsuperscript{69} The SOA and the new rules formalize and specify the audit committee’s responsibilities but theoretically do not change its function. It is perhaps more accurate to say that the new rules attempt to make audit committees take their existing role more seriously.\textsuperscript{70} They do not require that audit committees certify the accuracy of financial statements or take direct responsibility for the substance and content of financial reports.

It may, however, be true that in order to adequately perform the functions of an audit committee member, an individual will have to devote more time and attention to committee matters than has been the custom. The NYSE has recognized this reality by adopting the rule that if a member of an audit committee serves on more than three such committees, the issuer’s board must make an express determination that the member has the time available to serve on the issuer’s audit committee.\textsuperscript{71} The NYSE also supports additional compensation of audit committee members.\textsuperscript{72} Considering the important role the audit committee plays in safeguarding not only the interests of shareholders but also the integrity of the issuer’s financial reporting and disclosure, it is appropriate that additional funds be allocated to compensating the members of those committees.

Identifying, retaining, and compensating qualified and independent audit committee members should be viewed as a regular and essential corporate function, as worthy of attention and expense as the hiring of

\textsuperscript{68} See Plitch, supra note 64 (quoting corporate governance “guru” Ira Millstein that directors are only being asked to do “what they were supposed to be doing in the first place”).

\textsuperscript{69} See also Strine, supra note 12, at 1402 n.55. See generally id. at 1388-95.

\textsuperscript{70} A year after passage of the SOA, the Wall Street Journal reported that audit committees were in fact taking their jobs more seriously—reviewing more extensive materials before meetings, taking the lead in choosing to rotate the auditor’s lead audit partner, and questioning accounting practices. See Carol Hymowitz and Joann S. Lublin, Corporate Reform: The First Year: Boardrooms under Renovation---Scandal Prompted Changes, But Critics Say More are Needed to Prevent Another Enron, WALL ST. J., July 22, 2003, at B1.

\textsuperscript{71} NYSE Final Rules, supra note 52, § 303A(6) (commentary).

\textsuperscript{72} Id.
public auditors or the printing of disclosure documents.\textsuperscript{73} The \textit{Wall Street Journal} noted, for example, that a “Catholic priest, theology professor and former Georgetown University president” was leaving Disney’s audit committee to make room for an expert.\textsuperscript{74} Such an eminent individual may very well bring significant expertise and value to a board of directors, but the ability to understand the risks and implications of complex accounting policies, such as those at Enron, is not necessarily concomitant with noteworthiness, and high-profile board members may not, in fact, be appropriate audit committee members. In the words of the SEC, “The Sarbanes-Oxley Act was intended to enhance corporate responsibility by effecting significant change; its purpose was not to perpetuate the status quo.”\textsuperscript{75}

\textbf{B. Expanded Liability for Directors?}

Some commentators have questioned whether the SOA and the rules promulgated thereunder will increase the liabilities of directors in general or audit committee members in particular.\textsuperscript{76} The SEC, in promulgating rules defining audit committee financial experts, opined that

\begin{quote}
[t]he mere designation of the audit committee financial expert would [not] impose a higher degree of individual responsibility or obligation on that person. Nor did we intend for the designation to decrease the duties and obligations of other audit committee members or the board of directors.\textsuperscript{77}
\end{quote}

\textsuperscript{73} In the words of SEC Commissioner Cynthia Glassman, “if it is the responsibility of management and the board to maximize long-term shareholder value, companies that cut corners on compliance [with recent corporate governance reforms] fail in this regard by jeopardizing the long-term profitability, and ultimately the viability, of the company.” Commissioner Glassman Addresses Corporate Governance, CCH \textit{FEDERAL SECURITIES LAW REPORTS} No. 2045, Oct. 2, 2002.

\textsuperscript{74} See Bryan-Low, supra note 64. The \textit{Journal} also noted that Warren Buffett might not constitute a “financial expert” under the proposed SEC rules, because he did not have expertise in accounting. \textit{Id}. The rules finally adopted by the SEC addressed this concern by defining expertise to include experience in analyzing, as well as preparing, financial statements. See Section 406 Release, supra note 34, at 11.

\textsuperscript{75} Section 406 Release, supra note 34, at 14.

