CURRENT ISSUES IN AMERICAN CORPORATE GOVERNANCE

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by John L. Cooper*  

I. THE STRUCTURE OF THE AMERICAN CORPORATION  

A. An American corporation is an artificial person.  

1. The U.S. Supreme Court has described a corporation as “an artificial being, invisible, intangible, and existing only in contemplation of law.” Like a natural person, an American corporation can own, buy and sell property, conduct virtually any lawful business, lend and borrow money, sue and be sued, and even be convicted of a crime (although not imprisoned).  

2. The purpose of the corporate form is to provide advantages to those using it to do business which they would not have as individuals. 

   a) The most important of these advantages, and the one which originally prompted the development of the joint-stock company in England centuries ago, is that it limits the liability of its owners to the capital funding the company, shielding their personal wealth from creditors and judgments.  

   b) Other important properties of the modern corporate form are perpetuity (unless deliberately dissolved, as opposed to a charter with an expiration date), the power to issue securities, and free transferability of investment.  

3. There are many kinds of American corporations, but publicly traded, for-profit corporations are by far the most important economically, and these remarks will be limited to those corporations. Non-profit, government, and closely held corporations present other issues beyond the scope of this discussion.  

B. American corporations are creatures of state law.  

1. In order to gain the important advantages of the corporate form, investors must structure and govern their corporations according to the requirements of law.  

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2. In the United States this means the corporation law of an individual state, as American corporations are created by the states. With a few specialized exceptions the national government does not charter corporations. All of the most basic elements of the corporate form – for example that a corporation be governed by a board of directors – are prescribed by state law. The corporation laws of the states all follow the same basic structure but differ in details.

3. The state of incorporation is not necessarily the state where the company’s primary business is conducted. Although corporations must qualify before they can legally do business in a state, they need not be incorporated there. Consequently the state of incorporation may be chosen because its laws suit the corporation’s promoters – for example Delaware, where many American companies are incorporated despite its relative economic insignificance.

4. State officials may suspend a corporation from operating if it violates the corporation laws, or is delinquent in required reports or payments.

C. The purpose of the American corporation.

1. The goals of a corporation have traditionally been corporate profit and shareholder gain. When the corporation profits, the shareholders gain through appreciation of share value or payment of dividends, or both.

2. In the United States it is accepted, and reinforced by court rulings, that profit to the corporation and its shareholders is the only legitimate end purpose of a business corporation. Short-term profit may be foregone, and corporate gain may be sacrificed to public benefit, only insofar as the officers and directors have made a business judgment that doing so helps the corporation toward its goals of profit and gain.

3. In Europe and elsewhere this rule is not so firmly established, and the law often takes a broader view of the corporation’s relationship to society. There a corporation may and sometimes must balance the interests of the public, and stakeholders including its employees, customers and suppliers, against the economic interests of its shareholders. In the United States these interests may properly be considered only as they affect the prospects for profit and gain. This focus on economic self-interest is an accepted part
of American business culture, and can be enforced by litigation if necessary.

D. Separation of ownership and control.

1. A fundamental characteristic of the American corporation is that ownership is separated from control.

2. As the word implies, the shareholders collectively own the corporation. The value of all their shares equals the value of the corporation, and when the value of the corporation rises or falls the value of the shares varies accordingly.

3. However, it is impractical for the shareholders to run the company themselves. There are too many of them, their population shifts as shares are bought and sold, they often hold only relatively small amounts of equity, and typically they have neither the time to devote themselves to managing the company’s affairs, nor the competence to do so.

   a) This contracts with the European model, where a small number of institutional shareholders may own the majority of the stock and exercise closer control than is customary among American shareholders.

4. Because shareholders are not usually in a position to run the company themselves, by state law the actual management of the corporation is devolved on a board of directors. The shareholders elect the directors, and the directors then appoint the officers and employees who do the actual work of the company and are responsible to the board for their performance.

5. The shareholders thus usually govern the corporation only through their representatives on the board, who are obliged to report to them at least once a year on their conduct of the corporation’s affairs. However, at annual (or occasionally at special) shareholder meetings, those holding voting shares may exercise actual control by adopting or amending the governing by-laws and/or electing or replacing directors.

   a) Shares are sometimes issued in different classes and not all classes can vote. Shareholders in certain classes can also be given specific collective powers, such as the right to name particular directors or the right to veto mergers.

