Corporate Governance: Pre-Enron, Post-Enron

By

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“Corporate governance” is the process by which a corporation’s management is held accountable to its residual owners—the stockholders. Because of Enron and scores of other corporations currently embroiled in accounting and managerial scandals, the New York Stock Exchange (NSYE) and the Nasdaq Stock Market (NASDAQ) have approved sweeping new listing standards and the Congress has enacted wide-ranging federal legislation—the Sarbanes-Oxley Act of 2002¹—that will profoundly affect the nature of and control over corporate governance in the United States.

While the implosion of Enron was unquestionably the decisive event that shaped the content and timing of the new corporate governance paradigm, Enron’s significance in this regard cannot be fully appreciated except in the context of the changes in expectations as to “best practice” for corporate governance over the prior 30 years. In this paper, we examine the unique nature of the corporate governance problem, trace the development of a “consensus” model of “best practice” expectations, discuss the changes that the new listing standards and Sarbanes-Oxley will force on major corporations, and finally offer a few tentative comments on the sensible-

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ness of the entire “best practice” enterprise.

We wish to make clear that, in what follows, we touch only very briefly on an alternative to the “consensus” model of corporate governance, what Henry G. Manne has called “the market for corporate control.” We have chosen largely to ignore this alternative model not because of our personal views as to its potential effectiveness, but because recent legislative and judicial decisions have stripped it of much, if not all, of its usefulness as a management control mechanism. How and why that came about is an interesting and important story, but it is not the story we tell in this paper. Our story is decidedly immediate and practical: What is the current “consensus” model of “best practice” for corporate governance, how did it become such, and is it likely to accomplish its intended objectives?

I. Introduction

A. The Foreign Corrupt Practices Act

The sea change in corporate governance now upon us did not begin with Enron or Cendant or Sunbeam or even Bausch & Lomb. Rather, it began with a series of corporate misadventures in the 1970s that have an unsettling familiarity to those of today. In 1973, the Watergate Special Prosecutor’s announced that Lockheed, Northrop, Gulf Oil, and other prominent corporations may have used corporate funds to make illegal domestic political contributions. The Securities and Exchange Commission (SEC) immediately commenced an extensive investigation, the result of which was the revelation that scores of American corporations had violated United States election laws and hundreds more had made payments abroad in circumstances suggesting indifference or worse to domestic and foreign laws prohibiting bribery and other questionable methods of securing business. When the dust settled, many of the largest and most respected United States corporations were found to have used phony subsidiaries and off-book accounts to channel millions of dollars to government officials and others to influence the purchase of goods and the awarding of lucrative contracts. All told, more than 500 publicly held American companies, including 117 of the Fortune 500, were either charged by the SEC or voluntarily confessed to have engaged in serious misconduct, almost all involving accounting irregularities.

For the SEC, the widespread occurrence of questionable and illegal corporate payments—facilitated by the falsification of basic financial records—constituted evidence of a pervasive “frustration of our system of corporate accountability.” For the Congress, it was apparent that this seemingly epidemic corporate misconduct had “erod[ed] public confidence in the integrity of the free market system.” In December, 1977, following specific recommendations of the SEC, the Congress enacted the Foreign Corrupt Practices Act (FCPA), which criminalized foreign bribery and, for the first time in United States history, imposed on public companies a federal obligation “to maintain books and records that accurately and fairly reflect transactions and dispositions of [their] assets.” Shortly thereafter, the SEC adopted supplemental rules making it illegal for anyone to falsify (or cause to be falsified) any corporate accounting record or to
misrepresent (or cause to be misrepresented) to a corporation’s independent accountant any material fact.  

B. Harold Williams’ Three Act Play

In 1978, in the midst of the public and congressional outrage over “questionable and illegal payments,” then SEC Chairman Harold M. Williams gave an extraordinarily prescient speech on the likely future course for corporate governance. Williams began by outlining what he referred to as a “familiar” three act play entitled “Federal Regulation of Business.” In Act I of this play, a series of apparently isolated events involving corporate excess or insensitivity attracts press coverage under the rubrics of “scandals” and “flagrant abuses.” Next there are “thinly scattered comment by public interest types” and occasional arguments that “the government should do something to prevent these ‘outrages’ from happening again.” The general public, however is apathetic, and at this point the play’s plot seems weak, insignificant, and easy to ignore.

Act II is the longest act in the play. More corporate misdeeds occur, but at first only sporadically and in apparent isolation. After the passage of time—unspecified as to duration—the offending events begin to occur more frequently and the sense of their separateness dissipates. Public sentiment is fanned by the multiplication of “scandals” and “flagrant abuses.” The Congress then shows interest, and legislation is introduced “but [initially] attracts little support….” Act II, however, closes with a bang. “[I]nflamed by a single dramatic and widely publicized occurrence,” the Congress is spurred “to a full-blown and broadly based legislative effort.”

Act III is straightforward. The Congress enacts legislation designed to prevent the reoccurrence of the corporate misconduct at issue. “A chorus of businessmen deplor[e] the further intervention of government into business affairs.” And the audience is left with the moral that “it takes a law to get business to behave responsibly.”

In outlining this “familiar” play, Williams reminded his listeners that over the prior 10 or 15 years it had been frequently revived under a variety of subtitles including “auto safety,” “truth in packaging,” “occupational health and safety,” “ERISA,” and, most recently, “questionable and illegal payments.” Williams’ concern was that without reform of the mechanisms of corporate governance itself, the next revival of this play was likely to be entitled “federal legislation on corporate accountability.” Williams wanted to avoid such a revival, but he saw clearly that if American’s public corporations were to preserve their ability to control their own structures and governance, “they must be able to assure the public that they can discipline themselves…. Mechanisms which provide that assurance must become structural components of the process of governance and accountability of the American corporation.” The point of Williams’ exhortation was, thus, that the American business community could not ignore, stonewall, or adopt a head-in-the-sand attitude toward the corporate governance crisis if federal legislation was to be avoided.
C. Enron, WorldCom, and Federal Legislation

When Williams spoke in 1978, he thought that the United States was in “the early stages of Act II” of the “familiar” play.23 If that was the case, Act II was very long, indeed, lasting from the middle of the 1970s until earlier this year. But Act II ran its course just as Williams had predicted. Toward its end, the revelations of “flagrant abuses” at Enron, following as they had on a series of accounting and managerial scandals over the prior 10 years,24 resulted in the introduction of federal legislation designed to impose significant federal control over public accounting and the governance processes at all public companies.25 Public “outrage” at persuasive management self-enrichment was high.26 Executive compensation by 2000 had, on average, reached 411 times the amount of the average factory worker’s salary, which was up from only 42 times in 1982.27 Executive stock sales during the telecom bubble had resulted in “one of the largest transfers of wealth from investors—big and small—to corporate insiders] in American history.”28 Questionable and sometimes unapproved loans by corporations to top executives totalled billions of dollars.29 And in 2000, executives at America’s 325 largest corporations had been awarded options worth 20 percent of their corporations’ total pretax profit.30 The public’s view of corporate management seemed to be accurately captured by Alan Greenspan’s characterization of the business community as having been gripped in the late 1990s and early 2000s by “infectious greed.”31

Within six months after Enron’s collapse, however, the “wave of enthusiasm for overhauling the nation’s corporate and accounting laws ha[d] ebbed and the toughest proposals for change [were] all but dead.”32 Yet, just as Williams had predicted in 1978, Act II closed with a bang. WorldCom’s announcement of a $3.8 billion accounting restatement provided the “single dramatic and widely publicized occurrence” that energized both the public and the Congress to undertake “a full blown and broadly based legislative effort.”33

Act III then followed in straightforward and predicted fashion. The “wave” of enthusiasm for overhauling the nation’s corporate and accounting laws that only weeks before had been “all but dead” became an unstoppable tidal wave.34 Thirty-six days after WorldCom’s first public announcement of its accounting irregularities, President Bush signed into law Sarbanes-Oxley, the most sweeping federal legislation addressing public accounting and corporate governance since the 1930s.

The play that Williams named “federal legislation on corporate accountability” has now come to an end.35 Its moral appears to be as predicted: “It takes a law to get business to behave responsibly.”36 But the predicted businessmen’s chorus deploring government intervention has been largely missing. When President Bush signed Sarbanes-Oxley, The Business Roundtable (BRT), unquestionably the most prominent and outspoken defender of private corporate prerogatives, did not deplore government intervention in the area of corporate governance, historically left to contract and private initiative, but rather announced that it “welcomes these reforms and will quickly implement the changes to strengthen our companies’ governance. We believe the law will go a long way
toward establishing new higher standards for America’s corporations.”

A cynic no doubt would explain the business community’s position on Sarbanes-Oxley as a ploy designed to deflect public anger away from the “good” corporations. There is surely something to that explanation. But without yet turning in our cynic membership cards, we want to suggest that the business community’s attitude toward federal intervention in the area of corporate governance results, at least, in part, from its realization as a result of Enron, WorldCom, Tyco, and their fellow travelers that relying on individual corporations voluntarily to implement appropriate and effective corporate governance mechanisms has not and is not likely to stop the corporate “scandals” and “flagrant abuses” that have been so devastating for public confidence and corporate prosperity. Indeed, there now appears to be a general perception, even on the part of the major corporation community, that some form of collective action is needed—whether direct legislation, mandatory listing standards, or otherwise—to assure that all corporations behave responsibly toward their stockholders. In what follows, we trace the evolution, on the one hand, of the “consensus” view of the appropriate mechanisms for effective corporation governance and, on the other, of the agreement as to how those mechanisms are to be imposed.