\textsuperscript{76} See Members of Audit Committees Exposed to Greater Liability Post-Sarbanes Oxley, 71 U.S.L.W. (Dec. 10, 2002) at 2384 (quoting plaintiffs’ attorney Herbert E. Milstein); Pritch, supra note 64; \textit{Audit Committees Must Be Aware of New Liability Risks, CORP. COUN. WKLY.} (BNA), Nov. 26, 2003, at 368.

\textsuperscript{77} See Section 406 Release, supra note 34, § II.A.5, at 15-16.
Furthermore, the SEC explicitly stated that an audit committee financial expert is not to be considered an expert for purposes of section 11 of the Securities Act of 1933.\textsuperscript{78} There are a number of reasons to believe that the state law liability of an audit committee member will not be affected by the new rules.\textsuperscript{79} With respect to the duty of care, directors are often said to be held to the standard of “an ordinarily prudent person . . . in a like position and under similar circumstances.”\textsuperscript{80} There is no variation in the standard of care based on a director’s particular talents or expertise. More importantly, the business judgment rule protects disinterested directors who have acted with reasonable investigation and adequate information, so the standard of care in Delaware is gross negligence.\textsuperscript{81} Other cases considering the board’s duty to monitor corporate conduct, which is part of the duty of care, have described the board’s duty as 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.\textsuperscript{82}

Put another way, “a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists . . . .”\textsuperscript{83} Imposing liability on an audit committee member would thus require a showing that he or she made no such attempt, acted in bad faith, or approved the adoption of controls that were not “reasonably designed” to ensure compliance.\textsuperscript{84}

\textsuperscript{78} Id.
\textsuperscript{79} Of course, plaintiffs are likely, at least initially, to argue otherwise. See Plitch, supra note 63 (noting view of Ira Millstein that, although litigation is likely to increase, actual liability is not likely to increase).
\textsuperscript{80} PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994). See also Hargrave v. Canadian Valley Elec. Coop., 792 P.2d 50, 57 (Okla. 1990).
\textsuperscript{81} See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); compare Hargrave, 792 P.2d at 57.
\textsuperscript{82} In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
\textsuperscript{83} Id. (amended 2003 by 2003 Del. Laws 51 (2003)).
\textsuperscript{84} Id.
Such a showing will be difficult to make, and in any event the liability for failing to assure that such controls exist is not new.

Additionally, a Delaware corporation may include in its certificate of incorporation a provision eliminating or limiting a director’s liability for money damages for breaches of the fiduciary duty of care not involving bad faith or knowingly illegal conduct. Audit committee members acting in good faith would be protected from liability by such a provision. Institutional investors tend to support the adoption of such exculpatory provisions because they encourage board and committee service by qualified individuals.

It is to be expected that plaintiffs will challenge audit committees’ and boards’ good faith in litigation based on infrequent or brief meetings, cursory attention to complex financial issues, or ties to management that appear too close. Counsel should advise such committees on the importance of devoting substantial time and attention to fulfilling their oversight obligations. It is also possible that courts will apply existing rules more rigorously in light of the change in the political and social climate brought about not by the SOA but by the financial scandals that preceded and precipitated it. The Chief Justice of the Delaware Supreme Court has noted that judges are “stewards of setting the tone and the course of investor confidence incorporate governance.” Several recent Delaware chancery decisions have let challenges to director conduct and independence go forward. The fact that those cases survived motions to dismiss may indicate a changed attitude by the court, but in neither case did the court articulate new standards.

With respect to liability under the federal securities laws, a recent case decided under pre-SOA law illustrates that audit committee members have always been at risk. Members of the audit committee,

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86. See Strine, supra, note 12 at 1385 n.49.
87. For an excellent discussion of the arguments plaintiffs are likely to make, see Strine, supra note 12, at 1385-95. Vice-Chancellor Strine ultimately concludes, first, that courts must “proceed with great caution when confronted with [such] arguments,” but that “the law demands that directors be held accountable if they are clearly proceeding with conscious knowledge of their own inadequacy in performance.” Id. at 1393.
89. See In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).
90. See In re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).
92. However, the fact that the case was decided after the recent accounting scandals
among others, were sued for violation of section 10(b) of the 1934 Act (which prohibits fraud in the sale of securities) based on their having allegedly signed false documents.93 The court ruled that the plaintiff had raised sufficient evidence of recklessness to survive a motion to dismiss, in light of the fact that the company had failed to adopt internal audit controls despite the persistent advice of the company’s independent auditor, KPMG; in light of the fact that the audit committee had agreed to hire an internal auditor and review financial reports but had failed to do so; and because KPMG “continually” noted questionable accounting practices at the company.94 It is difficult to argue, in light of such facts, that an audit committee should be protected from liability. It is also the case, however, that securities fraud cases are much more likely to survive motions to dismiss since passage of the SOA.95 This trend may reflect a changed attitude by judges rather than a change in the legal standards determining liability.