6. Most holders of voting shares of large American corporations rarely attend meetings or vote personally. Decisions requiring shareholder approval are typically decided by proxy voting, where
those not planning to be present delegate to others the power to vote their shares. Where there are contested issues proxies are solicited by management, by insurgent shareholder factions, or by another company attempting a takeover. The solicitation of proxy votes (with the accompanying legally mandated disclosure requirements) is one of the main focal points of American corporate governance.

a) Even if there is no contested issue, management solicits proxies anyway, so it can re-elect the board and conduct routine business at the annual meeting.

7. In practice shareholder meetings are usually not very effective instruments of control by the owners, because management ordinarily controls most of the shares that are actually voted, directly or by proxy. Management is typically able to elect its own slate of directors and dominate the proceedings at shareholder meetings, and genuine contests are rare. Such devices as staggered terms for directors also restrict the influence the shareholders have on the board, and help limit shareholder power to mere theory.

8. In addition to a board of directors, corporations have articles of incorporation and by-laws, which act respectively as a private constitution and private statutes for the corporation, and state in detail how they are to be governed.

a) By-laws operate like a contract between the shareholders and the corporation, and may be enacted or changed by a vote of the shareholders, or sometimes by the board of directors. The articles may also be changed, subject to certain restrictions.

b) Typical by-law provisions regulate shareholder meetings, officers, directors and their committees, dividends and reserves, and similar matters.

E. The board of directors

1. Under American law directors have a fiduciary duty to the corporation, which requires them to give the corporation and its shareholders “undivided and unselfish loyalty” and to place the interests of the corporation above their own. This fiduciary duty is legally enforceable, and litigation over the conduct of directors often focuses on whether it has been performed. In America a contract by a director which limits her independence or freedom to act for the corporation’s benefit is unenforceable.

2. The directors have the authority to run the company, even though they must do so in the interests of the shareholders. Within broad
limits, directors are free to determine corporate and business policy without interference, as long as their decisions represent reasonable business judgments.

3. The “business judgment” rule usually insulates corporate management and directors from liability for bad decisions. As long as they acted (as they are rebuttably presumed to have done) in good faith, in a manner reasonably believed to be in the best interests of the corporation and its shareholders, with reasonable care and after reasonable inquiry, their actions are essentially unreviewable.

   a) But on a credible showing of bad faith, or dishonesty, or gross negligence, or corrupt self-dealing, this protection can be lifted.

   b) Interference with the shareholders’ free and informed exercise of their right to vote is not protected by the business judgment rule.

   c) Although directors are ordinarily immune from liability for their honest business judgments, corporations usually have “directors and officers” insurance to cover the cost of third-party litigation and possible judgments against them.

      (1) “Side A” coverage protects officers and directors directly; “Side B” coverage covers the company’s costs for indemnifying them; and “Side C” coverage, now hard to obtain, covers damages assessed against the company itself.

      (2) Coverage is usually only for negligence, with fraud and crimes excluded, and carries a high retention, or deductible, typically now around a million dollars. Some state laws prohibit insurance against crimes by directors and officers.

4. Directors are entitled to rely on information provided by management, officers, auditors, counsel, board committees, and the like, provided there is reason to trust their honesty and judgment.

5. Nevertheless boards sometimes adopt rules which limit the directors’ control. For example, a board can reserve a certain proportion of seats (or certain sensitive committees) for “outside” rather than “inside” directors.
a) The definition of an “outside” or “independent” director varies according to who is writing the rule, and for what purpose.

(1) Independent directors may not be employees of otherwise part of the management of the company.

(2) Sometimes there are additional restrictions, for example barring from independent status directors who have recently been employees, or who have recently received stock or other financial benefits from the company, or whose immediate families have done so.

(3) For some purposes a director is not independent if s/he is part of an “interlocking directorate” – for example if an officer of the company served on the compensation committee of the company which employs the director.

(4) For some purposes a director recently connected with the company’s outside auditor is not independent.

(5) The number, scope and reach in time of these restrictions is increasing as part of the general trend toward reformed corporate governance.

b) Independence requirements, and other such restrictions on the freedom of directors, are attempts to preserve the board’s oversight function against the trend of modern management to “capture” their boards and dominate them through their de facto power to nominate and compensate directors.

(1) The longer management is in power, the more directors it will have nominated. A classic case is Jack Welch of General Electric, who during 20 years as CEO nominated virtually every member of the company’s board. A board entirely nominated by a single manager will naturally have difficulty imposing control over that manager.

6. Directors, like shareholders, often devote only a small portion of their attention to their companies. They are actually visiting overseers, attending meetings at intervals but primarily dependent on management for information and policy recommendations. Even if they have not all been nominated by management, their independence of action is often more theoretical than actual.

a) Some companies have been experimenting with rules to correct this problem, including specifying minimum amounts
of time directors must spend on company business and restricting the number of boards on which they may serve.

