View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by University of St. Thomas, Minnesota

University of St. Thomas Law Journal

Volume 1
Issue 2 *Spring 2004*

Article 6

2004

Corporate Governance and Organizational Integrity

John H. Stout

Ruilin Li

Bluebook Citation

John H. Stout & Ruilin Li, *Corporate Governance and Organizational Integrity*, 1 U. St. Thomas L.J. 925 (2004).

This Article is brought to you for free and open access by UST Research Online and the University of St. Thomas Law Journal. For more information, please contact lawjournal@stthomas.edu.

ARTICLE

Corporate Governance and Organizational Integrity

John H. Stout*
Ruilin Li**

In October 2001, Enron Corp. reported over six hundred million dollars of quarterly loss and filed for bankruptcy protection soon thereafter. Thousands of employees lost their jobs and much of their retirement savings, and shareholders lost billions of their investment.[1] Unfortunately, the Enron debacle was merely the first of several high profile corporate collapses within a short period of time. Soon thereafter, accounting fraud and corporate misdeeds of other corporations such as WorldCom, Tyco International, Global Crossing and Adelphia Communications made headlines. These announcements shocked the business community, investors, regulators, and politicians. As a report by the American Bar Association Task Force on Corporate Responsibility stated, "[f]ew events in business history since the Great Depression have had the public impact of the stunning collapse of Enron and other major companies in the past year."[2] As a result,

---

* Fredrikson & Byron, P.A., shareholder, Chair of Corporate Governance Group; member, Board of Directors, National Association of Corporate Directors; member, American Bar Association Corporate Governance Committee and International Governance Developments and Corporate Governance Guidelines (Co-Chair) subcommittees. Adjunct Professor, Corporate Governance, University of St. Thomas Law School.

** Fredrikson & Byron, P.A., senior associate, member of Corporate Governance, Securities, and International Practice Groups; member, American Bar Association Corporate Governances Committee.

1. Enron's common stock was traded at about $90 per share in 2000; thereafter, it gradually went down to $50 to $60 per share by Summer 2001. *See* Robert W. Hamilton, *The Seventh Annual Frankel Lecture Address: The Crisis in Corporate Governance*, 40 Hous. L. Rev. 1, 7-8 (2003) (citing William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275, 1318 (2002)). As problems started to arise, Enron consistently used aggressive accounting principles to enhance the appearance of its financial condition as reflected in its financial statements. *Id.* at 8. In October 2001, Enron restated its earnings. The result was a $500 million accounting loss and a $1.2 billion reduction in shareholder equity. Within a few weeks, Enron's common stock had declined to less than one dollar per share and Enron filed for bankruptcy reorganization. *Id.*

2. *Id.* at 36 (citing James Cheek III et al., *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility 1* (2002)). The task force was created by Robert

"[i]nvestor confidence in the quality and integrity of public company corporate governance [was] compromised, and the pace of calls by the President, Congress, the SEC, stock markets, and other interested groups for regulatory reform quickened dramatically."[3]

These announcements of improper conduct and improper accounting caused deep concern about the integrity of corporate America. In many of these cases, executives clearly had taken advantage of their positions to increase their own personal wealth at the expense of shareholders, employees, and other stakeholders. Boards of directors also came under scrutiny for lax oversight.

The well-accepted governance paradigm is simple: management is accountable to the board, and the board is accountable to shareholders.[4] Among the three groups, the board of directors sits at the apex of a company's governing structure.[5] Senator Joe Lieberman stated that directors are a group of people selected by the shareholders to watch over the management of a corporation on their behalf.[6] Board members are like trustees for the shareholders, serving as guardians "for the integrity and reliability of our economic system."[7] The misdeeds that led to these corporate giants' demise were, in the first instance and ultimately, the responsibility of the corporations' management.[8] The boards, however, failed in their role as the ultimate overseers of management. The boards failed to take responsibility for the corporations' integrity, and the directors on those boards failed to see their corporation's integrity as an extension of their own integrity.[9]

Hirshon, President of the ABA, on March 28, 2002, to consider corporate governance issues raised by the wave of corporate scandals. *Id.*

3. Hamilton, *supra* n. 1, at 36.

4. Natl. Assn. of Corp. Dir., *Report of the NACD Blue Ribbon Commission on Director Professionalism* xi (2001) [hereinafter *NACD Rep. on Dir. Prof.*].

5. Perm. Subcomm. on Investigations, *The Role of the Board of Directors in Enron's Collapse*, Sen. Rpt. 107-70 at 5 (July 8, 2002).

6. Perm. Subcomm. on Investigations, *Statement of Chairman Joe Lieberman*, http://govt-aff.senate.gov/050702lieberman.htm (May 7, 2002).

7. *Id.*

8. Staff of the Comm. on Govt. Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, Sen. Comm. Print 107-75 at 1 (Oct. 7, 2002).

9. John H. Stout, *When Governance Goes Awry*, Star Trib., D3 (Feb. 4, 2002).

I. THE CURRENT CORPORATE GOVERNANCE ENVIRONMENT AND THE RESPONSIBILITIES OF BOARDS OF DIRECTORS: A MATTER OF INTEGRITY.

A. *Organizational integrity is the responsibility of the boards of directors and senior management.*

In the United States, the predominant view is that a business corporation's core objective is to create, increase, and sustain shareholder value,[10] although the view that "stakeholder" should be substituted for "shareholder," as is often the case outside the United States, is growing. Taking the "shareholder" view, one of the board's "paramount duties" is thus to safeguard and promote the interests of the company's shareholders.[11] From either perspective, what is needed most from boards of directors and senior management is assurance of the company's integrity – including an assurance that the company's values and culture support that integrity. Specifically, the organization's integrity must be reflected by:

i. Financial statements and reporting

In 1998, former SEC Chairman Arthur Levitt, in his speech called the "Numbers Game," expressed deep concern about "earnings management." "Too many corporate managers, auditors and analysts are participating in a game of nods and winks," he warned, "I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Management may be giving way to manipulation; integrity may be losing out to illusion."[12] Unfortunately, his warning proved prescient. The charter of Enron's Audit Committee explicitly required the audit committee to ensure the quality of its financial reporting and review Enron's financial statements.[13] On several occasions, Arthur Andersen (Andersen) informed the audit committee members that Enron "was engaged in accounting practices that 'push limits' or were 'at the edge' of acceptable practice." No board members, however, objected to such practices, requested a second opinion regarding Enron's accounting practices or demanded a more prudent approach. On the contrary, the board routinely relied on management and Andersen with little or no effort to verify the information provided, and exercised weak oversight over company accounting practices and financial reporting. During the interview of Enron board members by the Senate's Permanent Subcommittee on Investigation, all

10. Am. Bar Assn. Comm. on Corp. Laws, *Corporate Director's Guidebook* 5 (4th ed., Am. Bar Assn. 2003) [hereinafter *Corp. Dir. Guidebook*].

11. The Business Roundtable, *Statement on Corporate Governance* 3 (The Bus. Roundtable Sept. 1997) [hereinafter *Bus. Roundtable Statement*].