II. Why Corporate Governance?

A. The Unique Status of Stockholders

The modern corporation has many constituencies in addition to its stockholders: employees, suppliers, consumers, communities in which it operates and that it can affect, the public generally when the national interest is implicated, and undoubtedly many others. At various times since the late 1800s the corporation has been faulted for its failure to fulfill its responsibility to one or another of these constituencies. As the frequent revivals of Williams’ “familiar” play makes clear, the federal government periodically steps in to control what is perceived to be corporate “greed,” to demand corporate attention to an asserted “public interest,” or to protect one or more of the corporation’s “vulnerable” constituencies. Whatever the justification for any one of these interventions in particular or government intervention of this sort in general, such legislative efforts relating to one or more of these corporate constituencies are not addressed at corporate governance.

Corporate governance addresses a corporation’s relationship with only one of its constituencies: its residual owners or stockholders. However egregious a corporation’s “greed” or blatant its disregard of an asserted “public interest,” the conduct in question, in all likelihood, has been pursued to enhance the corporation’s profits and hence to benefit (ill gottenly perhaps, but benefit no less) its stockholders. As Peter Drucker remarked about Lockheed and the foreign bribery scandals of the 1970s:
Here was not a management looting a company; on the contrary, what the management did was intended to advance the interests of the company and of its employees—and, in respect to sales of military aircraft, even the interest of the country, of its foreign policy and of its balance of payments.38

Harm to stockholders occurs for reasons different from harm to the corporation’s other constituencies. When harm to stockholders is alleged, it is not because of the corporation’s “greed” or the corporation’s “indifference” to stockholder interests but rather because corporate management of the corporation is shirking its responsibilities, has fallen victim to extraordinary miscalculation, or is pursuing its personal self-interest at the stockholders’ expense. Corporate governance, thus, is concerned with the control of corporate managers to assure that they do not enrich themselves at the expense of the stockholders or act (as was surely the case in the corporate bribery scandals and, we believe, to a considerable extent in Enron) in such a grossly irresponsible manner as to seriously damage the corporation, if not wreck it entirely.

B. The Berle and Means Corporation

The Modern Corporation and Private Property by Adolf Berle and Gardiner Means, published in 1932, constitutes the paradigmatic articulation of the reason that effective corporate governance is both so needed and so elusive. Berle and Means’ fundamental insight was that “[t]he separation [in the modern corporation] of ownership from control produces a condition where the interests of owners [of the enterprise] and of [the enterprise’s] ultimate manager may, and often do, diverge.”39 A mechanism to assure the attention and faithfulness of corporate management—that is, an effective scheme of corporate governance—is needed if the divergence of such interests is to be prevented or, at least, the adverse consequences of such divergence minimized.

For Berle and Means, the large public corporation became in the 20th Century “the dominant institution in the modern world.”40 As the wealth of innumerable individuals was concentrated “into huge aggregates,” control over that wealth shifted from the hands of its “owners” to the hands of those able to provide a “unified direction” to these new corporate enterprises.41 This separation of ownership from control constituted a fundamental departure from the classic economic model under which the right of individual property owners to use their property as they saw fit could be “relied upon as an effective incentive to [the] efficient use of [that] property….” But as individual, self-interested, property owners moved from active market participants to passive investors, their capacity to direct the deployment and disposition of their property “declined from extreme strength to practical impotence.”42 As a consequence, owners are exposed to a continual risk “that a controlling group may direct profits into their own pockets [and fail to run] the corporation… primarily in the interests of the stockholders.”43

Berle and Means saw the separation of ownership from control as posing
an extraordinarily difficult economic problem, for the identification and implementation of mechanisms (beyond reliance on market forces and the goodwill and ethical probity of managers) that will assure the alignment of the interests of those who control the corporation with those who own it is neither obvious nor easy. Yet without this separation of ownership from control, there is no efficient solution to the problems of decision making within a large organization. The separation of ownership from control is, thus, a very sharp two-edged sword: Without the separation of ownership from a centralized management having virtually absolute authority, the essential wealth enhancing corporate decisions essential for the growth and well being of our capitalist economy would not and could not be made; yet as a result of such separation, management holds “the power of confiscation of a part of the profit streams and even of the underlying corporate assets....”

Since at least the 1970s, the presumed resolution of this dilemma has been seen by a consensus of establishment lawyers, corporate representatives, and academics to lie in a system of corporate governance whereby, on the one side, management, primarily in the form of a strong CEO, controls the direction and initiatives of the corporation, and, on the other side, a board of directors, independent of management and the CEO, has the knowledge, incentive, and authority to monitor management’s performance and curb its temptations for opportunism. The formulation, sharpening, and testing of this “consensus” view of corporate governance over almost 30 years sets the stage for approval of the new NYSE listing standards and passage of Sarbanes-Oxley.

III. Private Initiatives to Improve Corporate Governance

A. The Strong Corporate Board

Because of collective action problems, free riding temptations, and the so-called Wall Street Rule—it’s always easier to sell than fight—the modern corporation’s stockholders have neither the incentive nor the practical ability to act as the enterprise’s ultimate monitors. Thus, the consensus view that has developed is that this monitoring function can be, and can best be, performed by the board of directors. As one leading corporate scholar expresses the point, the monitoring of management is “of critical importance to the corporation and uniquely suited for performance by the board.” For William Allen, then Chancellor of the Delaware Court of Chancery, the basic responsibility of the board is “to monitor the performance of senior management in an informed way.” And yet another prominent corporate scholar states flatly that “[t]he heart of corporate governance has been the imposition of the so-called monitoring model [on the board of directors].”

In this “consensus” view, “best practice” for dealing with the problems caused by the separation of ownership from control, or, as contemporary corporate scholars would put it, of reducing corporate agency costs, is the establishment of what is variously called a “monitoring board,” “certifying board,” or “empowered board.” However labelled, the basic characteristics of this strong board of directors have come to be generally understood to include directors that are all, or a majority of whom, are independent; an active audit committee composed entirely of independent and adequately informed di-
rectors; other specialized committees (nomination and compensation, in particular) also composed entirely (or almost entirely) of independent directors; a formal charter setting out the board’s authority and responsibility to monitor the corporation’s performance, compliance and financial reporting; and a style of operation characterized by independence from management, scepticism with respect to unsupported assertions made to them, and dogged loyalty to shareholder interests.55

B. Evolution of the Consensus

The “consensus” view that a strong board of directors constitutes “best practice” with respect to corporate governance is of relatively recent origin. When Myles Mace published his landmark study of boards of directors in 1970, he concluded that boards did not manage corporations or monitor corporate management but served solely as advisors and counsellors to the CEO.56 And as Ira Millstein has observed, at this time “[c]orporate boards were the parsley on the fish... usually composed of a group of friends or acquaintances of the CEO who could be counted on to support management.”57 Audit committees, despite having been recommended by the SEC in 194058 and the NYSE in 193959 had spread slowly and had received relatively little public attention.60 Yet, between 1970 and 1980, the United States witnessed what can only be described as a revolution in the concept of “best practice” for corporate governance.

In May 1976, then SEC Chairman Rodrick Hills wrote to then NYSE Chairman Melvin Batten “suggesting” that the NYSE revise its listing standards to require that all listed companies have an independent audit committee.61 The NYSE accepted the suggestions, and effective June 30, 1978, all NYSE listed companies were required to “maintain...an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgement as a committee member.”62

In November of that same year, the Subcommittee on Functions and Responsibilities of Directors, of the Committee on Corporate Laws, of the American Bar Association (ABA) published the first edition of the Corporate Director’s Guidebook.”63 Revised and adopted by the full ABA Committee on Corporate Laws seven days before the adoption of the FCPA, the Guidebook represented the establishment bar’s first attempt to set forth “a structural model for the governance of a publicly-own business corporation.”64 At the heart of this model was a “board of directors [that] function[ed] effectively in its role as reviewer of management initiatives and monitor of corporate performance.”65 The effective performance of this role required, in the ABA’s view, that “a significant number of [the] board’s members should be able to provide independent judgment regarding the proposals under consideration.”66

Shortly thereafter, the BRT, a consistent and steadfast defender of CEO prerogatives, issued a statement entitled, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation.67 While, in hindsight, certain parts of this statement are embarrassingly defensive68 the BRT’s statement is remarkably consistent with that of the ABA, particularly in its acknowledgement of the board’s monitoring role69 and its firm recom-
mendation that all boards should have a sufficient number of “outside” directors “to have a substantial impact on the board[’s] decision process.”

In 1980, when its Staff Report on Corporate Accountability was issued, the SEC saw a new consensus…emerging with respect to the vital monitoring role to be played by the board of directors in the corporate accountability process and the most desirable and appropriate composition and structure of a board designed to play such an enhanced oversight role. The consensus is moving strongly towards greater participation by directors independent of management, currently calling for a board composed of at least a majority of independent directors, with properly functioning independent audit, compensation, and nominating committees, as essential to enhanced and effective corporate accountability.”

