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Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom Era

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TOO MANY BELLS? TOO MANY WHISTLES? CORPORATE GOVERNANCE IN THE POST- ENRON, POST-WORLDCOM ERA

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I. INTRODUCTION

When the pendulum swings, it swings too far. The Enron debacle—both ending and beginning with bankruptcy in December 2001, and a perfect storm in governance terms—was the first to nudge the pendulum. WorldCom's bankruptcy resulted in losses for millions of investors and caused the pendulum's swing to gather speed. By all accounts, the July 30, 2002 Sarbanes-Oxley (SOX) legislation[1] pushed the pendulum past the centerline; how far being the principal disagreement. Adelphia Communications, Tyco, HealthSouth, Global Crossing, Marsh & McLennan, Hollinger International, and other governance imbroglios have pushed the pendulum further.[2]

The pundits, law professors, governance advocates, commercial providers, and other reformers continue to write, unaware that this reform is breaking real-world backs. These reformers' unstated assumption is that, in corporate governance, more is always better: more board meetings, more audit committee meetings, longer meetings, longer meetings still, more certifications, more internal controls, new, often untried documentation of those controls, added auditing devices, beefed up gatekeepers, new gatekeepers, and separate counsel for independent directors. The list goes on, with few questions asked about the marginal utility of all these reforms. The pendulum may have been pushed all the way, fully against the stops.

This Article's purpose is threefold. First, this Article gives insight into the costs of, but does not detail, the legislatively mandated corporate governance reforms.[3] Second, this Article surveys the reforms which policy makers would have layered upon the reforms dictated by Sarbanes-Oxley. No one has attempted a snapshot, let alone a comprehensive picture, of the cumulative toll posed by all of this corporate governance reform. Third, the Article makes suggestions that may have the effect of pulling the pendulum toward the center line.

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 758 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C. (Supp. IV 2004)). The official popular name is the Public Company Accounting Reform and Investor Protection Act of 2002. Popular appellations include SOA and SOXA, as well as SOX.

2. *Cf.* William M. Bulkeley & Charles Forelle, *How Corporate Scandals Gave Tech Firms a New Business Line*, WALL ST. J., Dec. 9, 2005, at A1 (describing the technology boom that has resulted from the need for help with complex SOX regulations and the fear of legal consequences associated with not taking proper precautions: "A new gusher of technology sales is emerging from a surprising source: laws meant to fight corporate fraud," and "'Sarbanes-Oxley changed the world.'").

3. For detailed summaries of SOX, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003) [hereinafter Cunningham, *The Sarbanes-Oxley Yawn*]; Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002) [hereinafter Ribstein, *Market vs. Regulatory Responses*]; Brian Kim, Recent Developments, *The Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235 (2003). For shorter summaries of SOX, see Mike Allen, *Bush Signs Corporate Reforms Into Law: President Says Era of 'False Profits' Is Over*, WASH. POST, July 31, 2002, at A4; *Auditing Sarbanes-Oxley: A Price Worth Paying?*, ECONOMIST, May 21, 2005, at 71.

A. Background

A number of entities and individuals watch over the modern corporation and its performance. In modern parlance, those who earn their livelihood doing so are "monitors." The corporate governance "monitoring model" focuses on the board of directors, the subgroup of independent directors, and the committees of the board, most particularly the audit, nominating, and compensation committees.[4] With little effort, one can total up, aside from public and private investors, no less than twelve to thirteen watchdogs or monitors of corporate performance:

- Board of directors
- Independent directors
- Committees of the board, including the audit committee
- Debt rating agencies
- Accounting firms
- Lawyers and law firms
- Securities brokers ("registered representatives") and analysts
- Securities and Exchange Commission (SEC)
- New York Stock Exchange (NYSE) or NASDAQ (self regulatory agencies)
- Specialized government agencies (for example, Federal Energy Regulatory Commission (FERC) and state Public Utility Commissions (PUCs)
- Financial press (television, magazines, and newspapers)
- Whistleblowers, real and ersatz[5]

Modern corporations cannot continue their existence as publicly held firms without the certification or approval of certain of these monitors, such as the board, the independent directors, the audit committee, a public accounting firm, a multi-service law firm, the SEC, and perhaps a specialized agency or two at both the federal and state levels. Those monitors whose certification is essential are "gatekeepers," "reputational intermediaries who provide verification and certification services to investors"[6] and corporations.[7] Without gatekeepers, the corporation ceases to move forward.

Certain entities serve as mere monitors to some corporations, but are gatekeepers vis-a-vis other companies. Thus, debt rating agencies may be monitors

4. *See* DOUGLAS M. BRANSON, CORPORATE GOVERNANCE §§ 5.01–5.08 (1983 & Supp. 2001) (exploring the structure of the corporate governance monitoring model).

5. *See* Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 996 (2003) [hereinafter Branson, *When All Systems Fail*] (identifying and discussing the multitude of corporate performance monitors).

6. John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002).

7. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004) [hereinafter Coffee, *Gatekeeper Failure and Reform*].

with regard to certain issuers of bonds who regard their debt's rating as interesting but not essential. The same agencies may be gatekeepers for other issuers, like Enron, for whom a high rating is essential for continued access to markets. Some commentators eschew the terminology as having "no analytical utility or legal significance."[8] Nonetheless, in the post-Enron era, the gatekeeper terminology has become ubiquitous.[9]

Darwin's "survival of the fittest" seems to apply to gatekeepers' evolution and the roles they play in corporate governance. Over the years, certain gatekeepers' influence ebbs while others' increases. As law morphed from a profession to a business, the attorney's role lessened from that of a deal guru and wise counselor to that of a technician who could be replaced by several others, many of whom might perform the task more cheaply. Public accounting, once universally regarded as a repository of integrity and probity, became a commodity offered at prices which met or undercut those of competitors. By contrast, the financial press, arguably more of a monitor than a gatekeeper, gathered strength. Seemingly, each corporate earnings report has become the source of a news story, while twenty or thirty years ago, earnings reports were simply numbers reported in the back pages of newspapers.

One widely used approach is to view SOX as an attempt by Congress to reverse this Darwinian slide, bolstering up certain gatekeepers. The statute takes "off the shelf" many, sometimes conflicting, structural devices that may help restore gatekeepers to their rightful positions.[10] Other provisions put gatekeepers in positions that they have never occupied. Overall, a principal SOX focus is on "gatekeeper accountability."[11]

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8. Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 417 n.6 (2004).

9. Coffee, *Gatekeeper Failure and Reform*, *supra* note 7, at 308.

10. Cunningham, *The Sarbanes-Oxley Yawn*, *supra* note 3, at 918 ("[T]he Sarbanes Oxley Act reenacts in a new federal guise more than a dozen existing federal regulations, state laws, stock exchange and securities industry rules . . . .") (footnote omitted); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too* (Harvard John M. Olin Ctr. for Law, Econ. and Bus., Discussion Paper No. 525, 2005), *available at* http://www.law.harvard.edu/programs/olin_center/ papers/pdf/Clark_525.pdf ("These particular reform ideas [taken off the shelf, so to speak] were around long enough to have stimulated some empirical studies that cast doubt on their validity . . . .").

11. Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 519–520 (2003) ("Congress sought, through Sarbanes-Oxley, to improve corporate decisionmaking indirectly by imposing new obligations—including standards of conduct, regulation of conflicts, and disclosure obligations—on outside professionals . . . .") (footnotes omitted); *see* John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 59–60 (2005) (arguing that future prevention of Enron-style disasters depends on five sets of gatekeepers: "independent auditors, corporate boards of directors, private securities analysts, . . . securities regulators . . . [, and] criminal prosecutors. . . .").

B. A Selected SOX Reform or Two

Business and law articles and even entire treatises have devoted considerable attention to what SOX provides, criticisms of it, recommendations of how to implement it, and directions on the installation of structures and devices which, while not required by SOX, support its implementation.[12] This Article merely recounts one controversial "reform" measure SOX mandates so as to give flavor to and create context for the main subject: "Beyond SOX," "SOX Plus," and "Just how much might all of this cost?"

SOX section 404(a) requires that senior executives of public companies attest to the efficacy of internal accounting controls.[13] Senior executives must also ensure that public accountants supply a similar attestation.[14] Managers and accountants must do so in the lengthy, gray annual report public companies file each year on SEC Form 10K.[15]

Section 404 also requires that firms file periodic reports with the SEC on an "accelerated" basis. Firms must file 10Ks within two, rather than three, months after their fiscal year closes.[16] Firms must eventually file quarterly reports, which remain unaudited, within thirty-five days after a quarter closes.[17] These more mundane SOX features gave birth to the nomenclature, "accelerated filers," which has come to loom large in the section 404 attestation rule context.

Soon after SOX, large teams of expensive accountants descended upon large publicly held corporations. These accountants examined each and every accounting control, or the deficiency or absence of controls. They required installation of new controls and documentation of each and every control.

Some of these exercises proved beneficial. Internal controls are devices that cause managers to "squeeze the numbers" as they ascend up through the corporate organization, eventually contributing to the numbers the corporation publishes on its financial statements. For example, internal controls require that at each and every juncture, managers certify revenues, costs, and other accounting numbers—in a work center, at a plant, within a division, on up to a subsidiary, and on to the parent corporation's income statement and balance sheet—as those numbers percolate up through an organization. With adequate controls, senior managers have increased assurances that the final numbers reported reflect economic reality.

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12. For discussions regarding various aspects of Sarbanes-Oxley's impact, see Ribstein, *Market vs. Regulatory Responses*, *supra* note 3, at 1; Larry E. Ribstein, *Sarbox: The Road To Nirvana*, 2004 MICH. ST. L. REV. 274 (2004); Marc I. Steinberg, *Lawyer Liability after Sarbanes-Oxley–Has the Landscape Changed?*, 3 WYO. L. REV. 371 (2003).

13. Sarbanes-Oxley Act of 2002, § 404(a), 15 U.S.C. § 7262 (Supp. IV 2004).

14. *Id.* § 404(b).

15. 15 U.S.C. §§ 78m(a), 78o(d) (2000).

16. Acceleration of Periodic Report Filing Dates, Securities Act Release No. 8128, Exchange Act Release No. 46,464, 78 SEC Docket 1139 (Sept. 5, 2002).

17. Rachel McTague, *Again, SEC Votes Unanimously to Give Smaller Companies § 404 Relief*, 37 Sec. Reg. & L. Rep. (BNA) No. 38, at 1611, 1612 (Sept. 26, 2005) [hereinafter McTague, *Give Smaller Companies § 404 Relief*].

Much of this reform has proven to be trivial:

> Examples of remedial actions pressed upon companies by auditors in connection with 404 reviews include the following: having the technical support "help desk" document every call it receives from employees; requiring employees to respond to thousands of emails to prove they received them; proving that all of the physical keys to an office in Europe have been accounted for since it opened in 1995; and requiring an auditor to attend a meeting to prove that it took place. More generally, since these selected examples have a tendentious flavor, the section 404 attestation requirement is costly because it has pressed companies to document control processes much more fully and elaborately; to define and enforce restrictions on access to information technology systems; to separate accounting and financial functions more fully, even in smaller offices . . . .[18]

A large portion of the expense stems from section 404 requirements that corporations prove the negative, or demonstrate a higher certainty that their numbers are accurate.[19]

An unintended consequence at accounting firms is that many capable accountants, rather than be dragooned in section 404 compliance work, which often has to be performed on the road and away from home for days at a time, are leaving public accounting.[20]

SOX also put into law restrictions the SEC adopted in 2000 in the form of regulations.[21] Public accounting firms may no longer perform nine categories of "consulting services" ranging from in-house accounting and human resources to

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18. Clark, *supra* note 10, at 30 (footnotes omitted) (paraphrasing ALEX DAVERN ET AL., AM. ELEC. ASS'N, SARBANES-OXLEY SECTION 404: THE 'SECTION' OF UNINTENDED CONSEQUENCES AND ITS IMPACT ON SMALL BUSINESS 2 (2005), http://www.aeanet.org/governmentalaffairs/AeASOXPaperFinal021005.asp); *see also* David Henry, *Honesty Is a Pricey Policy*, BUS. WK, Oct. 27, 2003, at 100 ("[M]anufacturers will have to prove that they can trace their products from assembly line to customer. Temp agencies will have to show that the hours they bill match those worked by their employees.").

19. See Bulkeley & Forelle, *supra* note 2, which explains how "the process can still be ripe for manipulation":

> Employees can make false entries in the database, modify the dates of transactions or generate unauthorized expenditures.
>
> Sarbanes-Oxley aims to curb these abuses. . . . Companies need to demonstrate to auditors, for instance, that their programs are configured to reject bogus entries after the close of a quarter, or that they have a security system in place that would stop a rogue employee from writing himself a giant check.

20. Interview with a departing Ernst & Young partner in Pittsburgh, Pa. (Oct. 8, 2005).

21. These are the so-called Leavitt reforms mandating separation of auditing and consulting, which are based upon the recommendations of an American Bar Association Blue Ribbon Committee on audit committee reform. *See* 64 Fed. Reg. 73,389 (Dec. 30, 1999) (codified as amended at 17 C.F.R. § 210.2-01(c)(4)(i)-(ix) (2006)).

mergers and acquisitions, actuarial work, and fairness opinions, at least for clients whose financial statements the accounting firm audits.[22] For firms, auditing may no longer be offered as a loss leader, but must stand on its own. Section 404 attestation work, and the auditing and documentation that accompanies it, have surpassed consulting as profit centers.

The SEC originally estimated that section 404 attestation would cost $91,000 per corporation.[23] At the outset of the exercise, "[t]he SEC estimated that companies [overall] will pay some $2 billion a year to comply with Section 404."[24] At nearly the same time, 217 companies with average revenues of $5 billion estimated that the new procedure would add $3.14 million per company to compliance costs.[25] The same companies reported average costs of $4.36 million for "year-one Sarbanes-Oxley section 404 compliance," almost 40% more than their estimates.[26] Mid-cap companies reported a 66% rise in external costs for consulting, software, and the like, and a 58% rise in public accountants' fees.[27] The number of personnel hours for section 404 compliance averaged 26,758.7 people hours.[28] Autodesk, a California-based software company whose capitalization is $8.29 billion, reported spending $6 million and expending 28,000 personnel hours in the first year of section 404 attestation.[29] The aggregate cost section 404 imposes has been estimated at $35 billion per year.[30]

In subsequent years, corporations will presumably have lower compliance costs to obtain the needed section 404 attestations.[31] Lower costs have not stopped the

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22. Sarbanes-Oxley Act of 2002, § 201(a), 15 U.S.C. § 78j-1 (Supp. IV 2004) (detailing requirements for "independence," which still permit firms to undertake comfort letter writing in securities offerings and tax work). Of the $52 million Arthur Andersen billed Enron in 2000, $25 million represented auditing work while the rest represented consulting services. Branson, *When All Systems Fail*, *supra* note 5, at 1010.

23. Management's Reports on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 26,068, 80 SEC Docket 1014 (June 5, 2003).

24. Joyce E. Cutler, *Firms Note Frustration with Sarbanes-Oxley, Seek 'Rational' Inspection of Costs, Benefits*, 37 Sec. Reg. & L. Rep. (BNA) No. 8, at 333, 333 (Feb. 21, 2005).

25. Rachel McTague, *FEI Finds Actual Costs of Compliance with SOX Section 404 Exceed Estimates*, 37 Sec. Reg. & L. Rep. (BNA) No. 13, at 576, 576 (Mar. 28, 2005) [hereinafter McTague, *Costs Exceed Estimates*].

26. *Id.*

27. *Id.*

28. *Id.*

29. Cutler, *supra* note 24, at 333. The large national law firm, Foley & Lardner, reported that SOX increased corporations' governance legal costs by 91%. FOLEY & LARDNER LLP, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY (2005), *available at* http://www.fei.org. Market capitalizations came from Yahoo! Finance, http://finance.yahoo.com (last visited Oct. 10, 2006).