12. Sen. Comm. Print 107-75 at 3; Arthur Levitt, *The Numbers Game*, http://www.accounting.rutgers.edu/raw/aaa/newsarc/pr101898.htm (Sept. 28, 1998).

13. Sen. Rpt. 107-70 at 15.

thirteen Enron board members strongly disagreed with the Subcommittee's conclusion that the board had failed in its oversight duties. Such refusal to accept any degree of responsibility for Enron's collapse is an indicator of the board's failure to recognize its fiduciary obligation to oversee management and ensure responsible financial reporting.[14]

The Sarbanes-Oxley Act (SOXA),[15] New York Stock Exchange and NASDAQ, and governance practices articulated by various other organizations, have focused on ensuring the integrity of financial disclosures. The principles underlying SOXA require that financial statements and public disclosures be accurate and understandable so that they may be relied on by shareholders, regulators, and others who do business with a company, including employees, suppliers, and customers. A director's primary responsibility in the financial reporting process is to ensure that the corporation has procedures that are reasonably designed to produce accurate and appropriate public financial and business disclosures. Directors must read filings, raise questions, and be satisfied that the business information and financial statements convey accurate information about the corporation to the public.

ii. Actions of the Board of Directors

According to the Business Roundtable, the paramount duty of the board of directors of a public company is to select a CEO, and oversee that CEO and other senior management in the competent and ethical day-to-day operation of the corporation.[16] Sixty-five to seventy percent of U.S. corporations combine the role of Board Chair and CEO. The U.S. business community, for the most part, continues to believe that a CEO-centric model of governance serves corporations well.[17]

However, a CEO-centric culture may pose a boardroom problem. The CEO is the single most powerful person in a corporation, with the greatest access to, and control of, information about its business.[18] In many cases all business information provided to the board flows through, or is vetted by, the CEO. The board of directors, in discharging its responsibilities, will often rely extensively on the CEO for information and an understanding of the corporation. The board of directors, however, as the corporation's ultimate governing body, has a responsibility to oversee the performance and conduct of the CEO and the senior management team to assure that their

---

14. *Id.* at 17.

15. Pub. L. No. 107-204, § 302, 116 Stat. 745, 777 (2002).

16. The Business Roundtable, *Principles of Corporate Governance* iii (The Bus. Roundtable May 2002) [hereinafter *Bus. Roundtable Principles*].

17. *Id.* at 8. According to the Business Roundtable, U.S. corporations have traditionally vested responsibility in the CEO as the leader of management rather than diffusing the responsibility among a group of people. The Business Roundtable believes that this model has generally served corporations well.

18. R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greatest Collaboration and Oversight*, 54 Mercer L. Rev. 829, 839-40 (Winter 2003).

fiduciary duties of care and loyalty are observed, and that their conduct, and that of the corporation, is in compliance with the law.[19] This may be problematic when the oversight body is chaired by the CEO. However, as Enron and WorldCom demonstrate, the separation of the Chair/CEO roles does not assure strong board oversight. These and a number of the other high profile corporate scandals demonstrate the problems with board passivity or being overly deferential to the CEO. In many of these cases, including Enron and WorldCom, the board appears to have worked for the CEO rather than to have been an effective overseer of the CEO and senior management. On October 19, 2004, the National Association of Corporate Directors issued a Blue Ribbon Commission Report on Board Leadership. The Report describes several models, and references a "system" of board leadership aimed at strengthening the board's ability to be an effective overseer of management.[20]

iii. Actions of the CEO and Senior Management

The CEO, selected and regularly evaluated and compensated by the board, must above all responsibilities see that a company's business is conducted in a manner that serves rather than detracts from its integrity.[21] It is critical that the CEO be a person of integrity who takes responsibility for the corporation's adhering to the highest ethical standards.[22] The board, CEO and senior management set the "tone at the top." The board must assure that the CEO and senior management establish a culture of integrity, and see that it is communicated and adhered to throughout the corporation.[23] Management must put in place compliance systems and procedures that will give it early warnings of activities that would threaten the integrity of the organization, along with an effective reporting system to enable employees to alert management and the board to misconduct without fear of retaliation.[24] When a warning comes, the board or management must investigate the issue, independently if need be, without restrictions that might compromise the investigation.

iv. Actions of the corporation's advisors

Audit failures have increasingly occurred over the last several years, with restatements reaching levels in excess of 270 in 2001.[25] Every major accounting firm has been involved in at least one significant financial fraud

19. *See* Hamilton, *supra* n. 1, at 36-37 (quoting Cheek, *supra* n. 2, at 7).
20. Report of the NACD Blue Ribbon Commission on Board Leadership, 2004.
21. Stout, *supra* n. 9.
22. *Bus. Roundtable Principles*, *supra* n. 16, at 8.
23. *U.S. Sentencing Guidelines Manual* § 8B2.1(b)(5)(A), (C) (2004).
24. *Id.*
25. Sen. Comm. Print. 107-75 at 21.

litigation.[26] In Enron's collapse, Andersen, the company's auditor, "did not fulfill its professional responsibility in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions."[27] Further, Andersen helped Enron structure many transactions used to improve the appearance of its financial statements. The Senate Subcommittee investigation determined that Andersen was aware of Enron's accounting practices. Materials provided during the investigation indicated that Andersen personnel regularly briefed the Audit Committee about those Enron accounting practices that presented a high degree of risk of non-compliance with GAAP.[28] Another major concern about Andersen as Enron's auditor was that it did not "exhibit sufficient independence and objectivity in discharging its responsibilities."[29] Andersen earned a total of $52 million in fees from Enron during 2000, less than half of which was for audit work; the balance being for consulting services.[30] The investigation concluded that these large consulting fees created a serious conflict of interest for Andersen, and resulted in Andersen's failure to properly discharge its duties of verifying the accuracy of Enron's financial statements.[31]

Under SOXA, the board of directors is explicitly required to ensure that the company's auditor is independent.[32] It is also the responsibility of the auditing firm to ensure that it is truly independent. It must employ competent, ethical staff and carry out its duties in accordance with GAAP, and inform the board, through the board's audit committee, of any issues or concerns about accounting treatments, accounting practices, and internal control issues that may affect the company's reported financial condition or results of operations. The auditing firm should not rely on management to communicate any of its concerns to the board, and should communicate concerns in a forthright manner, on a timely basis, regardless of whether management has done so.[33]

Accountants have not been the only corporate advisors implicated in corporate failures. Attorneys and other advisors have assisted in structuring problematic transactions, and failing to advise appropriately regarding corporate conduct and investigations of warnings of misconduct. The SEC has

26. *Id.* PricewaterhouseCoopers audited Microstrategy, Ernst & Young audited Cendant, KPMG audited Rite-Aid and Xerox, and Deloitte & Touche audited Adelphia, all of which resulted in significant audit failures. *Id.* at n. 91.

27. *Id.* at 22 (quoting William Powers et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 24 (Feb. 1, 2002).