This “consensus” as to “best practices” for corporate governance included, according to the SEC, the following.

First, “a strong board of directors is the key to improved accountability.” For this to occur, the “board’s primary function [must be] to monitor management.” And if this monitoring process is to be successful, “the board of directors [must be] an independent force in corporate affairs rather than a passive affiliate of management.”

Second, because the traditional board dominated by insiders cannot adequately monitor the performance of management, “a majority of the board of directors should be non-management directors.” While corporations may differ as to the appropriate mix of insiders and outsiders on their boards, as well as the affiliations of their outside directors, “a majority of non-management, preferably independent, directors is necessary for the board to successfully perform its monitoring function.”

Third, while “there appear[ed] to be an emerging consensus that those directors with significant business relationships with the corporation should not be considered independent of management when…. determining if [the board] has a sufficient critical mass of independence,” the primary emphasis was on independence as “a state of mind” rather than a formal specification of affiliations that would disqualify someone from being viewed as independent.

Fourth, because of NYSE requirements and AMEX and NASD recommendations, a significant majority of public companies had audit committees. Although many of these audit committees had members that were not “independent,” the “consensus” view was that “audit committees should be composed exclusively of directors independent of management.”

Fifth, despite the recommendations in the Corporate Director’s Guidebook, there was no consensus that the audit committee should have the authority to engage or discharge the outside auditors. Likewise, despite the audit committee’s “important role…in
assuring the independence of the accounting firm,” very little evidence existed that this role was assumed by audit committees generally.\textsuperscript{83}

Sixth, the existence of a compensation committee—charged with review of compensation arrangements for senior management—composed of non-management directors some of whom were “independent” of management was viewed as desirable.\textsuperscript{84}

To summarize, by 1980, the strong corporate board had come to be seen by most observers as the critical and only realistically available check on management opportunism. Over the next 20 years, this “consensus” view grew sharper—the concept of “independence,” for example, became increasingly specific—and far less flexible in its application—one “size” of corporate governance was increasingly seen to fit all corporations. Yet through this entire period the changes in the “consensus” view were by and large evolutionary and incremental. Except, that is, in the crucial area of the appropriate relationship between the strong board and corporate management. At the end of the 1970s, the BRT, speaking for the “consensus,” described that relationship as appropriately one “of mutual trust…challenging yet supportive and positive…arm’s length but not adversary.”\textsuperscript{85} After Enron, the BRT, speaking now for a substantially evolved “consensus,” described the board’s appropriate attitude toward management as one “of constructive skepticism [, of] ask[ing] incisive, probing questions and requir[ing] accurate, honest answers….”\textsuperscript{86}

The story of the shift from “mutual trust” to “constructive skepticism” is also the story of the ultimate failure of Harold William’s hope that the response of corporate America to the continuing “scandals” and “flagrant abuse” would eliminate the need for federal legislation on corporate accountability and avoid the performance of Act III of the “familiar” play.

C. The Market For Corporate Control

But before starting to tell that story, it is worth pausing briefly to note the United States’ flirtation with and ultimate rejection of the “market for corporate control”\textsuperscript{87} as a model for control of managerial opportunism. The concept, in brief, is that there is a high positive correlation between corporate managerial efficiency and the market price of that corporation’s shares. If there is a relatively unimpeded market for corporate control, inefficient and over-compensated management is, thus, subject to ouster through the mechanism of the hostile takeover. According to Henry G. Manne, “[o]nly the takeover scheme provides some assurance of competitive efficiency among corporate managers and [thus] strong protection to the interests of vast numbers of small, non-controlling shareholders. Compared with this mechanism . . . [the benefits] of a fiduciary duty concept [associated with independent directors] seem small indeed.”\textsuperscript{88}

The merits of Manne’s claim that the “market for corporate control” provides the best approach for resolving the dilemma confronting the Berle and Means corporation, is provocative but certainly arguable. For example, both Enron and WorldCom declared bankruptcy within months of their stocks trading at what can only be regarded as extremely high multiples. Further, until they collapsed, these corporations were
active acquirers rather than likely prospects for a hostile takeover. Nevertheless, whatever one’s view of the benefits of a robust “market for corporate control,” several developments have imposed severe impediments to this market’s effective operation. First, following over 100 hostile cash tender offers in 1966, the Congress passed the Williams Act in 1968. This statute significantly limits the ability of a “corporate raider” to mount a hostile takeover without advance warning to the target corporation and extensive disclosure of the “raider’s” intentions and financing. Second, as a result of a series of highly publicized takeover battles, in 1985 the Delaware courts decided four cases that gave existing management unprecedented power to resist hostile takeover attempts. And third, by 1992, under intense lobbying from the BRT and other business groups, over two-thirds of the states had enacted highly effective anti-takeover laws. As a consequence of these developments, while hostile takeover activity continues in various forms, by the early 1990s the “market for corporate control” as Manne had envisioned it had effectively ceased to exist.

D. The “Consensus” Sharpens

The elimination of the hostile takeover as a useful mechanism for protecting stockholders from management opportunism renewed interest in the role and responsibility of the strong corporate board. In 1992, the American Law Institute (ALI) completed its 14-year project, Principles of Corporate Governance: Analysis and Recommendations. While the gestation of the ALI’s Principles was difficult and controversial, in the end, the Principles, at least in the areas with which we are concerned, sharpened, but remained solidly within, the “consensus” tradition. Under the Principles, the board is assigned “ultimate responsibility for oversight” of “the conduct of the corporation’s business to evaluate whether the business is being properly managed.” Public corporations with $100 million or more of total assets “should have a majority of directors who are free of any significant relationship with the corporation’s senior executives.” The audit committee should be composed entirely of persons who are not present or former employees, a majority of whom should “have no significant relationship with the corporation’s senior executives.” And while the board itself should have responsibility for determining “the appropriate auditing and accounting principles and practices” for the corporation, the audit committee should “recommend the firm to be employed as the corporation’s external auditor and review…the external auditor’s independence.” In performing the latter function, the audit committee “should carefully consider any matter that might affect the external auditor’s independence, such as the extent to which the external auditor performs non-audit services.”

Two years after the ALI adopted the Principles, the ABA amended its Corporate Directors Guidebook, emphasizing “the board’s role as an independent and informed monitor of the conduct of the corporation’s affairs and the performance of its management.” The second edition of the Guidebook changed the ABA’s original recommendation with respect to composition of the board of directors from a “significant number” who are “non-management directors” to “at least a majority” who are
independent of management; formalized the concept of a board member’s “independence”; and changed the previous ABA recommendation of a audit committee composed of “non-management directors, a majority of whom are unaffiliated non-management directors” to a committee composed solely of “independent directors.”

And in 1997, the BRT published a white paper entitled, *Statement on Corporate Governance.* Sharpening its 1978 recommendations, the BRT emphasized that the board of directors must have “a substantial degree of independence from management,” and that the members of the audit committee should meet “more specific standards of independence.” While the BRT’s *Statement* is less specific in a number of respects than those of the ALI or ABA, its recognition that “[t]he absence of good corporate governance . . . may imply vulnerability for stockholders,” and that the failure of “knowledgeable directors . . . to express their views” places a corporation at “risk,” gives the BRT’s *Statement* a decided air of serious practicality.

The corporate governance recommendations of the ALI, ABA, and BRT made in the 1980s differ in emphasis, specificity, and tone, but by and large they all build on the earlier consensus in apparently constructive ways. Although only the ALI’s recommendations continue to approximate the current “consensus” as to “best practice,” it is by no means an exaggeration to state that a corporation that had, in 1990, modelled its corporate governance mechanisms, in both process and spirit, on any one of these sets of recommendations, would have been a highly unlikely candidate for a corporate governance “scandal” or “flagrant abuse.” Unfortunately, however, all of these “best practice” recommendations were just that, recommendations, and a sharpened “consensus” with respect to corporate governance did not mean that most or any of the major corporations in the United States were following, in more than form, “best practice.”

E. The Need for “Cultural Change” and the Blue Ribbon Committee

Almost 20 years to the day after Harold Williams had delivered his speech on the “familiar” three act play, Arthur Levitt, then Chairman of the SEC, gave another prescient commentary on the future course for corporate governance. For Levitt, corporate America had done too little to implement the recommended corporate governance mechanisms for control of managerial opportunism. Levitt saw “[t]oo many corporate managers, auditors, and analysts [as] participants in a game of nods and winks.” The managerial motivation to meet Wall Street earnings expectations was “overriding common sense business practices.” Indeed, Levitt was concerned that “managing may be giving way to manipulation. Integrity may be losing out to illusion.” It is hard to imagine a harsher critique of corporate America, but Levitt, like Williams before him, apparently still believed that the situation could be corrected without government action if there was a voluntary re-examination by “corporate management and Wall Street [of] our current environment [and an] embrace [of] nothing less than a cultural change.”