30. Clark, *supra* note 10, at 28.

31. *See, e.g.*, Kara Scannell & David Reilly, *Small Firms' Sarbanes Suffering?*, WALL ST. J., Apr. 6, 2006, at C1 (discussing one study of 238 large and small corporations that showed a 13% drop in section 404 auditor fees in the second year of compliance); Rachel McTague, *SEC, PCAOB Roundtable on SOX 404: Year Two Better but More Guidance Needed*, 38 Sec. Reg. & L. Rep. (BNA) No. 20, at 863, 863 (May 15, 2006) (discussing another study that found that section 404 attestation "costs declined an average of between 15 and 25 percent in year two," with 400 of 3,000 reporting corporations finding "material weaknesses" in internal accounting controls).

proliferation of SOX consulting firms and products. Two of *Forbes's* top fourteen small cap stock picks for 2006, Corporate Executive Board, Inc. and Resources Connection, Inc., are SOX consulting firms.[32] Large consulting firms such as IBM or Accenture and Bearing Point, the latter two consulting firms spun off from Big 4 (formerly Big 5) accounting firms, as well as smaller entities such as Mercer Delta Consulting, Hyperion Solutions, Inc., Movaris, and Shareholder.com, aggressively market SOX services, including section 404 attestations.[33] All the software firms have SOX products as well, ranging from the large (Oracle and Microsoft) to the small (LRN Corp. of Los Angeles, California, and Paisley Consulting of Cokato, Minnesota).[34] Projections are that corporations will spend $7.5 billion per year on SOX software.[35]

Finally, with a stroke that will hold the line on corporations' costs, a Federal District Judge held that, in enacting SOX, Congress had no intention of creating a private right of action for investors allegedly aggrieved by violations of SOX.[36] The holding is a death knell to class actions for damages in cases of SOX violations by corporations. At least corporations presently do not have to worry about liability to investors.

C. *Praise and Criticism for SOX*

Evidently believing that the SEC has been taking names, public company officials have either timidly criticized or faintly praised SOX, at least in their public pronouncements. The Chief Executive Officer (CEO) of a small-cap manufacturer of industrial products says that SOX requires "a lot more documentation," "mak[es] it harder to recruit board members," and "is especially burdensome for smaller-cap firms."[37] The Enron restructuring officer reports that SOX provides "a 'very

32. *Fourteen Favorites*, FORBES, Oct. 31, 2005, at 171, 174. As of Sept. 16, 2006, the corporations had market capitalizations of $3.59 billion and $1.19 billion, respectively. Yahoo! Finance, http://finance.yahoo.com (last visited Oct. 10, 2006).

33. *See* Carol Hymowitz, *Experiments in Corporate Governance*, WALL ST. J., June 24, 2005, at R2; Peter Loftus, *Software for Sarbanes*, WALL ST. J., Apr. 25, 2005, at R8; *see, e.g.*, Kris Maher, *Sarbanes-Oxley Is Boon for Slew of Consultants*, WALL ST. J., Aug. 19, 2003, at B1 (featuring Ehticspoint, Inc., Listen Up Group, and other whistleblower hotline consultants); Phyllis Plitch, *A Piece of the Action: Corporate Governance Is Hot—And There's No Shortage of Companies Promising to Help*, WALL ST. J., Oct. 27, 2003, at R8 (featuring Movaris, Restricted Stock Systems, PeopleSoft, and Shareholder.com).

34. *See* Loftus, *supra* note 33, at R8 (reviewing the products and services of IBM, Browne & Co., EMC Corp., Steelent, Inc., Global Compliance Services, and Resources Connection, Inc., as well as the other companies already mentioned).

35. Bulkeley & Forelle, *supra* note 2 (describing SOX software by Consul Risk Management, Inc., EMC Corp., RSA Security, Inc., Computer Associates International, Virsa Systems, Inc., Orchestria, Inc., Lumigent Technologies, Inc., and Serena Software, Inc.).

36. Neer v. Perlino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005); Robert F. Serio & Matthew S. Kahn, *Private Rights of Action and the Sarbanes-Oxley Act of 2002*, 38 Sec. Reg. & L. Rep. (BNA) No. 16, at 668 (Apr. 17, 2006).

37. Judith Burns, *Is Sarbanes-Oxley Working?*, WALL ST. J., June 21, 2004, at R8 (reporting remarks of Janet Dolan, President and Chief Executive Officer, Tennant Co.).

helpful' blueprint for reform."[38] The representative of Ohio Public Employees Retirement System, a large institutional investor, thinks that SOX is "'a step in the right direction.'"[39] A general counsel believes there is "a lot more right than wrong,"[40] and a corporate governance watchdog says she would not "make any 'substantive changes.'"[41] The chief accounting officer of a well known large-cap corporation opines that "'Sarbanes-Oxley is working pretty well.'"[42]

The more outspoken of SOX's sponsors, Representative Michael G. Oxley of Ohio, weighed in with the House Financial Services Committee comments that SOX's costs are "unsubstantial."[43] In a speech at the World Bank on September 16, 2003, Representative Oxley pointed out that "retail investors came back to the markets after nearly two years of scandal and plummeting fortunes. . . . '[W]e had a small part in restoring that investor confidence.'"[44] Former Chairman of the SEC, William Donaldson, touted SOX as a "'valuable government intervention,'" one which "helped to improve the 'tone at the top' of U.S. public companies."[45] NASDAQ's president, Bob Greifeld, joined the chorus, stating that "[u]nlike some others on Wall Street, I support Sarbanes-Oxley. It's a good thing. . . . [S]erious legislation that [strikes] a sensible compromise."[46] The god-like Alan Greenspan, former Federal Reserve Chairman, found SOX to be proving surprisingly effective, revealing that he had been "an early and passionate advocate in internal deliberations of using laws and regulations to make chief executives more accountable."[47]

On the private side, a large public accounting firm took out a full-page advertisement in a national newspaper, stating that "to see the real impact of

38. *Id.* (reporting remarks of Stephen Cooper, Chairman, Kroll Solfo Cooper, LLC, New York, and interim Chief Executive Officer and Chief Restructuring Officer of Enron Corp.).

39. *Id.* (reporting remarks of Cynthia Richson, Corporate Governance Officer for Ohio Public Employees Retirement Systsem).

40. *Id.* (reporting remarks of Logan Robinson, Vice President and General Counsel, Delphi Corp., Troy, Mich.).

41. *Id.* (reporting remarks of Nell Minnow, Editor of the Corporate Library, Portland, Maine).

42. *Id.* (reporting remarks of Arnie Hanish, Chief Accounting Officer, Eli Lilly & Co., Indianapolis, Ind.).

43. Rachel McTague, *House Panel Argues Compliance Costs of Sarbanes-Oxley Are Not Substantial*, 35 Sec. Reg. & L. Rep. (BNA) No. 31, at 1289 (Aug. 4, 2003).

44. Richard Hill, *Oxley Says Returning Investors Signal Renewed Market Confidence, Success of Law*, 35 Sec. Reg. & L. Rep. (BNA) No. 37, at 1550 (Sept. 19, 2003).

45. *Donaldson Cites Sarbanes-Oxley Act as 'Valuable Government' Intervention*, 36 Sec. Reg. & L. Rep. (BNA) No. 44, at 1969 (Nov. 8, 2004).

46. Bob Greifeld, Op-Ed., *The View from Nasdaq*, WALL ST. J., July 30, 2004, at A10.

47. David Wessel, *Corporate Overhauls Are Proving to Be Effective, Greenspan Says*, WALL ST. J., May 16, 2005, at C3. For similar remarks by Paul Volcker, Federal Reserve Chairman from 1979 to 1987, and Arthur Levitt, Jr., SEC chairman from 1993 to 2001, see Paul Volcker & Arthur Levitt, Jr., Op-Ed. *In Defense of Sarbanes-Oxley*, WALL ST. J., June 14, 2004, at A16 ("We believe the benefits of the legislation outweigh the costs.").

404—improved investor confidence evidenced by a better capital allocation process—will take more than a few months."[48]

For the most part, commentators have been scornful in their criticism of SOX.[49] In an op-ed piece, one leading scholar questioned "strict enforcement of Sarbanes-Oxley in spite of mounting evidence that it is costly beyond any conceivable benefits."[50] The U.S. Chamber of Commerce president, Thomas Donohue, strident in his criticism of SOX, calls the costs of section 404 "unjustified" and labels the SEC as "overreaching" in its administration of the statute.[51] In an earlier pronouncement, he expressed that SOX produces a "risk averse economy," "puts too much of a burden on executives and officers to be perfect," and "create[s] enormous uncertainty."[52]

On its editorial page, the *Wall Street Journal* has been both profuse and colorful in its criticism of SOX. Bemoaning the cost of section 404 compliance, one editorial notes that Sarbanes-Oxley "did achieve one miracle. The accounting profession, reviled as the moral equivalent of porn merchants just two years ago, has been lofted to unexpected new heights of power and prosperity."[53] The editorial also reports that "audit fees, for the average company, have rise about 50% in a single year."[54] In addition, Fortune 100 corporations will pay an estimated $6 billion to comply with Sarbanes-Oxley in 2006.[55] Among the S&P 500, the average fees individual firms paid for auditing rose from $2.9 million in 2001 to $7.4 million in 2004.[56]

Other critics remain out of sight, or are lukewarm in their denunciations. Overall, among the public pronouncements, praise outweighs the criticism.

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48. Advertisement, *The Glass Is Half Full, But That's Debatable*, WALL ST. J., Feb. 10, 2005, at A5.

49. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (analyzing empirical literature suggesting that post-Enron government mandates are not likely to improve audit quality or enhance firm performance); David B. Kahn, *Let's Get Real—Why the Sarbanes-Oxley Act Is a Sham* 1 (2002), http://kahnlawchicago.com ("[T]he Sarbanes-Oxley Act will do little to prevent the false and inflated reports on the financial condition of our public companies.").

50. Henry Manne, Op-Ed., *Life After Donaldson*, WALL ST. J., June 6, 2005, at A10.

51. Brett Ferguson, *Chamber Raps Regulator Excessiveness in Overseeing Governance, Cites SEC, Spitzer*, 37 Sec. Reg. & L. Rep. (BNA) No. 2, at 52 (Jan. 10, 2005).

52. Richard Hill, *U.S. Chamber Head Says Sarbanes-Oxley Will Hinder Progress of Business Innovation*, 34 Sec. Law Daily 37 (BNA) (Sept. 19, 2002) (internal quotation marks omitted).

53. Holman W. Jenkins, Jr., Op-Ed., *Thinking Outside the Sarbox*, WALL ST. J., Nov. 24, 2004, at A13.

54. *Id.*; *see also* David Henry, *Bean Counter Bonanza*, BUS. WK., Oct. 27, 2003, at 101 (predicting that the Big Four accounting firms would take in 50% to 100% more in fees in 2004).

55. David Reilly, *Sarbanes-Oxley Changes Take Root*, WALL ST. J., Mar. 3, 2006, at C3.

56. Deborah Solomon, *At What Price?*, WALL ST. J., Oct. 17, 2005, at R3.

D. Calls for SOX II

Commentators have called outright for amendments to section 404, such as deleting the requirement for accountants' attestations for small-cap and some mid-cap corporations.[57] For these companies, section 404 tends to be regressive.[58] These corporations must pay out a large portion of the $2 million or $3 million required in auditing fees each year from a much smaller revenue base.[59] Even before SOX, many of these companies teetered on the brink of profitability because their products are often unestablished or experimental.

Indeed, the cost of compliance may be much higher for many smaller corporations. For years, large companies have had in place internal accounting staff who, as a principal task, evaluated, implemented, and documented the types of internal controls SOX requires. In contrast, internal accounting functions barely exist at smaller companies, if they exist at all. For practical purposes, with section 404 exercises, most small-cap companies start from scratch, writing on a clean slate. Thus, on a relative basis, their costs are much higher.

The one-size-fits-all mindset also persists, forcing smaller companies to do, or feel that they must undertake, the same SOX tasks as larger companies, such as the installation and verification of internal controls. In addressing the European Parliamentary Financial Securities Forum, SEC Commissioner Paul Atkins blamed the Public Company Accounting Oversight Board (PCAOB), whose thick, gray Auditing Standard Number 2, notable for "sheer length and tone[,] . . . ha[s] contributed to an excess of caution and an emphasis on needless detail."[60] Commissioner Cynthia Glassman is more colorful: "[A] company having 40,000 key [internal] controls is an oxymoron: 'How can they all be key?'"[61] An estimate is that to comply with SOX, small-cap public companies pay an average of eleven times what their larger cap brethren must pay.[62]

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57. *See, e.g.*, Andrew Skouvakis, Comment, *Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley*, 109 PENN ST. L. REV. 1279, 1280 (2005) (stating that Congress or the SEC should provide relief for small public companies burdened by the fixed costs of implementing the Sarbanes-Oxley Act); Nathan Wilda, Comment, *David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 J. MARSHALL L. REV. 671, 692 (2005) ("[A]n . . . exemption for small companies . . . would provide a balance between the protection of investors and the need to avoid overburdening small companies.").

58. Clark, *supra* note 10, at 29.

59. *See id.*

60. *Atkins Calls for SEC Review of PCAOB Internal-Controls Standard*, 37 Sec. Reg. & L. Rep. (BNA) No. 44, at 1867 (Nov. 7, 2005) (calling for SEC oversight of PCAOB standards and guidelines).

61. Kip Betz, *Glassman Says 404 Rules Aimed at Holding Management Accountable*, 37 Sec. Reg. & L. Rep. (BNA) No. 41, at 1738 (Oct. 17, 2005) ("[I]nternal controls reporting rules under section 404 of the Sarbanes-Oxley Act have turned off course and must be refocused on their original intent . . . ."). Citing the "one-size-fits-all" effect, the SEC Advisory Committee recommended, with one dissension, that regulations exempt small-cap companies from the requirement for external assessments of internal controls. Alison Carpenter, *SEC Advisory Group on Small Companies Backs Looser Section 404 Reporting Rules*, 37 Sec. Reg. & L. Rep. (BNA) No. 49, at 2113 (Dec. 19, 2005).

62. Bob Greifeld, Op-Ed., *It's Time to Pull Up Our SOX*, WALL ST. J., Mar. 6, 2006, at A14.

Foreign issuers seeking to have their shares listed on the NYSE or traded on NASDAQ had been one growing category of small-cap companies. As an example, Professor Jack Coffee points to the number of Israeli high tech firms that sought U.S. listings in 1999 and before.[63] He has predicted a continued migration of listings to the U.S., which saw 750 foreign listings in 2000 compared to 170 in 1990 as firms sought to associate with stricter corporate governance regimes.[64]

Post SOX, much of the discussion concerning foreign companies' withdrawal from U.S. markets has been either solely rhetoric or a combination of rhetoric with anecdotes. An editorial asserts "concern about the number of European and Asian companies delisting from, or not listing on, U.S. exchanges—to say nothing of a drastic decline in domestic IPOs."[65] *Mexican Firms Leave NYSE* profiles the departures of conglomerate Desc SA and steel manufacturer Groupo Imsa SA but contains no statistics.[66] Foreign businesses are not listing in the U.S. for other reasons over and above the costs of SOX compliance. For example, capital markets in home countries tend to be much deeper and more liquid than they once were.[67] With computerized trading mechanisms such as E*TRADE and Charles Schwab, U.S. investors find it much easier to access those foreign markets.[68] Large European companies, such as VNU, Roche, and Adidas-Salomon, think a U.S. listing is "expensive and . . . a lot of extra work."[69] For corporations on or close to the fence, the SOX compliance cost has been a tipping point against a U.S. listing.

The statistics demonstrate that voluntary delistings by foreign corporations are not as frequent as SOX critics predicted. The NASDAQ had at least ten voluntary foreign company delistings in 2004.[70] The NYSE had two in 2003 and two in 2004.[71] Delisting is difficult because the foreign firm must demonstrate that the number of U.S. shareholders has fallen below 300.[72] But in December 2005, the SEC adopted new rule 12h-6 which makes it easier for foreign firms that are in good standing to terminate their registrations.[73]

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63. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 675 (1999) (noting that more than 100 Israeli firms, of which 70 are high tech, are listed on NYSE, NASDAQ, or AMEX).

64. *See* John C. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1770–72 (2002) (noting that in 2002, nearly 17% of firms with NYSE listings were foreign).

65. Manne, *supra* note 50.

66. Amy Guthrie, *Mexican Firms Leave NYSE*, WALL ST. J., Jan. 17, 2005, at C14.

67. *Id.*

68. *See* Craig Karmin, *Listing in the U.S.—Some Can't Be Bothered*, WALL ST. J., Aug. 21, 2003, at C1 ("[B]uying foreign shares is much easier than it was a few years ago.").

69. *Id.* (noting that listing in U.S. is "more cumbersome and confusing than ever").

70. Silvia Ascarelli, *Citing Sarbanes, Foreign Companies Flee U.S. Exchanges*, WALL ST. J., Sept. 20, 2004, at C1 Fig. (chart generated by NYSE and Wall Street Journal research that displays the number of voluntary delisting by non-U.S. companies from 1996 to 2004).

