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From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level

Usha Rodrigues

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FROM LOYALTY TO CONFLICT: ADDRESSING FIDUCIARY DUTY AT THE OFFICER LEVEL

Usha Rodrigues[*]

Abstract

Conflicts of interest are the quintessential agency cost—the constant, lurking danger that agents may seek their own personal gain, rather than the good of the corporation. Yet many corporate employees lack knowledge as to exactly what constitutes a conflict of interest. This ignorance facilitated the kind of fraud seen in Enron, WorldCom, and the options backdating scandals, and may help explain the out-sized payouts that many high-level corporate officers received even as the financial institutions they headed verged on self-destruction. Each case required not only affirmative fraudulent behavior on the part of a few, but also the tacit acceptance of individuals throughout the company.

Currently there are no solutions to the core agency problem of conflicts. Corporate law, in both theory and practice, focuses on conflicts of interest only at the board level via the duty of loyalty. It largely ignores the true corporate decision makers—the CEO, CFO, and other corporate officers. To the extent state corporate law does address conflicts at the officer level, it only discusses how to treat conflicts that have been voluntarily disclosed—it is silent about how to identify conflicts ex ante. Federal regulation has likewise failed to prevent rogue agents from taking from their principals. Neither the Organizational Sentencing Guidelines nor Department of Justice memoranda on entity-level prosecution focuses on incentivizing corporations to prevent conflicts. The Sarbanes-Oxley Act mandates disclosure of waivers of a corporation's code of ethics for senior officers, but this rule may have the perverse effect of encouraging corporations to weaken their codes, so that there are fewer waivers to

* Assistant Professor, University of Georgia School of Law.

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disclose. This Article is the first to examine this question as an empirical problem, analyzing SEC filings and concluding that, indeed, this Sarbanes-Oxley requirement may not lead to any meaningful disclosure.

Because evidence suggests that part of the problem might be a lack of understanding of what constitutes a conflict, this Article advocates education as the best option, and explores implementation mechanisms such as conflicts training, licensing, or certification for high-level corporate officers.

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I. INTRODUCTION

With the tumult of recent bad news in the business world, it is easy to lose sight of the common threads that link seemingly disparate scandals. One important theme repeats itself: the durable problem of conflicts of interest. Even as the Enron and WorldCom frauds gave way to fresher tales of options backdating, corporate looting, insider trading, and more recently out-sized golden parachutes, the common denominator remained the fact that corporate agents put their own interests above those of the corporation.

Each of these frauds turned on the complicity of multiple individuals, either by participating in the wrongdoing or by turning a blind eye to it.[1] For example, many employees knew about accounting irregularities at Fannie Mae and about the fraud at HealthSouth.[2] The Enron board itself approved of its Chief Financial Officer's conflict of interest in investing in the special-purpose entities that ultimately led to Enron's downfall.[3]

Evidence suggests that a major problem may be ignorance of the nature of conflicts of interest. Studies have shown that many callers using corporate whistleblowing hotlines, for example, are seeking guidance on appropriate behavior, rather than reporting wrongdoing.[4] While most attorneys routinely advise boards of directors of their duty of loyalty, such advice and counsel is almost entirely lacking when it comes to corporate

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1. Although the potential for these conflicts exists in all firms, this Article focuses on the problem of conflicts of interest in large public corporations, where agency costs are apt to be higher because of the lack of owners who are motivated or able to monitor managers.

2. Marianne M. Jennings, *Fraud is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing Before Being Fired Upon and Not Being "Shocked, Shocked" That Fraud is Going On*, 46 WASHBURN L.J. 27, 44–48 (2006).

3. BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 197 (Portfolio, 2003); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 4–5 (2002). For further discussion of the knowledge of fraud throughout the Enron organization see Jennings, *supra* note 2, at 38.

4. Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1645 (1990). *See generally* Linda Klebe Treviño et al., *Managing Ethics and Legal Compliance: What Works And What Hurts*, 41 CAL. MGMT. REV. 131, 133–34 (Winter 1999) (suggesting that raising employees' awareness of ethical issues is the biggest challenge managers of ethics compliance face).

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officers.[5] The CFO of Walt Disney Company went so far as to claim: "I was not aware that it was a breach of the duty of loyalty to place one's own interests ahead of the interests of shareholders."[6]

Current mechanisms fail to address the conflict-of-interest problem, or operate only obliquely. In particular, they fail to grapple with the fundamental role that ignorance plays in the problem.

> (1) The Sarbanes-Oxley Act of 2002 only obliquely addresses conflict of interest, via disclosure;
>
> (2) The Organizational Sentencing Guidelines and the Department of Justice's method for prosecuting corporations focus on motivating corporations to prevent violations of *external* laws, but do not address *internal* conflicts of interest;
>
> (3) State corporate law focuses on conflicts for board members rather than for officers, and creates structural impediments to shareholder action to police such conflicts;
>
> (4) State corporate law, to the extent it does address conflicts of interest, describes only how to deal with conflicts once they are disclosed; it does not provide incentives or mechanisms to identify them ex ante.

The remainder of this Part will elaborate more fully on the failings of each mechanism, and propose officer-level conflicts licensing or certification as a first step towards rectifying the basic officer-level conflicts of interest problem facing corporations today.

First, the Sarbanes-Oxley Act focused on disclosure as a potential means of enforcement, but limited its mandate to disclosure of board waivers of the code of conduct for senior officers. This Article presents the first examination of the content of these disclosures, based on data collected from recent 10-Q filings with the Securities and Exchange Commission. This preliminary study, set forth in Part III.B.2, suggests that the Sarbanes-Oxley disclosure requirement does not provide meaningful information to the public, either because the codes of conduct have been weakened to avoid the necessity for disclosure, or because some behavior that would require a waiver is never brought before the board in the first place.

Second, post-Enron changes in the Organizational Sentencing Guidelines and in the Department of Justice's methodology for

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5. Lyman P.Q. Johnson & Robert V. Ricca, *(Not) Advising Corporate Officers About Fiduciary Duties*, 42 WAKE FOREST L. REV. 663, 665 (2007).

6. *Id.* at 663.

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prosecuting corporations attempted to prevent future problems. These changes focused on self-regulation by the organization—forcing corporations to police themselves to achieve compliance with the law. But these federal regulatory mechanisms concentrate on motivating corporations to monitor and prevent future violations of *external* law, such as securities and antitrust law, not on the fundamentally *internal* area of conflicts of interest. Tracking the federal regulatory responses, the scholarship in the field has mostly addressed successes or failures in promoting compliance with these external requirements, not on conflicts.[7]

Third, state corporate law, of course, does focus on the internal governance of the corporation via fiduciary duties. Problematically, however, the law that regulates fiduciary loyalty focuses on the board of directors, not on the officers. Furthermore, at the state level, shareholders seeking to enforce the rules against conflicts of interest through derivative suits face the barriers of the business judgment rule and the doctrines that limit derivative suits.

Fourth, to the limited extent that state law does address conflicts of interest, it merely provides a mechanism for sanitizing conflict-of-interest transactions. While such mechanisms are important, they do not provide a means of smoking out conflicts in the first place. Without the tools in place to identify conflicts ex ante, these sanitizing provisions are ineffective at addressing the underlying problem.