On the same day that Levitt spoke, the NYSE and the National Association of Securities Dealers (NASD)
announced that “in response to recent concerns expressed by …Levitt about the adequacy of the oversight of the audit process by independent corporate directors,” the two self-regulatory organizations were sponsoring a “blue ribbon” committee charged with recommending ways to improve the effectiveness of corporate audit committees. In February, 1999, this Blue Ribbon Committee issued its report with 10 recommendations “geared toward effecting pragmatic, progressive changes…[in] financial reporting and the oversight process.” The Committee acknowledged that the substantive matters covered by its recommendations had been “studied and commented upon….for years,” but the Committee “anticipate[d]” that “this time” there would be “prompt and serious considerations…..” And, indeed, before the year was over, the NYSE and NASD had proposed, and the SEC had approved, significant changes to their audit committee listing standards.

Levitt had emphasized the need for more reliable financial reporting to assure public confidence was maintained in the integrity of corporate America. The Blue Ribbon Committee concluded that this could be accomplished by making mandatory for listed companies more of the “consensus” model of corporate governance. The Committee, as the vast majority of commentators over the past 30 years, saw the board of directors as having the responsibility “to ensure that management is working in the best interests of the corporation and its shareholders” and the independence of a majority of these directors as “critical to ensuring that the board fulfills [this] objective oversight role and holds management accountable to shareholders….” The most serious problem the Committee found in the existing listing requirements for publicly companies was that the standards for determining “independence” allowed for “too much discretion” and [therefore,] should be fortified.

Since 1978, the NYSE had required that all listed companies have an audit committee composed of at least three directors, all of whom “in the opinion of the board of directors” are independent of management. Following the recommendation of the Blue Ribbon Committee, the NYSE amended its listing standards by specifying four specific criteria for determining the “independence” of audit committee members. Also on the recommendation of the Blue Ribbon Committee, the NYSE amended its listing standards to require that each board of directors adopt for its audit committee a formal written charter, which, among other matters, specified that the board and audit committee have the “authority and responsibility” to select, evaluate, and determine the independence of the outside auditor. In addition, the NYSE included in its amended listing standards a requirement that every listed corporation provide to the exchange annually a written confirmation (1) of “the financial literacy” of all audit committee members, (2) that at least one committee member “has accounting or related financial management expertise,” (3) that the committee’s charter is adequate, and (4) that any board determination regarding director “independence has been disclosed.”

In approving the new NYSE audit committee requirements, the SEC stated that these requirements “will protect investors by improving the effectiveness of audit committees … [and] enhance the reliability and credi-
bility of financial statements…. by making it more difficult for companies to inappropriately distort their true financial performance.” It would have been tempting in 2000 to believe that with the adoption of these amended listing standards, the sharpening of “best practice” recommendations by the ALI, ABA, and BRT, and the promulgation by the SEC of various new corporate disclosure requirements, that corporate governance for America’s public companies had finally been gotten right, or at least, was about to be gotten right. As the BRT, somewhat immodestly, stated in its 1997 white paper:

The Business Roundtable notes with pride that…many of the practices suggested for consideration by The Business Roundtable have become more common. This has been the result of voluntary action by the business community without new laws and regulations …. The Business Roundtable believes it is important to allow corporate governance processes to continue to evolve in the same fashion in the years ahead.

Unfortunately, in 2000, corporate governance was not even close to having been gotten right, and the processes for its development were certainly not to be allowed to evolve “in the same [voluntary] fashion” in the years ahead. Despite the recommendations of the Blue Ribbon Committee and the SEC’s brave assurances that “the reliability and credibility of financial statements [thereby] would be enhanced,” public revelations of corporate “scandals” and “flagrant abuses” were to continue at an accelerating pace.

IV. Enron

A. The Run-Up

Within months of the issuance of the Blue Ribbon Committee’s Report, Rite Aid Corporation, a more than $3 billion dollar corporation listed on the NYSE, restated its operating results for 1997, 1998, and 1999, eventually writing off more than $2.3 billion in pretax profits. Before resigning, Rite Aid’s outside auditor publicly announced that the corporation’s financial controls were so inadequate that it could not “accumulate and reconcile information necessary to properly record and analyze transactions on a timely basis.” Eventually, the SEC charged four former Rite Aid’s executives, including its former president, with “one of the most egregious accounting frauds in recent history.”

Three weeks after the SEC approved the new audit committee requirements, Cendant Corporation, another multi-billion dollar company listed on the NYSE, announced that it had agreed to pay stockholders $2.8 billion to settle accusations of widespread accounting fraud. The SEC subsequently brought charges against six former executives, including Cendant’s former Chairman, for “a long-running financial fraud” that “originated at the highest level of [the] company.”

On June 13, 1998, Sunbeam Corporation, another NYSE listed com-
pany, fired its then CEO, after the corporation’s directors began questioning the integrity of the reports they had been given on the financial condition of the company. The company announced a restatement of its financial statements back to 1996. The SEC eventually charged the former CEO and four other former executives with fraud, alleging that they had “orchestrated a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam [to] facilitate the sale of the company at an inflated price [with enormous gains for its executives].”

In February 1998, Waste Management, Inc., yet another NYSE listed company, acknowledged that it had misstated its pre-tax earnings by approximately $1.7 billion, the largest corporate restatement in history—until that time. In June, 2000, the SEC charged Waste Management with fraud and violations of internal financial control requirements for its failure to “maintain effective and accurate billing, accounting and management information systems.” The SEC subsequently charged Waste Management’s former CEO and five other former executives with perpetrating “a massive financial fraud lasting more than five years.” Waste Management, it appears, had used a veritable “catalog of ways to cook the books,” assuring the executives tens of millions of dollars in stock options and bonuses that would never have been paid out without the accounting fraud.

Perhaps ultimately more important than any of these high profile “scandals” and “flagrant abuses” was the fact that in 2000, 156 public companies restated their financial statements in 2000, compared with an average of less than 50 per year over the previous 10 years. And of the 201 securities fraud class action law suits filed in 1999 and 2000, over half were based on allegations of accounting fraud. Despite these alarming developments, for corporate governance the worst was yet to come.

B. Enron

Although by 2001 public belief in the integrity of corporate management and the ability of boards of directors to control managerial opportunism was extremely low, nothing had prepared the public, the regulators, or the Congress for the spectacular implosion of, and revelations of fraud by, Enron Corp, another NYSE listed company. Enron was classified as the seventh largest corporation in the United States, with over $100 billion in gross revenue and more than 20,000 employees worldwide. For the six years immediately prior to its collapse, Fortune Magazine had named Enron the most innovative company in America. And in February, 2001, Enron’s then Chairman, Kenneth L. Lay, and its CEO, Jeffrey K. Skilling, wrote to stockholders:

Enron has built unique and strong businesses that have tremendous opportunities for growth….The 10-year return to Enron shareholders was 1,415 percent compared with 383 percent for the S&P 500….Our results put us in the top tier of the world’s corporations….We plan to leverage all of [Enron’s] competitive advantages to create significant value for our shareholders…. 
Less than eight months later, Enron announced a $544 million after-tax charge to earnings and a $1.2 billion reduction of stockholders’ equity, both the result of transactions with an affiliated partnership that had been inappropriately accounted for. On November 19, 2001, Enron filed a further restatement of its financial statements with the SEC, which among other matters, reduced stockholders equity by $258 million in 1997, $391 million in 1998, $710 million in 1999, and $754 million in 2000. Three weeks later, Enron filed for bankruptcy protection, the largest such filing in history – until then. Thus in “a span of less than two months during the autumn of 2001, [Enron] fell from business idol to congressional doormat, or somewhat more importantly, from the new business model to a model of business greed and ultimate failure.”

Discussions of Enron and its collapse are now legion. According to the report released by Enron’s Special Investigation Committee of its Board of Directors, Enron’s Board of Directors had “failed” in its duty of “oversight” with respect to “the related-party transactions” that brought the company down. The Senate Permanent Subcommittee on Investigations found that “much of what was wrong at Enron was not concealed from its Board of Directors….The Subcommitte investigation…. found a Board that routinely relied on Enron management and Andersen representations with little or no effort to verify the information provided, that readily approved new business ventures and complex transactions, and that exercised weak oversight of company operations.” And the BRT, hardly a corporate gadfly, ascribed the Enron’s failure to “a massive breach of trust” involving “a pervasive breakdown in the norms of ethical behavior, corporate governance, and corporate responsibility to external and internal stockholders.”

Our concern is not the vehement denunciations of Enron and its management, but the consequences of this massive corporate fraud for the “consensus” model of corporate governance. By looking at the responses to Enron of the principal spokesmen on issues of corporate governance, it may become easier to understand why Sarbanes-Oxley became an inevitability, particularly, once the WorldCom “scandal” broke only six months after Enron had filed for bankruptcy.

C. Two Responses to Enron

Within the four years immediately preceding Enron’s implosion, the BRT and ABA had each issued comprehensive and confident recommendations with respect to “best practices” for corporate governance. Yet within weeks of Enron’s bankruptcy filing, both organizations convened task forces or special committees to reassess and further refine their positions on “best practice” for corporate governance. The first to do so was the BRT.

The BRT issued its restatement of the “guiding principles of corporate governance” in May, 2002. Three things are striking about the BRT’s new position in its Principles of Corporate Governance. First, although during 2000-2001, more than 300 corporations had restated their audited financial statements, the SEC had filed over 200 actions alleging financial fraud in 2000, and the five largest corporate bankruptcies in United States history had been filed in the previous 18 months, the BRT continued to insist that “[t]he United
States has the best corporate governance [and] financial reporting systems in the world.” As for Enron and its fellow travellers, BRT characterized them merely as “notable exceptions to a system that has generally worked well....”