71. *Id.*

72. David Epstein, *Goodbye, Farewell Auf Wiedersehen, Adieu . . .*, WALL ST. J., Feb. 9, 2005, at A10.

73. Rachel McTague, *SEC Unanimously Proposes Relaxation of Deregistration for Foreign Private Issuers*, 37 Sec. Reg. & L. Rep. (BNA) No. 49, at 2085 (Dec. 19, 2005).

Instead, even though the number of deregistrations of foreign firms has slowed, the number of foreign corporations seeking U.S. listings has gone from a robust stream to a mere trickle.[74] From peaks of 63 in 1997 and 60 in 2000, the number of foreign firms seeking a NYSE listing slowed to 16 in 2003, 8 in 2004, and 13 in 2005.[75] Experts and firms themselves cite SOX compliance as the culprit.

Besides calls for amendment or repeal of section 404, at least for small-cap companies, well-respected commentators have called for and outlined SOX repeal or accommodations for foreign corporations.[76]

E. The SEC Response: Delayed Implementation

In the eyes of some, the SEC response has been lukewarm. At first, the SEC took a tough stance, noting "'that improved corporate governance, improved financial reporting, [and] improved auditor performance is important for all companies, regardless of size.'"[77] Thus, large public corporations were required to file section 404 attestations on the SEC annual report form 10K for fiscal years ending on or after June 15, 2004.[78] Smaller corporations would have to do so for fiscal years ending on or after April 15, 2005.[79]

The SEC soon began to take a more middle-of-the-road, accommodating stance. The SEC delayed section 404 filings for "companies with [a] market

74. *See* Craig Karmin & Aaron Lucchetti, *New York Loses Edge in Snagging Foreign Listings*, WALL ST. J., Jan. 26, 2006, at C1. In 2000, foreign corporations raised \$9 of every \$10 raised in New York rather than in London or Luxembourg, the closet competitors. *Id.* In 2005, after Sarbanes-Oxley had taken hold, the statistic was exactly the opposite: foreign corporations raised \$9 of every \$10 in London or Luxembourg. *Id.* In 2000, foreign firms raised 46.8% of capital on U.S. exchanges; in 2005, the number had fallen to 5.7%. *Regulatory, Litigation Costs Seen Causing Loss of U.S. Listings*, 38 Sec. Reg. & L. Rep. (BNA) No. 18, at 750. Furthermore, "in 2005, only one of the world's top 24 IPOs registered in the United States." *Id.*

75. Ascarelli, *supra* note 70 (citing a chart generated by *Wall Street Journal* research that displays number of foreign firms seeking a NYSE listing from 2001–2004); *see also* Karmin & Lucchetti, *supra* note 74 (providing the 2005 statistic).

76. *See generally* Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 STETSON L. REV. 849, 886 (2004) (explaining the consequences of a unilateralist policy that forces foreign issuers to rise to U.S. standards and the benefits of an international approach to business regulation) (Professor Karmel is a former commissioner of the SEC); Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on US Law*, 3 J. CORP. L. STUD. 299 (2003) (explaining that the Sarbanes-Oxley Act imposes requirements on foreign firms that often conflict with the law of the firms' home countries); Corinne A. Falencki, Note, *Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality*, 36 GEO. WASH. INT'L L. REV. 1211, 1236–38 (2004) (recommending that the SEC work towards regulating businesses on a global scale to promote harmony in the global market).

77. Richard Hill, *Beller Says SEC Prepared to Ease Burden of SOX Compliance on Small Firms*, 36 Sec. Reg. & L. Rep. (BNA) No. 38, at 1706 (Sept. 27, 2004) (quoting Alan Beller, Director of the SEC Division of Corporate Finance).

78. *Large Companies Expect to Spend Millions to Meet SOXA Internal Controls Requirements*, 36 Sec. Reg. & L. Rep. (BNA) No. 7, at 315 (Feb. 16, 2004).

79. *Id.*

capitalization of up to $75 million until [fiscal years ending after] July 2007."[80] The SEC also delayed implementation for foreign corporations.[81] Further, SEC Chairman Donaldson publicized an SEC website the Commission had created so that "all interested parties can send us feedback on their experiences with Section 404."[82] Nonetheless, the SEC Chairman labeled cries for a partial repeal of SOX to be "short-sighted."[83] The SEC also founded a twenty-one member Advisory Committee on Smaller Public Companies, which held its first meeting in April 2005.[84]

In September 2005, the SEC relented further. It announced a three-tiered regulatory format: "large accelerated filers" with a market capitalization over $700 million, "accelerated filers" with a market capitalization under $700 million, and "non-accelerated filers" with a market capitalization under $75 million.[85] The latter category numbers over 6,000 public companies which will not have to comply until after mid-2007.[86] The SEC also exempted the middle category from the accelerated annual sixty day and quarterly thirty-five day filing deadlines.[87]

Critics of SEC accounting regulation were quick to speak out, "crying foul" over delayed implementation and what wags have termed SOX Lite.[88] An accounting professor noted that approximately "75% of companies that were the subject of fraud allegations described in SEC enforcement releases from 1998 to 2003 had market capitalizations of less than $700 million . . . ."[89] "'A good internal-control system within these companies would have prevented a good number of these,'" stated another accounting professor.[90]

Studies flatly contradict the latter. Fraud and accounting imbroglios come to light because of a tip (42.6%), internal auditing (24.6%), accident (18%), outside auditors' discovery (16.4%), and last of all, by virtue of an earlier-installed internal

80. Deborah Solomon, *Small Firms to Get Another Extension on Sarbanes Rule*, WALL ST. J., Sept. 13, 2005, at A2.

81. William H. Donaldson, Op-Ed., '*We've Been Listening*,' WALL ST. J., Mar. 29, 2005, at A14 (noting that foreign private issuers are experiencing a dual burden upon their conversion to international financial reporting standards).

82. *Id.*

83. *Id.*

84. *See* Kip Betz, *Witnesses Ask Panel to Seek Amended SOX Rules for Smaller Firms*, 37 Sec. Reg. & L. Rep. (BNA) No. 26, at 1129 (June 27, 2005) (outlining the discussion of prominent business leaders testifying before the SEC Advisory Committee on smaller public companies).

85. *SEC Sets Meeting to Consider Extending Compliance Date for Internal Controls Rules*, 37 Sec. Reg. & L. Rep. (BNA) No. 37, at 1555 (Sept. 19, 2005) ("[T]he SEC said it will consider whether to propose amendments to the 'accelerated filer' definition in Rule 12b-2 of the 1934 Securities Exchange Act.").

86. McTague, *Give Smaller Companies § 404 Relief*, *supra* note 17.

87. *Id.*

88. Micheal Rapoport, *Watchdogs Frustrated by Sarbanes Extension*, WALL ST. J., Oct. 4, 2005, at C3.

89. *Id.* (commenting on the remarks of Joseph Carcello, University of Tennessee professor who regularly works with the SEC).

90. *Id.* (quoting Thomas Weirich, an accounting professor at Central Michigan University).

control (8.2%).[91] Because of the costs involved and their desperate attempts to hold the line on costs, smaller corporations and other smaller issuers are "outsourcing" section 404 attestation work to India.[92]

Meanwhile, executives at a number of smaller cap public companies find themselves unable to obtain an accounting firm to do section 404 attestations at all, or to do them at a price anywhere near what companies feel they can afford.[93] The condition is so widespread that it has even taken on a name, "Sarbanes-Oxley limbo."[94] In Roman Catholic teachings, at least of the old fashioned kind, limbo is "a region believed to exist on the border of hell as the abode of souls barred from heaven through no fault of their own (as the souls of . . . unbaptized infants)."[95] Corporations' inability to comply at all may well have played a part in the SEC decision to delay implementation to late 2007 and beyond.

F. Beyond SOX (or SOX and Beyond)

Despite the costs this Article describes, at least in small part, corporate governance advocates and reformers layer added requirements over what Sarbanes-Oxley requires. There is a first generation of "best practices" blueprints in corporate governance. In the United States, they include the General Motors 28 Points[96] and the American Law Institute's (ALI) *Principles of Corporate Governance and Structure*.[97] Elsewhere in the world, sources include the Cadbury Report in

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91. Clark, *supra* note 10, at 30.

92. Eric Bellman, *One More Cost of Sarbanes-Oxley: Outsourcing to India*, WALL ST. J., July 14, 2005, at C1 ("An increasing number of companies are looking to India's information-technology outsourcing firms to cut the cost and time needed to comply with the law . . . .").

93. *See Give Smaller Companies § 404 Relief, supra* note 17 (providing a detailed discussion of the challenges facing smaller companies when complying with SOX section 404 attestation costs).

94. *See generally* Press Release, S. Comm. on Small Business & Entrepreneurship, Snowe: Small Businesses Could Face Expensive, Paralyzing Regulatory Limbo Under Sabanes-Oxley Law (Mar. 9, 2006), http://sbc.senate.gov/HTML/news/release4.html (last visited Oct. 10, 2006) ("Currently, many small public companies are caught in an expensive and paralyzing state of regulatory limbo." (quoting Letter from Senator Olympia J. Snowe, Chair, Senate Committee on Small Business & Entrepreneurship, to Christopher Cox, Chairman, SEC)).

95. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1312 (2002) (providing secondary definitions that include "a place or state of restraint or confinement . . . [or] of neglect or oblivion").

96. GEN. MOTORS BD. OF DIR., GM BOARD GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (June 1995 ed.) (on file with South Carolina Law Review).

97. 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS XXV (1994) [hereinafter ALI CORP. GOV. PROJ. The ALI effort to "restate," or state for the first time, principles applicable to corporate governance] proved very controversial. It began in 1980 and lasted until 1993. *Id.* at XI n.1.

England,[98] the Vié-not and Marini Reports in France,[99] the Bosch Report by the Institute of Corporate Directors in Australia,[100] and many more.[101]

In the United States, second generation best practices blueprints include academics' articles and other pronouncements.[102] Perhaps attempting to mushroom large engagements into even larger ones, the consulting firms have come up with lists of governance add-ons. Other consultants, including no less than the venerable Standards & Poor's Corporation, sell services that audit and grade corporations' compliance with scores of corporate governance metrics.[103] In the larger corporate governance debacles, investigative committees of the boards of directors render

98. THE COMM. ON THE FIN. ASPECTS OF CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992) (This report is known as the Cadbury Report after the Committee's Chair, Adrian Cadbury). Cadbury was followed by the Greenbury Report, STUDY GROUP ON DIRECTORS' REMUNERATION, DIRECTORS' REMUNERATION: REPORT OF A STUDY GROUP CHAIRED BY SIR RICHARD GREENBURY (1995), and the Hampel Report, THE COMM. ON CORPORATE GOVERNANCE, COMMITTEE ON CORPORATE GOVERNANCE: FINAL REPORT (1998) (Committee chaired by Ronnie Hampel). They have recently been revised and re-issued as the Turnbull Guidance. *See* FIN. REPORTING COUNCIL, INTERNAL CONTROL: REVISED GUIDANCE FOR DIRECTORS ON THE COMBINED CODE (2005).

99. *See* James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 57 (1998) ("[B]oth the Viénot Report and the Marini Report urge French directors to take their basic duty of care more seriously.").

100. AUSTL. INST. OF CO. DIR. ET AL., CORPORATE PRACTICES AND CONDUCT (2d ed. 1993) Chaired by Henry Bosch AO) (on file at the National Library of Australia).

101. *See, e.g.*, Valentina Barbanti, *The Reform of Corporate Governance in the United States and the New Challenge of the European Union: The Italian Case*, 14 IND. INT'L & COMP. L. REV. 227, 242 (2003) ("Upon implementation of the Legislative Decree No. 6 of January 17, 2003, the Italian system of corporate governance will materially change."); Marco Ventoruzzo, *Experiments in Comparative Corporate Law: The Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition*, 40 TEXAS INT'L L. J. 113, 115 (2004) ("The Reform introduced profound changes to the rules contained in Italian Civil Code . . . that dwarf . . . other corporate law reforms . . . .").

102. Academic blueprints include the following: FRED R. KAEN, A BLUEPRINT FOR CORPORATE GOVERNANCE: STRATEGY, ACCOUNTABILITY, AND THE PRESERVATION OF SHAREHOLDER VALUE (2003); Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J. L. BUS. & FIN. 127 (2002); Cunningham, *The Sarbanes-Oxley Yawn*, *supra* note 3; William W. Bratton & Margaret M. Blair, *Restoring Trust in America's Business Institutions* (Georgetown Law and Economics Research Paper No. 784526, 2003), *available at* http://ssrn.com/abstract+784526.

103. *See* Clark, *supra* note 10, at 4 ("The rating agencies . . . include Institutional Shareholder Services ('ISS'), the largest and most influential of the active agencies, as well as Governance Metrics International ('GMI'), the Corporate Library, Moody's, and Standard & Poor's."); *see, e.g.*, Institutional Shareholder Services (ISS) Corporate Governance Quotient, http://www.isscgq.com/abouttheratings.htm (last visited Oct. 1, 2006) (describing the eight core criteria used to calculate a Corporate Governance Quotient Ô); The Corporate Library (TCL): Board Analyst, http://www.boardanalyst.com/ (last visited Oct. 1, 2006) (providing independent corporate governance analysis through Board Analyst, an online database covering corporate governance, compensation, and performance metrics (formerly known as Board Effectiveness Ratings)); *see also* Phyllis Plitch, *S & P Quits Rating Corporate Governance in U.S.*, WALL ST. J., Sept. 13, 2005, at C3 (reporting that in September 2005, Standard & Poor's ceased marketing its corporate governance ratings and services in the U.S. but plans to continue the ratings and services in emerging markets such as Russia); Clint Riley, *Citigroup's Corporate Governance Improves*, WALL ST. J. ASIA, Mar. 20, 2006, at 21 (mentioning GMI, TCL, and ISS as premier rating agencies).

reports and make good-governance recommendations. Two leading reports are the Powers Report at Enron, prepared by a committee chaired by Dean William Powers of the University of Texas School of Law,[104] and the Wilmer Cutler & Pickering Report at WorldCom, written under the names of three expansion directors, but prepared by a leading Washington, D.C. law firm.[105] The American Bar Association rendered a report with its own recommendations via a committee chaired by James H. Cheek, III.[106]

When bankruptcy follows a governance debacle, bankruptcy examiners also render lengthy written reports.[107] Neal Batson rendered the reports for Enron.[108] Governor Richard Thornburgh, assisted by his law firm, rendered three lengthy reports in WorldCom's bankruptcy.[109]

Last of all, a new player, the "corporate monitor," has come into existence. The first monitor report, written by former Chairman of the SEC, Richard Breeden, entitled *Restoring Trust*,[110] provided the beginning framework for this section of the article. *Restoring Trust* mandates installation of seventy-eight corporate governance "improvements" at WorldCom, later known as MCI, Inc., now part of Verizon Communications, Inc.[111] Mr. Breeden and his consulting firm have served as

104. SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIR. OF ENRON CORP., REPORT OF INVESTIGATION 31 (2002), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf.

105. SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIR. OF WORLDCOM INC., REPORT OF INVESTIGATION (2003), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/worldcom/Bdspcomm6093rpt.pdf.

106. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, REPORT (2003); *see also* ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT (2003), http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

107. *See, e.g.*, *Planet Hollywood Forgave Loans: A Bankruptcy Examiner Says the Restaurant Company Wrote Off $5-Million in Loans to Celebrities*, ST. PETERSBURG TIMES, Aug. 14, 2002, at D3 (discussing independent bankruptcy court examiner's report revealing loans to celebrities); *Professor Named to Probe Case of Revco Drug's LBO*, WALL ST. J., June 13, 1990, at A2 (reporting that a bankruptcy court judge required Barry L. Zaretsky, as examiner in the Revco Drugstores bankruptcy, to submit a detailed report); *Raytheon's Statement on WGI's Bankruptcy Examiner's Report*, PR NEWSWIRE, Aug. 28, 2001 (discussing the examiners report for WGI's bankruptcy).

108. *See* First Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002), *available at* http://www.enron.com/corp/por/supporting.htm.; *see also Examiner Named for Enron*, N.Y. TIMES, May 23, 2002, at C4 (Neal Batson's appointment as bankruptcy examiner for Enron's Chapter 11 bankruptcy).