Aside from these four blunt tools, there are no existing mechanisms that motivate or even educate corporate actors (particularly officers) to identify conflicts when they emerge, and to respond to them appropriately. Because the policing of conflicts of interest is weak, and there exists a basic lack of understanding of what constitutes a conflict of interest, education seems a logical first step. By creating an environment in which individuals can identify conflicts, and a culture that does not tolerate violations of conflicts policies, corporations can help prevent conflicts problems from arising. Officer licensing or certification in conflicts-of-interest training provides one avenue for reform.

This Article first explains why conflicts matter. They are central not only to corporate law, but also to the field of business ethics. Part II.B explains how conflicts of interest provide a least common denominator,

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7. *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 687–89 (1997); Frank O. Bowman, III, *Drifting Down the Dnieper with Prince Potemkin: Some Skeptical Reflections About the Place of Compliance Programs in Federal Criminal Sentencing*, 39 WAKE FOREST L. REV. 671, 678 (2004); Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 269 (2004); Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 319 (2007); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 493–94 (2003); Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 957–59 (2006).

the importance of which both lawyers and ethicists can agree on. Part II.C and Part II.D then survey a wide spectrum of the types of conflicts that can arise within the corporation, distinguishing vertical from horizontal conflicts of interest.

To focus in on the duty of loyalty as it applies to the officers who are the powerbrokers of the corporation—the CEO, CFO, and similar employees—one must look to the conflict-of-interest policies contained in internal corporate codes of conduct. Accordingly, Part III.A examines the typical provisions in these codes, distinguishing conflicts provisions from those that focus on "compliance," (that is, on external laws and regulations that apply to the corporation) and the aspirational provisions typical of the corporate social responsibility movement. It is important to distinguish conflict-of-interest terms from the other provisions of codes of conduct. Because they are a unifying concern, all corporations are, or should be, concerned with reducing the agency costs associated with conflicts of interest, and should want to train and monitor their employees with regard to breaches of their conflicts policies.

Part III.B of this Article explores how conflicts enforcement is lacking in present-day corporate practice. Part IV surveys a range of options for regulating conflicts of interest. It concludes in Part IV.B that education is a logical first step, given (1) corporations' independent incentive to police for conflict, (2) the apparent lack of understanding of what conflicts are, and (3) the difficulty of accurately assessing the extent of the conflicts problem. Increasing education or training would make corporate actors more aware of conflicts as they arise, and of what to do about them. Without this fundamental knowledge, increased regulation will have limited effect.

II. WHY CONFLICTS MATTER

A. *The Centrality of Conflicts in Corporate Law*

Conflicts of interest arise when individuals, although obligated by virtue of their positions to pursue one interest, suffer a bias that naturally leads them to pursue a contradictory interest. Corporate law hinges on the notion of conflicts, although it does so obliquely. It purports to concern itself with the fiduciary duties of care and loyalty (and possibly good faith) that directors owe to the corporation.[8] However, because of the limits

8. "The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith." Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (citing Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998)); *see* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 459–60 (2004) (examining developments of the good faith doctrine in

placed on the duty of care in practice,[9] the dominant duty is loyalty.[10]

Despite the legal salience of the topic, everyday businesspeople tend not to talk about duties of loyalty. Instead, they speak the language of conflicts of interest. Businesses may favor the phrase "conflicts of interest" over "duty of loyalty" because the latter phrase sounds too old-fashioned for modern business practice. Perhaps the tendency reflects the reality that the duty of loyalty in practice is not the resounding aspiration of Cardozo's famous *Meinhard* language,[11] but rather a simple prohibition against conflicts of interest.

An additional reason for favoring conflict of interest over duty-of-loyalty language may be that corporate law's duty-of-loyalty jurisprudence focuses mostly on *board* decisions.[12] To the extent that we focus on conflicts, then, we enlarge our focus to encompass not only the problems that arise at the board level, but also those that arise with the most powerful individuals in the corporation—the CEO, CFO, and other officers. Studying the language of conflicts will give us a perspective on the duty of loyalty as it applies *outside* the boardroom.

Delaware); *cf.* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (citing Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)) (holding that the duty of good faith is part of the duty of loyalty).

9. Duty-of-care suits pose little threat to corporate defendants except when plaintiffs seek injunctive relief or if a corporation has not used a provision like Delaware's § 102(b)(7) to limit director liability for gross negligence. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

10. Corporate law students will remember § 102(b)(7) as the Delaware legislature's reaction to *Smith v. Van Gorkom*'s imposition of liability on the Trans Union board for gross negligence. Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 836 & n.13 (2007). Section 102(b)(7) of Delaware's code allows corporations to exculpate directors from liability under the duty of care. DEL. CODE ANN. tit. 8, § 102(b)(7).

11. "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

12. Even though a bedrock principle of agency law is that each agent—each employee, each officer—owes a duty of loyalty to his or her principal, that is, to the corporation, as Lyman Johnson and David Millon remind us, corporate officers like the CEO and CFO are fiduciaries by virtue of their employee status; so, even if they are not directors of the corporation, they are bound by the agent's duty of loyalty. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1601 (2005). Officers' entitlement to business judgment rule protection remains unclear. *See* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 440 (2005) (arguing that the business judgment rule does not, and should not, apply to officers with the same breadth as it applies to directors).

B. *Conflicts: A Bridge Between Business Ethics and Corporate Law*

As we will see in Part III.A, codes of conduct provide the means by which corporations address conflicts of interest "on the ground." Business ethicists and corporate law scholars approach codes of conduct completely differently. Indeed, there is a fundamental disconnect between how lawyers and business ethicists think about the proper purposes of a corporation. Corporate law scholars tend to assess the potential liability, enforcement, and costs created by a code. Business ethicists speak of the positive ethical duties a code should embody. The different perspectives of business ethicists and corporate law scholars are unsurprising given the deep schism that exists between the two disciplines regarding what ends corporate governance should serve. This section will first discuss this divide, and then suggest that the avoidance of conflicts of interest provides a common ground on which both sides can agree as a starting point for a discussion of business ethics.

The dominant normative theory for corporate governance in U.S. corporate law is the shareholder primacy model.[13] The model postulates that the management and directors of a corporation must serve the interests of the corporation's shareholders alone, and therefore maximize profits.[14] Admitedly, there are alternate conceptions of the role of management in corporate governance—for example, Margaret Blair and Lynn Stout's team production theory,[15] Stephen Bainbridge's director primacy model,[16]

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13. Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2026 n.1 (2007) ("[S]hareholder primacy remains the dominant ideology."); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS. LAW. 1, 1 (2004) ("[T]he shareholder primacy model has become the dominant model in scholarship theories with regard to the firm, although other models have been proposed and debated."); D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 862 (2007) ("As the adherents of director primacy acknowledge, shareholder primacy remains the dominant view among corporate law scholars."). In Europe, the stakeholder model has gained greater traction. *See* John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 J. CORP. L. 1, 2–3 (2005).

14. Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 J. CORP. L. 975, 976, 978–79 (2006) (citing Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919)).

15. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999) (arguing that the prevailing principal-agent model of the public corporation should be replaced by a team production approach in which the board exists "not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members of the corporate 'team,' including shareholders, managers, rank and file employees, and possibly other groups, such as creditors").

16. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003) (proposing that corporate law theorists should adopt a director primacy theory that "treats the corporation as a vehicle by which the board of directors hires various factors of production").