Second, in its congressional lobbying efforts, the BRT sought to emphasize “the inherently self-correcting nature of our market system [as evidenced by the fact that] corporate boards of directors are [already] taking steps to assure....that Enron-like failures will not occur at their corporations.” The BRT’s pitch to the Congress was that before proceeding with any new legislation, it should give consideration to the “SEC and private sector initiatives already underway [including BRT’s] pending update [of] its 1997 Statement on Corporate Governance.”

Third, despite its refusal to acknowledge a systemic problem in corporate governance and its initial (pre-WorldCom) opposition to federal legislation in its new Principles, the BRT recommended a role and responsibilities for the board of directors that were clearly inconsistent with its 1978 statement and far beyond the position it had taken only five years earlier. For example, rather than urging a relationship between the board and corporate management characterized by “mutual trust...[that is] challenging yet supportive,” the BRT’s Principles describe “effective directors” as those that “maintain an attitude of constructive skepticism [and] ask incisive, probing questions and require accurate, honest answers....” Further, in 1997 the BRT had called on corporations to have a “substantial majority [of directors who are] outside (non-management) direc-

On July 16, 2002, less than two months after the BRT issued its Principles, a specially appointed Task Force on Corporate Responsibility of the ABA (Task Force) issued its own Preliminary Report. The two reports were poles apart. Unlike the BRT, the Task Force did not see Enron and its fellow travellers as aberrations. To the contrary, the Task Force forcefully acknowledged that “the system of corporate governance at many public companies has failed dramatically.” Evidenced by “the disturbing series of recent lapses at large corporations involving false or misleading financial statements and misconduct by executive officers,” it is apparent, in the view of the Task Force, that “the exercise by [independent directors and advisers] of active and informed stewardship of the best interests of the corporation has in too many instances fallen short.” Despite the ABA’s three editions of the Corporate Directors Guidebook, the ALI’s massive corporate
governance project, the BRT and other business groups’ numerous recommendations, the NYSE’s listing requirements, and the SEC’s jawboning over 20 years, the central feature of the corporate governance “consensus” to which all of these organizations subscribed—a “monitoring” board sufficiently independent of management to control managerial opportunism—had too often, the Task Force believed, failed in practice because many aspects of the outside directors’ role have reflected a dependence on senior management. Typically, senior management plays a significant part in the selection of directors, in proposing the compensation for directors, in selecting their committee assignments, in setting agendas for their meetings, and in evaluating their performance. In addition, directors often defer to management for the selection of the key advisers to the board and its committees (e.g., compensation consultants), as well as the outside auditors for the company. Recommendations to create active independent oversight must address these realities and bring about actual change.165

For the Task Force, therefore, the “solution” to the failure of independent directors to perform the role assigned to them was a set of standards that will “establish active, informed and objective oversight as a behavioural norm [and] create mechanisms that empower [directors] to exercise such oversight . . . .”166 Specifically, all public corporations, in the view of the Task Force, should adhere to tough, new “standards of internal corporate governance,” essentially identical to the new listing standards proposed by the NYSE and discussed in the next section of this paper.

The problem for the Task Force was whether and, if so, how such standards should be imposed. In the third edition of its Corporate Directors Guidebook, the ABA had emphasized that “[n]o one governance structure fits all public corporations, and there is considerable diversity of organizational styles. Each corporation should develop a governance structure that is appropriate to its nature and circumstances.”167 And the BRT, only weeks before the Task Force released its report, had asserted, as it had since its first statement on corporate governance in 1978, that “[p]ublicly owned corporations employ diverse approaches to board structure and operations, and no one structure is right for every corporation.”168 The Task Force, however, rejected this position, concluding that “substantial uniformity of governance standards applicable to public companies is desirable and would have the greatest impact on reliable corporate responsibility.”169 The trick, of course, was how to achieve that uniformity.

The BRT’s approach of allowing corporate governance mechanisms to continue to evolve through “voluntary action by the business community”170 was now out of the question. And the new listing requirements at the NYSE, by themselves, would not achieve uniform “best practice” mechanisms for all
public corporations. Therefore, the Task Force suggested that the NYSE, the NASDAQ Stock Market, the American Stock Exchange, and the regional exchanges jointly to appoint a new Blue Ribbon Committee to recommend uniform corporate governance standards for adoption by all exchanges. But the Task Force clearly recognized that if “the desired uniformity is not achieved through this approach,” “serious consideration” would have to be given to legislation amending the Securities Exchange Act of 1934 “to empower the SEC to amend the rules of a self-regulatory organization to assure uniformity in listing standards with respect to corporate governance matters.”

The Task Force saw the need for tough, uniform corporate governance standards for all public corporations, acknowledged that federal legislation might be necessary to achieve such uniform standards, and even suggested that the Congress could achieve the needed uniformity through the intermediation of the SEC. And that is precisely what Sarbanes-Oxley did, at least with respect to audit committees. But one more event, what Harold Williams had called “a single dramatic and widely publicized occurrence,” was still needed to spur the Congress to the “full-blown and broadly based legislative effort” that would result in the passage of federal legislation.

V. WorldCom

WorldCom, Inc. was the second largest long-distance carrier in the United States. It had 20 million consumer customers, thousands of corporate clients, and 80,000 employees on six continents. Its CEO, Bernard J. Ebbers, was “an icon of the business world…. Its common stock, listed on NASDAQ, had hit its high of $64.50 in June, 1999, giving it a market capitalization of $191 billion.

On April 22, 2002, WorldCom reduced its revenue projections for 2002 by “at least” $1 billion. Seven days later Ebbers resigned as President, CEO, and a director “under pressure from outside directors frustrated with the company’s sinking stock price, controversy over Mr. Ebber’s $366 million [the May 20, 2000, WorldCom Proxy Statement revealed that the true amount was $408.2 million] personal loan from the company and the wide-range investigation of the firm by the Securities and Exchange Commission.” On June 25, 2002, WorldCom announced that as a result of an internal audit it had determined that approximately $3.8 billion of expenditures were improperly capitalized rather than expensed. What then followed was the uncovering of “one of the largest accounting frauds in history…. The day of the announcement, WorldCom stock closed at $0.83, representing a decline from its high of over 98 percent and a loss of investor wealth of more than $188 billion. The next day the SEC filed suit against WorldCom alleging “a massive accounting fraud totalling more than $3.8 billion.” On July 21, 2002, WorldCom filed for bankruptcy protection, listing assets valued at $107 billion, making its filing by far the largest in United States corporate history. Enron, which had previously held that distinction, had listed assets of only $63.4 billion. On August 8, 2002, WorldCom announced that its “ongoing internal review of its financial statements” had uncovered an additional $3.3 billion of “improperly reported earnings…. And on August 28, 2002,
Scott Sullivan, the former CEO of WorldCom, was indicted in New York for engaging “in an illegal scheme to inflate artificially WorldCom’s publicly reported earnings by falsely and fraudulently reducing…expenses.”

But the accounting misadventures and managerial self-dealing at WorldCom and other corporations that occurred after July 30, 2000, are really irrelevant to our story, for on that date President Bush signed Sarbanes-Oxley into law. It took only 28 days for WorldCom to collapse after its management’s accounting fraud was discovered. It took only two days longer for the Senate to pass the new reform legislation, the Conference Committee to reach agreement, both houses of the Congress to vote on the compromise bill, and the President to sign it. WorldCom was unquestionably the “bang” that Williams had predicted would end Act II of the “familiar” play, and Sarbanes-Oxley is quite obviously the “federal legislation on corporate accountability” that he had reluctantly predicted in 1978 would close Act III.

VI. Corporate Governance Post-Enron

A. Overview

Harold Williams’ “familiar” play is now ended. Sarbanes-Oxley has been enacted, the first direct federal regulation since the 1930s of matters of internal corporate governance—matters historically governed by state law and private contract. Yet as this paper has tried to make clear, this legislation did not come about, as Williams feared it would, because the American business community (as represented by its most prominent spokesmen) ignored, stonewalled, or adopted a head-in-the-sand response to the corporate accountability “scandals” and “flagrant abuses” of the past 30 years. To the contrary, over that period a voluntary “consensus” view of “best practice” with respect to corporate governance was continually promoted and refined. Indeed, Sarbanes-Oxley, to the extent it addresses audit committee matters, is based directly on this “consensus” view and is an expression not of the Congress’ disagreement with the “consensus” recommendations but of its frustration with the corporate community’s inability voluntarily and comprehensively to impose these “consensus” recommendations on itself.