109. See Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, *In Re* WorldCom, Inc., No. 2-15533 (Bankr. S.D.N.Y., Nov. 4, 2002).

110. *See* RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI (2003), *available at* http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf.

111. *Id.* at 1.

corporate monitor and rendered reports in several other high profile corporate governance cases including Fannie Mae, Hollinger International, and KPMG.[112]

II. THE REFORMS

The following represents a survey of the "bells and whistles" that have, do, and may adorn modern corporate governance efforts.

A. Board of Directors

Old

1. *Board Meetings.* Boards met quarterly, often with one board meeting held as a "fly away" meeting at a resort or in a more distant city. The corporation may have permitted spouses to attend the latter. The meeting was often held as a planning meeting or strategic retreat.
2. *Meeting Duration.* Meetings lasted three to four hours, often during the morning and sometimes into the early afternoon.
3. *Larger Boards.* The group may have consisted of twenty or more directors.[113] With a very large number, a group of inside directors, although less than a majority, could control the agenda due to collective action problems that prevented the majority of independent directors from networking amongst themselves.[114]
4. *Single Leader.* The same individual held, and insisted on holding, both the positions of CEO and Chairperson. Proponents argued that with separation of the two offices, two individuals would vie for a single leadership position to the detriment of the company.[115]
5. *Board Composition: Several "Independent" Directors.* The corporation would recruit several directors free from significant financial or familial ties to the

112. *See Breeden is Tapped to Help Fannie Mae*, WALL ST. J., Jan. 28, 2005, at A1 ("Fannie Mae has hired Richard Breeden to assist in its financial restatement and to help shore up corporate governance."); Geraldine Fabrikant, *Investigator and Hollinger Chief Clash Over Paying $850,000*, N.Y. TIMES, Jan. 6, 2004, at C4 ("Richard C. Breeden . . . is overseeing a special committee's investigation into payments made to Lord Black and other top Hollinger executives.") Arshad Mohammed, *"Bulldog" Breeden to Monitor Tax-Fraud Deal*, WASH. POST, Aug. 30, 2005, at D1 (stating that Breeden "was named yesterday to monitor [KPMG's] agreement" with the Justice Department).

113. *See, e.g.*, RALPH D. WARD, 21ST CENTURY CORPORATE BOARD 4 (1997) (noting that "[t]he 1965 model GM board had 29 directors," of which 17 were insiders).

114. *Cf.* Steve Lohr, *Rubber Stamp Is Tossed Aside by G.M. Board*, N.Y. TIMES, Apr. 8, 1992, at A1 ("General Motors Corp. . . . has abandoned its past in placing an outside board member in charge of a top board committee to monitor more closely G.M.'s management.").

115. *See, e.g.*, Len Boselovic, *Split About Splitting; Separating CEO, Chairman's Jobs In Vogue, But Some Aren't Sure It's Worth It*, PITTSBURGH POST-GAZETTE, Mar. 16, 2004, at C9 (reporting statements by Professor Charles Elson that "[u]nless you get the right person, the company could end up with two leaders, 'which makes it hard to run a company'").

senior managers. Some companies included social ties as well.[116] The remainder of directors would include the CEO; another high ranking manager or two, such as the chief financial officer (CFO), chief operations officer (COO), or executive vice president; the head of a principal division or subsidiary; and one or more "gray directors," such as a lawyer or commercial or investment banker who, while an outsider, derived significant revenues from the corporation either directly or through her firm.[117]

6. *Board Committees.* The New York Stock Exchange (NYSE) has required that listed companies have an audit committee since 1977.[118] Earlier corporate statutes authorized, and corporations had, only an executive committee. Between meetings of the full board, the executive committee, comprised perhaps of three insiders, was delegated the full board's powers, save for powers made non-delegable by statute. It was thought to be abuse that an executive committee could easily usurp the prerogatives and powers of the full board. Among more elaborate committee structures, finance, capital investment, and social responsibility committees rounded out the committee lineup. In more modern times, executive committees have become rarer and the required lineup includes audit, nominating (often denominated "governance" or "nominating and governance"), and compensation committees.[119]

New

1. *Board Meetings.* The full board should meet at least ten times per year. On at least two of those occasions, the board should meet at a non-headquarters facility of the company.
2. *Duration.* Board meetings should last a full day, or even two days.
3. *Smaller Boards.* Mid-cap company boards average 9.2 directors while S&P 500 company boards average 10.9.[120]

116. The courts have not recognized a mere social tie as negating a director's independence. *See, e.g.*, Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 409 (Del. Ch. 1999) (holding that two board members who "were neighbors or former neighbors is of no moment." (citing *In re* Grace Energy Corp. S'holder Litig., No. 12,464, 1992 Del. Ch. LEXIS 134)); *see also* 1 ALI CORP. GOV. PROJ., *supra* note 97, § 1.23 cmt., at 27 ("It is not intended that a person would be treated as subject to a controlling influence, and therefore interested, solely because of a long-time friendship or other social relationship . . . .").

117. *See, e.g.*, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 576 (E.D.N.Y. 1971) (finding an attorney at a prestigious law firm to have been an insider for purposes of securities law due diligence analysis).

118. *In re* N.Y. Stock Exch., Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977).

119. *See* ALI CORP. GOV. PROJ., *supra* note 97, § 3A.02–.05, at 114–27 (discussing audit, nominating, and compensation committees).

120. *Board Basics*, WALL ST. J., Oct. 27, 2003, at R7 (range is from 3 to 31 members).

4. *Board Composition.* A majority of all directors should be independent.[121] While SOX mandates that only audit committee members be independent,[122] Self Regulatory Organizations (SROs) such as the NYSE and NASDAQ require that a majority be independent.[123]
5. *Executive Sessions.* Each board meeting should have time reserved for an executive session at which no member of management, including the CEO, will be present.
6. *Side Jobs.* Experts opine that by acceptance of consulting and similar arrangements, directors forfeit a portion of their independence.[124] In the Senate Hearings on Enron, Professor Charles Elson of the University of Delaware testified that "directors should 'have no financial connection to the company whatsoever' other than their board compensation."[125] Elson further testified, "'[I]f a director's role is as a consultant, hire the director as a consultant. If the director's role is to be a director, hire them as a director. You cannot blend the two.'"[126]

   At Enron, each and every director received annual consulting fees from the company in addition to their director compensation.[127] The NYSE limits side job compensation to $100,000 annually[128] while NASDAQ set the limit at $60,000.[129] Directors who accept more may still serve, but they lose their status as "independent." Among other things, swing votes by such directors are ineffective and courts will not count them to determine if a board decision is entitled to heightened "business judgement rule protection."[130]

Proposed

1. *Yearly Strategic Planning Sessions.* Corporations should have a plenary board meeting at which directors review all major areas of the corporation's business.

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121. *See id.* Overall, 66% of directors on all boards and 72% of directors on S&P 500 boards are independent. *Id.* Members' average tenure is 8.4 years, average age is 58.9 years (59.9 years in the S&P 500), and 10% are women. *Id.*

122. Sarbanes-Oxley Act of 2002 § 301(m)(3)(A), 15 U.S.C. § 78j-1 (Supp. IV 2004).

123. NYSE, Inc., Listed Company Manual § 303A.00 (2006).

124. *See* S. REP. NO. 107-70, at 51–53 (2002). Retired Chairman and CEO of Sunoco, Inc., Robert Campbell, gave similar testimony: "[C]onsulting arrangements with directors [are] absolutely incorrect, absolutely wrong." *Id.*

125. *Id.* at 52.

126. *Id.* at 53.

127. Enron directors, or their firms, received annual consulting fees of $70,000 to $493,914. *Id.* at 51-52. Enron made gifts of $500,000–$600,000 to charities with which directors had close affiliations, as well as other indirect payments. *Id.*

128. NYSE, Inc., Listed Company Manual § 303A.02(b)(ii).

129. NASDAQ, Inc., NASDAQ Corporate Governance Summary of Rule Changes (Nov. 4, 2003), *available at* http://www.nasdaq.com/about/CorpGovSummary.pdf.

130. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987).

2. *Risk Management Committee.* Corporations should have a board committee whose role is constantly to assess the company's various businesses' exposure to and compliance with legal, regulatory, and other important matters.
3. *Boot Camp.* Corporate bylaws or governance guidelines should require refresher courses for all directors and new directors to attend. Several graduate schools of business, such as those at Stanford and Indiana Universities, conduct multiple-day short courses for corporate directors.[131]
4. *Independent Director Certification.* Directors should undergo a training and testing process before they join boards. Schemes in Australia and East Asia have initiated, or discussed initiation of, certification requirements.[132]
5. *Term Limits.* Boards should enact limits of ten years or so and provide that at least one new director be elected annually. In the "old" days, board service of an individual lasting twenty to twenty-five years was not uncommon.[133]
6. *Elimination of Trophy Directors.*[134] Directors and director candidates should serve on no more than two or three additional boards. Many corporate CEOs, long considered prime candidates for other corporations' boards of directors, no longer serve on any others, limit themselves to one, or are limited by contract, guideline, or bylaw to one additional directorship.[135]
7. *Shareholder Nomination.* Some good governance checklists imply that corporations should provide a system for shareholder nominations. In 2005, SEC Chairman William Donaldson sought to have the Commission adopt a rule that would mandate authorization of nominations by institutional and similar large shareholders in cases in which a given percentage of shareholders could "withhold authority" for proxy votes, that is, for the corporate slate of directors.[136] The history of that proposal is beyond the scope of this article.
8. *Resignations.* Bylaws and employment contracts should provide that any resignation from a corporate office such as CFO or COO automatically constitutes a courtesy resignation from the board seat held by the corporate

131. *See* Institute for Corporate Governance, Indiana University Kelley School of Business, http://kelley.iu.edu/icg/psp.html (last visited Oct. 3, 2006); Stanford Graduate School of Business, http://www.gsb.stanford.edu/exed/ (last visited Oct. 3, 2006).

132. *Professionalism or Incarceration - Will Future Directors Need To Be Accredited*, COMPANY SECRETARY (Hong Kong), July 2004, at 6. In the United States, the National Association of Corporate Directors (NACD) maintains a registry of potential directors but does not certify them. Bratton & Blair, *supra* note 102, at 86 (reporting comments of Dr. Richard Raber, President and CEO, NACD).

133. *See, e.g.*, WARD, *supra* note 113, at 45 (discussing the tenure of directors at General Motors).

134. *See, e.g.*, Judith H. Dobrzynski, *When Directors Play Musical Chairs*, N.Y. TIMES, Nov. 17, 1996, § 3, at 1 (describing trophy directors as "well-connected types" who "can navigate corporate America's wood-paneled board rooms as easy as their own homes.").

135. *See, e.g.*, Anita Raghavan, *More CEOs Say 'No Thanks' to Board Seats*, WALL ST. J., Jan. 28, 2005, at B1 (documenting the growing reluctance of CEOs to serve on multiple boards of directors and on corporations to allow such service).

136. Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (proposing SEC Rule 14a-11 that was later withdrawn).

officer.[137] In the WorldCom case, even after Scott Sullivan had been revealed as the mastermind of a massive fraud and removed from his position as CFO, he refused to resign his WorldCom board seat.[138]

9. *Independent Counsel.* The independent directors should have an attorney present in the boardroom whose fees the corporation should pay and whose role should be to represent the board members on a day-to-day and a meeting-to-meeting basis.[139]

B. *Board Leadership*

Old

1. *Board Chair.* This position was an empty vessel into which various corporations poured various things. The position had no legal status in corporate statutes and remained obscure in corporate governance treatises.[140]
2. *Chair as Honorary Position.* At many corporations, the board chair position was, and predominately remains, ceremonial. The chair presides only over board meetings but might also preside over shareholders' meetings; serves as the primary liaison between directors and the corporation; controls meeting agendas; or serves as the CEO's confidante or right-hand man. Corporate bylaws may spell out some, but rarely all, of these varying responsibilities. At many corporations, the CEO presides at shareholders' and even at directors' meetings.
3. *Lead Directors.* Worldwide, the trend is to separate the offices of CEO and Board Chair, rising to 95% or 100% of corporations in some countries.[141] If the highest calling of modern boards is to evaluate and if necessary, remove senior executives from office, particularly the CEO, critics question how a board can perform this function if the same person who calls the meeting and sets the

137. *See, e.g.*, Susanne Craig, *How One Firm Uses Strict Governance to Fix its Troubles*, WALL ST. J., Aug. 23, 2003, at A1 (discussing "E*Trade board rule . . . requir[ing] directors to tender their resignation" once they change positions within the company or leave the company permanently).

138. *See* Jonathan Krim & Christopher Stern, *2 Key WorldCom Witnesses Silent; Founder Ebbers, Ex-CFO Sullivan Take Fifth Before Angry House Panel*, WASH. POST., July 9, 2002, at A1 (reporting that although Sullivan was fired, he "is still on the company's board but has been asked to leave").

139. *See* Geoffrey C. Hazard Jr. & Edward B. Rock, *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel*, 59 BUS. LAW. 1389, 1398–1412 (2004) (discussing how independent directors often desire to work with independent counsel). See *infra* text accompanying note 242 for a more complete discussion of Hazard and Rock's work.

140. One of the few sources is Australian: HENRY BOSCH, CONVERSATIONS BETWEEN CHAIRMEN (1999).

141. Among the Fortune 200, non-executive chairpersons numbered 39 in 2001 and 34 in 2002, or approximately 13%. DOUGLAS M. BRANSON, THE BOARD OF DIRECTORS, WORLDCOM, INC., Tabs 14, 15 (2004) [hereinafter BRANSON, WORLDCOM, INC.] (on file with author). The author served as the corporate governance expert for independent directors and the non-executive board chairman and, in that connection, compiled data on the Fortune 200.

agenda is also the CEO.[142] The United States' partial answer has been to appoint a senior or capable person on the board as lead director who also has the power to convene board meetings. Although seemingly more corporations have separated the offices than discussion reveals, the formal U.S. answer remains appointment of a lead director.

New

1. *Formal Responsibilities.* Corporate bylaws or corporate governance guidelines should detail the Board Chair's duties.
2. *Minimum Responsibilities.* These responsibilities would include the following: controlling the agenda for meetings (annual, regular, and special); chairing both shareholders' and directors' meetings; coordinating the work of board committees; preparing board packets; coordinating board visits to company facilities; reviewing corporate ethics programs; conducting annual reviews of board members; and organizing the formal annual CEO review process.

Proposed

1. *Mandatory Leadership Rotation.* The chair position should go to a new director at least every six years.
2. *Office of Chairperson.* The corporation should provide a physical office and staff appropriate to the chairperson's position and responsibilities.
3. *Annual Performance Reviews.* Staff, managers, and fellow directors must conduct annual 360-degree reviews of the Board Chair.

C. *The Audit Committee*

Old

1. *Composition.* Independent directors staffed the audit committee.[143] At least one member, preferably more, had financial literacy—familiarity with how financial statements are prepared and how outside accountants audit and certify them.

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142. Judith Burns, *Corporate Governance Special Report: Everything You Wanted to Know About Corporate Governance . . . But Didn't Know to Ask*, WALL ST. J., Oct. 27, 2003, at R6 (explaining the "top of the list" recommendation of "a panel of the Conference Board, a business-research group in New York," as "splitting the role of chairman of the board from that of chief executive" and saying that "[s]upporters argue that separating the roles will provide more independence and greater accountability to shareholders.").

143. As noted earlier, the NYSE added a requirement for an audit committee to its listing standards in 1977. *Supra* note 118 and accompanying text.

2. *Function.* The committee was composed solely of board members and was responsible, primarily or only, for serving the board.[144] The committee served as one additional structural device assuring the integrity of the financial information reaching the full board (upon which the board evaluated the senior executive officers, particularly the CEO).
3. *Meeting Frequency.* The committee met with the corporation's outside auditors before commencement of the annual audit to discuss the accountants' audit plan and direct the auditors to problem areas or issues of which directors were aware.[145] Later, the committee conducted an exit interview with the auditors, asking for assessments of internal accounting and personnel and several questions about the conduct of the audit.[146] Acting as a focal point for discussion of accounting issues, the committee met one or two other times per year.
4. *Meeting Duration.* Traditionally, audit committees conducted their meetings before the full board's meeting, such as at 7:00 or 7:30 a.m. if the full board were to convene at 9:00 a.m.[147] Accordingly, many audit committee meetings would last between one and two hours.