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or Charles R.T. O'Kelley's entrepreneur primacy model.[17] The corporate social responsibility movement has also gained traction within corners of corporate law scholarship.[18] Still, it is safe to say that shareholder primacy continues its reign. Two prominent corporate law scholars even declared "[t]he [e]nd of [h]istory for [c]orporate [l]aw" because of the complete triumph of the shareholder primacy model.[19] Shareholder primacy's response to the idea that the corporation owes a duty to anyone besides its shareholders is embodied by economist Milton Friedman's article entitled: "The Social Responsibility Of Business Is to Increase Its Profits."[20]

Most business ethicists, in contrast to legal scholars, subscribe to the stakeholder theory of corporate governance.[21] This view requires that corporate managers and directors consider the interests not only of the shareholders, but also of other "stakeholders" of the corporation: employees, the local community, suppliers, creditors, and society in general.[22] Ethics for them means much more than simply maximizing shareholder returns. The corporate social responsibility movement[23] is but

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17. Charles R.T. O'Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753, 756 (2006) (advocating for an entrepreneur primacy view of corporate law by which "corporation law may be understood as a mechanism to support private ordering intended to provide the modern corporation with a surrogate for the classic entrepreneur").

18. *See, e.g.*, Claire Moore Dickerson, *Ozymandias as Community Project: Managerial/Corporate Social Responsibility and the Failure of Transparency*, 35 CONN. L. REV. 1035, 1062 (2003) (arguing that in the multinational corporate setting, "even where there exists an identifiable and widely held interest in full transparency, meaningful disclosure will not occur, unless, at minimum: (1) those in a position to disclose have internalized the transparency norm; and (2) those outside the community (a) have internalized a norm against a wrong revealed by transparency, and (b) then act on that revelation").

19. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (announcing the triumph of the shareholder primacy model over competing theories of corporate law).

20. Milton Friedman, *The Social Responsibility Of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, (Magazine), at 32–33 (rebutting the notion that a corporation has a "social responsibility" to do anything other than increase shareholder profits).

21. Lumen N. Mulligan, *What's Good for the Goose Is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981, 2004 (2007) ("By most accounts, stakeholder theory is the preeminent contemporary normative theory of business ethics, especially among business practitioners.").

22. *Id.*; *see also* Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 680 (2006) (identifying "the stakeholder theory as viewing corporate responsibility as a balance of the interests of all corporate constituents, even when that balance does not maximize profits").

23. *See* Conley & Williams, *supra* note 13, at 1–2 (providing empirical study of the corporate social responsibility movement); *see also* Lisa M. Fairfax, *Easier Said Than Done? A Corporate Law Theory for Actualizing Social Responsibility Rhetoric*, 59 FLA. L. REV. 771, 786 (2007) ("Regardless of when it emerged, empirical evidence suggests a broad adoption of stakeholder rhetoric within the corporate arena. While that adoption is not universal, the evidence indicates that most corporations focus on stakeholders in some respect when explaining their corporate

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one manifestation of this ethos.

Disagreement between the two models is nothing new—indeed, it is at least as old as the debates between Adolf Berle and Merrick Dodd in the pages of the *Harvard Law Review* in 1932.[24] What is striking is that two different disciplines have apparently settled on two completely different answers to the central question in their fields—for whom should a corporation be governed?[25] Even more striking has been the general lack of interest from either side in bridging the gulf between business ethics and corporate law.[26] On one hand, ethicists work from philosophical theories in order to arrive at the stakeholder theory.[27] For them, ethics and morality both predate law and are normatively superior to it.[28] On the other hand, corporate law scholars and financial economists treat business ethics as "irrelevant" because it fails to take into account the financial and legal structures underpinning the corporation.[29]

Although business ethicists' positive prescriptions are probably closer to the lay understanding of ethics, they are more difficult to generalize from than negative proscriptions against conflicts of interest. Although laudable, these prescriptions are difficult to enforce and more a matter of choice for a corporation. For example, although many individuals might regard environmentally friendly policies as a part of ethical governance, not all corporations might apply these policies, and those that did might apply them differently. When generalizing about serving the interests of the corporation as a whole, the avoidance of conflicts of interest is a much safer, lower common denominator than any particular positive ethical prescription.

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responsibility.").

24. *Compare* A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) (arguing that corporations exist to increase shareholder wealth), *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147–48 (1932) (arguing that the corporation owes responsibilities to all corporate constituents, and to society as a whole).

25. For an excellent discussion of the conflicting rhetoric of the two fields, see Fairfax, *supra* note 22, at 679–90.

26. John R. Boatright, *Business Ethics and the Theory of the Firm*, 34 AM. BUS. L.J. 217, 218–19 (1996).

27. "Philosophers generally bring philosophical theories of ethics to bear on problems of business, and they regard the contractual theory of the firm primarily as a subject for criticism using the resources of philosophical ethics. In particular, stakeholder theory, which stresses the importance of all groups that affect or are affected by a firm, has been proposed as a more adequate theory of the firm for studying business ethics." *Id.* at 218.

28. *See* Jeffrey Nesteruk, *Commentary: A New Role for Legal Scholarship in Business Ethics*, 36 AM. BUS. L.J. 515, 517–18 (1999) (quoting three "prominent business ethicist[s]" who prioritize morality over law).

29. "Business ethics is widely dismissed as irrelevant by researchers in these fields because of its failure to recognize the existing financial and legal structures of the corporation." Boatright, *supra* note 26, at 219.

Avoiding conflicts of interest is a concrete way to force corporate actors to act beyond their immediate self-interest.[30] On this, at least, corporate scholars and business ethicists agree. Ethicists will want to make the leap beyond considering the corporation's self-interest, or, at least, defining the corporation to include various stakeholders so that it may serve a larger self-interest, and on that fundamental point, disagreement will remain. But conflicts of interest provide a starting point, at least, for bridging the divide that separates the shareholder and stakeholder models of corporate governance.

C. *A Survey of Vertical Conflicts of Interest*

Conflicts of interest are "ubiquitous and inevitable."[31] Conflicts arise when decisional dynamics create incentives that make it possible that an individual will succumb to an undesirable bias.[32] More specifically, this Article is concerned with "vertical" biases that exist between principal and agent. Simply put, these conflicts always involve agents of the corporation[33] who are positioned to take from its owners.[34] All owners fear unfaithful agents who pay themselves too much, shirk the work that they are employed to perform, or steal from the corporation; therefore corporations should logically have developed mechanisms to deal with this fundamental problem.

A wide spectrum of vertical conflicts of interest exists. On one extreme lie outright theft and misappropriation of corporate assets; on the other lie more nuanced actions such as excessive diversification (which protects managers' jobs but ignores the interests of already diversified shareholders) or empire building undertaken more to feed management's egos than for the shareholder's good.[35] Most organizations instruct

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30. This is especially true if we say "'[e]thics' means what we do when we think beyond immediate self-interest; [and that] ideally, ethics involves inspired and creative compassion for others.'" Don Mayer, *Fort's 'Business as Mediating Institution'—A Holistic View of Corporate Governance and Ethics*, 41 AM. BUS. L.J. 595, 596 (2004) (book review) (citing TIMOTHY L. FORT, ETHICS AND GOVERNANCE (2001)).

31. Jonathan Macey, *The Nature of Conflicts of Interest Within the Firm*, 31 J. CORP. L. 613, 613 (2006).

32. *Id.* at 630 n.74 (citing Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

33. Although agency costs matter not just for a corporation, but for any firm, I will primarily use the term "corporation" in this Article because my ultimate proposal is for public corporations.

34. "Horizontal" conflicts, in contrast, focus on conflicts between principals. See Part II.D, which distinguishes these from vertical conflicts.