7. In theory (and sometimes in practice) the board is a place for important stakeholders, such as major shareholders, key creditors, and others (sometimes including the union representing the company’s workers) to have a say in overseeing the corporation.
   a) In the United States labor has nothing close to the level of institutional representation it has on the boards of European corporations.

8. Officers (such as the president or CEO, treasurer, secretary, and controller) are management, although they may also serve on the board. In theory they may be dismissed by the board.

F. Board of directors committees

1. Many public corporations have developed complex structures to assist the directors in their oversight, ensure their access to accurate information and independent points of view, and keep the company’s policies both prudent and lawful. The current wave of reform in corporate governance, discussed below, may be expected to intensify this trend. Corporate Audit, Compensation, and Nominating Committees are typical of such structures.

2. An Audit Committee exists to provide independent oversight of management’s financial controls and reports, of the company’s internal auditors, and most importantly of the external auditors who review the financial information and company accounts.
   a) Even well-meaning management cannot ensure financially responsible conduct or accurate reporting to the markets if it cannot trust the competence and impartiality of its auditors.
   b) This is part of how Enron got into so much trouble – its auditors were co-opted by shady management because of their dependence on the company for non-audit consulting contracts.

3. A Compensation Committee sets the compensation given to officers and employees, including bonuses, stock options, and other benefits. One of its main functions is to guard against unfair self-dealing or outright looting.
   a) This is sensitive because some of the enormous compensation and severance packages given to corporate managers in recent years have outraged the public and in some cases have been
big enough to have a serious effect on the value of the corporation.

b) The opportunity for conflict of interest in compensation matters is obvious, and unfairly high compensation can be an indication that a board or board committee has been “captured” by management.

4. A Nominating Committee searches for new directors, especially independent ones, and for new additions to senior management. It recommends candidates to management, but usually defers to management’s choices. One of its most important functions in selecting candidates is to guard against the board becoming so closely tied to management that it is not receptive to new ideas or points or view, and so cannot exercise independent judgment.

5. All of these critically important committees should ideally be staffed primarily by independent directors, and should meet regularly without the rest of the board. At least some members of the audit committee should have accounting or other financial expertise.

II. INFLUENCES ON AMERICAN CORPORATE GOVERNANCE

A. State corporation laws.

1. The importance of these laws in structuring the American corporation and its governance has already been mentioned. These laws also govern issuance of stock and dividends and other important corporate functions.

B. Federal securities laws.

1. Federal securities laws include mainly federal statutes and the rules of the Securities and Exchange Commission (SEC), a federal agency set up to regulate the stock markets after the crash of 1929.

2. These statutes and rules are aimed primarily at protecting investors and the securities markets from fraud and unfair manipulation.

   a) Thus, for example, rules about insider trading are intended to protect the investor rather than the shareholder. This is so even though an investor who buys a company’s stock then becomes a shareholder. The two roles involve quite different issues and policies.

   b) The American disclosure-based system has been compared to a consumer protection system, with the investor regarded as a consumer of corporate securities.
3. The effect of these statutes and rules on corporate governance is incidental to this purpose, but is nevertheless pervasive.
   a) For example, federal securities regulations govern tender offers, proxy statements, record-keeping, accounting and audit procedures, and many other aspects of corporate conduct.

4. The primary focus of federal securities regulation is on disclosure. The American regulatory regime operates on the theory that if everyone in the market has access to current and accurate information about all the factors affecting a company’s value, the market will operate fairly. Thus every public company must report a vast amount of information to the shareholders and to the SEC, on a continuous and periodic basis as well as in connection with specific events such as public offerings and proxy solicitations.
   a) These reports are public documents, available on the internet and elsewhere. Insiders with information not available publicly are not permitted to trade in the securities of the companies concerned.
   b) After 70 years of this disclosure-based regulation system, the entire financial system of American business relies on free access to reliable information. When this is compromised the confidence of investors, lenders and others in the integrity of American business suffers, with systemic effects throughout the economy. This is why the accounting and auditing on which the disclosures are based must be trustworthy, and be believed to be so. The Enron affair is a cautionary example of what happens when this safeguard fails, and the information disclosed is unreliable or misleading.

C. Exchange listing requirements

1. The listing rules of the stock exchanges are another important influence on corporate governance. These rules impose governance standards on companies before their shares can be traded. The rules are more elaborately developed in the United States than in Europe or elsewhere.