New

1. *Composition.* SOX mandates that the audit committee be composed exclusively of independent directors, defined so as to exclude professionals or others whose firms derive any compensation from the corporation.[148]
2. *Expertise.* At least one member must be a financial expert, the definition of which is determined by the SEC. The SEC defines an expert as one who has hands-on experience in auditing publicly-held companies.[149]

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144. *See, e.g.*, Steigerwald v. A. M. Steigerwald Co., 132 N.E.2d 373, 375–76 (Ill. App. Ct. 1955) (holding that Illinois statutes required executive committees be composed of board members).

145. Audit committee meetings "provide the independent directors with the opportunity of asking such questions as 'are you aware of any matters which you think the board should know and which you think the board may not know?'" HENRY BOSCH, CONVERSATIONS WITH A NEW DIRECTOR 45 (1997) (outlining the thoughts and recommendations of a director concerning committee meetings about auditing).

146. *Id.*

147. *Id.*

148. Sarbanes-Oxley Act of 2002, § 301, 15 U.S.C. § 78j-1 (Supp. IV 2004). The old rules and some of the proposed new rules are described and analyzed in Helen S. Scott, *The SEC, the Audit Committee, Rules and the Marketplaces: Corporate Governance and the Future*, 79 WASH. U. L.Q. 549, 562–63 (2001). *See also* Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 363 (2003) (interpreting the Sarbanes-Oxley definition of independence to mean "absence of conflict"); Peter M. Collins, *The Sarbanes-Oxley Act Creates a New Role for the Audit Committee*, 228 N.Y.L.J., Oct. 17, 2002, at 4 (discussing criteria for independence under Sarbanes-Oxley).

149. Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8138, Exchange Act Release No. 46,701, Investment Company Act Release No. 25,775, 67 Fed. Reg. 66,208, 66,210 (Oct. 22, 2002).

3. *Meeting Frequency.* Committees are to meet more often than three or four times per year. In 2002, the year Congress enacted SOX, audit committees at Fortune 200 corporations met an average of 7.8 times, with both a median and a mode of 7 times.[150]
4. *Hotline Responsibility.* To comply with SOX, the audit committee should put in place and supervise mechanisms whereby anyone in the organization can report to and obtain the attention of those in top positions regarding financial or accounting irregularities.[151]
5. *Reporting Up Receptacle.* In addition to serving as a hotline receptacle, the audit committee acts as an alternative receptacle for attorney reports of evidence of "securities law violations and similar misconduct" within the organization.[152] SOX section 307 provides that an attorney may make reports to the audit committee or full board, in lieu of reports to the Chief Legal Officer (CLO) or CEO.[153]

Proposed

1. *Meeting Frequency.* The audit committee should meet at least eight times per year, and more frequent meetings may be advisable.
2. *Duration.* One, two, or even three hour meetings are insufficient. Meetings should last at least one-half day or longer.
3. *Chair Rotation.* The board should rotate the chair position on the committee at least once every three years.
4. *Interested Director and Officer Transactions.* The committee should review the documentation regarding interested person transactions, such as flight logs and similar records, to police director use of the corporation's personal and real property.[154]
5. *Special Meetings.* At least annually, the committee should meet with interested shareholders, securities analysts, and other observers for an accounting and "disclosure review."
6. *CFO Review.* The committee should conduct an annual review of the CFO's performance and personal finances to be able to enforce an absolute prohibition on outside income or activities by the CFO (an Enron-Fastow provision).

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150. BRANSON, WORLDCOM, INC., *supra* note 141, Tab 20. The related numbers for 2000 were a mean and a median of 5 times, with a mode of 4 times. *Id.* at Tab 18. For 2001, a mean of 5.379, a median of 5, and a mode of 4. *Id.* at Tab 19.

151. Marc I. Steinberg & Seth A. Kaufman, *Minimizing Corporate Liability Exposure When the Whistle Blows in the Post Sarbanes-Oxley Era*, 30 J. CORP. L. 445, 458 (2005).

152. *See* Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (Supp. IV 2004).

153. *Id.*

154. The ALI Corporate Governance Project provided that to free up board members from such tasks, which can become mundane, the board (or shareholders) could pass a resolution that would delegate such tasks to a corporate manager who would be free of all conceivable conflicts of interest in the matter. ALI CORP. GOV. PROJ., *supra* note 97, § 1.36, at 39, § 5.09, at 315–16.

7. *Annual Training*. Audit committee members should undergo an initial and then annual refresher training course. Such a course should cover accounting principles, auditing standards, ethical compliance, and any new pronouncements of the Fair Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). The courses should introduce members to nomenclature and analytical tools such as WACC (weighed average cost of capital) and EBITDA (earnings before interest, taxes, depreciation, and amortization).

D. *Accountants*

Although the number ebbs and flows almost on a daily basis, there are approximately 16,200 corporations that file periodic reports with the SEC.[155] In 2002, Big 4 firms[156] audited 79% of the 16,200 corporations that file with the SEC and 97% of corporations with revenues exceeding $250 million.[157] The breakdown is as follows: PriceWaterhouseCoopers, 34%; Deloitte & Touche, 24%; Ernst & Young, 23%; and KPMG, 18%.[158] Eighteen other accounting firms (the "intermediate eighteen"), including some that are quite large, such as BDO and Grant Thornton, also audit public companies.[159]

SOX creates an independent, quasi-governmental corporation, the Public Company Accounting Oversight Board (PCAOB), with which accountants must register if they audit one or more publicly held corporations.[160] Under SOX, the PCAOB must annually audit firms that audit more than 100 clients.[161] The PCAOB must audit other firms at least every three years.[162] The PCAOB also issues guidance to accountants, including Audit Standard No. 2, a voluminous guideline concerning installation and documentation of internal controls.[163]

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155. *See* Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process, Securities Act Release No. 8,109, Exchange Act Release No. 46,120, Public Utility Holding Company Act Release No. 27,543, Investment Advisors Act Release No. 2,309, Investment Company Act Release No. 25,624, 67 Fed. Reg. 44,964, 44,999 (July 5, 2002); ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 150 n.19 (2d ed. 2004).

156. Sometimes referred to as the "Final Four." Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 368 (2004) [hereinafter Partnoy, *Strict Liability*].

157. U.S. GEN. ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 21–22 (2003); *see also* Sarbanes-Oxley Act of 2002 § 701(c), 15 U.S.C. § 7201 (Supp. IV 2004)(mandating the study and ensuing report to Congress).

158. U.S. GEN. ACCOUNTING OFFICE, *supra* note 157.

159. *See id.* at 17 tbl.1.

160. Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C. § 7211 (Supp. IV 2004).

161. *Id.* § 104(b)(1)(A), 15 U.S.C. § 7214 (Supp. IV 2004).

162. *Id.* § 104(b)(1)(B), 15 U.S.C. § 7214 (Supp. IV 2004).

163. Allison Carpenter, *PCAOB, SEC Internal Controls Guidance Focuses on Risk-Based Integrated Reviews*, 37 Sec. Reg. & L. Rep. (BNA) No. 21, at 921 (May 23, 2005) ("Audit Standard No. 2 [(AS2) is titled] 'An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.'"). The PCAOB has issued a number of question and answer publications and other forms of guidance for companies and for accountants. *Id.*

As of November 2004, 1,378 accounting firms had registered with PCAOB, of which 499 are foreign-based firms.[164] One reason for the high number of registrations is that each office of a large firm registers. Thus, the Big 4 plus BDO and Grant Thorton alone account for approximately 232 registrations.[165]

New

1. *Registration.* As aforesaid, accounting firms that audit so much as one public company must undergo screening and have a registration accepted by the PCAOB.[166]
2. *Audits of Auditors.* The PCAOB conducts inspections of registrants.[167]
3. *Off Books Entities.* SOX and the SEC require regulated corporations to make disclosures of off balance sheet arrangements, such as those Enron employed with its special purpose entities (SPEs).[168] Concurrently, the Financial Accounting Standards Board (FASB) has tightened the rules, requiring financial statement disclosure on SPEs if the corporation is a "prime beneficiary" of the arrangement, however contrived.[169] The change represents a shift from the bright line accounting rules under which Enron operated, requiring 3% of capital from an independent source as well as independent governance of the entity as well.[170]
4. *Cost.* In addition to paying on average $4.2 million in year-one section 404 compliance and other costs,[171] publicly held corporations must pay an annual levy to fund the PCAOB.[172] The formula is simple. Corporations are responsible for annual payments according to the fraction their market capitalization bears to the market capitalization of all firms.[173] The PCAOB collects as much as $2 million annually from large public companies.[174]

164. George R. Goodman, *Better Governance and Reporting Under Sarbanes-Oxley: Are We There Yet?*, 36 Sec. Reg. & L. Rep. (BNA) No. 46, at 2074 (Nov. 22, 2004).

165. *Id.*

166. In this screening process, PCAOB has rejected registrations by four accounting firms. *Id.*

167. *Id.*

168. Sarbanes-Oxley Act of 2002 § 401(a)(j), 15 U.S.C. § 7201 (Supp. IV 2004).

169. FIN. ACCOUNTING STANDARDS BD., INTERPRETATION NO. 6, CONSOLIDATION OF VARIABLE INTEREST ENTITIES, at 15 (2003), *available at* http://www.fasb.org/pdf/fin%2046R.pdf.

170. *See* Peter Behr, *Hidden Numbers Crushed Enron: 'Partnerships' Shielded $600 Million Debt*, WASH. POST, Jan. 12, 2002, at A1 ("[T]o qualify as independent partnerships outside Enron, [SPEs] had to satisfy an accounting requirement that at least 3 percent of their capital be contributed by outside investors.").

171. McTague, *Costs Exceed Estimates*, *supra* note 25, at 576.

172. Sarbanes-Oxley Act of 2002 § 109(d)(1), 15 U.S.C. § 7219 (Supp. IV 2004).

173. Sarbanes-Oxley Act of 2002 § 109(g), 15 U.S.C. § 7219.

174. Alison Carpenter, *PCAOB Approves $103M Budget for 2004, with Focus on Inspections*, 35 Sec. Reg. & L. Rep. (BNA) No. 47, at 2065 (Dec. 8, 2003). SOX delegates to PCAOB the power to set funding levels and payment responsibilities. Sarbanes-Oxley Act of 2002 § 109, 15 U.S.C. § 7219.

Proposed

1. *Financial Statement Insurance.* Corporations should obtain coverage after an insurance company conducts its own audit, or mini audit, to determine premium amounts.[175] The insurer should select the firm to do the audit,[176] which eliminates the conflict of interest that arises when the company to be audited chooses and then pays the firm to examine its financial statements.[177] A disadvantage is the high premium that corporations might have to pay, the amount of which came to light in the Marsh & McLennan and AIG scandals.[178] Another question is why insurance firms have not previously written such coverage into Director and Officer (D&O) policies.[179]
2. *Financial Statement Reliability Indexes.* Corporations would have to disclose a numerical ranking, or the rank of the tranche in which evaluators had placed the company's financial statements. Moody's, Standard & Poor's, and other rating agencies which have made forays into corporate governance[180] might compile such indexes. The existence of financial statement insurance might aid these rating agencies since the index assigned might correlate closely with the premium paid, potentially, for each $10 million in revenues.
3. *Installation of Early Warning Accounting Systems.* In truth, SOX, along with Auditing Standard No. 2, already incorporates an early warning system. "Traditional financial statement auditing begins with an auditor assessing a company's internal control environment . . . ."[181] That task gives the auditor an early indication of the reliability of financial statements the client company has

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175. *See* Cunningham, *supra* note 8, at 430 (explaining a pending proposal for insurance companies to perform independent audits).

176. *See id.*; *see also* Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 53 (2002) (arguing that the insurer should exert pressure on the auditor to audit meticulously).

177. *See* Cunningham, *supra* note 8, at 435 ("Absence of conflict and capture risks should heighten auditor willingness to second-guess management and not give it the benefit of the doubt."); *see also* Ronen, *supra* note 176, at 56 (explaining that this proposal will align the auditor's interest with the insurer's interest).

178. *See* Diane Brady & Marcia Vickers, *AIG: What Went Wrong*, BUS. WK., Apr. 11, 2005, at 32 ("Investigators believe that AIG may have goosed its financial performance with dubious transactions and improper accounting."); Ian McDonald & Monica Langley, *AIG Expected to Pay $1 Billion-Plus to Settle Probes*, WALL ST. J., Jan. 13, 2006, at A4 (noting that AIG misled investors through improper accounting).

179. Former SEC Commissioner Joseph A. Grundfest asked this question. Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 7–8 (2002) ("D&O insurers could today easily make the retention of insurer-approved auditors a condition of coverage. They could today also require an element of control over the audit process. Yet they don't.").

180. *See supra* note 103 and accompanying text.

181. *See* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability, and Safe Harbors*, 55 HASTINGS L.J. 1449, 1450 (2004) [hereinafter Cunningham, *Facilitating New Early Warning System*].

provided.[182] By requiring auditors to undertake that process and disclose the results to investors, SOX enables insiders and outsiders to gauge, at an early point, the reliability of financial statements.[183]

In performing the task, however, the auditor must speak out on the subject of internal controls. By doing so, he becomes a primary, rather than secondary, violator of securities laws. After *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* eliminated aiding and abetting liability,[184] plaintiffs encounter extreme difficulty in reaching secondary defendants, difficulty which is absent in reaching the pockets of primary violators.[185] To fine tune the early warning system and come closer to an "adversarial audit," the law should "develop safe harbor protections for forward looking auditor statements regarding [internal] control . . . that parallel existing safe harbors for issuer statements."[186] Generally, the safe harbor for forward looking statements provided under the Private Securities Litigation Reform Act[187] does not apply to statements auditors might make.[188] Auditors should be able to report their findings regarding internal controls without fear of liability.[189]

4. *Choice of Auditors By Lottery.* A leading piece of scholarly commentary discussing choice of auditors contains two different proposals, with the co-authors airing the differences between them.[190] Both proposals address the same problem, namely, that the corporation responsible for financial statements, through its self-interested managers, selects and later compensates

182. *See id.* ("[E]nhanced transparency in the financial reporting process promises to promote the integrity of financial statements.").

183. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 2—AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS ¶ 6 (2004) ("[I]nformation on internal control over financial reporting is also intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements . . . .").

184. 511 U.S. 164, 177 (1994) ("[T]he text of the 1934 Act does not itself reach those who aid and abet a § 10b violation.").

185. *See* Cunningham, *Facilitating New Early Warning System*, *supra* note 177, at 1474 ("[I]n post-*Central Bank* private actions, plaintiffs would allege that auditors acted as primary violators of section 10(b) . . . .").

186. *Id.* at 1479.

187. 15 U.S.C. § 77z-2(c)(1)(A)(i) (2000) (providing a safe-harbor for forward-looking statements when "accompanied by meaningful cautionary statements . . . .").

188. *See* Cunningham, *Facilitating New Early Warning System*, *supra* note 177, at 1481 ("Generally, existing safe harbors governing issuer forward-looking information do not apply to auditors.").

189. Professor Cunningham also finds that the emphasis on internal controls only "partially succeeds as an early warning system." *Id.* at 1490. SOX seems to regard internal controls as "an end in itself" when errors of judgment, estimation, or preparation may also render financial statements misleading. *See generally id.* at 1487–90 (arguing that although the early warning system is rational, producing reliable financial statements should be the goal).

190. David B. Kahn & Gary S. Lawson, *Who's the Boss?: Controlling Auditor Incentives Through Random Selection*, 53 EMORY L.J. 391, 414 (2004).

the accounting firm that vouches for the statement's reliability.[191] "It is as though baseball pitchers called their own balls and strikes and then hired and paid umpires to verify their calls."[192]

Corporations could voluntarily make the relationship less cozy and more adversarial. Indeed, they might even attempt to do so, for it would increase the reliability of financial information and lower the cost of capital.[193] However, the corporations would have difficulty communicating to the world that their auditor relationship was different from other company-auditor relationships, or in getting the public to believe them.

One way to put the requisite distance between company and auditor and to communicate with credibility would be to select auditors by lottery. The Kahn lottery method would require companies to select at random from a pool of potential auditors.[194] A public oversight board, such as the SEC or the PCAOB, would oversee the process and fix the auditor's compensation.[195] The thrust of the program would be "to reduce the extent to which auditors need to worry about pleasing the management of the companies that they audit."[196]

The Lawson lottery proposal embraces a contract, rather than a regulatory approach.[197] The company would "selec[t] at random from among the auditing firms that express a willingness to accept the engagement at the specified price."[198] If the posted price "does not attract a critical mass . . . the company would have to raise its offering price."[199] To the extent oversight is necessary (for example, determining if the pool were a reasonable size) stock exchanges or other SROs would supply it.[200]

5. *Mandatory Rotation of Auditing Firms.* SOX requires that corporations rotate the "audit partner" and the "engagement partner" assigned to the firm at least

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191. *See id.* at 392–93; *see also* Sean M. O'Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. Rev. 741 (2004) (arguing that the current system of auditor independence results in a conflict of interest for auditors).