35. *See* Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 37 (2005) (citing Kenneth E. Scott, *The Role of Corporate Governance in South Korean Economic Reform*, 10 J. APPLIED CORP. FIN. 8 (1998)).

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employees to avoid even the appearance of conflict. For example, the New York Stock Exchange listing requirements provide that a conflict of interest exists "when an individual's private interest interferes in any way—or even appears to interfere—with the interests of the corporation as a whole."[36]

The classic vertical conflict involves self-dealing, a situation in which an individual sits on both sides of the transaction and obtains a special benefit.[37] In some cases these transactions may ultimately benefit the corporation; for example, a founder may be willing to offer the corporation a below-market loan in order to help it out in a credit crunch.[38] Still, an employee on both sides of a transaction is necessarily put in a conflict.[39] On one hand, as a corporate fiduciary, she must pursue the best bargain for her principal, the corporation. On the other hand, she will naturally lean toward favoring her own personal interest in order to extract gain for herself.[40] While in the above example, the employee's loyalty to the corporation might prevail over her own self-interest, the corporation should have procedures in place to identify these types of conflicts and to ensure that its own interests are protected—for example, by requiring disclosure to and approval of the board for any self-dealing transaction.[41]

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36. NYSE, Inc., Listed Company Manual § 303(A)(10) (2004) [hereinafter NYSE Manual]. The comment continues:

> A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern.

Id.

37. Baums & Scott, *supra* note 35, at 38. A director who is also a common shareholder and who votes for the corporation to declare a dividend does not engage in self-dealing, because the benefit she receives as a shareholder is shared pro rata with her fellow shareholders.

38. This is the reason for title 8, § 144 of the Delaware Code, which provides an avenue for sanitizing conflicting interest transactions. DEL. CODE ANN. tit. 8, § 144 (2008); *see* Fliegler v. Lawrence, 361 A.2d 218, 224–25 (Del. 1976).

39. *See* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 467 (2008).

40. Corporate transactions with controlling shareholders raise a similar concern, but controlling shareholders' fiduciary duty to fellow shareholders is a more complicated topic. For the sake of simplicity, I will limit this discussion of conflicts to shareholder versus director/officer in a public corporation, where there is generally (although not always) no single large controlling shareholder.

41. Corporations could use the treatment of corporate opportunities under the American Law Institute's § 5.05 as a framework. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.05 (1994). The idea would be that an individual is protected from liability for a conflict-of-interest transaction if the transaction is properly disclosed to the board, and the

Yet many employees in this situation may focus on their "good" motives in making the loan and not realize that a conflict nevertheless exists.

The 2007 financial aid scandal offers an example of self-dealing. Several student loan providers used illegal inducements to gain preferred lender status at financial aid offices at universities around the country.[42] In some cases, school officials received and held shares of one lender, Student Loan Xpress, at the same time that the lender was ranked highly—perhaps over-ranked, given its ratings for customer service—on the school's lender list.[43] Because the officials owned stock in the lender while working for the schools, placing Student Loan Xpress at the top of a list of preferred lenders amounted to self-dealing because the additional business generated would make the officials' stock shares more valuable.[44] This conflict of interest was not disclosed to the universities or to the student loan consumers.[45]

In a famous instance of self-dealing, Enron's chief financial officer, Andrew Fastow, owned and managed several special-purpose entities that helped Enron move transactions off its balance sheet.[46] Fastow made $45 million from the partnerships.[47] In that case, ironically, Fastow followed Enron's internal ethics code; he disclosed his self-dealing to the board of directors, which waived the conflict of interest and allowed the transactions to proceed.[48] This is a case, then, where the proper procedures to deal with conflicts of interest were in place, but were sub-optimally enforced. Rather than approving the waiver as a matter of course, the board should have probed more deeply into the transactions and ensured that Enron's interests were protected (and inquired into why the CFO of a giant public company should be permitted to engage in such atypical behavior). But the board's ignorance, not of the conflict, but of its importance, kept it from taking appropriate action.

In a second type of vertical conflict, related-party transactions, the agent is not on both sides of the transaction, but one closely related to him

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board approves it in good faith. *Id.* § 5.05 cmt. a. Without this prior disclosure, the conflicting transaction would be tainted and the corporation could unwind it. See *infra* note 68 for further discussion of the ALI's treatment of corporate opportunities.

42. STAFF OF S. COMM. ON HEALTH, EDUC., LABOR & PENSIONS, 110TH CONG., REPORT ON MARKETING PRACTICES IN THE FEDERAL FAMILY EDUCATION LOAN PROGRAM 11 (Comm. Print 2007) [hereinafter FFEL REPORT].

43. *Id.* at 35.

44. *Id.* at 33–40.

45. *Id.* at 35, 41 n.42.

46. Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 374–75 (2003).

47. James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1094 n.59 (2003).

48. Beecher-Monas, *supra* note 46, at 374.

is. The World Bank/Paul Wolfowitz affair represents one example. Wolfowitz's employment contract specifically referenced the World Bank's Code of Conduct, which required that he "avoid any conflict of interest, real or apparent."[49] World Bank Staff Employment Principles characterize a sexual relationship between a staff member and a direct report as a "*de facto* conflict of interest."[50] Wolfowitz followed procedure by, at the beginning of his tenure as president of the World Bank, disclosing to the Ethics Committee the existence of a relationship between him and a current employee, Shaha Riza.[51] Despite asking to be recused from decisions involving Riza, Wolfowitz apparently sent Bank human resources vice president Xavier Coll a letter "not seen by executive directors, Ethics Committee or general counsel—dictating terms of Ms. Riza's current and future pay."[52] The terms included a substantial pay raise, which the Ethics Committee approved.[53] A World Bank subcommittee found that these actions violated the Bank's ethics rules.[54]

Another example of an interested transaction is the case of Conrad Black, the former chairman of Hollinger International, Inc., who was convicted of mail fraud and obstruction of justice in 2007.[55] Among other transgressions, during a sale of former Hollinger newspapers, Black allegedly "came up with a scheme to approve millions of dollars of payments to himself and others . . . . The payments were said to be for the executives' agreement not to compete with the new owners of the papers."[56] These noncompete payments would have been perfectly innocent if they were actually requested by the buyer, and the buyer's bid represented the best overall deal for the corporation's shareholders.[57] However, a buyer's representative testified that it had *not* asked for the

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49. Vice President & Corporate Secretary, *Second Report of the Ad Hoc Group*, 4, *delivered to the World Bank*, R2007-0089 (May 14, 2007), *available at* http://online.wsj.com/public/resources/documents/worldbankadhocgroup-20070514.pdf [hereinafter *Ad Hoc Group Report*].

50. *Id.* at 7 (citing Staff Rule 3.01 § 4).

51. *Id.* at 10–11, 13.

52. Gregg Hitt, *Terms of Employment: Wolfowitz Memo, Dictating Raises Given to Friend, Now Haunts Him*, WALL ST. J., May 17, 2007, at A1. The letter also contained this language: "I wish to reiterate [my] deep unhappiness with the whole way of dealing with a situation that I still believe . . . should have been resolved by my recusal." *Id.*

53. *Ad Hoc Group Report*, *supra* note 49, at 20–22, 24. Ms. Riza would leave the Bank with a salary of $180,000 and be guaranteed a promotion upon return in five years. *Id.* at 20.

54. Greg Hitt & Neil King, Jr., *Wolfowitz's Support Diminishes; The White House Wavers As World Bank President Continues to Fight for Job*, WALL ST. J., May 16, 2007, at A3.