2. Examples include the New York Stock Exchange and the NASDAQ. There are also a number of other less important stock exchanges in the United States, and they too have listing standards.

3. The New York Stock Exchange will excuse compliance with its listing standards by foreign companies who certify that their governance procedures comply with their own country’s laws.
D. Litigation and the threat of litigation

1. In the United States litigation (and the fear of it) has a major influence on corporate activity.

2. Typical forms of litigation include suits by shareholders against the corporation for injunctive or other equitable relief, derivative actions in which shareholders sue management in the name of the corporation to block or compel certain corporate conduct, securities class actions, government civil enforcement actions (usually but not always in the securities area), and criminal prosecutions.
   a) State provisions for immunity of directors do not extend to federal securities violations.

3. Grounds on which state court intervention into corporate conduct may be sought include violations of law or of the corporation’s governing instruments, fraud, oppression of minority shareholders, and waste or misapplication of the corporation’s assets.

4. In 1995 Congress responded to perceived abuses in securities class actions by passing the Private Securities Litigation Reform Act (“PSLRA”) over President Clinton’s veto.
   a) Class actions often follow optimistic projections by management which are not fulfilled. When a projection fails a plaintiff (sometimes regarded as a “professional” plaintiff) then brings suit on behalf of everyone who bought stock soon after that statement, alleging that they had relied on the statement and been defrauded.
   b) The PSLRA sheltered forward-looking statements either made without actual knowledge that they were false or misleading, or issued with meaningful cautions and qualifications about how and why the projected improvement might not be realized. It also tightened pleading requirements, provided for proportionate liability and for sanctions for frivolous filings, and made some other changes designed to discourage groundless actions brought in the hope of a nuisance settlement.
   c) As it happened, however, the numbers of securities class actions declined only for the first year after passage. After that they began to rise again and now far exceed their levels at the time the PSLRA was passed.

5. The threat of hostile takeover also operates as a check on management.
6. In the United States, when a company invokes the protection of a bankruptcy court (always a federal proceeding), that automatically stays private litigation against the company. Consequently companies in trouble sometimes enter bankruptcy for tactical reasons, or to gain time, even if they are technically solvent.

a) In bankruptcy the fiduciary duty of the directors to the shareholders expands to include the company’s creditors also.

7. In many European civil law jurisdictions, basic corporate actions need advance court approval, which require adherence to corporate governance standards. In the United States and other common law jurisdictions compliance is often enforced through litigation after the fact, or the through apprehension before the fact that litigation (or enforcement action) may impose accountability.

E. Other influences

1. Federal antitrust, tax and banking laws also affect the operations of public corporations.

2. State laws, other than the corporations laws already mentioned, also influence corporate conduct and governance. For example, states have their own securities, tax and antitrust laws, and other state laws also affect corporate conduct.

3. Formally stated corporate codes of ethics and governance charters are becoming increasingly popular and influential as the crisis of confidence in American corporate conduct deepens.

a) Although largely aspirational and not legally enforceable, these voluntary charters have a normative function in stating what is expected. They encourage compliance and reinforce ethical conduct against pressure to cut corners.

b) They also can provide evidence, in case of litigation or enforcement action, that people knew what was expected of them, and that their departures from the prescribed norms were not accidental or mistaken.

c) A recent survey found that 81% of public corporations capitalized at more than $20 billion had written corporate governance guidelines.

d) Other devices, such as corporate ombudsmen and formal protection for whistleblowers, are aimed at encouraging insiders to bring improper or unlawful practices to the attention of management. Corporate compliance programs
help ensure that insiders follow applicable laws and codes of conduct.

4. Finally, public pressure, applied through the press and above all the markets, is forcing reforms in corporate governance. The recent scandals have led to a loss of confidence in the integrity of American corporations which threatens the markets and indeed the whole economy, and is forcing the speedy and dramatic reforms discussed in Part III below.

5. While American corporations raise capital directly from investors through stock markets, European and Asian corporations raise more of their capital through other financial intermediaries, principally banks. For this reason, and because of their highly concentrated ownership, these risk-averse intermediaries exercise more control over corporate management than is the case in the United States.

  a) The prevalence of large concentrated holdings in European corporations, as opposed to the wider dispersion of equity among many smaller shareholders in the United States, has led academic commentators to call the European system “blockholding.”

  b) Blockholders tend to exercise more immediate, informed supervision of management, and management is under less pressure to concentrate on short-term gain at the expense of long-term benefit.

  c) However blockholders, having sacrificed diversification and liquidity in favor of concentrated control, are more likely to seek the private benefits of self-dealing, and the laws of their jurisdictions are more likely to permit them to do so, than is the case in the United States.