28. Sen. Rpt. 107-70 at 15.

29. Sen. Comm. Print 107-75 at 22.

30. *Id.*

31. *Id.*

32. The auditor independence requirement is further discussed later in this article.

33. *Bus. Roundtable Principles*, *supra* n. 16, at iv.

set new standards of professional conduct for attorneys appearing and practicing before the SEC to implement section 307 of SOXA. The rules require an attorney to report evidence of a material violation "up-the-ladder" to the chief legal counsel or the chief executive officer of the company. If such officers do not respond appropriately to the evidence, the attorney should report to the audit committee or the full board.[34] In addition, the ABA House of Delegates, in response to the corporate failures, adopted changes to two ABA Model Rules of Professional Conduct and a resolution providing guidelines for corporate governance.[35] Model Rule 1.6 was revised to require attorneys to reveal client confidences if the attorney believes the disclosure will prevent the client from committing a crime or fraud that would lead to substantial injury to the financial interests or property of another. This rule applies, however, only when the client uses the attorney's services to commit a crime or fraud, and the crime or fraud is reasonably certain to result in substantial financial injury.[36] Model Rule 1.13 requires an attorney to report "up-the-ladder" if the attorney learns that an employee's conduct may lead to substantial injury unless the attorney reasonably believes that it is in the company's best interest not to do so.[37] In the event of their termination or resignation, lawyers must communicate their understanding of the reasons for their termination to the highest level of authority in the entity.[38] In sum, the accounting, legal, and consulting firms engaged by the company must conduct their activities in a manner that will serve rather than detract from the company's integrity.

v. Board and management compensation

For years executive compensation has been a troublesome issue for many organizations. It is still very much a focus of regulators, shareholders, and the media. It is the board's—or its compensation committee's—responsibility to oversee compensation plans for top executives. One of the six findings reached by the Senate Subcommittee on Investigations was that the Enron board approved excessive compensation for Enron executives, failed to monitor the cumulative cash drain caused by annual bonus and performance plans, and failed to monitor or stop company financed multimillion dollar personal credit lines for senior executives.[39] Based on such finding, the Subcommittee recommended that directors of public companies should take steps to prevent excessive executive compensation by (i) exer-

34. 68 Fed. Reg. 6296, 6296 (Feb. 6, 2003).

35. Chris Little, *Changes to Model Rules and New Corporate Governance Resolution: A Reaction to Corporate Malfeasance*, 32 Colo. Law. 73, 73 (newsletter of Colo. Bar Assn.) (Oct. 2003).

36. *Id.*

37. *Model R. Prof. Conduct 1.13* (ABA 2002).

38. *See* Cheek, *supra* n. 2, at 52.

39. Sen. Rpt. 107-70 at 3.

cising ongoing oversight of compensation plans and payments, (ii) barring the issuance of company financed loans to directors and executive officers, and (iii) preventing stock-based compensation plans which company personnel may use to improperly increase the company stock price for personal gain.[40]

Executive compensation plans should be designed to encourage the achievement of performance objectives and create long-term shareholder value, and which do not detract from the integrity and ethical standards of the company. Executive compensation should be comprised of a combination of cash and equity, and direct equity ownership on the part of directors and management should be encouraged. All stock compensation plans should be fully disclosed to, and approved by, shareholders. The bottom line is that the board, or its compensation committee, should ensure that the compensation and perks awarded to board members and senior management will not in actuality or perception co-opt their judgment, compromise their objectivity (and in the case of independent directors, their independence), or detract from the organization's integrity.

vi. Board oversight of conflicts of interest

The investigation of Enron revealed blatant conflicts of interest issues. Enron had a detailed code of ethics covering its officers and employees. The Enron Code of Ethics had general and specific policies on conflicts of interest.[41] The specific provisions that related to ownership by Enron employees of companies that do business with Enron provided: the Company [Enron] is entitled to expect of such person complete loyalty to the best interests of the Company. . . . Therefore, no full-time officer or employee should: . . . *Own an interest in or participate, directly or indirectly, in the profits of another entity which does business with or is a competitor of the Company.*[42] The Enron board, however, waived the company's policy for Andrew Fastow, its CFO, with respect to his ownership interest in complex off-balance sheet entities on at least three different occasions without vigorous discussion.[43]

40. *Id.* at 4.

41. Enron Corp., *Code of Ethics* 12 (July 2000). The general ethical principle on conflicts in the Enron Code was:

> Employees of Enron Corp., its subsidiaries, and its affiliated companies (collectively the "Company") are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the company.

Id.

42. Marianne M. Jennings, *Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance – Restoration of Active Virtue in the Corporate Structure to Curb the "YeeHaw Culture" in Organizations*, 3 Wyo. L. Rev. 387, 406-407 (2003).

43. *Id.* at 407.

The conflicts issues with Mr. Fastow were just a part of the conflicts of interest involving Enron management.[44] As previously discussed, Andersen served as both Enron's auditor and consultant, and was paid millions of dollars more annually for consulting services than audit services. "Andersen was doing what virtually all of the other Big-Five accounting firms did, in terms of providing audit and consulting services, all the while offering their unequivocal assurances that they had no conflicts of interest in mixing their roles."[45] Further, David Duncan, the audit partner for Enron from the Houston office was a close personal friend of Mr. Richard Causey, the company's chief accounting officer. The Andersen-Enron relationship was so close that employees at Enron were reportedly often unable to tell who was working for Andersen and who was working for Enron, as various times many Andersen employees had permanent offices at Enron—including Mr. Duncan.[46]

Most state corporate laws have statutory provisions that deal specifically with director conflicts of interest. Generally speaking, these laws require that a director who has a conflict disclose it to the board in advance of any discussion or action relating to the matter, and not participate in the discussion and decision-making process in the matter involving the conflict. These laws do not deal with conflicts of interest involving a company's management. The SEC now requires that a public company disclose in its SEC filings whether it has adopted a code of ethics addressing, among other issues, conflicts of interest, and disclose any waiver of its code to the public.[47] The requirement to disclose such waivers on Form 8-K is a response to the granting of waivers by some companies, and is designed to facilitate the monitoring of such waivers by investors and regulators. Given the attention focused on the waiver of certain conflicts of interest by the Enron board of directors, boards will be very cautious about waiving conflicts or suspending ethical conduct policies.

B. *The Bottom Line of Governance: Integrity of Directors and the Company are Intertwined.*

The bottom line of governance is that the ultimate authority for the governed entity is responsible for the entity's integrity. In many of the current corporate scandals the boards of directors failed because they did not take responsibility for the organizations' integrity. The directors did not

44. *Id.* at 400-402 (2003). Enron CEO Ken Lay's son, Mark, did work for Enron for a time, but then went off on his own, creating two privately held technology firms. Enron entered into contracts with both companies and invested in one of them. Mark Lay was also hired by Enron as a consultant at a salary of $1,000,000. Enron's major travel agency was co-owned by Mr. Lay's sister, Sharon Lay. Ms. Lay's Alliance Worldwide Travel booked more than $10 million in travel for Enron and its employees.

45. *Id.* at 408.