55. Emily Steel, Ashby Jones, & Douglas Belkin, *Press Baron Black Guilty in Fraud Case; Jury in a Mixed Verdict, Finds Executives Skimmed Millions From Hollinger*, WALL ST. J., July 14, 2007, at A3.

56. *Id.*

57. *See id.*

noncompetes,[58] making the payments look like bribes paid to Black and other insiders to ensure that the buyer's bid was accepted.[59]

Corporations address a third example of vertical conflict by prohibiting employees from receiving gifts, favors, or remuneration from entities that sell products to the corporation. If an employee favors a particular vendor not because of quality pricing, or delivery terms, but rather because of personal gain to the employee, then the corporation is ultimately the loser.

The financial aid lender scandal presents this type of conflict. Reports include almost comical inducements, including efforts by lenders to provide financial aid offices with tequila, parties, happy hours, and birthday cakes, in exchange for elevated "visibility."[60] Some lenders offered financial aid officers positions on an advisory board, sponsoring lavish trips for board members.[61] Others paid consulting fees to financial aid officials.[62] While the financial aid officials did not share the lender's profits as shareholders, the gifts operated as bribes to gatekeepers to increase revenue. And while the high-level officials clearly knew that such practices violated the organization's policies, some of the rank-and-file employees did not.[63]

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58. *Id.*

59. In two subsequent Delaware cases, the Chancery Court warned against such leveraged buyouts that seem tilted in favor of management. *See In re* Lear Corp. S'holder Litig., 926 A.2d 94, 112–15 (Del. Ch. 2007) (stating that shareholders are irreparably injured if they are asked to vote without knowledge of material facts, such as a CEO's personal financial interests in a potential merger); *In re* Topps Co. S'holders Litig., 926 A.2d 58, 64 (Del. Ch. 2007) ("When directors bias the process against one bidder and toward another not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty.").

60. FFEL REPORT, *supra* note 42, at 12–13.

61. *Id.* at 28.

62. *Id.* at 41.

63. Not all companies have this ethical knowledge gap between leadership and lower-level employees. Wal-Mart, Inc. has a famously rigorous code of ethics that forbids employees from accepting gifts from vendors. James Bandler & Gary McWilliams, *Wal-Mart Chief Bought Ring From Firm's Vendor*, WALL ST. J., May 30, 2007, at A4. The code came under criticism, however, after corporate officials invoked it to fire a manager who had accepted gifts, including liquor and expensive dinners, from suppliers. *See id.* Wal-Mart's code requires employees to "'avoid conflicts of interest in supplier selection, such as directing business to a supplier owned or managed by a relative or a friend.'" Gary McWilliams & James Covert, *Uncomfortable Suit: Roehm Accuses Wal-Mart Brass of Ethics Lapses; Fired Executive Claims CEO Gets Sweet Deals from Longtime Supplier*, WALL ST. J., May 26, 2007, at A1. It further provides that employees are not permitted to "'have social or other relationships with suppliers, if such relationship would create the appearance of impropriety or give the perception that business influence is being exerted.'" *Id.* Claiming that the corporation had applied a double standard in her case, the employee alleged that the CEO of the company had also violated the code by purchasing "'a large pink diamond'" and "'a number of yachts'" from a vendor at "preferential prices." Bandler & McWilliams, *supra*. According to Wal-Mart's court filings, "'[i]nstead of working solely in Wal-Mart's interest,' . . . Ms. Roehm 'frequently put her own first. She did not merely fail to avoid conflicts

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Compensation decisions present a fourth type of vertical conflict of interest, particularly when an agent sets his own rate of pay. Perhaps because of the obviousness of this conflict, executive compensation has been a focus of scholarship and regulatory interest for years in both Europe[64] and the United States,[65] and corporations deal with compensation-related conflicts—unlike the other types of conflicts—via formal internal structures. Most commonly, company policies prohibit the executive from participating in deliberation on her own compensation—which would, if allowed, represent self-dealing. These structural constraints, however, may not always work—as illustrated by claims made over Disney's $140-million payment to departing CEO Michael Ovitz.[66] In that case, plaintiffs alleged facts suggesting that the compensation committee came very close to improperly ceding its responsibility to negotiate with Ovitz to Ovitz's friend, then-CEO Michael Eisner.[67] "Negotiating" with a corporate representative who is also a good friend creates an obvious conflict of interest.

Finally, there is a rich tradition of common law dealing with corporate opportunities, but it is an area of vertical conflict many employees may not consider.[68] The idea is that certain business opportunities presented to the agent belong by right to the corporate entity. Although the classic scenario

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of interest, she invited them.'" Louise Story & Michael Barbaro, *Wal-Mart Fights Back Over Firings*, N.Y. TIMES, Mar. 20, 2007, at C1. Wal-Mart further alleged that Ms. Roehm explored career opportunities with the supplier, which "tainted" the process of supplier selection. *Id.*

64. Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, 6 THEORETICAL INQUIRIES L. 413, 460 (2005).

65. *See, e.g.*, Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 33 (2004) ("Individuals are known to develop beliefs that support positions consistent with their self-interest.").

66. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005) (concluding that the Disney corporate directors and officers did not breach their fiduciary duties or commit waste in hiring and subsequently firing Michael Ovitz); Laura M. Holson, *Ruling Upholds Disney's Payment in Firing of Ovitz*, N.Y. TIMES, Aug. 10, 2005, at A1.

67. *In re Walt Disney Co.*, 907 A.2d at 706–10.

68. The NYSE defines corporate opportunities as (a) "opportunities that are discovered through the use of corporate property, information, or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company." NYSE Manual, *supra* note 36, § 303(A)(10). Delaware case law and the American Law Institute's Principles of Corporate Governance have different definitions of what constitutes a corporate opportunity. *See* Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 154–55 (Del. 1996); A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, *supra* note 41, § 5.05(b). In the case of the ALI, whenever a senior executive becomes aware of an opportunity "closely related to a business in which the corporation is [currently] engaged [in] or [in which it] expects to engage," such opportunity is the property of the corporation, and must be disclosed to it. *Id.* § 5.05(b)(2). Delaware, on the other hand, employs a balancing test involving numerous factors in assessing whether a situation constitutes a corporate opportunity. *Broz*, 673 A.2d at 154–55.

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for a corporate opportunity involves someone offering an officer or director a valuable asset, corporate opportunities can sometimes take unexpected forms. In 2004, in *In re eBay, Inc. Shareholders Litigation*,[69] the Delaware Chancery Court recognized a cause of action where plaintiffs alleged that eBay directors usurped a corporate opportunity by accepting shares in other companies' public offerings from Goldman Sachs, an investment bank.[70] Plaintiffs argued that Goldman Sachs had provided valuable initial public offering allocations (virtually guaranteed to go up in value given market conditions at the time) to eBay directors in order to encourage them to steer eBay business towards Goldman.[71] Because eBay was in the business of investing in securities, and was financially able to do so, the court found that the Goldman IPO allocations constituted a corporate opportunity that the directors should have offered to the corporation.[72]

D. *Distinguishing Horizontal Conflicts*

"Horizontal" conflicts exist between two principals. A common example involves the situation in which one attorney represents two clients who have conflicting interests. Although horizontal conflicts exist within corporations, they are not the focus of this Article. A brief discussion of horizontal conflicts, however, may help clarify the nature of the vertical conflicts on which this Article focuses.