C. The Role of the Board

Finally, some commentators have argued that the SOA and proposed rules contemplate an adversarial relationship between the independent directors and management. There may be some truth in this observation, but some degree of dissension between the board and the officers is neither new nor inappropriate.96 The ultimate managerial authority in a

raised awareness of the importance of audit committee oversight probably affected the court’s view of the matter.

93. See Lernout, 286 B.R. at 37-39. The court also ruled that audit committee members may be “control persons” for the purposes of Section 20(a) of the 1934 Act. See id. at 39-41.

94. See id. at 37-38.


96. In a 1961 case holding an independent director liable for failing to prevent wrongdoing by management, the court observed:

These men are prime examples of what can happen when a man undertakes a substantial responsibility with public overtones without any appreciation of his obligation thereunder. . . . [T]hese non-affiliated directors gave almost automatic approval to the management Agreement; they did not examine the registration statements carefully; they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties; most of the time at the directors’ meeting was spent in determining dividends on the basis of work sheets provided by the [wrongdoers]; the directors did not know who selected securities for purchase or sale;
corporation lies with the board as a whole. The officers are appointed to carry out the directions of the board. Just as employer-employee relationships may contain an element of dissension in the employer’s oversight of his or her employees, the board should be prepared to oversee, and where appropriate challenge management’s performance. This is not a new requirement, and many well-run boards have engaged in vigorous oversight over the past decade.\textsuperscript{97} If management views such attention as interfering or adversarial, it is misunderstanding both the legal role of the board and its own responsibilities. In fact, as discussed below, executives’ expectations about the role of the board have been changing over the past several years.\textsuperscript{98}

VI. MARKET-DRIVEN DEVELOPMENTS IN EXECUTIVE COMPENSATION AND GOVERNANCE

The SOA and the rules promulgated by the SEC with respect thereto stopped short of requiring radical changes in the way executives are compensated and boards operate. Nevertheless, many firms are changing their practices.

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\textsuperscript{97} In a 1994 speech, well-known corporate governance expert Ira M. Millstein of Weill, Gotschal & Manges spoke of the need for board members who “understand that their principal roles are to evaluate management, and to replace underperformers in a timely manner; and who have such stature and lack of relationship to management and the corporation as to be believable.” Laurie Cohen, \textit{Why 2 Tyco Directors May Keep Their Jobs}, \textit{Wall St. J.}, Nov. 6, 2002, at C1. Jeffrey Sonnenfeld of the Yale School of Management notes that directors at companies such as Enron, Tyco, and WorldCom followed most accepted practices but failed “to question enough and to think of dissent as an obligation–qualities that directors at the highest-performing companies routinely exhibit.” Carol Hymowitz, \textit{In The Lead: Building a Board That’s Independent, Strong and Effective}, \textit{Wall St. J.}, Nov. 19, 2002, at B1.

\textsuperscript{98} See also Bruce Orwall, \textit{Leading the News: Disney’s Eisner Feels New Pressure}, \textit{Wall St. J.}, May 31, 2002, at A3 (describing an upsurge in “director activism” in the entertainment business as companies’ performance has lagged).
A. Executive Compensation

With the exception of section 402 of the SOA, which prohibits issuer loans to officers and directors,99 and the rule changes to the NYSE and NASDAQ listing standards requiring shareholder approval of stock option plans,100 there have been no changes to the laws and regulations governing executive compensation. During the last Congress, several bills were introduced that would have addressed compensation issues, including requiring issuers to include stock option expenses in their earning calculations. Those efforts were not successful. In the interim, however, a number of major public companies voluntarily began including stock option expenses in their earnings.101 The information necessary to calculate stock option expense is publicly disclosed in a company’s financial statements, and so may receive further attention from analysts and institutional investors even if the company does not disclose the calculations directly. In addition, investors have occasionally increased pressure on boards to consider compensation more carefully.102 Disney’s shareholders’ outrage at the severance package awarded to Michael Ovitz and the pay package awarded Michael Eisner led to an acrimonious shareholder meeting and eventual changes in the composition of Disney’s board.103 Thus, voluntary and private market-based action may lead to greater disclosure of the costs of stock options to issuers.104 Whether such disclosure will eventually lead to changes in executive compensation practices remains to be seen.