46. *Id.*

47. 68 Fed. Reg. 5110, 5110 (Jan. 31, 2003).

see their organization's integrity as an extension of their own integrity – and ultimately that is the critical point.[48]

II. Two Reactions to Recent Corporate Governance Problems Bode Well for the Future:

A. *The emergence of recognized good governance practices.*

For several years there has been emerging a body of "best practices" in corporate governance. These practices are a distillation of the suggestions, pronouncements, and decisions of a variety of organizations, regulatory and legislative bodies, courts, and individual companies. Adherence to these practices is wholly voluntary, though reputational and market forces provide some compliance pressures.

i. Sources of Governance Practices

The sources of what are often referred as "best practices" include, but are not limited to the following:

- Corporate governance practices articulated by Boards of Directors (this got a huge public push from General Motors many years ago)
- Corporate governance practices authored by institutional investors such as TIAA-CREF and CALPERS, and proxy advisors such as Institutional Shareholder Services
- State and federal legislatures; state corporate laws for the most part do not distinguish between public and private corporations with respect to governance and the duties of directors
- Various regulatory agencies, e.g., the SEC, the Internal Revenue Service, and the Comptroller of Currency
- Various self-regulatory organizations such as the New York Stock Exchange and NASDAQ
- Federal and state officials charged with enforcement (note the recent actions of the SEC, the Justice Department through U.S. District Attorneys' Offices, and several State Attorneys General)
- State and federal court and regulatory agency decisions
- Various business organizations such as the Conference Board and Business Roundtable
- The National Association of Corporate Directors which has issued a number of Blue Ribbon Commission Reports on matters such as director professionalism, director and executive compensation, board and director evaluation, detection of fraud, board organization and leadership

48. John Stout, *Corporate Governance and Organizational Integrity*, 3, http://www.fredlaw.com/articles/ corporate/TELFACorporateGovernance2.pdf (June 2, 2004).

- The American Law Institute's Principles of Corporate Governance
- The American Bar Association Task Force on Corporate Responsibility
- Corporate Governance Ratings Agencies, such as Institutional Shareholder Services (61 metrics), Governance Metrics (625 metrics), The Corporate Library, Moody's, and Standard and Poors are providing corporate governance ratings for public companies whose metrics will also be a source of governance best practices

ii. Subjects of Governance Practices

Good governance practices generally speak to the following subjects:

BOARD ORGANIZATION AND LEADERSHIP.

Almost all regulatory agencies, self-regulatory organizations, institutional investors, and rating agencies require or strongly suggest that a public company have an audit committee, a compensation committee, and a nominating/governance committee comprised of solely independent directors, or that the independent directors on the board perform the functions of those committees. Recent legislation and regulations have also expanded the responsibilities and competency requirements of audit committee members. It is accepted practice in large and many smaller publicly held corporations that there will be audit committees, governance/nominating committees, and compensation committees comprised solely of independent directors. In some smaller publicly held companies the functions of the latter two committees are performed by the board as a whole.

There is much discussion as to whether the roles of Chair and CEO should be separated, and, if there is separation, that the Chair be an independent director.[49] If a board does not choose to separate the Chair and CEO positions, it should designate a lead or presiding director who would at the least preside over executive sessions of independent directors and interact with the Chair/CEO on board agendas and supporting materials. In any event, the role of Chair, lead or presiding director, and CEO should be clearly defined and separately evaluated.

BOARD COMPOSITION.

In determining its composition, a board should consider each director's independence, familiarity with director responsibilities and governance

49. The Conference Board, *Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2: Corporate Governance* 19 (Jan. 9, 2003). TIAA-CREF would leave to the discretion of the board whether to separate the two positions. Teachers Ins. and Annuity Assn. - Colleges Ret. Equities Fund, *Policy Statement on Corporate Governance* at 8 (TIAA-CREF 2004) [hereinafter *TIAA-CREF*]. The Business Roundtable has stated that "[m]ost American corporations are well served by a structure in which the CEO also serves as chairman of the board." *Bus. Roundtable Principles, supra* n. 16, at 13. The NACD Blue Ribbon Commission Report on Board Leadership discusses a "system of Board leadership."

matters, business and other relevant experience, reputation for sound judgment and ethical conduct, all in the context of the needs of the board as a whole and the mix of experience and skills of the other directors. Both the New York Stock Exchange and the NASDAQ Stock Market now require all listed companies to have a majority of independent directors. Some respected institutional investors and governance organizations suggest that a "substantial majority" of board members be independent.[50] The New York Stock Exchange and the NASDAQ Stock Market have also adopted specific rules as to who qualifies as "independent," and requires boards of listed companies to make an affirmative determination of the independence of each director and disclose that determination to the public.[51] Boards must thus establish and disclose definitions of independence that take into account various laws and regulations.[52]

The fact that a director is independent under various listing standards and board definitions, however, does not mean that a director will be considered disinterested as to a particular decision. In reviewing conflict of interest situations, a board should examine the range of business and personal relationships between directors participating in the decision in determining whether such director is disinterested.[53]

DIRECTOR SELECTION PROCESS.

Under the SEC rules, public companies are now required to disclose in their SEC filings the process for identifying and evaluating nominees for director; the specific, minimum qualifications for recommended nominees; any other qualities and skills that the nominating committee believes are important for nominees to possess; and whether the boards or nominating committees will consider candidates recommended by shareholders.[54] There is growing pressure for nominating committees to be more responsive to shareholder recommendations for director nominees, and for committees to reach out to their companies' major shareholders for suggestions. Nominating committees should be authorized to retain a search firm, where appropriate, to assist the committee to identify board candidates.

BOARD PROCESSES.

---

50. ALI, *Principles of Corporate Governance* 110 (ALI 1994); Cal. Pub. Employees Ret. Sys., *Corporate Governance Core Principles & Guidelines* 4 (Cal. Pub. Employees Ret. Sys. Apr. 13, 1998); *NACD Rep. on Dir. Prof.*, *supra* n. 4, at 12; *Bus. Roundtable Principles*, *supra* n. 16, at 12; *TIAA-CREF*, *supra* n. 49, at 4.

51. N.Y. Stock Exch., *Listed Company Manual, Corporate Governance Standards, Independence Tests* § 303A.02, http://www.nyse.com/lcm/lcm_section.html (Nov. 4, 2004); The NASDAQ Stock Market, Inc., *Marketplace Rules* §§ 4200(a)(15), 4350(c) http://www.nasdaq.com/about/MarketplaceRules.pdf (Apr. 15, 2004).

52. In addition, for all public companies, audit committee members must meet a more stringent definition of independence. 17 C.F.R. § 240.10A-3 (2004).

53. *See Corp. Dir. Guidebook*, *supra* n. 10, at 27-28.

54. 68 Fed. Reg. 66992-01, 66992 (Nov. 28, 2003).