6. The twin board structure characteristic of German corporations, for example – with separate supervisory and managerial boards, and the resulting failures of communication and cooperation between them – has no counterpart in the United States.

III. RECENT DEVELOPMENTS IN AMERICAN CORPORATE GOVERNANCE

A. The recent scandals

  1. Just about all of the misconduct at the root of recent corporate scandals could have been prevented through serious, independent, pro-active oversight by the companies’ boards, and serious, honest,
independent accounting by the accountants and auditors who reviewed these practices and in some cases devised the means of concealing them. The new corporate governance and accounting reforms are intended to prevent this kind of misconduct from recurring. The examples which follow are only a selection – the possibilities for chicanery are limited only by the ingenuity of the malefactors and the vigilance of the directors, auditors and whistleblowers who try to restrain them. It may be hoped that the reforms discussed in the next section will help keep such activities from harming other corporations in the future.

2. **Prematurely recognizing revenue.** By recognizing as revenue transactions which are not final, a company can exaggerate its actual earnings. For example, Sunbeam posted as revenue “sales” which were really only orders, and which sometimes were never completed. They also offered deep discounts to dealers in return for large orders – even though many of the orders were returned unsold, they had already been posted as revenue. Similarly Xerox recorded as sales copiers which had only been leased. Telephone companies like Qwest claimed as revenue the projected income from service contracts actually subject to termination.

3. **Concealing debt.** For example, Coca-Cola divested itself of its bottlers, which took huge debts with them in divestiture. Although Coca-Cola was exposed on this debt through its ultimate ownership of the bottlers, the debt was on the bottlers’ books and not Coca-Cola’s, making the company look more solvent than it really was. ACR, parent of American Airlines, has long-term leases which don’t count as debt although they act like it.

4. **Using off-balance sheet transactions to understate debt and risk.** This was the key to the disaster at Enron. The company guaranteed the debts of a maze of limited partnerships and investment entities, run for the personal profit of Enron executives. Because accounting rules did not require that these “off-balance-sheet” guarantees appear on Enron’s books, and because Arthur Andersen cooperated in keeping them off, Enron’s true debt load was vastly understated. As creditors of the off-balance sheet entities enforced the company’s guarantees, Enron collapsed rapidly into insolvency.

5. **Overvaluation of goodwill.** WorldCom acquired companies and then overvalued their goodwill, giving their balance sheets a huge boost which did not necessarily correspond to actual value. Goodwill is essentially unverifiable, meaning in practical terms only the difference between what an acquired company’s assets are
worth and what the acquirer paid for the company. When WorldCom’s acquisitions turned out not to be worth what was paid for them, it became necessary to take a charge against earnings later, but in the short run this artificial inflation of earnings sustained the stock price and allowed for profits.

6. Self-dealing by management. WorldCom is the leader here – its CEO Bernie Ebbers ended up owing his company over $360 million! It should go without saying that this demonstrates a total failure of the board’s oversight function. Most of the loan was to cover his margin debt so he wouldn’t have to sell such huge holdings of WorldCom stock that the stock would crash (it crashed anyway).

7. “Managing” earnings. This is like an accounting sinking fund. Tyco, for example, is said to have aggressively acquired companies, and then written down more than was justified for the cost of the acquisitions. This created a reserve which could then be written up again when additional “earnings” were needed to keep the current financial reports looking good. General Electric and IBM are accused of having done something similar by overestimating the return on capital earmarked to fund future pensions. If performance did not meet projections, there would have to be a revision later, but it could still benefit from high reported earnings now. Insurance companies can do the same with their reserves for claims.

8. Abuse of stock options. Stock options have become a popular method of employee compensation. This is so in part because they do not require a cash payout. This was especially true in the high-tech industry, where companies were either undercapitalized or had no business revenue, or any source of funds beyond venture capital and public offerings, but attracted workers much as they attracted investment, through confidence in future success. Nevertheless stock options are not free, but if exercised would require the company to part with its stock for less than the market price. The traditional practice has been not to post these options as expenses, because they are difficult to value, but doing that distorts the company’s financial reports. Sprint became notorious for accelerating the vesting schedule for the options when prices are high, and repricing options already issued where the stock price has sunk below the strike price (so-called “underwater” options).