Yet, significantly, Sarbanes-Oxley imposes on all public corporations only a small part of the full set of “best practice” standards embraced by the now current “consensus” view that developed after Enron. This view, expressed in the proposed new listing standards at the NYSE and endorsed by the Task Force and the BRT, goes well beyond the requirements in Sarbanes-Oxley and constitutes the most comprehensive, specific, and rigorous articulation to date of the “consensus” model of corporate governance “best practices.” But if the Task Force is correct and “substantial uniformity of governance standards applicable to [all] public companies is desirable…”, then Sarbanes-Oxley will achieve that uniformity for only certain key “consensus” standards—primarily with respect to the composition and authority of the audit committee. Left unaffected and decidedly non-uniform are many other important components of the new “consensus” view, including the composition, selection, and authority of the board of directors as a whole, the composition and authority of other board committees, and the development and content of
codes of business conduct and committee charters. In the last section of this paper we discuss our overview of the ultimate value of this “consensus model” and whether the SEC, which appears to be so inclined, should expend significant resources to achieve uniformity in these other areas as well. But before doing so, the current corporate governance saga needs to be concluded with a summary of the principal provisions of Sarbanes-Oxley and the new NYSE listing standards.

B. Sarbanes-Oxley

Most of the press coverage of Sarbanes-Oxley has focused on its creation of a new Public Company Accounting Board and its establishment of new standards of auditor independence. One title of the Act, however, is entitled “Corporate Responsibility,” and four features of Sarbanes-Oxley’s approach to corporate governance are worthy of careful note.

First, as we pointed out above, the only part of the “consensus” view of corporate governance that Sarbanes-Oxley enacted into federal law concerns the composition and authority of the audit committee. To an extent, this limited federalization of corporate structure is entirely understandable. Matters of internal corporate structure have been historically the province of state law and private contracts, and the Congress is surely correct to legislate in the area only with great deference. Furthermore, the impetus for the Act was the “recent corporate failures [that highlighted the need] to improve the responsibility of public companies for their financial disclosure.” It was, therefore, logical for the Congress to have limited its incursion into the area of corporate governance simply to assuring that all public companies have “strong, competent audit committees with real authority.”

Nevertheless, despite the limited federalization of the “consensus” view of “best practice,” the Congress was prepared to ignore entirely such “best practice” notions and rely on an entirely different model of corporate governance model when it saw a clear need to control specific types of management opportunism. Thus, for example, (1) Sarbanes-Oxley prohibits outright any publicly held corporation from making a loan to any of its directors or officers; (2) it forces the CEO and CFO of any publicly held corporation that is required to file a financial restatement “due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws” to reimburse the corporation for any bonuses received or profits from stock sales realized during the 12-months following the filing of the inaccurate financial report; (3) it requires CEOs and CFOs to certify that all financial statements filed by their corporations with the SEC “fairly present in all material respects the financial conditions and results of operations of the issuer…” and makes it a federal crime to do so “knowing” that the financial statements do not; (4) it prohibits directors and executive officers from selling company stock during benefit plan “blackout periods;” and (5) it makes it unlawful for any officer or director to take any action “to fraudulently influence, coerce, manipulate, or mislead” the corporation’s auditor.

In the “consensus” view, a strong independent board can and will protect stockholders from management’s temp-
tation, in Berle and Means’ words, to “direct profits into their own pockets [and fail to run] the corporation...primarily in the interest of the stockholders.” But at least in the five areas identified above, Sarbanes-Oxley reflects the Congress’s serious doubts as the ability of the board of directors, however independent, effectively to perform that function.

Second, in the audit committee area, Sarbanes-Oxley does follow the “consensus” model of corporate governance by requiring every publicly listed corporation to have an audit committee composed entirely of “independent” directors, defined as individuals who are not in any way “affiliated” with the corporation or receive “any compensatory fee” from the corporation other than for serving on the board of directors. Every public corporation must disclose whether at least one member of its audit committee is a “financial expert” and if not, why not. The audit committee must be “directly responsible for the appointment, compensation, and oversight” of the corporation’s outside auditor, and pre-approve any “non-audit services” that the outside auditor provides to the corporation. The audit committee is required to receive from the outside auditor reports as to “all critical accounting policies...and all alternative treatments of financial information...discussed with management...” And the audit committee must have “the authority to engage independent counsel and other advisers...” and to compensate these advisers through such corporate funding as it determines appropriate.

Third, the method by which the Congress chose to impose the new audit committee requirements on publicly “listed” corporations is precisely that recommended by the Task Force. That is, Sarbanes-Oxley does not impose these requirements directly, but rather requires the SEC to “direct” the exchanges and NASDAQ to “prohibit the listing” of a corporation that is “not in compliance with these requirements.” The significance of this apparently convoluted approach has generally gone unnoticed, but by structuring the audit committee requirements in this way, corporations, their boards of directors, and their audit committee members are not faced with liability in the event the audit committee requirements, for whatever reason, are not adhered to.

Fourth, Sarbanes-Oxley creates new financial crimes, increases the criminal penalties for many existing financial crimes, and gives the SEC substantial new enforcement authority. It does not, however, except for extending the statute of limitations for fraud, in any way facilitate stockholders’ ability to sue for a breach of the securities laws or any new requirement imposed by the Act. Indeed, as noted above, even an interventional a breach of the new audit committee requirements will not be actionable because those requirements will be imposed by self-regulatory organization rules. And enforcement of the new prohibition against fraudulently influencing an auditor is specifically limited to the SEC. Thus, while the Congress sought through Sarbanes-Oxley “to increase corporate responsibility,” it most clearly did not want to use increased stockholder litigation as a means for accomplishing that objective.
C. NYSE Listing Standards

In February 2002, at the request of the Chairman of the SEC, the NYSE appointed a special Corporate Accountability and Listing Standards Committee (Accountability Committee) to review the NYSE’s listing standards in light of Enron. On June 6, 2002, the Accountability Committee issued its report. Although the report of the Blue Ribbon Committee had been completed less than three years earlier, the Accountability Committee saw a need “in the aftermath of the ‘meltdown’ of significant companies due to failures of diligence, ethics, and controls, [for] the NYSE…once again [to use its authority] to raise corporate governance and disclosure standards.” Unlike the Blue Ribbon Committee’s recommendations, there is little conventional and nothing timid about the recommendations of the Accountability Committee. These recommendations, which in all significant respects have been incorporated in proposed rule changes filed by the NYSE with the SEC on August 1, 2002, are unquestionably the most far reaching and rigorous expression of the “consensus” view of corporate governance ever promulgated. A brief summary of certain key provisions of the new listing standards should illustrate their boldness.

The starting point is hardly surprising. All listed companies must have a majority of independent directors. Interestingly, a director does not qualify as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the corporation, and that determination (and its basis) is “disclosed in the company’s annual proxy statement.” In addition, regardless of any board determination, no director may be considered to be “independent” until five years after he or she ceases to be an employee of, affiliated with the auditor for, been part of an interlocking directorate involving, or a member of the immediate family of someone who is not independent of, the listed company.

It is, however, in the powers and authority of the independent directors that the recommendations of the Accountability Committee take the corporate governance paradigm of the strong board of directors to what must be regarded as its apotheosis. First, with the explicit objective of “empower[ing] non-management directors to serve as a more efficient check on management,” these directors must “meet at regularly scheduled executive sessions without management.” Second, each listed company must have three committees comprised solely of independent directors: a nominating/corporate governance committee, a compensation committee, and an audit committee. The nominating committee must have the authority “to select, or to recommend that the board select,” the future director nominees and the responsibility to prepare a “written charter” addressing, among any other matters, “a set of corporate governance principles applicable to the corporation.” The compensation committee must “review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals and objectives, and set the CEO’s compensation level based on this evaluation.” With respect to the audit committee, no member of the audit committee may receive any “compensation” from the corporation other than director’s fees; the committee must have “the sole authority to hire and fire independent auditors; and it must pre-
approve any significant non-audit relationship with the independent auditors.\textsuperscript{230} In addition, the audit committee is empowered “without seeking board approval” to “obtain advice and assistance from outside legal, accounting or other advisors.”\textsuperscript{231}

The Accountability Committee’s report and the NYSE’s actual proposed new listing standards contain many more specific requirements designed to “give the legions of diligent directors better tools to empower them and encourage excellence.”\textsuperscript{232} Indeed, it is hard to think how independent directors could be more empowered than they will be under the new NYSE standards without seriously interfering with the need for strong, centralized management capable of efficiently making the adaptive decisions necessary for the competitive operation of the modern corporation.\textsuperscript{233} The question, of course, to which we now turn, is whether the fully empowered, independent board of directors will have the disposition, incentive, and resolution “to serve as a more effective check on management.”\textsuperscript{234}

VII. Conclusion

Virtually all of the significant developments in corporate governance over the past 30 years flow from a paradigm shift in the general view of the role of the board of directors that occurred in the 1970s. At the start of that decade, boards of directors were seen as operating best through consensus, not conflict, and the outside directors’ principal value was understood to be that of experienced, constructive advisors to the CEO, offering knowledgeable and objective perspectives on the company’s competitive challenges. As the decade progressed, however, scholarly and regulatory concern was increasingly expressed that such collegial, conflict avoiding boards were little more than rubber stamps for CEOs. Thus, a “consensus” of establishment lawyers, academics, and business leaders developed that such boards should be replaced by “monitoring” boards, characterized by independence, skepticism, and unflinching commitment to stockholders interests. As corporate “scandals” and “flagrant abuses” continued through the 1980s and 1990s, this “consensus” view of the monitoring board as “best practice” spread and sharpened, culminating ultimately in Sarbanes-Oxley’s audit committee requirements and the NYSE’s new listing standards.