All directors are expected to devote substantial time and attention to their responsibilities, and enough time to permit them to prepare for and attend board and committee meetings and stay informed about the corporation's business and affairs.[55] The frequency and length of board and committee meetings depend in part on the complexity of the corporation and its operations, but also must take into account the particular issues and circumstances of the corporation that require the directors' attention. The board agenda must be carefully planned and flexible enough to accommodate unexpected developments. The chairman, or an independent director where the chairman is not independent, and the CEO should collaborate on the agenda and plans for the meeting, and should be responsive to requests of directors respecting items that they wish to have included. Agenda-related information must be provided to directors sufficiently in advance of board or committee meeting to allow for careful study.[56] The NYSE listing standards now require boards of listed companies to schedule regular meetings of non-management directors, and at least one meeting annually of only independent directors.[57] The NASDAQ Stock Market requires that independent directors must have regularly scheduled executive sessions at least twice a year.[58]

Appropriate board process has been the subject of judicial scrutiny and criticism. It is critical to the proper performance of director responsibilities and to limiting director liability that board and committee meeting agendas be constructed, and board and committee meetings be actually conducted, in a manner which encourages and allows for due consideration and decision-making as to important matters. Further, it is important that the substance of these meetings be appropriately documented in meeting minutes.

BOARD SERVICE CONDITIONS.

One of the most sensitive challenges a board and nominating committee faces is whether to renominate a director. The NACD Blue Ribbon Commission on Director Professionalism "explicitly rejects the notion of directorship as a lifetime sinecure, even for highly qualified directors."[59] The Commission suggests that once a director has served for a period of time, ten to fifteen years for example, or has reached a predetermined retirement age, it is desirable to promote director turnover to obtain fresh ideas and the critical thinking of new directors. The Business Roundtable also recommends that the board should establish a mandatory retirement age, a term limit, and a requirement that a director tender his/her resignation upon the change of his/her primary employment.[60] Further, a board should also

---

55. *Corp. Dir. Guidebook, supra* n. 10, at 30-31.
56. *TIAA-CREF, supra* n. 49, at 11-12.
57. N.Y. Stock Exch., *supra* n. 50, at § 303A.03.
58. The NASDAQ Stock Market, Inc., *supra* n. 50, at § 4350(c)(2).
59. *NACD Rep. on Dir. Prof., supra* n. 4, at 21.
60. *Bus. Roundtable Statement, supra* n. 11, at 14.

consider requiring that a director submit his/her resignation for consideration if evaluation indicates substandard performance, if the director's poor health or other commitments prevent him or her from functioning effectively,[61] or if the director's actual or alleged conduct may adversely impact the business or reputation of the company.

BOARD DUTIES.

State corporation laws generally provide that the business and affairs of a corporation are to be managed by or under the direction of a board of directors, subject to the shareholders' right in private corporations to assume the responsibilities otherwise required of boards.[62] The phrase "under the direction of" establishes the basis for the board's delegation to management of day-to-day responsibility for the conduct of the corporation's business. Such a delegation to management, however, does not relieve the board of its oversight duties. There are now proposed amendments to the Model Business Corporation Act that underscore the board's oversight responsibilities.[63]

Board duties are not, for the most part, specified in detail in state corporation laws. Rather they have emerged from the practice of directorship over many years, and are articulated by a variety of groups representing various stakeholders, regulators and the stock exchanges, and respected authorities on corporate governance. A contemporary listing of core director duties would include:

- Assuring the integrity of the organization
- Approving governance principles, ethical codes of conduct, and compliance policies, and overseeing their implementation and enforcement
- Nominating (or periodically electing), evaluating, and compensating directors
- Overseeing the development of, and respect for, the corporation's culture and values
- Electing corporate officers
- Annually evaluating and compensating the CEO
- Overseeing the evaluation, compensation, promotion or termination of key senior management
- CEO/senior management succession planning
- Reviewing and approving management's strategic and business plans
- Reviewing and approving the annual budget
- Reviewing and approving extraordinary expenditures (or extraordinary expenditures above certain dollar amount)
- Reviewing and approving transactions not in the ordinary course of business

61. *NACD Rep. on Dir. Prof.*, *supra* n. 4, at 21.
62. Del. Gen. Corp. L. § 141 (2004).
63. Rev. Model Bus. Corp. Act § 8.01 (ABA 2004).

- Reviewing quarterly operating results against plan/budget
- Authorizing board committees and committee membership
- Approving committee charters and compensation
- Reviewing and approving board meeting minutes
- Director orientation and education (business, organization, governance)
- Reviewing conflicts of interest involving senior executives and directors, including current and proposed other directorships of officers and directors
- Agreeing on other organization actions that need approval or consultation
- Overseeing the governance of subsidiary companies

Directors have a dual role: proactive overseer on the one hand, effective collaborator with management for the good of the corporation and its constituents on the other.

BOARD COMPENSATION.

"Directors have an unavoidable conflict of interest in fixing their own compensation."[64] Recognizing this conflict, directors should consider data on comparable companies as well as any special factors related to their corporation to reach a fair result. "A major objective of board compensation plans should be to align the directors' financial interests closely with the long-term interests of the corporation and its shareholders."[65] In recent years, many corporations have moved toward equity-based compensation for directors, in whole or in part. NACD recommends that boards set a target for stock ownership by each director and a time period by which the target should be met.[66] While this trend may align director interest with shareholder value, the board must be careful in designing equity compensation plans to avoid unintended incentives, such as focusing directors on short-term stock price as opposed to longer term corporate value. Equity-based compensation has also raised concerns about the timing of director stock sales. Boards should consider establishing policies that restrict director stock sales during a director's tenure to avoid even the appearance of improper trading, and signals to the corporation's constituents about a director's confidence in the company's prospects.[67]

EVALUATION OF BOARD, CEO, AND DIRECTOR PERFORMANCE.

The board's duty to evaluate the CEO is well accepted. Recently, however, there have been increasing discussions respecting the importance of a board's evaluation of its and its committees' performance as well as the performance of its individual directors. The evaluation process should be controlled by a board's independent directors. Typically an independent

---

64. *Corp. Dir. Guidebook, supra* n. 10, at 31.
65. *Id.* at 31-32.
66. *NACD Rep. on Dir. Prof., supra* n. 4, at 6.
67. *Bus. Roundtable Principles, supra* n. 16, at 23-24.

committee is charged with the evaluations or an independent evaluator is engaged. Effective evaluations require that the board, committee, or director have clearly stated objectives and responsibilities. In the case of the board this often means a board charter or other document that sets out board objectives and duties. For committees the defining document is the committee charter. For directors it is helpful to articulate a position description for all directors generally, with specially described duties for those who serve as Chair or lead director, committee chair, or in some other special capacity.

CEO performance objectives should be agreed to by the CEO and the board, and established in advance of each fiscal year. Given the many current governance issues raised by director and management inattention and misconduct, it is critical that boards include in CEO evaluations an assessment of whether the CEO is setting the desired tone for the company. CEOs must exemplify consistent values of high ethical awareness, honesty, fairness, and courage, while demanding the achievement of company objectives.[68] Poor CEO performance may reflect on the board, and raise questions as to whether the board is performing its functions properly. Finally, in evaluating an individual director's performance, the board should consider the director's core competency, judgment, independence, participation and performance individually, as well as in collaboration with the director's colleagues.[69]

BOARD SIZE.

Board size may vary depending upon a company's size, complexity, industry, business cycle, and global reach. Each board should determine the appropriate size to accommodate its own needs and objectives.[70] The Business Roundtable and NACD suggest that smaller boards are often more cohesive and work more effectively than larger boards. Board size has been trending downwards in recent years.

COMMITTEE ORGANIZATION; INDEPENDENCE.