192. Kahn & Lawson, *supra* note 190, at 393.

193. *Id.* at 399.

194. *Id.* at 414.

195. *Id.*

196. *Id.* at 415.

197. *Id.* at 417 ("Professor Lawson does not endorse this publicly supervised lottery mechanism because of a deeply rooted philosophical opposition to government compulsion.").

198. *Id.*

199. *Id.*

200. In the past, there have been proposals that the government should supply auditors. *See, e.g.*, Mark A. Gullotta, Comment, *The SEC's Auditor Independence Rule: Missing the Boat on Independence*, 42 SANTA CLARA L. REV. 221, 222 (2001) ("The government, rather than private, profit-minded participants, should perform audits."); *see also* Jenkins, *supra* note 53 ("Auditors might be sent to work for the SEC, which has [the] responsibility to uncover fraud."). Another proposal is that stock exchanges assign auditors to firms. *See, e.g.*, DAVID SKEEL, ICARUS IN THE BOARDROOM 189 (2005) ("[O]ne commentator pointed out . . . another regulator would be much better positioned to handle this kind of task[,] . . . the stock exchanges.).

every five years.[201] Some original SOX proposals required a mandatory change of auditing firms, although the proposals did not survive in the final legislation.[202] Nonetheless, commentators believe best practices should dictate that firms should change auditing firms at least every five years.[203]

6. *Contractual Liability Caps*. In engagement agreements signed with client corporations, accounting firms now include provisions for alternative dispute resolution, elimination of punitive damages, and a cap on compensatory damages the auditor may be adjudged to owe the client.[204] Post-SOX, Big 4 accounting firms have been insistent on these types of terms.[205] The auditors' liability, or lack thereof, to third party investors remains unaffected since the contract can only affect the relationship between the auditor and the client corporation.[206]
7. *Combinations*. None of the proposals are mutually exclusive, except perhaps for the financial statement insurance proposal. A hypothetical corporation could purchase insurance, at least in some forms, choose its auditor by lot, agree to liability caps, install an early warning system, disclose a financial statement reliability index, and rotate its outside auditing firm periodically. The cost, while not insignificant, would not be prohibitive, or would not be prohibitive if the corporation omitted the purchase of financial statement insurance.
8. *Strict Liability or Warranty Accounting*. At present, absent a contractual provision stating otherwise, auditors may be liable to the audit client for

201. Sarbanes-Oxley Act of 2002 § 203, 15 U.S.C. § 78j-1 (Supp. IV 2004). SOX also contains a "revolving door" provision that requires a one-year minimum period before an auditor may assume an executive position (CEO, CFO, comptroller, etc.) with a corporation whose financial statements she has audited. Sarbanes-Oxley Act of 2002 § 206, 15 U.S.C. § 78j-1.

202. *See* Kroger, *supra* note 11, at 136.

203. *See, e.g.*, *id.* at 135–37 (discussing the need of a mandatory auditing rotation to "eliminate the stick that corporations hold over auditing firms."); John Plender, *Don't Be Fooled By the Rotating Audit Partner: Big Watchdogs Easily Tamed*, FIN. TIMES (UK & Ireland), July 29, 2002, at 12 (arguing that audit partner rotation is no substitute for audit firm rotation). On average, Fortune 1000 firms retain the same audit firm for 22 years. U.S. GEN. ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION 6 (2003).

204. *See* Michael Rapoport, *Auditing 'Liability Caps' Face Fire*, WALL ST. J., Nov. 28, 2005, at C3.

205. David Reilly, *Outside Audit: A Generally Accepted Accounting Principle?—Auditor Pacts with Companies That Prevent Suits, Limit Awards Draw Scrutiny as Disclosure Grows*, WALL ST. J., Mar. 6, 2006, at C1. Corporations have been disclosing agreements with audit firms that prevent the audit client from suing the auditor in court, cap the amount of money damages a court may award, or eliminate the ability of the corporation to seek punitive damages. *Id.* Critics contend that the agreements morph the arm's length agreements corporations should have with auditors, which impugns auditors' independence. *Id.*; *see also* Michael Rapoport, *More Companies Are Disclosing Pacts with Auditors on Liability Caps*, WALL ST. J., June 22, 2006, at C4 ("Opponents . . . say these kinds of restrictions can compromise an auditor's performance independence . . . .").

206. Douglas M. Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327, 338 (1986) (noting that accountants are generally only liable to those with whom they are in privity, unless the specific plaintiff is foreseeable).

malpractice.[207] Their liability to third parties, most particularly to investors, is more problematic. In most jurisdictions, the accountant will be liable to those who are "the very end and aim of" the transaction,[208] and to foreseen but not to foreseeable parties.[209] With the Supreme Court's elimination of aiding and abetting under federal securities law,[210] investors have had difficulty holding accountants liable. However, as Professor Lawrence Cunningham has pointed out, this may change as accountants attest to the efficacy of internal controls under section 404.[211] In the post-SOX era, a number of proposers seek to change all of this, replacing the scheme with potentially more expansive accountants' liability.

Borrowing from a concept originally advanced at the American Law Institute (ALI) but implemented by only a few states, ALI reporter Professor John Coffee would hold accountants strictly liable but would cap the amount of liability at a multiple of the annual revenues the accountant derived from an audit client.[212] Specifically, Professor Coffee proposes "to convert the gatekeeper into the functional equivalent of an insurer, who would back its auditor's certification with an insurance policy that was capped at a realistic level."[213] Regulators would oversee the process.[214]

Harking back to a proposal made earlier, Professor Frank Partnoy espouses a contractual system whereby accountants would agree to be strictly liable for a percentage of the total damages.[215] Partnoy's system, which would result in greater liability and possibly lead to more bankruptcies,[216] would also have the same hallmark as Professor Coffee's proposal. That hallmark is a substitution of strict liability for a system based upon fault. Such a system would require proving that accountants had been negligent in performing audits, usually by showing a failure to exert the due diligence the law requires.[217]

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207. *Id.*

208. Glanzer v. Shepard, 135 N.E. 275, 276 (N.Y. 1922). Justice Cardozo coined the term. *Id.*

209. *See* Abrams Ctr. Nat'l Bank v. Farmer, Fuqua & Huff, P.C., No. 08-05-00140CV, 2005 WL 2806316, at *6 (Tex. App. Oct. 27, 2005) (unpublished decision) ("A defendant must have the specific purpose of providing information to either a known plaintiff or a known group of plaintiffs before a duty is owed."); *see also* Branson, *supra* note 206, at 338 ("The erosion of privity to admit liability to third parties in a foreseen class is the Restatement position." (citing RESTATEMENT (SECOND) OF TORTS § 552 (1976)).

210. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994).

211. *See* Cunningham, *Facilitating New Early Warning System*, *supra* note 177, at 1475 ("Auditing Standards No. 2 may be seen to nullify *Central Bank* as to control audits.").

212. Coffee, *Gatekeeper Failure and Reform*, *supra* note 7, at 349.

213. *Id.*

214. *Id.* at 350.

215. Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540 (2001) [hereinafter Partnoy, *Barbarians*].

216. *See* Partnoy, *Strict Liability*, *supra* note 156, at 366.

217. *See* Partnoy, *Barbarians*, *supra* note 215, at 540.

9. *Criminalize Accountant Negligence.* Still another proposal retains liability based upon fault but would criminalize a portion of it under "a new federal criminal statute making [accountant misconduct] a misdemeanor, punishable by up to one year in jail."[218] The proposal's author, a former Enron prosecutor, points out that "[e]very legal system in the world criminalizes at least some types of negligent conduct to protect important interests in life, limb and property."[219] He believes that criminalization is essential to create incentives for auditors to take reasonable care in their conduct.
10. *Fewer Criminal and Civil Proceedings.* In *Auditing: A Profession at Risk*,[220] the U.S. Chamber of Commerce calls for diversion of all or most disputes to alternative dispute resolution and regulation of the ability to indict accounting firms in criminal matters.[221]

E. Attorneys

1. *Reporting Up.* The receipt of evidence of a "material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" triggers SOX section 307.[222] Upon receipt of such evidence, the attorney must report up to either the CLO or the CEO.[223] Failing appropriate action by the CLO or CEO, the attorney must blow the whistle to the audit committee, the independent directors, or the full board.[224] The SEC may censure, suspend, or revoke the privilege of practice before it of any attorney who fails to comply.[225] Much has been written about section 307, most of which is beyond the scope of this Article.[226]

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218. Kroger, *supra* note 11, at 131.

219. *Id.* at 130 (footnote omitted).

220. U.S. CHAMBER OF COMMERCE, AUDITING: A PROFESSION AT RISK (2006), *available at* http://www.uschamber.com/publications/reports/0601auditing.htm.

221. *Id.* at 11–13; *U.S. Chamber Calls for Reform to Make Industry More Competitive, Viable*, 38 Sec. Reg. & L. Rep. (BNA) No. 5, at 183 (Jan. 30, 2006); *see also* Reilly, *supra* note 205 (noting that many audit firms are including provisions for arbitration in engagement letters they sign with audit clients).

222. Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (Supp. IV 2004).

223. *Id.*

224. *Id.*

225. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8,150, Exchange Act Release No. 46,868, Investment Company Act Release No. 25,829, 67 Fed. Reg. 71670 (Dec. 2, 2002).

226. *See, e.g.*, Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 179–82 (2002) (supporting federal regulation of the professional conduct of attorneys and discounting criticisms that section 307 may result in breach of confidentiality and greater civil liability for lawyers); Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 J. CORP. L. 397, 419–22 (2004) (discounting arguments that exempt foreign lawyers from section 307 rules will result in increased hiring of foreign lawyers); *see also* Otis Bilodeau, *Painter's Putsch; Richard Painter Argued for Years that Corporate Law Needed Policing. Enron Gave Him His Opening*, 25 LEGAL TIMES, at 21 (Dec. 23, 2002) (reporting Professor Richard Painter's "campaign for tougher ethical duties" for corporate legal advisors under section 307);

2. *Past History*. In *SEC v. National Student Marketing Corp.*,[227] the SEC contended that, faced with suspicious accounting irregularities, lawyers from two prestigious law firms should have resigned and blown the whistle to the SEC.[228] Instead, the lawyers accepted the explanations the clients proffered and took no action to delay the merger.[229] The court found that the lawyers had violated the law but refused to grant the injunction the SEC requested.[230] *National Student Marketing* and the arguments for attorney whistleblowing may be attributed to SEC zeal and the post-Watergate morality that pervaded the country at the time.

   A few years later, in a 2(e) Rules of Practice disciplinary proceeding, the full Commission upheld an internal whistleblowing requirement for lawyers who practice before the SEC.[231] The "lawyer must take further, more affirmative steps," such as "[a] direct approach to the board of directors or one or more individual directors or officers."[232] Although the SEC never insisted upon whistleblowing by attorneys, internal or otherwise,[233] presumably a percentage of them did so in one form or another.

Proposed

1. *Qualified Legal Compliance Committees (QLCCs)*. SOX section 307 set off a whirlwind of lawyer criticism.[234] Experienced directors thought that boards and board committees were even less likely to welcome a lawyer into the room or

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Anthony Lin, *Crusader Says Year-Old Reform Is Working*, 230 N.Y.L.J., July 31, 2003, at 4 (supporting an extension of section 307 to ban corporate lawyers from receiving contingent fees for completion of a corporate transaction).

227. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

228. *Id.* at 712.

229. *Id.* at 691.

230. *Id.* at 713–14, 717.

231. *In re* Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (Feb. 28, 1981).

232. *Id.*

233. In a 1982 speech, the SEC General Counsel stated that the SEC would not do so unless a court had adjudicated that the attorney had violated the securities laws. Edward F. Greene, *Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission*, [1981–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,089, at 84,802 (Jan. 13, 1982). *But see In re* Gutfreund, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,608-09 (Dec. 3, 1992) (clarifying the SEC's view that legal and compliance officers have an affirmative duty to ensure that misconduct is addressed).

234. *See, e.g.*, Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 736–79 (2004) (arguing that the SEC rules weaken the reporting up requirement by allowing broad exemptions from the duty to report); *see also* George M. Cohen, Roger C. Cramton & Susan P. Koniak, *The Defective Trigger of the SEC's Rule Implementing SOXA's Duty to Report*, 37 Sec. Reg. & L. Rep. (BNA) No. 3, at 108 (Jan. 17, 2005) (criticizing the standards triggering the reporting up obligation as weak and easy to circumvent); C. Evan Stewart, *Holding Lawyers Accountable in the Post-Enron Feeding Frenzy*, 34 Sec. Reg. & L. Rep. (BNA) No. 38, at 1587 (Sept. 30, 2002) (exploring potential SOX section 307 implementation issues including what evidence triggers the reporting requirement and the reach of an attorney's fiduciary duties).

make material disclosures to her knowing the lawyer has a legal duty to report up any evidence of wrongdoing she might perceive to exist. One little-noticed partial response has been to change the party to whom the lawyer must report. By rule, the SEC has authorized a third method, introducing the QLCC as a "mechanism for reporting, as well as investigating and responding to, misconduct."[235]

Board members may not perceive the QLCC as an answer. Even before SOX, many directors and students of governance felt that law and best practices blueprints combine to overburden board committees. Post-SOX, audit committees face overwhelming responsibilities imposed by law. In addition, nominating, governance, and other committees face a welter of proposed additional responsibilities. Consequently, as a matter of best practices, many believe that "this committee thing has gone too far." Committees and committee responsibilities take directors away from monitoring and strategic planning exercises, which are often regarded as directors' highest and best uses, especially considering the part-time nature of directors' positions. The QLCC is "yet another independent board committee."[236]

Attorneys may have an opposing view, preferring creation and use of a QLCC. Bylaw or corporate governance guideline consignment to a QLCC of section 307 reporting up responsibilities may relieve attorneys from over-entanglement in possible wrongdoing. Lawyers will be able to concentrate on "process" and "transaction" engineering, which they regard as their best use. "Attorneys, especially those at elite law firms, may refuse engagements with issuers who do not have QLCCs."[237]

Despite the widespread belief that use of board committees has already extended far beyond its usefulness, the SEC affirmatively "encourages issuers [to create QLCCs] as a means of effective corporate governance."[238] Perhaps blissfully unaware of the burdens it is imposing, the SEC requires one of the QLCC's three members to also be a member of the audit committee.[239]

2. *Noisy Withdrawals*. Newly invigorated by SOX, the SEC implemented section 307 by including within its proposed rules a provision for noisy withdrawals. Having reported evidence of wrongdoing and determining that corporate officials had not taken appropriate action, an attorney could insulate herself by

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235. Fisch & Gentile, *supra* note 11, at 523 (discussing SEC Rule 205 that "sets forth minimum standards of professional conduct for attorneys appearing before the Commission") (citing 17 C.F.R. § 205).

236. *Id.* at 540.

237. *Id.* at 550–51.

238. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,083 (Jan. 29, 2003).

239. *Id.* at 87,089.

ceasing the representation and notifying others, including the SEC, that she had done so.[240]

The noisy withdrawal may be criticized as tantamount to the whistleblowing responsibility the SEC attempted to foist upon attorneys in *National Student Marketing*, at least through a back door. Due to the noise associated with withdrawal, onlookers, including prosecutors and regulators, would ask questions. Questions might bring wrongdoing to light. Withdrawal then might lead to prosecution or other enforcement action.

Bending but not bowing to cries that the SEC had exceeded any authority section 307 had bestowed upon them, the SEC did not include the noisy withdrawal safe harbor in the final version of Rule 205.[241] The Commission, however, still keeps noisy withdrawal proposals, or narrower versions thereof, in its desk drawer.