9. Payola is the corrupt practice of taking kickbacks for placing orders. It is not only costly but involves anyone practicing it in a
breach of duty to the corporation. Perhaps more important, because the practice is forbidden it is not reported accurately, and the actual cost is hidden somewhere else in the accounts, it distorts and falsifies the accounts themselves. This was one of the abuses at Qwest, where executives received stock options in supplier companies for awarding them contracts. Then, as they had a financial stake in the supplier’s success, they sent them more business trying to send their stock up, even though what they bought was of inferior quality or not what Qwest really needed.

10. **Irrational exuberance.** Unlike the crash of corporations like Enron and WorldCom, which were the result of mismanagement and chicanery, the bursting of the so-called “high tech bubble” was not primarily a corporate governance problem. Here people invested unwisely in companies known to be overvalued, whose financial statements revealed in many cases that they were built on sand. But many investors were so entranced by the long bull market that they came to feel that prices could only go up, and to believe that high-tech and internet companies could not lose (as for a while they didn’t). While there may have been some puffery in valuations, the main fault lay in the “irrational exuberance” of investors, both venture capitalists and market speculators, and not on dishonesty or malfeasance by the companies themselves.

B. **Regulatory and other responses**

1. The disasters which resulted from failure of oversight and accounting controls, and the crisis of confidence in American corporations which they produced, resulted in new mandatory guidelines from various sources.

2. The most important and comprehensive of these was the Public Company Accounting Reform and Investor Protection Act of 2002, popularly known as Sarbanes-Oxley after its principal sponsors in Congress. This law imposed a series of new requirements on public corporations and on the accounting firms who audit them. Many observers are calling Sarbanes-Oxley the most comprehensive restructuring of federal business regulation since the Securities and Exchange Acts of the 1930s. This may be somewhat overstated, but there is no doubt that these reforms represent a watershed in American corporate governance.

3. We speak of Sarbanes-Oxley as one thing, but really it is a collection of many separate reforms taking effect at different times and in varying forms.
a) Some elements have already taken effect; some will take
effect at various future dates, and some (for example
regulations whose comment period have been extended) are
still in the course of development.

b) Some parts of the Sarbanes-Oxley reforms are statutory; some
are regulatory. Some are to be imposed by non-governmental
agencies like the stock exchanges, under statutory or
regulatory mandates, but may vary from one institution to
another.

c) Some will proceed from companies themselves, in response
to strong encouragement in the statute and regulations; and
some will come from new institutions such as the new Public
Company Accounting Oversight Board.

d) These remarks will not dwell on distinctions among parts of
the Sarbanes-Oxley reforms – that requires a level of
specificity and technical commentary unsuitable for this
forum. This overview discussion relies on substantial
generalization, and the reforms will be treated here as if they
were all of a piece.

(1) For those who want more detail I will gladly provide
copies of a white paper prepared by my law firm,
separating out the principal elements of the reforms and
stating their times of becoming effective. Of course
neither these remarks nor my firm’s white paper are a
substitute for legal advice.

4. Major reforms under Sarbanes-Oxley and new exchange listing
requirements.

a) New corporate governance standards.

(1) Boards to have a majority of independent directors.

(2) Non-management directors to meet regularly in executive
session, out of the presence of management.

(3) Every company to have an Audit Committee composed
mostly of independent directors, including at least one
with financial or accounting expertise, to oversee
independent auditors. The Audit Committee is to be
autonomous and is to be advised of all special accounting
procedures.
(a) Audit committees may retain independent counsel, and there is to be a limit to the number of audit committees on which a director may serve.

(4) Every company to have a Compensation Committee and a Nominating/Governance Committee, with written charters, the power to retain and discharge independent consultants, and provision for evaluation of their performance. There is an increased emphasis on independent directors here too.

(5) An institutional means to be established for shareholders and others to contact the independent directors.

(6) Companies to adopt codes of conduct and corporate governance guidelines.

(a) Each company to adopt corporate governance guidelines covering director qualifications and responsibilities of directors, director access to management and independent advisors, director compensation, management succession, a process for annual evaluation of the board, and other topics.

(b) Each company to adopt codes of ethics covering conflicts of interest, confidentiality, public disclosure, use of corporate assets, compliance with law, and reporting of and accountability for illegal or unethical conduct.

(c) Codes, guidelines, and committee charters to be posted to company website.

(d) Waivers to be granted only by the board and publicly disclosed.