To better enable the board to perform its oversight duties, boards are delegating certain key functions to committees comprised of independent directors. The most commonly utilized committees are governance/nominating, compensation, and audit. In order for boards to establish that reliance on the work of its committees is appropriate, boards must assure that (i) the membership of each committee is appropriate to its purpose and in compliance with law and various regulations (particularly in the case of public or highly regulated companies); (ii) the committee keeps the board informed of its activities; (iii) committee actions observe the limits imposed

68. Natl. Assn. of Corp. Dir., *Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors* 10 (1994).

69. *NACD Rep. on Dir. Prof., supra* n. 4, at 20.

70. *Corp. Dir. Guidebook, supra* n. 10, at 28.

by law, the organization's governing documents and the committee's charter; and (iv) the authority and responsibilities of each committee are clearly defined and periodically reviewed.[71]

The importance of the audit committee has increased dramatically in recent years. The SEC regards the audit committee as the essential means by which boards oversee the integrity of the company's financial reporting process, system of internal controls, and financial statements.[72] SOXA, the establishment of the Public Company Accounting Oversight Board, and additional SEC regulations have further emphasized the importance of audit committees. Recent SEC rules and the revised listing standards of the major stock exchanges require a company to disclose in its 10-K, (i) whether its audit committee has at least one "audit committee financial expert;" (ii) that the audit committee is comprised solely of independent directors; (iii) that the audit committee is responsible for the appointment, compensation, retention, and oversight of the independent auditor; (iv) that the audit committee has established procedures to receive, retain, and treat complaints regarding accounting and audit matters; (v) that the audit committee has authority to engage independent counsel and advisors; (vi) that the company will provide appropriate funding to the audit committee for engagement of independent counsel and advisors; and (vii) that the audit committee will pre-approve all audit and permissible non-audit services.[73]

Compensation committees have also been impacted by the changing governance environment. Even though SOXA does not address compensation committees, both the NYSE and NASDAQ listing standards require that CEO compensation be determined by an independent compensation committee or by the independent directors on the board. Given the focus on executive compensation abuses at a number of the corporations involved in recent scandals and the New York Stock Exchange, compensation committees must be especially diligent in their approval, review, and understanding

---

71. *Id.* at 42-43.

72. The SEC has stated:

> For most public companies, audit committees have become an essential means through which corporate boards of directors oversee the integrity of the company's financial reporting process, system of internal accounting control, and the financial statements themselves. Among other things, an audit committee serves as the board's principal interface with the company's auditors, and facilitates communications between the company's board, its management, and its internal and independent auditors on significant accounting issues and policies.

65 Fed. Reg. 76008, 76023 (Dec. 5, 2000).

73. It is worth noting that neither SOXA nor the federal securities laws and the rules promulgated thereunder expressly require a public company to have a separate audit committee. If the board does not have a separate audit committee, the entire board is required to serve as such a committee. Pub. L. No. 107-204, § 2, 116 Stat. 745, 747 (2002); 17 C.F.R. § 240.10A-3 (2004). In reality however, this approach is not practicable as the audit committee is required to be comprised solely of independent directors and very few boards of public companies would meet this requirement. As a result, in light of the SEC disclosure rules and listing standards of major stock markets, almost all large public companies have established independent audit committees.

of their companies' executive compensation plans and agreements. The current Disney case[74] involving the compensation of Michael Ovitz suggests the possibility of substantial personal liability for directors whose failure to perform their duties is so egregious as to constitute a failure to act in good faith. The rational proffered by the Delaware Chancery Court in this case could extend well beyond the compensation decisions at issue.

In recent years, the traditional "nominating committee" has evolved into the "corporate governance/nominating committee" at a large number of public companies. This change reflects the increased pressure on boards to address more broadly appropriate corporate governance principles and practices, in addition to nominating board candidates. Even though SOXA does not require a public company to have a corporate governance/nominating committee, the SEC now requires that public companies disclose in their SEC reports whether they have nominating committees.[75]

B. The emergence of proactive boards.

It used to be the law and the practice that directors were not responsible for discovering problems; they were only responsible to act once there had been some kind of a "triggering event" – something that called their attention to a matter that needed to be addressed. Directors could avoid liability for oversight failures if there were no "red flags" to alert them. Directors were not expected to "ferret out wrongdoing."[76] This view of director responsibility started to change with the development of the Federal Sentencing Guidelines, which reduced corporate penalties for infractions where it could be demonstrated that the corporation had taken reasonable steps to avoid the conduct of which the corporation was accused.[77]

Board proactivity got a further push from a Delaware court decision in the *Caremark* case[78] in which Chancellor Allen articulated the proposition that boards cannot wait for a triggering event, but must act proactively to assure that management puts systems and processes in place, and engages in active monitoring, in an attempt to avoid illegal conduct, and to pick up warnings of such conduct. The recent corporate scandals and resulting litigation are underscoring the importance of, and need for, proactivity at the board level. This is supported by SOXA with its certification requirements and criminal penalties, revised listing standards such as those adopted by

74. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 291 (Del. Ch. 2003).

75. For more discussion of SEC disclosure requirements of nominating committees, please see Section II of this article addressing the director selection process.

76. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

77. U.S. Sentencing Guidelines Manual § 8C2.5(f) (Nov. 1, 2003). A key factor in determining whether an organization qualifies for a sentence reduction under the Guidelines is a finding that the organization had, at the time of the offense, an effective program to prevent and detect violations of law.

78. *In re Caremark Intl. Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

the New York Stock Exchange and NASDAQ, governance rating agencies, current court decisions, as well as the positions taken by institutional investors, business groups, the ABA Corporate Responsibility Task Force, and NACD.

As the Committee on Governmental Affairs of the United States Senate recommends, directors of publicly held companies should take steps to: (i) prohibit accounting practices and transactions that put the company at high risk of non-compliance with GAAP and recently adopted SEC rules regarding financial reporting requirements and result in misleading and inaccurate financial statements; (ii) prohibit arrangements that allow company transactions with senior management or a business owned or operated by such persons; (iii) prohibit off-the-books activities used to make a company's financial condition appear better than it is; (iv) publicly disclose all activities or transactions that materially affect the company's financial condition; (v) prohibit excessive executive compensation; and (vi) prohibit the company's independent auditor from providing various consulting services to the company and from auditing its own work for the company.[79] Recently retired Chief Justice of the Delaware Supreme Court, the Honorable Norman Veasey, has stated that the obligation to be proactive in the discharge of their responsibilities requires that directors have the courage to be "skeptical, probe, ask questions, and put management to its proof."[80] "Directors should not 'go along' with any matter that is within their province of 'direction' unless they are satisfied that they fully understand it and have prudently evaluated the risks."[81]

III. How Have Sarbanes-Oxley and the Fall-Out From Corporate Scandals Affected Corporations and Their Boards?

SOXA is intended to address "systemic and structural weaknesses" in corporate financial reporting that has been revealed in recent years, which has serious implications for the capital markets.[82] SOXA is fundamentally impacting the governance and financial reporting of public companies. The Act establishes a comprehensive framework to improve the quality and transparency of corporate financial reporting and strengthen the independence of auditors and audit committees. It also enhances the direct responsibility of senior executives for financial reporting and for the quality of financial disclosures. Overall, SOXA underscores that the board and senior