3. *Separate Counsel for Independent Directors*. Two eminent academics have proposed that at major corporations, independent directors have their own lawyer going forward, and on a permanent basis.[242] When academics pose structural improvements such as this, the considerable out-of-pocket cost aside, most business persons respond that they do not wish to see lawyers as central players in the board room. Lawyers tend to see legal issues, often with potential liability, lurking in every nook and cranny. If an attorney acting alone tends to be too risk averse, two attorneys in the board room would compound the problem. In a sizeable subset of cases, attorneys would engage in one-upsmanship, each attempting to demonstrate to the board that she has the right stuff. Such a rivalry would obfuscate rather than clarify legal aspects of doing business. On a more rarefied plane, at least in Delaware corporate jurisprudence, the protection afforded to directors by the standard of care and the business judgment rule makes it unnecessary to have a second attorney representing independent directors in the boardroom.[243]

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240. Attorney Conduct Proposals, Securities Act Release No. 8150, Exchange Act Release No. 46,868, Investment Company Act Release No. 25,829, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,513 (Nov. 21, 2002).

241. Implementation of Standards of Professional Conduct for Attorneys, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 87,070 (announcing the decision not to adopt the noisy withdrawal provision in light of the numerous negative comments received).

242. Hazard & Rock, *supra* note 139, at 1395–96.

243. *See* E. Norman Veasey, *Separate and Continuing Counsel for Independent Directors: An Idea Whose Time Has Not Come as a General Practice*, 59 BUS. LAW. 1413, 1413–14 (2004). Former Delaware Chief Justice Veasey identifies the following six situations in which corporate provision of separate counsel would be appropriate:

> (i) an independent committee, such as the audit or compensation committee, has a tradition of having its own regular, outside counsel . . .; (ii) the general counsel has a real or perceived conflict; (iii) the board or committee believes that it needs to explore independently something that appears questionable; (iv) a special investigation; (v) the need for a particular legal expertise; or (vi) simply—to invoke a medical analogy—the board or committee seeks a "second opinion."

Id. at 1417.

F. Nominating, or Governance, Committee

Old

The primary purpose of a nominating committee was to take the process of developing board candidates out of the CEO's hands where the power had traditionally been lodged.[244] The committee would thus reinforce board independence. Creation of the nominating committee also had the corollary purpose of encouraging board diversity, that is, addition to the board of persons of color, women, and others historically on the board.[245]

Even after the use of nominating committee had become widespread, certain CEOs continued to subvert committees and their work. For example, CEOs Dwayne Andreas at Archer Daniels Midland (ADM) and Bernie Ebbers at WorldCom insisted upon CEO nominating committee membership.[246] In Decatur, Illinois, according to wags, ADM referred to the board of directors as "All Dwayne's Men."[247] During the 1980s and 1990s, at a number of major corporations (American Express, Sunbeam, Scott Paper, Archer Daniels Midland, Morrison Knudsen), CEOs were able to co-opt or end run nominating committees, allowing them to remold or reshape boards of directors themselves, thus postponing a comeuppance for CEO under-performance or wrongdoing.[248] A properly functioning governance and nominating committee would have prevented illicit board molding.

New

1. *Nominations.* The committee, not the CEO, should be responsible for committee as well as board nominations.
2. *Rotation of Committee Chairs.* Rotation should be mandatory. The nominating committee implements and enforces the provision.
3. *Board Leadership.* The Committee, not the CEO, should identify and nominate persons for the board chair position.

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244. ALI CORP. GOV. PROJ., *supra* note 97, § 3A.04 cmt., at 122–23.

245. WARD, *supra* note 112, at 226–27; *see also* DOUGLAS M. BRANSON, NO SEAT AT THE TABLE: HOW CORPORATE GOVERNANCE AND LAW KEEP WOMEN OUT OF THE BOARDROOM (forthcoming Dec. 2006).

246. *See* Jared Sandberg & Joann S. Lublin, *Questioning the Books: WorldCom's Travails Could Affect Its Directors*, WALL ST. J., Oct. 17, 1995, at B1.

247. *See* Joann S. Lublin, *Management: Is ADM's Board Too Big, Cozy, and Well-Paid?*, WALL ST. J., Oct. 17, 1995, at B1 ("The nominating committee, for instance, consists of M. Andreas, the Chairman and the CEO; his son . . . ; [a] retired [c]hairman . . . [and] the father of the company treasurer.").

248. WARD, *supra* note 113, at 115 ("[T]he general issue of overpaid executives, and the more specific concern of pay that did not match results, were both symptoms of a larger problem—boards that were in bed with management.").

4. *Committee Charters*. The nominating, or governance, committee should oversee the adoption and the periodic updating of charters, which all board committees must have.
5. *Organic Corporate Documents*. The committee should recommend and oversee the process of amending the articles of incorporation and bylaws.

Proposed

1. *Independence*. The committee should define director independence and monitor the same on an ongoing basis.[249]
2. *Separation of Offices*. The committee should pull the laboring oar on the periodic discussion of separate offices for chair and CEO and on the appointment of a lead director if the same individual remains both chairperson and CEO.[250]
3. *Executive Sessions of the Board*. Again, the enforcer should be the nominating, or governance, committee.[251]
4. *Risk Management Functions*. These functions should be assigned to a separate risk management committee on some corporate boards. The committee should perform two tasks:
   a) "Develop and monitor law compliance systems;"
   b) "Develop and ensure compliance with a sound business ethics code.[252]
5. *Schedules, meetings, and workloads*. The committee should periodically evaluate board schedules, quality of board meetings, and workloads of committees and individual directors.[253]
6. *Disclosure Documents*. The committee should "[e]nsure director responsibility for disclosure documents," or portions of them.[254]
7. *Conflicts of Interest*. The committee should have the responsibility to call attention to and deal with interested directors, corporate opportunity, and other duty of loyalty issues.[255]
8. *Insider Trading*. The committee should have a similar responsibility with regard to insider trading issues as it has to conflicts of interest.[256]
9. *Succession Planning*. The committee should have plans in effect for the CEO, members of the board, and key corporate officers.[257]

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249. Veasey, *supra* note 243, at 1416. Chief Justice Veasey would assign sixteen discrete responsibilities to the nominating, or governance, committee, including those discussed in this text. *Id.* at 1416–17.
250. *Id.* at 1416.
251. *Id.*
252. *Id.*
253. *Id.* at 1417.
254. *Id.*
255. *Id.*
256. *Id.*
257. *Id.*

10. *Evaluations*. The committee should maintain and otherwise be in charge of the evaluation process for directors, the board, and board committees.[258]
11. *Shareholder Relations*. The committee should be charged with oversight of effective shareholder relations and communications.[259]
12. *Electronic Town Meetings*. The committee should establish and maintain a website on which any 1% shareholder would be entitled to post ideas and resolutions without the type of screening corporations currently undertake with shareholder public interest proxy proposals.[260]
13. *Disclosure Committee*. The governance committee should set up a disclosure committee composed of directors, members of senior management, and outside advisers, who might include a securities analysts.[261]
14. *Shareholder Proxy Statement Proposals*. The committee should oversee the reimbursement of shareholders for proposals they make, which by SEC rule corporations must include in the corporation's own annual proxy statement.[262] Shareholder activists are advancing the reimbursement proposal, which is itself new, by proposing that corporations amend their by laws to include this responsibility.[263]

G. Compensation Committee

This committee, comprised of independent directors, while becoming commonplace in corporations,[264] generally has been conceded to be a failure. CEO compensation has run rampant in the United States. In 1990, Graef Crystal estimated CEO compensation to be 16 times that of the average worker in Japan, 21 times in Germany, and 160 times in the United States.[265] By 2000, Crystal put the number "north of 400 times and heading rapidly to 500 times."[266] For several reasons, the committee has not checked this rapid rise of compensation or otherwise worked well.

One reason for the committee's failure to check the rapid rise in compensation is the committee's hiring of compensation consultants, either because of advice from lawyers or because they are seeking the safe harbor protection of the business

258. *Id.*

259. *Id.*

260. *See generally* Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2006) (addressing "when a company must include a shareholder's proposal in its proxy statement . . . .").

261. *See* Veasey, *supra* note 243, at 1417.

262. Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2006).

263. *See* Mark Maremont & Erin White, *Stock Activism's Latest Weapon*, WALL ST. J., Apr. 4, 2006, at C5.

264. *See* ALI CORP. GOV. PROJ., *supra* note 97, § 3A.05, at 127–28.

265. GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 205, 207, 209 (1991).

266. Kathleen Day, *Soldiers for the Shareholder*, WASH. POST, Aug. 27, 2000, at H5 (reporting remarks of Graef Crystal).

judgment rule.[267] Consultants use a quartile method of comparison. Even though the quartile method of comparison systems have had their obvious inadequacies highlighted,[268] compensation committees and consultants continue to use them. Because almost all companies want their top executives' compensation to be in the highest quartile, the result is an upward pressure on compensation.[269]

CEOs have also come to know how to game the system. They tend to appoint the newest and likely most insecure director to the committee. CEOs then appoint a director who also is a sitting or former CEO who has a vicarious interest, at least, in ever higher levels of CEO compensation.[270]

Nonetheless, most corporate governance schematics continue to include a compensation committee of outside directors as a central element.

New and Proposed

1. *Review Meetings*. The compensation committee charter should provide for semi-annual committee meetings with the director of human resources and the general counsel of the corporation to review related party transactions, human resources compensation levels, and complaints or disputes over benefits or other compensation levels.
2. *Annual Staff Review*. The compensation committee oversees the annual review of the human resources director.
3. *Public Disclosure*. Agog at the sums CEOs receive, in January, 2006, the SEC rolled out proposed regulations that would treble the disclosures public corporations must make about senior executives' pay.[271] In a new "Compensation Discussion and Analysis" (CD&A) section in every proxy statement, annual report, and registration statement, corporations will have to narrate how the board of directors sets pay levels, disclose the long-term value of stock options and the value of executive perquisites, and quantify severance

267. *See, e.g.*, *In re* Walt Disney Co. Derivative Litigation, No. 411, 2006 WL 2056651, at *3 (Del. June 8, 2006) ("To assist in the financial terms of the OEA, Russell recruited Graef Crystal, an executive compensation consultant, and Raymond Watson, a member of Disney's compensation committee and a past Disney board chairman who had helped structure Wells' and Eisner's compensation packages.").

268. *See* RAKESH KHURANA, SEARCHING FOR THE CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 193 (2002) (noting that "external compensation consultants (which were generally chosen by the CEO candidate himself) entered the picture and introduced the false yardstick of the compensation packages of other CEOs," which has been further undermined by recent evidence demonstrating how loosely connected CEO compensation is to shareholder wealth).

269. Joann S. Lublin, *The Great Divide: CEO Pay Keeps Soaring Leaving Everybody Else Further Behind*, WALL ST. J., Apr. 11, 1996, at R1.

270. *See* WARD, *supra* note 113, at 219 ("If two CEOs serve on the compensation committees of each other's board, the temptation is to subtly help 'one hand wash the other.'").

271. 17 C.F.R §§ 229.402, .407 (2006); *see* Joann S. Lublin & Kara Scannell, *They Say Jump: SEC Plans Tougher Pay Rules*, WALL ST. J., Jan. 11, 2006, at C1; Rachel McTague, *SEC Votes Unanimously to Adopt Rules Updating Executive Compensation Disclosure*, 38 Sec. Reg. & L. Rep. (BNA) No. 21, at 1310 (July 31, 2006).

and retirement pay to be received under existing provisions.[272] Filed documents will contain up to six tables containing information regarding executive compensation.[273] CEOs and CFOs both must certify the CD&A much like they certify financial statements under section 302.[274] The SEC regulations are part of the growing dissatisfaction in the United States about the inordinate growth and high levels of CEO pay.[275] When the SEC adopted the regulation, it added a new layer of responsibility for compensation committees members.

4. *Overcompensation*. The SEC and public companies have also faced another emerging scandal involving how corporations over-compensate executives, that of "backdating" and "spring loading" stock option grants to increase executives' option exercise profits.[276]

H. Risk Management Committee

Proposed

Risk management is one of the newer ideas prevalent in certain corporate governance circles.[277] The committee's mission is to identify major risks in the corporation's businesses operations. The committee reviews the corporation's responses to manage and minimize those risks.

The committee should review risk disclosures or reports and employ experts, as necessary, to understand and clarify risk disclosures in documents the company files.

Modern corporate governance schematics now call for as many as six committees of the board of directors: audit, nominating and governance, compensation, legal compliance (QLCC), disclosure, and risk management. In addition, individual corporations may retain one or two first generation board committees, such as finance or capital expenditure, bringing the total to eight or more committees.

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272. McTague, *supra* note 271, at 1310.

273. *Id.*

274. *Id.* ("The CD&A will be 'filed,' meaning it must be certified by the [CEO] and [CFO] . . . .").

275. *See* LUCIEN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 67–68 (2004); Jesse Eisinger, *Memo to Activists: Mind CEO Pay*, WALL ST. J., Jan. 11, 2006, at C1.

276. "Spring loading" is the practice of granting additional options to executives shortly before the corporation announces bullish (favorable) developments. Kara Scannell, *Can Companies Issue Options, Then Good News?*, WALL ST. J., July 8, 2006, at A1; *see also* Gretchen Morgenson, *At the Options Buffet: Some Got a Bigger Helping*, N.Y. TIMES, July 21, 2006, at 1 (discussing companies facing criminal charges for backdating); Floyd Norris, *Options Brought Riches and Now Big Troubles*, N.Y. TIMES, July 25, 2006, at C1 (reporting criminal charges against CEO of Brocade Communication Systems for abuse of executive options).

277. *See, e.g.*, *News Digest: Risk Management*, J. ACCOUNTANCY, October 2003, at 20 (announcing that the Committee of Sponsoring Organizations of the Treadway Commission released a draft framework "which defines and describes enterprise risk management and provides a standard" for public and private entities).

I. The Ethics Officer and the Code of Ethics

Proposed

1. *The Ethics Office.* The board of directors should establish a formal ethics office that would function under the supervision of the CEO and CLO but would provide the board with regular written reports and briefings and undergo periodic program reviews by the board.[278]
2. *Ethics Pledge.* In addition to overseeing signatures by employees on the code of conduct, the ethics office should ensure that all new employees as well as existing staff swear to and sign an ethics pledge.
3. *Annual Reviews.* The full board of directors should meet with the CLO to review the resources and leadership of the ethics office; the adequacy of ethics and ethics compliance programs; and the contingent legal risks the corporation may face due to ethical failures.
4. *Ethics Director.* This person should have a substantial level of legal experience, ideally including direct regulatory or law enforcement experience.
5. *Diversity.* Through the ethics office and human resources department, the board of directors should undertake a wide-ranging review of the corporation's diversity practices.

J. Compliance Officer

The SEC Commissioner suggested that corporations should recruit an upper-level management corporate officer whose task is to ensure the corporation's compliance with regulatory and legal requirements.[279] Presumably, such an officer would perform much of the day-to-day work of the risk management committee in corporations where one exists.

K. Whistleblowers

Old and New

SOX adds an umbrella whistleblower provision to an existing patchwork of other federal protection provisions.[280] The SOX provision creates a new cause of action for those who suffer adverse employment actions as a result of reporting

278. *See* Rachel McTague, *Glassman Says Firms Need Officer to Handle Corporate Responsibility*, 34 Sec. Reg. & L. Rep. (BNA) No. 39, at 1626 (Oct. 7, 2002).

279. SEC Commissioner Cynthia Glassman has been a proponent. *See id.* (reporting a speech by Commissioner Glassman to the American Society of Corporate Secretaries).

280. These other federal protections include, for example, provisions in the Toxic Substance Control Act, 15 U.S.C. § 2622(a) (2000); Clean Water Act, 33 U.S.C. § 1367(a) (2000); and Energy Reorganization Act of 1977, 42 U.S.C. § 5851(a) (2000).

corporate fraud.[281] The provision is broad, covering subcontractors' and other employees' actions as well as those of direct employers.[282] The complainant must file with OSHA within ninety days of the occurrence.[283] After an investigation, written findings, and a hearing before an administrative law judge, OSHA may award damages making the employee "whole,"[284] which may include litigation costs, expert witness fees, and reasonable attorneys' fees.[285]

Proposed

1. *Private Inspector General Position.* Then SEC Enforcement Director Stephen Cutler has "urged companies to appoint a permanent ombudsman or business practices officer to receive and investigate complaints."[286]
2. *Formal Intake Process.* The corporation should ensure that a process exists to provide the employee with reasonable assurance of confidentiality. The employee should not have to notify anyone in her "chain of command" over her[287] and may, under certain schematics, blow the whistle to a third-party subcontractor interposed precisely for purposes of preserving anonymity.[288]
3. *Publicized Corporate Policy.* The corporation should post notices, send letters, and otherwise inform employees of their whistleblowing apparatus, including the intake procedure and provisions for employee anonymity.[289]
4. *Educational Programs.* Corporations should assure that training exists in contractor and subcontractor organizations because, even though these entities may not be publicly held, the SOX whistleblower protections apply if the entity

281. Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514 (Supp. IV 2004); *see also* Steinberg & Kaufman, *supra* note 151, at 448 (noting that SOX forbids discriminatory actions toward employees who report violations). The U.S. Court of Appeals for the First Circuit gave employers some relief when it affirmed Department of Labor and District Court conclusions that the whistleblowing provisions have no extraterritorial application, rejecting the claim of an employee of an Argentine subsidiary. Carnero v. Boston Scientific Corp., 433 F.3d 1, 18 (1st Cir. 2006).