(7) Every company to have an internal audit function, including at a minimum:

(a) an appropriate control process for reviewing and approving internal transactions and accounting;

(b) periodic assessment of internal control function, attestation by outside auditor, and quarterly reporting on its effectiveness; and

(c) periodic certification by CEO or CFO to SEC of adequacy of internal disclosure controls.
(8) Companies to institute procedures for receiving complaints, including anonymous complaints, and to protect whistle-blowers.

b) CEO and CFO accountability

(1) The chief executive officer (“CEO”) or chief financial officer (“CFO”) of a company will have to certify personally that its SEC filings fairly present, in all material respects, the financial condition and results of the operations of the company. False certifications carry criminal penalties. This is intended to prevent management from relying either blindly or cynically on rigged or overly complaisant audits.

(2) A system of “disclosure controls and procedures” is to be established in each company, designed to ensure that management discloses all necessary information to the auditors.

(3) The CEO or CFO will also have to certify personally, with respect to each quarterly and annual report, that they have reviewed it, that based on their knowledge it is not misleading, that the reports “fairly represent” the financial condition, operations and cash flow of the company, and that they have performed certain tasks in aid of internal controls and the company’s auditors, including disclosure controls.

(a) These certifications will cover not only the financial statements, but all financial information as well as the management discussion and analysis section of the filing, which presents management’s commentary on the data in the reports.

(b) The new “fairly represents” standard is higher than that presently in force, which allows reliance on “generally accepted accounting practices.”

(c) “Generally accepted accounting practices” – called “GAAP” for short in American business circles – sometimes allow for reporting which does not fairly represent the true state of the company. That is one of the problems at the root of the accounting scandals of the past few years, a problem this reform is aimed at correcting.
(4) CEOs and CFOs may extend this reform within their companies, insisting on “sub-certifications” from lower echelons. The purpose of this is to impose the same degree of personal responsibility (although without the criminal sanctions) on those who provide information to top management, so management can rely on the information it uses in its own certifications.

(5) The New York Stock Exchange will also require CEOs to certify annually that they are not aware of any breach of exchange rules.

(6) If a company is required to restate its financial reports due to “material noncompliance” with reporting requirements, based on misconduct within the company, the CEO and CFO must forfeit or reimburse any bonus or equity-based compensation received during the year following the flawed report. They must also forfeit any profits on sales of company securities during that period.

(a) There is no requirement that the triggering misconduct be by the CEO or CFO for this penalty to affect them.

(b) This is a radical change – no law has imposed such a requirement before. It is one of the most potent instruments in the Sarbanes-Oxley package, because it affects management’s personal finances, because it imposes responsibility based on the misconduct of subordinates, and because the triggering event is a restatement of a report, a common and mandatory procedure.

(7) Payouts to management or directors

(a) “Extraordinary payments” to directors, management, employees or agents of a company may be frozen by a court, at the request of the SEC, when there is an ongoing securities investigation.

(b) Companies may no longer make personal loans to their management or directors. This curbs a notorious abuse, and will affect not only outright loans but also cashless exercise of stock options, split-dollar life insurance plans, and other compensation dependent on extension of credit by the company.

(i) Existing loans may stand, but may not be modified or renewed. Stockholders will
have to approve equity compensation plans, including stock options.

(8) There are other reforms – for example the standard for barring a person from serving as an officer or director is made lower.

c) Financial reporting requirements will be tightened in other ways.

(1) Off-balance-sheet arrangements (such as those used at Enron) must now be reported if they have or are “reasonably likely” to have a material current or future effect on the company’s financial condition.

(2) Payments due under certain contractual obligations will now also have to be reported.

(3) Material changes in a company’s financial condition or operation will have to be explained in “plain English.”

(a) The rules for this have not yet been adopted, but when adopted will likely push the American system closer to the British practice.

(b) Filings accompanied by non-GAAP analysis must also have GAAP equivalents.

(4) A long series of events which formerly did not have to be reported will have to be reported under newly proposed rules not part of Sarbanes-Oxley. These include:

(a) material agreements not made in the ordinary course of business, or which would trigger a material contingent financial obligation;

(b) termination or reduction of a business relationship leading to a loss of 10% of a company’s revenue;

(c) commitment to actions leading to material write-offs or restructuring charges;

(d) change in credit rating, refusal of a credit rating, issuance of a credit watch, and similar events;

(e) a decision to record a material impairment charge.

(i) When the cost of asset cannot reasonably expected to be recovered through use or sale, generally accepted accounting principles require
a material impairment charge to write down the asset to its net realizable value.

(f) exchange delisting or notice of intent to do so;

(g) notice from current or previous independent accountants that prior reports should no longer be relied on;

(h) change in director, officer, or certain senior management positions;

(i) unregistered sales of equity securities; and

(j) a number of other events.