---

79. Sen. Rep. 107-70 at 4.

80. E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. Rev. 2135, 2146 (2003).

81. *Id.*

82. James Hamilton & Ted Trautmann, *Sarbanes-Oxley Act of 2002, Law and Explanation* ¶ 101 (CCH Inc. 2002).

management are responsible for the integrity of the company. As discussed briefly below, the Act's principal reforms include the following:

1. Auditor independence. The issue of auditor independence is at the center of SOXA. Each of the federal securities laws requires that financial statements must be prepared by an *independent* public accounting firm. In passing SOXA, Congress evidenced its conclusion that the dramatic increase in consulting services provided by the major accounting firms to their audit clients during the last decade eroded their independence. Under section 201 of the Act, it is unlawful for a public accounting firm that audits a public company to provide certain non-audit services to that company.[83]

2. Audit committees. The board should have an independent audit committee with authority to hire and fire the company's auditors. SOXA mandates that audit committee members be independent, thus audit committee members may not accept any consulting, advisory, or other compensatory fee from the company, and may not be affiliated persons of that company or its subsidiaries.[84]

3. Attorneys' responsibilities. Concerns affecting the well-being of the entity should be addressed with management and reported up the ladder. SOXA requires lawyers to notify company directors of management misconduct that top officers refuse to rectify. An attorney must report evidence of a material violation of securities law or breach of fiduciary duty by the company or its employees to the chief legal counsel or the CEO. If either does not appropriately respond, the attorney must report the matter to the audit committee, another independent committee, or the board of directors.[85]

4. CEO and CFO certifications. Information should fairly present, on a current basis, the condition of the organization. SOXA mandates that CEOs and CFOs certify in periodic reports containing financial statements filed with the SEC that the financial statements and disclosures fairly pre-

---

83. The nine categories of prohibited non-audit services included in the Act are:

> Bookkeeping or other services related to the accounting records or financial statements of the audit client;
> Financial information systems design and implementation;
> Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
> Actuarial services;
> Internal audit outsourcing services;
> Management functions or human resources;
> Broker or dealer, investment adviser, or investment banking services;
> Legal services and expert services unrelated to the audit; and
> Any other service that the PCAOB determines, by regulation, is impermissible.

116 Stat. at 771-72.

84. In order to be considered to be independent, section 301 of the Act provides, a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof. *Id.* at 776.

85. Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002).

sent the company's operations and financial condition.[86] Under section 906 of the Act, a person certifying a statement knowing that the periodic report does not comport with all the requirements is subject to fine and criminal penalty.[87]

5. Codes of ethics. Organizations should have a code of ethical conduct applicable to directors, executives, and employees. SOXA section 406 requires that a public company disclose in its SEC filings whether it has adopted a code of ethics that applies to senior financial officers and disclose any waiver of a code provision.[88] The requirement to disclose waivers granted is a response to highly publicized corporate waivers, and is designed to facilitate monitoring such waivers by investors and regulators.[89] Both the NYSE and NASDAQ listing standards now require that listed companies adopt codes of conduct that apply to all directors, officers, and employees.

6. Tampering with records. Corporate information must not be tampered with or destroyed if relevant to an actual or prospective government investigation or proceeding, or private litigation. SOXA strengthens existing federal laws that prohibit obstruction of justice through tampering with or destroying information that may be material to a contemplated or pending investigation or proceeding. SOXA permits the government to prosecute an individual who destroys evidence, even where the evidence is destroyed prior to the issuance of a grand jury subpoena.[90]

7. Whistleblower protection. Corporate employees who alert the organization to compliance issues must not be the subject of retaliation. SOXA provides whistleblower protection to employees when they act lawfully to disclose information about actual or suspected illegal activities within their company. If the employer does take action in retaliation for lawful and protected conduct, the statute allows the employee to file a complaint with the Department of Labor. The employee is permitted to bring the matter to a federal court if the Department of Labor fails to resolve the matter within 180 days.[91] Under SOXA section 1107, anyone who knowingly, with the intent to retaliate, takes any action harmful to any person for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, will be subject to up to ten years in prison.[92]

---

86. *Id.* at 777.

87. *Id.* at 806.

88. *Id.* at 789.

89. Student Author, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 Harv. L. Rev. 2123, 2134-35 (2003).

90. 116 Stat. at 807.

91. *Id.* at 802-04.

92. *Id.* at 810 (the applicability of sections 806 and 807 is not limited to public companies).

8. Prohibition of loans to officers and directors. SOXA section 402 prohibits most loans by a public company to its directors or executive officers. This provision is designed to limit the types of compensatory or quasi-compensatory actions that can be offered to executives, which in the past have escaped public disclosure.[93]

9. Management assessment of internal controls. In order to increase investor confidence and enhance the accuracy of financial reporting, SOXA requires that annual reports filed with the SEC must be accompanied by a statement of company management that it is responsible for establishing and maintaining adequate internal controls. Management must also present its assessment of the effectiveness of such controls. In addition, the company's auditor must report on, and attest to, management's assessment of the company's internal controls. SOXA section 404 compliance has substantially escalated auditor fees, and is a source of continuing corporate protest about the costs imposed on companies by SOXA.

10. Bar from officer/director service. The SEC is empowered to bar any person from serving as an officer or director of a publicly held company if such person committed a securities law violation and his/her conduct demonstrated unfitness to serve in either capacity. Under prior law, only a federal court could issue an order prohibiting a person from serving as an officer or director of a public company. SOXA gives the SEC the authority to bar an officer or director, who has committed an unlawful act, where the SEC has not yet instituted an enforcement action. The Act also modified the standard governing imposition of officer and director bars from "substantial unfitness" to "unfitness."[94]

11. Restrictions on CEO/CFO stock sales. SOXA includes provisions designed to prevent CEOs or CFOs from making profits by selling company stock, or receiving monetary bonuses, during a period with respect to which a company's financial statements are sufficiently misleading as to require restatement. CEOs and CFOs must disgorge bonuses and other incentive-based or equity-based compensation and profits on stock sales if the non-compliance results from misconduct. The required disgorgement applies to amounts received during 12 months after the first public issuance or filing of a financial document embodying such misleading information.[95]

In light of the growing duties and responsibilities imposed upon directors and management by SOXA, NYSE and NASDAQ listing standards, court decisions, federal and state enforcement actions, and the activities of institutional investors, boards are becoming more proactive. There is a greater focus on the audit committee, its composition, responsibilities, and performance. Certifications are being used by CEOs and CFOs at other

93. 148 Cong. Rec. S6762 (daily ed. July 15, 2002) (remarks of Sen. Dianne Feinstein).
94. 116 Stat. at 778-79.
95. *Id.* at 778.

levels of responsibility in companies. State legislatures will consider, and are considering, enacting provisions similar to many of those in SOXA, or preparing their own revised version of corporate disclosure/conduct requirements. Regulators are looking at governance practices articulated by other regulatory agencies and self-regulatory organizations, and beginning to incorporate these into regulations affecting, and settlements with, companies. Without regard to what regulators do, boards of directors are looking at examples of good corporate governance practices, and bringing those practices to the organizations, public or private, for-profit or nonprofit, that they govern.