100. See supra note 53.
101. See Steve Burkholder, FASB Plans Final Rules on Special-Purpose Entities, Expensing of Stock Options, Hybrid Debt-Equity Instruments, CORP. COUN. WKLY. (BNA), Nov. 20, 2002, at 360 (noting that 150 companies have announced that they would begin expensing stock options).
102. See Wade Lambert, Glaxo Listens to Shareholders and Calls Off CEO Pay Boost, WALL ST. J., Nov. 27, 2002, at B2 (noting that several U.K. companies, including GlaxoSmithKline PLC, had responded to investor concerns about “disappointing share prices and soaring compensation packages”).
104. There is a considerable degree of controversy over the way such costs should be calculated. See Robin Sidel, Heard on the Street: Two’s a Crowd and Three’s Confusion When Accounting for Options Expenses, WALL ST. J., Sept. 6, 2002, at C1 (also published as Three Choices Are Two Too Many for Expensing Options).
Corporate Governance Under Sarbanes-Oxley Act

B. Corporate Governance

Even in the absence of regulatory change, many public companies are changing their corporate governance practices, and institutional investors are prodding those companies that have not yet done so. Separating the positions of CEO and Chair of the Board, which provides a degree of independence for the board because the agenda is not set by the CEO and which also provides an advisor and board liaison for the CEO, is becoming increasingly common. Activist investment firm Providence Capital proposed a bylaw amendment to require the split at six issuers' annual meetings in 2003. Fidelity Investments, California Public Employees Retirement System, and the American Federation of State, County and Municipal Employees Pension Plan have all been active in seeking changes to board practices.

Institutional investors can stimulate change on a variety of issues, including board practices. Pension fund TIAA-CREF advocates a number of governance measures, including a board composed of a "substantial majority of independent directors," removal of anti-takeover devices such as "poison pills," and takes steps, including proposing shareholder resolutions, if an issuer is not responsive to their concerns. In the past, TIAA-CREF used its influence to force companies to increase the number of independent directors on their boards.

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108. This is not a new phenomenon. See Greg Ip, As Activists Flex Muscles, Bull Charges Ahead, WALL ST. J., June 8, 1998, at C1.


111. See Joann S. Lublin, Major Disney Investor Scraps Proposal Calling for Greater Board Independence, WALL ST. J., Dec. 4, 1998, at B6 (noting that the pension fund was
Similarly, Vanguard Group, the mutual fund company, pressures companies on executive pay, auditor independence, and audit committee oversight.  

Companies increasingly respond to shareholder pressure. General Electric Co. (GE), for example, has been a leader in reforming its board. In 2002, it announced the appointment of a presiding director who will call at least three meetings of outside directors a year, a requirement that two-thirds of the board be independent, the elimination of stock options for directors and their replacement with deferred stock grants, a limit on the number of other boards and committees on which GE directors can sit, and a policy requesting all outside directors to visit two GE businesses each year outside the presence of management. Other companies have adopted reforms in response to a variety of pressures:  

E*Trade reacted to an “investor rebellion” following a sharp drop in the stock price but an increase in executive pay; Apria Healthcare agreed to let shareholders nominate director candidates at the urging of an activist investor who serves as board chairman; Siebel Systems agreed to governance changes as part of the settlement of shareholder litigation. Some studies have suggested that poor corporate governance practices can correspond to poor corporate performance.

sponsoring proposals at four companies in 1999 and withdrew five when the issuers agreed to restructure their boards).


113. Stock grants are perceived to be less subject to abuse than stock options, because the recipient of an option can only benefit: if the stock price increases, so does the value of her option. If the stock price declines, she suffers no out-of-pocket loss. With actual stock, however, the holder suffers a real loss if the price declines. In addition, stock grants are not subject to “repricing,” in which the exercise price of an option is reduced to preserve the option’s value after a decline in the price of the underlying stock.


If so, market-pressures are likely to cause more far-reaching reforms than the SOA contemplated.