1. Professional Conflicts

For lawyers, the phrase "conflict of interest" naturally conjures up cases in which the quality of an attorney's representation of a current client is threatened by her ties to another current or former client. Although these conflicts could result in gain to a law firm (if, for example, the firm were to favor the interests of a deep-pocketed repeat client while ostensibly representing a less wealthy opponent), the primary concern with client conflicts is not an agent taking from his principal, but rather a lack of zealous representation for a particular client. A law firm, like any organization, may suffer from vertical conflicts of interest; the managing partner, for example, might insist on the firm employing her irresponsible son as office manager. In general, however, law firm conflicts are not principal/agent conflicts, but rather horizontal conflicts between the firm's interests and its duties to represent each client zealously.

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69. No. 19988-NC, 2004 WL 253521 (Del. Ch. Jan. 23, 2004).
70. *Id.* at *4.
71. *Id.* at *1.
72. *Id.* at *4.

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The Enron and WorldCom accounting scandals presented a similar horizontal conflict. Although Arthur Andersen's professional mandate was to audit its client's financial statements and certify them as accurate, because of the structure of partner compensation and the amount of revenues from consulting fees, there was strong pressure to sign off on Enron's financials for the sake of non-audit revenue.[73] Although the particular partners in charge of the Enron and WorldCom accounts benefitted from this, there were also benefits to Arthur Andersen as a whole from the increased revenues from these clients.[74]

2. Conflicts Within the Firm

Jonathan Macey asserts: "[A] strong argument can be made that corporate law does very little of much value other than regulating conflicts within the firm."[75] As Macey points out, however, conflicts occur within the firm both between principal and agent, and between the various constituents of a firm.[76] The former is our concern here, not the latter. Sometimes, for example, the interests of credit holders and shareholders will conflict: creditors and shareholders will have different answers to the question of when a firm should liquidate.[77] Creditors will prefer the more certain payout, and shareholders, as the residual claimants, will tolerate more risk if it generates the possibility of a higher payout.[78] While these conflicts between constituents are real and inevitable, they present a different question from the simpler agency cost problem this Article explores. They present another horizontal, inter-principal conflict, requiring the examination of the many principals that make up a corporation, but that do not act as its agents.

Having distinguished horizontal conflicts, we can return to our focus, vertical conflicts. Their unifying theme is that all vertical conflicts, in different ways, deal with the internal governance rules of the corporation. Corporations choose to prohibit some or all of this behavior not because of the pressure of external laws,[79] but because it makes for a more efficient

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73. Richard M. Weber, Jr., *Subtle Hazards*, 124 BANKING L.J. 324, 335–38 (2007).

74. Obviously, in hindsight it was bad for the firm as a whole to turn a blind eye to the audit function for the sake of the consulting business. But at the time the decision seemed like a positive one for Arthur Andersen. George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1330 (2003).

75. Macey, *supra* note 31, at 613.

76. *Id.* at 613–14.

77. *See id.* at 617.

78. *Id.* at 615–19.

79. State corporate law provides the sole exception. The distinction I draw here is that conflict-of-interest rules are internally focused: any violations of the rules result in damages paid to the corporation (via a derivative suit), not to a third party.

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governance structure that ultimately should benefit the corporation as a whole. As discussed in the next Part, conflicts are generally dealt with in a corporate code of conduct. After describing codes of conduct, this Article will explain the failings of the current approach to policing conflicts of interest.

III. The Problematic Current Approach

Current approaches to officer conflicts of interest are wholly inadequate. Because many of these approaches center on codes of conduct, this Part begins by describing the different kinds of provisions that these codes contain: not only prohibitions against conflicts of interest, but also provisions for compliance with external laws like antitrust or environmental laws, and aspirational provisions concerning the environment, the local community, or similar topics. The fact that codes contain so much may contribute to the dilution of the impact of conflicts provisions, which are central to internal corporate governance.

Next, this Part describes the problems with current conflicts approaches. The Department of Justice and Organizational Sentencing Guidelines are concerned with compliance with *external* laws. The Sarbanes-Oxley Act focuses on disclosure of waivers of the code of conduct, but this requirement may have had the perverse incentive of weakening codes of conduct. This Part describes the first-ever empirical study of these disclosures in SEC filings, and that preliminary data suggest that the disclosures of waivers fail to provide meaningful information to shareholders. State law focuses only on dealing with conflicts once they arise, but provides no way to identify the conflicts beforehand, and litigation by shareholders is hobbled by structural constraints like the business judgment rule and the limitations for bringing a derivative suit. None of these mechanisms—not federal compliance, not disclosure regulation, not state law—address the common core of these corporate scandals: the internal failure to control conflicts of interest that causes a corporate employee to elevate his own interests above those of the corporation, and the possibility that this failure is the product of ignorance.

A. *Codes of Conduct: Where Corporations Locate Conflicts Policies (and a Whole Lot More)*

Corporate codes of conduct are "corporate governance rules that a company generates voluntarily, as opposed to rules imposed by law."[80]

80. Note, *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, 2125–26 (2003) [hereinafter *The Good, the Bad, and Their Corporate Codes of Ethics*]; *see* Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L.

These codes of conduct generate information for the board and senior management concerning potential problems with employees.[81] Furthermore, particularly at the senior management level, the codes are a way to discharge employees without triggering expensive severance payments.[82]

The most common subject of corporate codes of conduct is the avoidance of conflicts of interest.[83] However, codes of conduct contain not only conflict provisions, but also other ethics and compliance provisions.[84] Separating out these three different strands will enable us to focus more closely on the conflicts provisions of the codes of conduct.

1. Compliance Contrasted with Conflict

Although compliance provisions are not the focus of this Article, it will be helpful to discuss these provisions to delineate the boundaries of conflicts provisions and to contrast existing enforcement mechanisms. Although the two are often conflated, conflicts of interest rules differ from compliance provisions in that corporations have independent reasons for wanting to implement conflict-of-interest rules—the desire to minimize agency costs. Compliance provisions are voluntary provisions adopted by

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REV. 253, 257–58 (2005). For a general history of these codes, see Pitt & Groskaufmanis, *supra* note 4, at 1574–600.

81. *The Good, the Bad, and Their Corporate Codes of Ethics*, *supra* note 80, at 2136.

82. *Id.* at 2137. Wal-Mart's firing of Julie Roehm for alleged violations of its ethics rules, and her fiery retaliation in court that the CEO had also violated the ethics policy by receiving a diamond and several yachts from suppliers at discounted prices, illustrates both this mechanism and a potential pitfall of it. *See* Bandler & McWilliams, *supra* note 63.

83. Newberg, *supra* note 80, at 260; Pitt & Groskaufmanis, *supra* note 4, at 1603.

84. The SEC's definition of a "code of ethics" is illustrative of this amalgamation. It uses the term to describe written standards that are "reasonably designed" to prevent "wrongdoing," and also to promote:

> (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
> (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a [company] files with, or submits to, the Commission and in other public communications made by the [company];
> (3) Compliance with applicable governmental laws, rules and regulations;
> (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
> (5) Accountability for adherence to the code.