282. Steinberg & Kaufman, *supra* note 151, at 447–48.

283. *Id.* at 449.

284. *Id.* at 448.

285. *See, e.g.*, Welch, USDOL/OALJ Rep. No. 2003-SOX-00015 (Dep't of Labor Jan. 28, 2004), *available at* http://www.oalj.dol.gov/PUBLIC/WHISTLEBLOWER/DECISIONS/ALJ_DECISIONS/SOX/0350x15c.htm (A.L.J. final admin. review) (recommending remedies of reinstatement, back pay, and award of costs to former CFO).

286. *Cutler Calls For Corporate Ombudsman to Enhance Whistleblower Provision*, Fed. Sec. L. Rep. (CCH) No. 2156, at 4–5 (Dec. 29, 2004).

287. Mark R. Attwood, *When the Whistle Blows: Renewed Enthusiasm Among Employee Watchdogs*, *in* ADVANCED CORPORATE COMPLIANCE WORKSHOP 2003, at 1113, 1130 (Practising Law Institute 2003).

288. William R. McLucas & Mark M. Oh, *Whistleblowing: Protection of Corporate Officials and Employees Who Provide Evidence of Fraud Under the Sarbanes-Oxley Act of 2002*, *in* CORPORATE GOVERNANCE 2004, at 61, 71 (Practicing Law Institute 2004).

289. *See* Steinberg & Kaufman, *supra* note 151, at 460.

renders services for the publicly held corporation.[290] At the end of training, the company should retain SOX acknowledgment certificates stating that employees understand the policy and agree to abide by it.[291]

5. *Documentation.* Employers should create a document gathering and retention system so that if the need arises, the company possesses evidence tending to show, or actually showing, that supervisors took adverse employment for reasons other than possible knowledge of whistleblowing activities.[292]

L. Other

1. *Prescreening Candidates for Officer Positions.* Bank regulators have long vetted officers proposed by a bank's board of directors, insisting on experience in the financial field and other qualifications.[293] Regulators of public corporations should do the same.[294]
2. *Reimbursement of Shareholder Proxy Proposal Expenses.* The SEC has insisted that Bank of New York and American Express, among others, include shareholder bylaw amendment proposals that would effect such reimbursements in their annual proxy statements.[295]

III. WHAT HAVE WE WROUGHT?

Each corporate governance expert and corporation can best answer the question of whether the corporate governance pendulum has swung too far and whether the addition of the devices reviewed, and others as well, are valuable adjuncts or just bells and whistles. Only a corporate official, with proximity to installation of various charters, committees, codes, software, and SOX devices and processes, can estimate the costs. Nonetheless, from an examination of the events and recommendations of recent years, a number of intangible costs have not been, but should be, articulated:

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290. Further, criminal penalties apply both to public and private companies. *See* Sarbanes-Oxley Act of 2002 § 1107, 15 U.S.C. § 78ff(a) (Supp. IV 2004); Steinberg & Kaufman, *supra* note 151, at 448.

291. *Cf.* Victoria Donati, *Whistleblowers and Other Retaliation Claims*, *in* 2 32ND ANNUAL INSTITUTE ON EMPLOYMENT LAW 989, 1019–23 (Practising Law Institute 2003) (describing training practices to improve employee knowledge of complaint policies).

292. *Id.* at 1022; Steinberg & Kaufman, *supra* note 151, at 462.

293. James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation* (Brooklyn Law Sch. Legal Studies Paper No. 49, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=873667.

294. *See id.* (proposing that the SEC appoint monitors for some large public firms who will fulfill roles similar to large bank examiners).

295. *Proposals to Reimburse Shareholders for Election Expenses Not Excludable*, 38 Sec. Reg. & L. Rep. (BNA) No. 12, at 502 (Mar. 20, 2006). Reimbursement proposals form the tip of the iceberg, the iceberg being the advancement of shareholder proposals as bylaw amendments which, if adopted, would be binding rather than advisory. *See* Mark Maremont & Erin White, *Stock Activism's Latest Weapon*, WALL ST. J., Apr. 4, 2006, at C1.

1. *More Is Not Necessarily Better.* If four meetings a year had been adequate, and some corporations held six, eight meetings per year is the new standard and ten is even better. If meetings lasted an hour or an hour and a half in the "bad old days," meetings now should go on for three, four, or five hours. More is better.

   For anyone who has attended a number of meetings in her lifetime, she knows that after an hour and a half or two hours, meetings encounter rapidly diminishing returns.[296] Attendees begin to doodle excessively and toss their pencils in the air. One famous management guru shuns meetings as much as he is able.[297] More—more meetings, longer meetings, more committees—is not better governance. Someone, preferably someone in authority, should bang this drum and bang it loudly. In corporate governance, things have gotten out of hand.
2. *The Role of Board Committees, Particularly Audit Committees.* Again, as originally conceived, the board constituted committees from among their own number.[298] The sole original purpose of committees was to aid the board in its work. For example, the audit committee was an additional check, additional to the outside auditor and to such internal controls as existed, on the integrity of financial statements and similar information that would ultimately reach the full board. The full board would then use the information to evaluate the corporation's senior executives. SOX, preceded by the NYSE and others' public statements, has changed all of this. Audit committees now have responsibilities directly to shareholders and the investing public.[299] Under SOX, an audit committee now has a stand- alone existence.[300] The committee, not the board, hires the outside auditor and receives reports.[301] The committee has the freedom to hire attorneys, accountants, and consultants.[302] This role for the audit committee is a sea change in the makeup and use of board committees, but it is change that has received little notice, or has been taken for granted.
3. *Change in the Role of the Board.* Similar to its effect on audit committees and with little fanfare, SOX and the good governance movement have changed the board's role, bringing it perhaps full circle back to what it was in the 1940s and 1950s. Back then, statutes affirmatively provided that it was the board of directors upon which the law bestowed responsibility for management of the

296. *See* SIMON RAMO, MEETINGS, MEETINGS, AND MORE MEETINGS: GETTING THINGS DONE WHEN PEOPLE ARE INVOLVED 107–09 (2005) (discussing the tendency of people to fall asleep during meetings).

297. Warren Buffett, the most celebrated investor of our time and CEO of Berkshire Hathaway, "steers clear of meetings and advisers." Susan Pulliam & Karen Richardson, *Warren Buffett, Unplugged*, WALL ST. J., Nov. 12, 2005, at A1.

298. *See supra* note 144 and accompanying text.

299. Sarbanes-Oxley Act of 2002 § 301 15 U.S.C. § 72j-1 (Supp. IV 2004).

300. *Id.*

301. *Id.*

302. *Id.*

corporation's business and affairs.[303] In many corporations, large and not so large, directors do not manage. Instead, they oversee and provide strategic direction to management of the corporation by others.[304] Acceding to the reality of this situation, in the late 1970s and early 1980s statutes began to provide that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . ."[305] The drafters adopted a less imperative tone, enhanced by use of the passive voice, in contradistinction to older statutory commands to boards that "Thou shalt manage."

The ALI Corporate Governance Project continued the trend. The Corporate Governance Project provided that "[t]he management of the business of a publicly held corporation . . . should be conducted by or under the supervision of such principal senior executives . . . as are designated by the board of directors . . . ."[306] In turn, the highest calling and primary mission of the board became to "[s]elect, regularly evaluate, fix the compensation of, and, where appropriate, replace the . . . senior executives."[307] In the 1990s, many corporate boards adapted to this new, more focused role for boards of directors, monitoring the performance of, and often replacing, CEOs.

In the early 1980s, when the ALI Reporters introduced this concept, it was quite controversial. Corporate house counsel, who began to attend the ALI annual meetings in droves, were indignant, questioning the standing of a law reform organization to tell directors whether or not they could manage.[308] The ALI sought to address their concerns, affirmatively providing that a board has power, at its option, to engage in management-type functions.[309]

Prior to Enron and WorldCom, at least in corporate governance circles, the monitoring model had become an accepted description of a board's proper role. Now, post-Enron and post-WorldCom, regulators, investors, and journalists raise the hue and cry: "Where were the directors? Why weren't they

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303. *See* ALI CORP. GOV. PROJ., *supra* note 97, § 3.01 cmt., at 82 ("The formulation . . . differs from the literal terms of the older statutory formulations (which commonly provided that the business of a corporation 'shall be managed by [its] board')."); *see, e.g.*, MO. ANN. STAT. § 351.310 (West 2000) ("The property and business shall be controlled and managed by a board of directors").

304. Am. Bar Ass'n, Comm. on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, at 1603, 1621 (1978), states:

> It is generally recognized that the board of directors is not expected to operate the business. Even under statutes . . . it is recognized that actual operation is a function of management. The responsibility of the board is limited to overseeing such operation.
>
> . . . .
>
> It is important to [emphasize] that the role of the director is to monitor . . . .

305. REVISED MODEL BUS. CORP. ACT § 8.01(b) (1984).

306. ALI CORP. GOV. PROJ., *supra* note 97, § 3.01.

307. *Id.* § 3.02(a)(1).

308. The author is an elected member of the ALI and attended annual meetings from 1981 to 1994, save the 1991 San Francisco meeting.

309. ALI CORP. GOV. PROJ., *supra* note 97, § 3.02(b).

managing?" The answer is that, under the prevailing model, they were not supposed to be.

Boards must manage now. The present view seems to put boards of directors back into the positions they held in 1955, with little cognizance of the winds of change and trends in the intervening years. It is a separate question whether a board comprised of part-time overseers can actually manage or actively oversee the management of large complex enterprises, or whether the device has reached or gone past its inherent limitations.[310] Reflecting doubts about a board's ability to manage, SOX and other modern reforms place much of their emphasis on strengthening gatekeepers other than independent directors. The point here, however, is that another change has taken place with little awareness of where we have been or of where we might be going.

4. *Monitors and Inspectors*. Under English Company law, regulators may appoint an inspector who delves deeply into the affairs of public companies that have gone awry.[311] The inspector then publishes a book-length work that divines what may have gone wrong. In commonwealth countries, company law may provide for a Royal Commission, a distinguished body headed by a judge on leave from the bench.[312] After its investigation, the Royal Commission reports its findings, often in a multi-volume work. In Australia, for example, a Royal Commission has reported back on what went wrong at HIH Insurance, Australia's largest corporate collapse.[313]

In the United States, unlike the United Kingdom and elsewhere, short of bankruptcy, no statutory authority exists for such a mechanism. In bankruptcy, courts often appoint examiners who hire fancy law firms (often their own), and then render not one but two or three expensive and lengthy reports.[314]

Lack of statutory authority has not stopped U.S. courts. Federal district judges have appointed "corporate monitors" who go inside of troubled companies for months at a time. They then render lengthy and expensive reports. For example, judges have appointed monitors to review and report on corporate governance at Hollinger International and WorldCom (later known as MCI), among others.[315]

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310. *The Role and Composition of the Board of Directors of the Largely Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2094 (1978) ("It is plainly impossible for a board composed partly of 'outsiders,' that is partly of persons who are not full time employees, to conduct . . . day-to-day [corporate] affairs.").

311. *See* Companies Act, 1985, 33 & 34 Eliz. 2, c.6 § 432.

312. *See, e.g.*, Royal Commissions Act, 1902–1973 §§ 1–16 (Austrl.) (establishing Australia's use of a Royal Commission to regulate companies).

313. *See* MARK WESTFIELD, THE INSIDE STORY OF AUSTRALIA'S BIGGEST CORPORATE COLLAPSE 239-40 (2003); Michael Adams, Professor, Univ. of Tech., Sydney, Australia Corporate Governance: Lessons from HIH Insurance, Presented at the Australia Law Teachers Ass'n. Conference at Waikato University, Hamilton, New Zealand (July 8, 2005) (on file with author).

314. *See supra* notes 107–09 and accompanying text.

315. *See* Joann S. Lublin & Shawn Young, *Even as MCI Makes Strides, Monitor Stays*, WALL ST. J., Apr. 20, 2004, at B1 (reporting that former SEC Chairperson Richard Breeden, alone and via his consulting firm, billed $2.3 million at $800 per hour, over twenty-one months, and showed no sign of

Perhaps the next bell (or whistle) may be a proposal to statutorily authorize this new breed of outside corporate cop.[316] Certainly, many corporate monitors and legal academics do not subscribe to the proposition that "more is not necessarily better." They not only tend to hold the opposite view, but would be willing to write law review articles, give congressional testimony, and do whatever else it takes to advocate a governance scheme in which the presumption is more is better.

IV. CONCLUSION

The time has come for a retrenchment from Sarbanes-Oxley. This Article attempts to demonstrate not only one of the costs SOX poses, but also the welter of proposals, services, and software coming from all directions at publicly held corporations, in this new $35 billion per year industry. That marketing onslaught alone is reason for retrenchment.

The legislation's most outspoken sponsor, Representative Michael Oxley, has taken the position that "it is unlikely that Congress will revisit it."[317] By contrast, the SEC's Advisory Committee on Small Companies has taken a refreshing and proactive stance, which four out of five SEC Commissioners has rejected,[318] recommending elimination of section 404 attestation procedures for smaller corporations, among other things.[319] Perhaps the SEC Advisory Committee or the American Bar Association, or both, could take the lead, sending the message that more is not necessarily better. So far, however, "[t]he Sarbanes-[Oxley] Act is a lot like the weather: Everyone talks about it, but no one does anything about it."[320]

Other countries have concluded that even among public companies, tiers of disclosure and other requirements may be more appropriate than "one-size-fits-

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leaving).

316. *See, e.g.*, Fanto, *supra* note 293 (proposing that the SEC appoint monitors for some large public firms who will fulfill roles similar to large bank examiners).

317. Barney Tumey, *Congress Unlikely to Revisit Sarbanes-Oxley Act to Help Small Companies*, 37 Sec. Reg. & L. Rep. (BNA) No. 42, at 1781 (Oct. 17, 2005) (reporting on Oxley's speech at the law firm of McKenna, Long & Aldridge, in Atlanta, GA). One debate is whether administratively the SEC can offer significant relief. *See, e.g.*, Rachel McTague & Richard Hill, *Oxley, Baker Tell SEC Agency Has Power to Mitigate SOX Problems*, 38 Sec. Reg. & L. Rep. (BNA) No. 11, at 449 (Mar. 13, 2006) (discussing attorney Damon Silver's argument that the SEC has no such power).

318. *See* Scannell & Reilly, *supra* note 31, at C1; Steven Marcy, *SEC Promises More Section 404 Guidance but Rejects Exemption for Small Companies*, 38 Sec. Reg. & L. Rep. (BNA) No. 21, at 901 (May 22, 2006).

319. Rachel McTague, *Panel Seeks to End Auditor Attestation Under SOX § 404 for Micros, Small Caps*, 37 Sec. Reg. & L. Rep. (BNA) No. 43, at 1825 (Oct. 31, 2005).

320. Harvey Pitt, *Make SOX Fit*, WALL ST. J., Apr. 13, 2006, at A12. Mr. Pitt is a former Chairperson of the SEC. *But see* Rachel McTague, *Feeney, Demint Introduce Bills to Exempt Smaller Firms from SOX 404*, 38 Sec. Reg. & L. Rep. (BNA) No. 21, at 902 (May 22, 2006) (reporting a proposed exemption for companies whose market capitalization is less than $700 million and whose annual revenues are less than $125 million).

all."[321] The United States should evolve and authoritative bodies should advocate a two or even three-tiered system not only of disclosure but also of SOX. Such a system would constitute the rootstalk for a generation of renewed entrepreneurship and capital formation in the United States.

321. *See, e.g.*, Karen Howlett, *Regulators Propose Two-Tiered Disclosure*, GLOBE AND MAIL (Toronto), Oct. 30, 2004, at B7 (reporting on Canadian proposal for a two-tiered system of corporate governance).