C. Case Study: Walt Disney Co.

The Walt Disney Company (Disney) provides a useful example of the way corporate governance practices change, or fail to change even when regulation is not involved. In 1996, Business Week named Disney one of the worst boards in America, largely because of the number of insiders on its board. The following year, it won the honor of worst board. At the company’s annual meeting that year, nearly thirteen percent of shareholders withheld support for the directors up for election, and the “bashing” of the company and CEO Michael Eisner lasted for six-and-a-half hours. In addition to the lack of independence on the board, shareholders were angry about a huge severance package given to former President Michael Ovitz and Eisner’s own unusually large compensation package. Eisner’s attitude was defiant: he refused to be “intimidated into changing the direction of the board” and offered to buy back the shares of the California Public Employees Retirement System (CalPERS), an activist shareholder. Nevertheless, Disney executives entered into negotiations with TIAA-CREF and CalPERS, and the following year agreed to elect all directors (rather than one-third) annually.

In 1998 the annual meeting was more sedate, but a remarkably high thirty-five percent of shareholders supported TIAA-CREF’s resolution calling for a more independent board. These attacks occurred despite the fact that Disney’s financial performance remained solid. The following year, TIAA-CREF withdrew a similar resolution after Disney nominated two new independent directors to the board. Meanwhile, shareholder litigation over the Ovitz severance package proved

122. See generally Byrne, supra note 120.
123. Id.
126. See id.
unsuccessful, although the Delaware Supreme Court had some harsh words for the Disney board:

[I]t appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. . . . From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions.127

In 2002, as Disney’s stock price collapsed, Eisner initiated a broad series of measures to improve Disney’s board, including reducing the size of the board, appointing a presiding director, adopting new definitions of independence, and nominating new, more independent, directors.128 In addition, existing Disney directors were reported to have exerted more pressure on Eisner to improve the company’s performance and stabilize senior management.129 In short, after the bubble burst, Eisner acceded to investor demands for governance reforms.

Whether reform will ultimately improve Disney’s performance is another question. In the summer of 2003, the Delaware Court of Chancery ruled that the shareholders amended complaint in the litigation over Michael Ovitz’s severance pay was sufficient to allege lack of good faith by the board that approved the package without discussion.130 Later that year Roy Disney and Stanley Gold noisily resigned from the Disney board.131 They called on Eisner to resign, accused the board of being “an enabler of an entrenched management,” and claimed the governance

“reforms” were being used to stifle dissent on the board. The company, meanwhile, improved its performance somewhat but continued to have problems.

VII. CONCLUSION

The corporate governance provisions of the SOA and the rules adopted by the SEC, the NYSE, and the NASDAQ are extensive, but it is questionable whether they would have been able to prevent any of the alleged wrongdoing that generated them. Enron, for example, had a board consisting of fourteen members—eleven of which were independent. Many of the independent directors received substantial compensation in cash and stock options, which would continue to be permitted under the new rules. If many of the recent earnings restatements were necessitated by executives “managing” earnings to protect the value of their stock options, “independent” directors who are also compensated with stock will be subject to similar pressures. Enron’s independent directors approved at least some of the conflict-of-interest transactions that later proved so devastating. In addition, Enron’s audit committee had an ambitious charter requiring it to oversee financial reporting and auditing.

The real solution to providing adequate checks and balances on management is to enable those directors who want to do a good job to do so. This may require regularizing meetings of independent directors outside the presence of management (so that the calling of an executive session does not constitute a “red flag”) and providing regular outside

132. Id.
133. Id.
134. In the words of Jay Lorsch, corporate governance advisor and professor at Harvard Business School, “Independence is a psychological condition as well as a legal one, so you can have directors who are technically independent but who don’t act that way when they become connected to a board.” Id.
135. See Strine, supra note 12, at 1378-79.
137. In a 2001 survey of directors of Fortune 1000 companies (conducted before the Enron, WorldCom and Tyco scandals developed), eighty-seven percent of directors described “a willingness to challenge management” as the most important attribute of board members. Id.
counsel to independent directors. It will also require a change of mind-
set among many directors, managers, and advisors that internalizes the
value of shareholder protection. Finally, it will require shareholders
themselves to value good corporate governance practices and provide a
market incentive for good management.\textsuperscript{138}

\textsuperscript{138} In a recent survey, three-quarters of institutional investors were willing to pay a
substantial premium for stock in companies that have good governance practices, and
more than sixty percent might avoid investing in certain companies based on governance
concerns. See Commissioner Glassman Addresses Corporate Governance, supra note 73.