Good governance policies adopted by various companies will become benchmarks for regulators as well as litigants. The subject of conflicts of interest, already a focal point for the press, will receive even more scrutiny from boards, regulators, and litigants. Non-audit services provided by auditors are being increasingly scrutinized, and this is true of services provided by other consultants as well, to minimize conflicts and insure objectivity.

Codes of ethics, compliance policies and document retention policies are being adopted by more companies, and boards and management are more carefully monitoring adherence. Finally, boards and board committees are more frequently engaging independent counsel and other advisors to provide second opinions, greater objectivity, and independent due diligence and advice to assist them in the performance of their duties.

IV. What Can Boards Learn From the Current Governance Problems That Will Assist Them in Assuring Corporate Integrity?

The malfeasance and wrongdoings of a number of well-known public companies have provided sobering lessons to the boards of corporate America.

1. Governance is a discipline different from management. Governance is about oversight. Management is about organizing and conducting the day-to-day business activities of the corporation. Governance requires skills, processes, and behaviors that are in many ways different, at least in their application, from management. Governance is about process, inquiry, review, discussion, evaluation. It is about bringing people with a range of skill sets and experiences who are independent of management to oversee management's conduct of the businesses. Management is about employing the necessary skill sets to devote full time to the accomplishment of the company's objectives. Management is not ultimately a "checking" or "sounding board" function, it is a doing function. In the boardroom, directors are peers. There is, or should be, no hierarchy in the sense of a superior/subordinate relationship. Managers are not peers. The relationships are differentiated by function and hierarchy. The environment is more com-

mand and control. While CEOs and senior management are often excellent directors, it is because they understand the difference between governance and management, and have successfully applied these skills and experience to the directorship role and function.

2. Integrity is everything. Integrity is the root of shareholder, stakeholder and public confidence in a corporation. Organizational integrity starts at the top, i.e., with the board of directors and senior management.

3. Organizational culture and board and management leadership are critical. Boards must take more responsibility for insuring that the board and management have appropriate leadership, and that leadership is held accountable. Boards must actively monitor the culture of the organization to assure that it reflects ethical values and trustworthiness, and require management to build and maintain an ethical culture. Boards must also be conscious of the signals they send to the organization with respect to the importance of a culture which values ethics, fairness, and doing the right thing.

4. Boards must take more responsibility for compensation, perks, and incentives. The media and a number of institutional shareholders have flogged this subject for years. Recent disclosures of compensation levels and perks paid to senior management of companies have incensed the public and their political representatives. Compensation plans for senior executives and other managers must be reviewed to assure improper behavior is not incentivized. Boards should make sure that company stock-based compensation plans do not encourage management to use improper accounting or other measures to increase company earnings for personal gain. Boards must realize that excessive director and executive compensation reflect poorly on their independence, integrity, and judgment, and may impede efforts to develop an ethical, compliant culture.

5. Boards must develop a greater sensitivity to actual and perceived conflicts of interest. Conflicts of interest in general, but particularly involving directors, senior management, and key advisors, must be carefully assessed, and independent advice should be sought when necessary. This was a major problem with several of the Enron special purpose entities. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on boards' independence, integrity, and judgment, and have a corrosive effect on corporate culture.

6. Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.

a. Care in every decision. The current *Disney* cases underscore the importance of informed board action. Directors should not approve matters they do not understand. Directors should ask questions until they are satisfied that all material information relevant to an issue is available to the board and has been considered. Independent ad-

vice should be sought when necessary. Real or perceived pressures should not overshadow the duty to make an informed judgment. The process followed in making a decision is a critical factor in judicial review of board actions.

b. Loyalty. The interests of the company always come first. Directors should not use their position, or the confidential information they gain, for their or others' benefit.

c. Good Faith. Directors must act in good faith, i.e., acting honestly and dealing fairly.[96] In Minnesota, directors may not be indemnified by the corporation if their act, or failure to act, was not in good faith.[97]

d. Compliance. Directors must oversee the company's compliance with its governing documents, policies and agreements, and the laws and regulations to which it is subject. It is difficult to enforce a company's code of conduct and standards of legal compliance if the message of compliance does not start with the board and senior management, both in terms of emphasis and conduct.

e. Oversight. A board's job is not to manage; it is to vigorously oversee and evaluate management. The CEO reports to the board, not the other way around. An adversarial relationship with management is counterproductive. Collaboration is essential. But personal relationships and compensation cannot be allowed to obscure a board's duty to provide vigilant oversight.

7. Boards must strive to understand risks, pay attention to warnings, and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary, to assure objectivity. History provides ample lessons of the disastrous consequences of cover-ups. A cautionary note: when conducting an investigation pay close attention to issues of attorney-client privilege.

8. Transparency is good; obscuring reality is bad. Transactions, schemes or practices that make it difficult for those who rely on the company's financial and business information to clearly understand that information will be questioned. Boards need to be increasingly aware that if third parties' decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.

9. Targets are good; quarterly earnings obsessions are bad. It is agreed that plans, targets, and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to

96. *Corp. Dir. Guidebook*, *supra* n. 10, at 11.

97. Minn. Stat. § 302A.521 (2004).

result in deliberate distortions, or the use of "cutting edge" accounting or business practices. A survey by *CFO Magazine* found that 17% of CFOs, many from the nation's largest companies, had been pressured by CEOs one or more times in the five-year period preceding the survey to misrepresent financial results. Directors need to be aggressive about investigating and ending that pressure.

10. Monitor corporate disclosures. Boards are increasingly aware of the company's responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, the public stock markets, and others who rely on or require the company's business and financial information. Boards must also be aware of the many ways in which the company provides information, e.g., public comments by management, management conduct, media interviews, analyst updates, press releases, websites, broadcast or directed email, regulatory agency filings, and a multitude of forms and applications for other third parties.

11. Directors need to be schizophrenic. Vigilant overseers, on the one hand, and effective, constructive collaborators with each other and management on the other.

12. Reputations take years to build; moments to lose. For most companies their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and corporate conduct that compromises a company's reputation for integrity and trustworthiness. As we have seen, the consequences of a breach of trust can be brutal.

13. Good governance practices. Good governance in actuality, not just in appearance. The boards of many companies in the news are populated with individuals who have excellent credentials. Often the appropriate board committees are in place, and the governance documentation is current. However, good governance is about organization, process, education, and EXECUTION. And finally EVALUATION – evaluation of management, principally the CEO, evaluation of the board and its committees, and evaluation of each individual director.

The integrity of the corporation is the keystone of our capitalistic system. Lenders, investors, the financial markets, employees, suppliers, customers and communities must be able to rely on the business and financial information communicated by companies. A high level of transparency is essential. Truthfulness is essential. Corporate cultures must embody the values that make integrity, transparency, truthfulness and compliance equal partners with financial performance. A proactive, diligent, thoughtful, accountable, independent board of directors skilled in governance and oversight is central to assuring the appropriate culture and the integrity of the organization.