SEC Code of Ethics Rule, 17 C.F.R. § 229.406(b) (2008). The first prong is what I would term a true ethics code provision, but the second two are compliance provisions. The second is concerned specifically with compliance with securities laws, and the third with general compliance with all applicable laws, rules, and regulations.

corporations to ensure compliance with externally imposed laws.[85]

The traditional doctrine of respondeat superior makes corporations vicariously liable for the actions of their employees.[86] Without respondeat superior, corporations would fail to internalize the costs of doing business; they could avoid payments to tort victims by claiming that their agents acted without authority, and consequently that the agents alone should be held responsible.[87] Corporate criminal liability borrows directly from the doctrine of respondeat superior.[88] Just as in the tort context, so in the corporate criminal context, the doctrine makes the corporation responsible for criminal acts performed by its employees for its own benefit, forcing the corporation to internalize the costs of crimes committed on its behalf, and to monitor and train its employees to prevent them.[89]

The Organizational Sentencing Guidelines provide another mechanism for motivating corporations to undertake compliance programs.[90] Corporate defendants can reduce the amount of criminal fines levied against them if they have an "effective compliance and ethics program."[91] Furthermore, a January 20, 2003 DOJ memorandum from Deputy Attorney General Larry Thompson focusing on the factors militating for and against federal prosecution of business organizations[92] and its successor memoranda issued by Paul J. McNulty and Mark Filip (the

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85. Many corporations also have separate codes and policies to ensure compliance with equal employment opportunity law, and there is a rich literature regarding compliance efforts and results. *See* Krawiec, *supra* note 7, at 493–94. However, because these policies are so area-specific, they are less relevant to ethics codes than are general compliance codes, and this Article therefore will not discuss them. For a discussion of the application of various liability regimes to the problem of compliance, see Arlen & Kraakman, *supra* note 7, at 691.

86. Pitt & Groskaufmanis, *supra* note 4, at 1563.

87. *Id.* at 1563–65. The customary quotation is that the corporation acts only through its agents, and has "'no soul to be damned, and no body to be kicked.'" *Id.* at 1562 (attributing the quote to Baron Thurlow, an eighteenth-century British jurist). To limit the scope of the doctrine, corporations are only liable for actions committed by employees within the scope of their employment. *Id.* at 1565.

88. *Id.* at 1570; *see also* Miriam Hechler Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1044 (2008) (discussing, among other things, the origins of corporate criminal liability).

89. Pitt & Groskaufmanis, *supra* note 4, at 1573.

90. The United States Sentencing Commission promulgated the Guidelines in 1991. Leonard Orland, *The Transformation of Corporate Criminal Law*, 1 BROOK. J. CORP. FIN. & COM. L. 45, 48 (2006). The courts applied the guidelines as mandatory until *United States v. Booker*, 543 U.S. 220 (2005). *Id.* at 49. It is unclear whether *Booker* applies to corporate defendants; if it does, then the Guidelines would become advisory only. *Id.* Even still, they would likely continue to play a role in corporate governance. *Id.*

91. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a) (2007); *see also id.* at intro. cmt.

92. OFFICE OF THE DEPUTY ATTORNEY GENERAL, U.S. DEP'T OF JUSTICE, MEMORANDUM OPINION FOR THE HEADS OF DEP'T COMPONENTS U.S. ATTORNEYS: PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS (2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter THOMPSON MEMO].

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"McNulty Memo"[93] and the "Filip Memo"[94]) stress not only the cooperation of a corporation with a federal investigation once it has begun, but also the implementation of a corporate compliance program beforehand.[95] Corporations cannot rely on a mere "paper program," but must establish well-designed and comprehensive compliance programs.[96]

The starting point for these sorts of regulatory moves, corporate crime, is too large a problem with which to tax limited government resources.[97] Both the Guidelines and the DOJ memos purposefully do not dictate specific provisions or make specific requirements for corporations to undertake.[98] Instead, they create incentives for corporations to police and monitor themselves, and to report any violations to the government.[99] This

93. OFFICE OF THE DEPUTY ATTORNEY GENERAL, U.S. DEP'T OF JUSTICE, MEMORANDUM OPINION FOR THE HEADS OF DEP'T COMPONENTS U.S. ATTORNEYS: PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS (2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf [hereinafter MCNULTY MEMO].

94. Principles of Federal Prosecution of Business Organizations, 9-28.800, *available at* http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf.

95. *Id.* § VII; THOMPSON MEMO, *supra* note 92, § VII. The SEC's Framework for Cooperation, in contrast, focuses mostly on the misconduct at issue and its detection, inquiring only generally as to "[w]hat compliance procedures were in place to prevent the misconduct now uncovered . . . and [w]hy did those procedures fail to stop or inhibit the wrongful conduct?" Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 786 (2005) (citing Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm).

96. THOMPSON MEMO, *supra* note 92, § VII. Corporations should (1) communicate the compliance code to employees through periodic training, (2) put monitoring and auditing systems in place, (3) implement a reporting system so that employees can report violations without fear of retaliation, and (4) task high-level personnel with overseeing the compliance structure. Krawiec, *supra* note 7, at 496. Although they are only guidelines, the Thompson factors (unchanged, for our purposes, by the McNulty and Filip Memos) "have become the canonical text for assessing corporate cooperation." Griffin, *supra* note 7, at 319.

97. Griffin, *supra* note 7, at 340–41 ("[Corporate fraud's] harm is great, the charges are complex, and government resources are stretched thin . . . . [T]he organizational guidelines were adopted in part on the theory that strong private corporate compliance efforts would augment limited government resources. Unraveling the threads of an intricate corporate fraud scheme without extensive cooperation is also a daunting challenge, and a direct approach to potential employee cooperators may be constrained by ethical rules prohibiting contact with employee witnesses without the consent of the company.").

98. *See, e.g.*, MCNULTY MEMO, *supra* note 93, at 14 ("The Department has no formal guidelines for corporate compliance programs.").

99. *See* Baer, *supra* note 88, at 1050 (taking a harsher view and noting that "[the criminal justice compliance system] provides the government with a method of screening potential defendants, maintaining control over business entities, and leveraging its prosecution of individuals. Moreover, because it leaves the specific details of internal compliance largely to the private sector, the system creates an impression of flexibility and private initiative.").

arrangement presents a "carrot and stick" approach, where corporations are rewarded for having effective programs in place.[100]

Enforcement is left to the corporation's discretion. Generally, larger companies will have an ethics or compliance officer, sometimes coordinated by in-house counsel.[101] Many codes require employees to report suspected violations.[102] Enforcement of compliance provisions is relevant for conflicts purposes in two ways. First, enforcement of compliance provisions at least pays lip service to enforcing a corporation's code of conduct (including its conflicts provisions) generally. Second, though often termed a form of "self-regulation," compliance provisions involve a de facto form of government by delegation. Such provisions involve corporations in monitoring for violations of external laws and enforcing penalties against wrongdoers, generally by turning them over to external regulators. In contrast, conflicts provisions—which involve self-imposed limits designed for the specific purpose of reducing agency costs—operate in a very different way.

2. Aspirational Ethical Provisions in Codes of Conduct

Business ethicists focus on the positive duties of corporate citizens to act ethically, and how corporations can incorporate these duties into their codes of conduct. Some of these codes are brief "corporate credos" or "values statements," articulating principles that guide the conduct of the company's business.[103] These voluntary principles, standards, or guidelines can be "broad and aspirational" or "more detailed and operational in nature."[104] They generally focus on labor rights, human rights, consumer protection, anti-corruption, and environmental concerns.[105] One scholar has termed the environmental requirements imposed via private contract by large corporations onto their suppliers the "new Wal-Mart effect."[106] Third parties have made some efforts to enforce these voluntary policies, but they have largely failed.[107]

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100. Bowman, *supra* note 7, at 678.

101. Newberg, *supra* note 80, at 263–64.

102. *Id.* at 263.

103. *Id.* at 257.