But the validity of the “consensus” view, in general, and of these recent corporate governance initiatives, in particular, rests on the assumption that increases in director independence and empowerment lead to decreases in instances of management opportunism. While it may be difficult to disprove (or prove) this assumption,\textsuperscript{235} we want to offer in closing some brief but skeptical comments on the wisdom of the apparently ever increasing public reliance on it.

First, boards of directors in the later 1990s and early 2000s were undoubtedly far more “independent” than those in the early 1970s. But surely no one would argue that the managerial misdeeds leading to passage of the FCPA were worse than those leading to passage of Sarbanes-Oxley. Enron, WorldCom, Adelphia, Tyco, and Global Crossing were all listed on the NYSE or NASDAQ. These companies were in full compliance, formally at least, with all applicable requirements for board and audit committee independence, yet it
would be hard to find any corporation in the 1970s whose management behaved with comparable piracy.

Second, if independent directors are to perform an effective monitoring role, they need “to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals.” But these characteristics are likely to be far different from the characteristics of directors valued by a CEO for their strategic insights and business acumen. At a minimum, therefore, the “consensus” demand for a “monitoring” board forces a tradeoff of strategic vision for skeptical objectivity—without any demonstration that a cost-benefit analysis favors a “monitoring” versus “counselling” board. More fundamentally, the success of the monitoring board would appear to depend on the recruitment of directors with profiles very different from those of the directors that now oversee our major corporations. Without exaggeration, the rhetoric used by the NYSE’s Accountability Committee and the ABA’s Task Force—and the apparent objective of Section 301 of Sarbanes-Oxley—suggests that in recruiting members for their boards of directors, public companies should be looking not for successful executives at other companies, investment bankers with broad industry expertise, or professional consultants with detailed knowledge of business processes and operations, but rather, for former staff members of the SEC’s Division of Enforcement. Surely, this cannot be right.

Third, if the premise of the monitoring board is correct, that is, if the stockholders are, in fact, to rely on the independent directors to prevent management opportunism, then one would expect that when such a board fails to prevent such opportunism, through negligence or worse, it should be possible to call the board to account for its failure. But that is not the case. “On the contrary…many prominent features of corporate law [are] designed for the express purpose of making it difficult for shareholders to hold the board…legally responsible, except in the most provocative circumstances…. [And it would be] dangerously optimistic [to] assum[e] that the level of judicial supervision of business can be dramatically increased without unforeseeable and incalculable consequences for the efficiency with which businesses make necessary adaptive decisions.” Yet, as we assign more and more responsibilities to the “independent” directors but do not in any way attend to the legal consequences of their negligent performance of these responsibilities, we are, in effect, putting cops on the beat without supervision or risk of sanction. Neither Sarbanes-Oxley nor the NYSE’s new listing standards acknowledge this anomaly, but surely the disconnect between director responsibility and director accountability is far too large to remain unaddressed.

Fourth, and finally, the “consensus” model of “best practice” in the area of corporate governance represents an attempt to control corporate opportunism through private initiatives, thereby avoiding federal intervention into matters of internal corporate organization and management. Over the last 30 years, the pattern has been for the “consensus” to recommend “independence” on corporate boards to prevent further “scandals” or “flagrant abuses.” When more “scandals” and “flagrant abuses” occur, the “consensus” recommends even more “independence,” and then when “scandals” and “flagrant abuses”
continue, it recommends yet more “independence,” and so on and so on. In Sarbanes-Oxley, the Congress showed its impatience with this continual ratcheting up of the standards for, and powers of, the independent directors by imposing federal bans on such matters as corporate loans to executives and forced executive repayments of bonuses and stock gains before corporate restatements. In doing so, the Congress was testing a new approach to corporate governance.

Berle and Means focused corporate scholarship’s attention on the risks of management opportunism given the separation of ownership and control. Berle and Means, however, never suggested that a monitoring board was the solution to that endemic corporate problem. At present, the “consensus” view as to corporate governance “best practice” is so dominant that it is difficult even to suggest that further empowerment of an independent, monitoring board may not be the solution to the current round of corporate “scandals” and “flagrant abuses.” Nevertheless, after watching “independence” and “empowerment” ratcheted up and up and up for 30 years, our conclusion is that enough is now enough. It is time to recognize that other “best practice” models of corporate governance need to be evaluated. First, the costs and benefits of allowing an efficient “market for corporate control” to develop need to be re-evaluated. Second, members of the “consensus” and particularly the establishment business community need to think seriously about the trade-offs between boards that “counsel” and boards that “monitor.” And third, attention needs to be paid to other approaches to controlling management opportunism. While more direct federal prohibitions on specific types of management misconduct and more substantive corporate governance authority in the SEC are not particularly attractive on their own, they nevertheless may need to be explored once the impact of Sarbanes-Oxley is thoroughly analyzed. More promising approaches may be carefully tailored oversight of executive compensation, mandatory holding periods for options, and limitations on executive stock sales. An increase role for trained internal monitors is not out of the question, and surely there are any number of other approaches that could be explored. The point is that by turning the corporate board into the “monitor” of corporate management, we do not appear to have been able to stop the “scandals” and “flagrant abuses,” and we may well be losing the vision, advice, and competitive perceptiveness that a good board should be providing the CEO. Surely there must be better ways to deal with the consequences of the separation of ownership from control in the modern corporation. The time has come, we believe, to think outside the “consensus” box.
End Notes


2 See Section III C, below.


14 See note 9, above.


17 Ibid.

18 Ibid.

19 Ibid.

20 Ibid.

21 Ibid, p. 327.

22 Ibid, p. 319

23 Ibid, p. 320.

24 See Section IV.A. below.

25 Legislation was introduced in the House as H. R. 3763 on February 14, 2002, and in the Senate as S. 2673 on June 25, 2002.

26 The chairman and CEO of Goldman Sachs said he “cannot think of a time when business over all has been held in less repute.” McGeehan (2002), p. A1. See also Morgenson (2002), p. C4, addressing a May CBS/Gallop poll
finding that “84 percent feel that [the accounting impropriety] issue is punishing stock prices, ranking it ahead of conflict in the Middle East and terrorism.”


28 See Berman (2002).

29 See Lublin and Sandberg (2002).


31 Greenspan (2002). “If the past thirty years have demonstrated anything, it is that the avarice of America’s corporate leaders is practically unlimited, and so is their power to run companies in their own interest.” Cassidy, John, The Greed Cycle, The New Yorker, Sept. 23, 2002 at 76.

32 Labaton and Oppel (2002).


34 See Labaton and Oppel (2002).

35 Sarbanes-Oxley was signed into law on July 30, 2002.

36 See Williams (1978), p. 320.


39 Berle and Means (1991), pp. 6-7. Adam Smith made much the same point a little over 150 years earlier. In discussing joint stock companies, Smith wrote: “The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.” Smith, Adam, An Inquiring Into the Nature and Causes of the Wealth of Nations, Vol. 2, p. 741, Chapter v.i.e., General Editors R.H. Campbell and A.S. Skinner, Textural Editor W.B. Webb Todd, Clarendon Press, Oxford 1976.

40 Ibid, p. 313.

41 Ibid, p. 4.

42 Ibid, p. 131.

43 Ibid, p. 293.


46 By “opportunism” we mean not only management’s pursuit of its self-interest at the expense of the stockholders, but also (1) what is generally referred to in the economic literature as the temptation for “shirking,” that is, management’s tendency to avoid responsibility, negligently perform assigned duties, and free ride on the efforts of others, and (2) the likelihood of systematic deviation from rationality when managers attempt to deal in complex situations and are “erroneously confident” in their knowledge and underestimate the odds that their information or beliefs will be proved wrong. See Bazerman and Messick (1996).


48 See Eisenberg (1976).


50 Bronson (1983).

51 Jensen and Meckling (1976).

52 See Eisenberg (1976), pp. 140-8.
56 Mace (1970).
57 Millstein (1993).
63 “Corporate Directors' Guidebook” (1978).
64 Ibid., p. 1619.
65 Ibid.
66 Ibid.
68 For example, “We enumerate all these legal, regulatory and political constraints on U.S. business organizations with some mixed emotions because a number of them impose excessive and unnecessary costs [and] impair the effectiveness of U.S. business in a world increasingly characterized by transactional markets and transactional competition.” Ibid, p. 293.
69 BRT (1978).
70 Ibid., p. 310.
72 Ibid, pp. 8-9.
73 Ibid., p. 428.
74 Ibid. at 431.
75 Ibid., p. 428.
76 Ibid., p. 437.
77 Ibid., p. 442.
78 Ibid., p. 448.
79 Ibid., p. 469.
80 Ibid., p. 495.
81 Ibid., p. 494.
82 See “Corporate Directors' Guidebook” (1978), p. 32.
83 *Staff Report on Corporate Accountability, 96th Cong. 2d Sess. Senate Committee On Banking, Housing and Urban Affairs*, (Comm. Print 1980), at 499.
84 Ibid., p. 519.
85 See BRT (1978), pp. 304, 312, and 315.
86 See BRT (2002), p. 3.
In Smith v. Van Gorkom, directors were given the authority to make takeover-related decisions based not on a corporation’s market value, but on its “intrinsic value.” Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). In Unocal Corp. v. Mesa Petroleum Co., takeover defenses were permitted provided they were “reasonable in relation to the threat posed” test. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). In Revlon v. MacAndrews & Forbes Holdings, directors were held to have a duty to maximize the short-term value of the corporation once the decision had been made to sell, but they were under no duty to make the corporation available “for sale” at all times. Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986). And, in Moran v. Household International, Inc., board authority to adopt “a poison pill” was affirmed, effectively blocking any takeover attempts unless share-holders replaced the directors with a takeover-friendly board. Moran v. Household International, 500 A.2d 1346 (Del. 1985).