(5) Shorter filing periods for adverse disclosures.

(6) Disclosure of non-binding agreements, such as merger agreements or letters of intent.

(7) The SEC will review filings at least every three years.

d) Accounting reform.

(1) There is to be a Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of public companies – accounting firms will have six months to register.

(2) An accounting firm cannot be an “independent” auditor for a year after an accountant who audits the company accepts a “financial reporting oversight” position with the company.

(3) Audit partners must rotate every five or seven years – the firms do not have to rotate but they could.

(4) Fees are to be publicly disclosed.

(5) Accounting documents are to be maintained for seven years.

(6) Public accounting firms may not offer non-audit services to clients.

(a) These include: bookkeeping, designing financial information systems, appraisal or valuation services, fairness opinions, internal audit outsourcing, management or human resources functions, and broker, dealer, investment adviser, investment banking, legal, actuarial, and expert services.
(b) These restrictions help prevent accounting firms from auditing their own work.

(c) They also help avoid the situation where accounting firms are dependent on management for non-audit work. As noted, many observers connect this dependence with the complaisant attitude major accounting firms like Arthur Andersen showed toward improprieties at Enron and elsewhere.

e) Reforms affecting other professionals.

   (1) Tighter restrictions on securities analysts, including disclosure of conflicts and imposition of research blackout periods.

      (a) A “research blackout period” is a set period of time after a stock offering in which the analyst’s firm participated as an underwriter or dealer. During this time analysts from that firm may not publish research reports on the company. The intent of this prohibition is to restrict investment banking firms from giving favorable coverage to a company as a tacit *quid pro quo* for its underwriter or dealer fees generated by participating in the offering.

   (2) Restriction on investment banker involvement with securities analysts.

   (3) Requirements that lawyers finding material violations report them “up the ladder” within the company until they get a satisfactory response.

      (a) An earlier proposed rule, requiring lawyers who did not get a satisfactory response within the company to disaffirm SEC filings and make a “noisy withdrawal” from representation before the SEC, has been temporarily blocked after much resistance. The idea is still in play but the comment period has been extended and the final result is still uncertain.

f) Additional reforms.

   (1) Even arguably lawful trading by insiders will have to be reported within two days rather than in the following month.

   (2) The bar on insider trading during a “pension fund blackout period” will be extended.
(3) There will be a substantial extension of criminal offenses and penalties.

(4) Equitable relief (such as injunction) will become more easily available in SEC enforcement actions.

(5) Exchange authorities may issue public reprimands for offenses not warranting delisting.

5. Other reforms are being planned or studied.

a) The SEC and other U.S. government agencies are investigating other areas bearing on corporate governance, accounting, and securities regulation. Possible subjects for future government action include:

(1) Regulating consolidation of public accounting firms.

(2) Principles-based accounting as opposed to rules-based accounting.

(3) Regulating credit rating agencies.

(4) Additional regulation of investment banks.

(5) Requiring expensing of stock options. Some companies are now doing this on a voluntary basis but it is not yet required.

b) Non-governmental organizations are also working on proposals for reform. While not binding they are useful sources for companies considering taking voluntary action.


(2) The American Institute of Certified Public Accountants has resisted systemic reform but updates its standards on a continuing basis. See www.aicpa.org.

(3) The Conference Board’s Commission on Public Trust and Private Enterprise has issued a report addressing many of these issues. See www.conference-board.org/knowledge/governCommission.cfm

(4) The Report of the National Association of Corporate Directors’ Blue Ribbon Commission on Board Evaluation details techniques for improving the effectiveness of
oversight by corporate boards. See link at www.nacdonline.org.

(5) Many other non-governmental organizations have also been working in this area.

c) Corporations are now considering proposals for increasing the involvement of their directors. Ideas include time commitments for directors, orientation and on-going education, annual retreats, increased involvement in financial disclosure, risk management and corporate governance issues, and restricting the number of other boards on which a director may serve.

d) New accounting rules require companies to write down goodwill on acquired companies if they suffer a sustained decline.

IV. CONCLUSION

A. The abuses of recent years, and the sharp reaction to them in the markets and among the public, have caused acute concern at the highest levels of government and business.

B. This reaction has led to a constellation of reforms, through the SEC, the securities exchanges, and other agencies, of which Sarbanes-Oxley is the most pervasive but not the only one.

C. While it is too early to tell for certain, it seems as if these reforms are more than cosmetic, and will actually lead to cleaner corporate governance, more objective accounting, and more detailed, timely, accurate and useful reporting.