Manne (2002).


American Law Institute (1994), at § 3.02(c).

Ibid. at § 3.02(a)(2).

Ibid. at § 3A.01.

Ibid. at § 3A.05.

Ibid. at § 3.02(a)(4).

Ibid. at § 3A.03.


Ibid., p. 16.

Ibid.


See American Bar Association (1994), p. 27.

BRT (1997).

Ibid., pp. 10-11.

Ibid., p. 1.


Ibid. While there were a number of accounting “scandals” that predated Levitt’s speech, perhaps the most notorious was reported in 1994 when auditors discovered that Bausch & Lomb’s Hong Kong division had inflated sales with a scheme of phony invoices and hidden inventory. Later in the same year, an SEC investigation revealed that the company’s contact lens division inflated 1993 profits by offloading enormous amounts of unwanted inventory to distributors at year-end under delayed payment plans. After these issues surfaced, Bausch & Lomb announced that excess distributor inventories would slash 1994 earnings by 54 percent. Further investigations disclosed a pattern of corporate misdeeds, including funneling products onto the “gray market;” threatening distributors unless they agreed to take excess inventory; pre-shipping products without obtaining orders and recording them as sales; and providing customers unusually long payment terms. See Maremount and Barnathan (1995). SEC investigations found that Bausch & Lomb
had overstated income by $17.6 million. The company later settled a shareholder lawsuit for $42 million. See “Accounting Failures…” (2002).

115 Ibid.
117 NYSE and NASD (1999).
118 Ibid., p. 4.
120 NYSE and NASD (1999), pp. 20, 22.
122 NYSE Company Manual § 303.01. The NASD made similar but not identical changes to the NASDAQ listing standards.
123 See SEC, Rel. No. 34-42233 at 9-10; See SEC, Rel. No. 34-42231 at 12.
124 See, for example, revisions to the proxy rules relating to disclosure of executive compensation (SEC, Regulation 14A, Item 10) and audit committees operations, (SEC Regulation 14A Item 7(d)).
125 See BRT (1997) at Foreword.
126 Norris (2000).
128 Treaster (1999).
130 Norris and Henriques (2000).
135 SEC, Litigation Release No. 17435 (March 26, 2002).
137 SEC, Litigation Release No. 17435 (March 26, 2002).
139 Min (2001).
140 “Heard on the Street” (2002).
142 In December 2000, 30 percent of Americans had no, or very little, confidence in large corporations and only 9 percent had a great deal of confidence. By comparison the comparable percentages for the Congress were 24 percent and 10 percent. NBC News/Wall Street Journal Poll conducted by Hart-Teeter. online.wsj.com/documents/poll-20020724.html.
144 Barroveld (2002).
147 Clayton, Scroggins, and Westley (2002).


The Role of The Board of Directors in Enron’s Collapse, Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs United States Senate, 107th Congress 2d Session, Report 107-70 (July 8, 2002).


Ibid., p. iii.


Ibid., p. 9.

BRT (1978).

BRT (2002), p. 3.


Ibid., pp. 13-14.

American Bar Association (2002).

Ibid., p. 6.

Ibid., pp. 3 and 10.

Ibid., p. 13.

Ibid.


American Bar Association (2002).

See BRT (1997), at foreword.


See Williams (1978).

WorldCom, Form 10-K for the fiscal year ended December 31, 2001.

Blumenstein and Jared (2002).

Young (2002).

Blumenstein and Jared (2002).

Sandberg, Blumenstein, and Young (2002).

SEC, Litigation Release No. 17588 (June 27, 2002).

Young, Mollenkamp, Sandberg, and Sender (2002).


WorldCom not the only corporate scandal to follow Enron. The Task Force cites the following: (1) On June 25, 2002, Adelphia Communications filed for bankruptcy protection three months after revealing that it had guaranteed loans of $2.3 billion to members of the Rigas family, Adelphia’s controlling shareholders. Treaster (2002), p. C2. Adelphia’s common stock, which had reached a high of nearly $28 per share in December, 2001, was now essentially worthless. Lauria (2002). (2) The market capitalization of the stock of Tyco International has fallen by some $100 billion in 2002, after the indictment of its former CEO on charges of state sales tax evasion, and by concerns about the use of corporate funds for the personal benefit of the CEO and the general counsel of the company. See Berson (2002). (3) Gary Winnick, the former head of Global Crossing Ltd., sold over $700 million of his stock from 1999 (when the price reached $60 per share), through the end of 2001 shortly before the company’s bankruptcy filing. Global Crossing’s revenues were alleged to be inflated due to swaps without economic substance. See Stewart (2002). Before these companies, went into bankruptcy, their common stock was traded on the NYSE or the NASDAQ National Market.


Sarbanes-Oxley also contains provisions—blanket prohibitions of loans to corporate executives, recapture of profits from stock sales in the event of an earnings restatement, executive certification of financial statements, and prohibition of executive stock sales during “blackout periods”—that reflect substantial skepticism with respect to the “consensus” view that strong boards of directors can effectively control management opportunism. See Section VII, below.

Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporation Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, Aug. 1, 2002, available at <www.nyse.com>. On August 21, 2002, NASDAQ’s Board of Directors approved a comprehensive package of corporate governance reforms that basically tracks the NYSE’s new listing standards. Because the full text of the NASDAQ proposals are not yet available, we will cite hereafter only to the NYSE Standards. A summary of the NASDAQ Corporate Governance proposal is available at <http://www.NASDAQnews.com/about/corpgov/Corp_Gov_Summary082802.pdf>.


See note 1, above.

Ibid. at Title I.

Ibid. at Title II.

See text accompanying notes 188, 189, and 190.


Ibid.

See note 1, above at § 402. This provision could well have far reaching implications for several well established corporate employee benefit programs. See Rozhon and Treaster (2002), and Treaster and Rozhon (2002).

See note 1, above, at § 304. Presumably, this provision can be enforced in the same manner as the current prohibition on short-swing profits in Section 16(b) of the Securities Exchange Act of 1934, that is, through stockholder derivative action.
See note 1, above, at § 302. The SEC has now adopted rules implementing section 302 of Sarbanes-Oxley as well as imposing extensive additional requirements regarding internal controls for both disclosure and financial reporting. SEC, Rel. No. 33-8124, Certification of Disclosure in Companies’ Quarterly and Annual Reports, August 29, 2002.

See note 1, above, at § 906.

Ibid. at § 306.

Ibid. at § 303.


This is a narrower universe than that of all public corporations because it includes only corporations “listed” on NASDAQ or an exchange.

This is a defined term and includes any person directly or indirectly controlling, controlled by, or under common control with the corporation. See Securities and Exchanges Act of 1934, § 3(a)(19).

See note 1, above at § 301.

Ibid. at § 407.

Ibid.

Ibid. at § 202.

Ibid.

Ibid. at § 301.

See American Bar Association (2002).

See note 1, above, at § 301.

The generally accepted legal doctrine is that there is no private right of action for violation of rule of a self-regulated organization.

See note 1, above, at §§ 802, 807, 1102, and 1107.

See note 1, above, at §§ 902, 903, 904, and 1106.

See note 1, above at §§ 305, 602, and 1105.

Ibid. at § 804.

Ibid. at § 303.

See note, above, at 1.

Report of New York Stock Exchange Corporate Accountability and Listing Standards Committee (June 6, 2002).

Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002, available at <www.nyse.com>.

While the NYSE’s actual proposed rule changes were approved by its Board after enactment of Sarbanes-Oxley, the Corporate Accountability Committee’s recommendations on which they were based were made almost two months before the Act was signed into law and several weeks before Senator Sarbanes’ Senate Banking Committee reported the bill. The Nasdaq Stock Market has proposed somewhat similar requirements. NASDAQ Press Release, June 5, 2002.

See note 222, above, at ¶ 1. The NYSE had previously only required a listed company to have three independent directors, all of whom were to serve on the audit committee. NYSE Listed Company Manual, § 303.01 (B)(2)(a).

See note 222, above, at ¶ 2(a) and Commentary.

Ibid. at ¶ 2(b).
227 Ibid. at ¶ 3.
228 Ibid. at ¶ 4.
229 Ibid. at ¶ 5.
230 Ibid. at ¶ 7(a).
231 Ibid. at ¶ 7(b)(ii) (E) and Commentary.
232 Ibid., at 1.
233 See Arrow (1974).
234 See note 221, above, p. 8.
235 But see Bhagat and Black (1999). “[Evidence suggests] the opposite—that firms with super majority-independent boards perform worse than other firms, and that firms with more inside than independent directors perform about as well as firms with majority (but not super majority) independent boards.”