104. Sean D. Murphy, *Taking Multinational Corporate Codes of Conduct to the Next Level*, 43 COLUM. J. TRANSNAT'L L. 389, 400 (2005).

105. *Id.*

106. Michael P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 UCLA L. REV. 913, 918 (2007).

107. For example, in 1998, Nike consumer Marc Kasky sued Nike, Inc. regarding company statements about working conditions in its offshore factories. Kasky v. Nike, Inc., 45 P.3d 243, 247 (Cal. 2002). Among other allegations, Kasky claimed that Nike violated its own vendor policies, under which Nike "assumed responsibility for its subcontractors' compliance with applicable local laws and regulations concerning minimum wage, overtime, occupational health and safety, and

Some corporate social responsibility advocates focus on transnational relationships with suppliers as a way to enforce higher standards, given weak international law and the fact that some developing countries choose not to regulate multinational corporations or their domestic partners.[108] Nike, The Gap, Levi Strauss, Reebok, and Mattel have responded to scandals involving labor conditions in overseas factories by implementing voluntary codes of conduct that apply to their suppliers and subcontractors.[109]

Conflicts provisions properly understood, then, are the provisions of the code of conduct where the corporation is not responding to external laws, but rather implementing internal governance measures that try to prevent its employees from misappropriating corporate assets.[110] They attempt to address the issues of self-dealing, related-party transactions, relationships with vendors, and corporate opportunities.[111] Topics commonly dealt with include permissibility of gifts; policies for leaving and returning to employment with the government, a customer, or supplier; selection of vendors; sales; or travel and entertainment expenses.[112]

Thus conflicts provisions, although so crucial to corporate governance, are sandwiched between compliance and aspirational provisions in corporate codes. It is up to individual corporations to emphasize this most fundamental part of their corporate codes. Yet, as the next Part will explain, most of the policing mechanisms corporations face focus on external compliance, not internal conflicts of interest.

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environmental protection." *Id.* at 247–48. In another case, the International Labor Rights Fund sued Wal-Mart, Inc. for failing to enforce provisions of its code of conduct relating to fair-labor practices of its suppliers. *See Retail Brief—Wal-Mart Stores, Inc.: Group Files Suit Challenging Enforcement of Conduct Code*, WALL ST. J., Sept. 14, 2005, at A16.

108. Murphy, *supra* note 104, at 395–96 ("[G]overnments in the developed world resist regulating MNCs abroad and, if pressed to issue regulations, might set lower standards than may be achieved in voluntary codes. Furthermore, civil society groups are aware that governments in the developing world often lack the capacity or the will to regulate MNCs. Indeed, authoritarian or non-democratic regimes may be uninterested in addressing broad social concerns."); *see also* Katherine Kenny, Comment, *Code or Contract: Whether Wal-Mart's Code of Conduct Creates a Contractual Obligation Between Wal-Mart and the Employees of its Foreign Suppliers*, 27 NW. J. INT'L L. & BUS. 453, 455 (2007) (examining whether corporate codes of conduct are binding on foreign suppliers and their employees, or merely voluntary, non-contractual devices).

109. Newberg, *supra* note 80, at 290–91.

110. *See supra* Part II.C.

111. *Id.*

112. *Corporate Conflicts of Interest, American-Style*, 23 ACC DOCKET 98, 98 (2005).

B. *Problems with Current Means of Enforcing Codes of Conduct*

1. Enforcement via Compliance: An Imperfect Tool

Compliance enforcement largely takes the form of "carrot and stick."[113] The DOJ memos promise less chance of prosecution, and the Guidelines provide for reduced penalties, if corporations put systems in place and report infractions to the appropriate authorities. Additionally, *In re Caremark International Inc. Derivative Litigation*,[114] a famous Delaware case that appeared to establish an affirmative duty to monitor compliance systems, increased the pressure to create compliance enforcement mechanisms.[115] The opinion alluded to the Guidelines in articulating a board's duty to

> assur[e] . . . that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[116]

However, as many commentators have observed, the actual standard for proving liability under *Caremark* is "quite high."[117]

Although there is some mention of ethics programs in the Guidelines, their intent is to regulate compliance,[118] not conflicts. Crucially for my purposes, although the language of the Guidelines refers to a compliance and ethics program, the operational language focuses solely on compliance with external law. So, for example, although the description of a qualifying program requires that the organization not only "prevent and detect criminal conduct," but also "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance

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113. Bowman, *supra* note 7, at 678.

114. 698 A.2d 959 (Del. Ch. 1996).

115. *Id.* at 970. *Caremark*'s standard was adopted by the Delaware Supreme Court in *Stone v. Ritter*, 911 A. 2d 362 (Del. 2006).

116. *In re Caremark*, 698 A.2d at 970.

117. *Id.* at 971. ("[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."). For further discussion of Delaware's treatment of the duty to monitor, see *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) and *In re Walt Disney Company Derivative Litigation*, 907 A.2d 693, 755–56 (Del. Ch. 2005).

118. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (2007).

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with the law,"[119] the minimal requirements set forth in the following sections all focus on the detection and prevention of criminal conduct.[120] The ethical conduct language seems tacked on, serving no operative purpose.

Given this emphasis on compliance, conflicts provisions may not be put in place at all, or may exist in only a flawed form. Agency costs can explain a failure to implement conflicts provisions or internal controls in the first place; if the agents in charge are already unfaithful, they will be loath to put monitoring systems[121] or a code of ethics in place that will only constrain their actions.[122] Lawrence Cunningham describes how, thanks in part to lawyers and their love of processes and desire to avoid legal liability, internal controls (which should address, among other concerns, conflicts of interest) morphed from positive means to help a corporation meet its objectives to processes focused on preventing "undesired events" from occurring.[123]

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119. *Id.*

120. *See, e.g.*, *id.* § 8B2.1(b)(1) ("The organization shall establish standards and procedures to prevent and detect criminal conduct."); *id.* § 8B2.1(b)(5) ("The organization shall take reasonable steps—(A) to ensure that the organization's compliance and ethics program is followed, *including monitoring and auditing to detect criminal conduct*; [and] . . . (C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding *potential or actual criminal conduct* without fear of retaliation." (emphasis added)); *id.* § 8B2.1(b)(6) ("The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through . . . appropriate disciplinary measures *for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct*." (emphasis added)); *id.* § 8B2.1(b)(7) ("After *criminal conduct* has been detected, the organization shall take reasonable steps to respond appropriately to the *criminal conduct and to prevent further similar criminal conduct*, including making any necessary modifications to the organization's compliance and ethics program" (emphasis added)). Only the section on employment of "substantial authority personnel" refers to the application of an effective compliance and ethics program to more than just criminal activity, requiring that the organization use "reasonable efforts" not to place an individual who "has engaged in illegal activities *or other conduct inconsistent with an effective compliance and ethics program*" into a substantial authority personnel position. *Id.* § 8B2.1(b)(3) (emphasis added). "Substantial authority" is defined in an earlier part of the statute as those "who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization." *Id.* § 8A1.2 cmt. 3(c).

121. Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 958 (2006).

122. *Id.* Donald Langevoort also suggests that the costs of setup (undoubtedly more of an issue for internal controls than for a code of ethics, although enforcement mechanisms such as a helpline may prove costly) may explain failure to put these systems in place, or, intriguingly, it may be a question of path dependency: more extensive systems might make more sense later in a corporation's life cycle, rather than earlier, but sometimes "the original structure [may stay] in place too long without modification simply because the managers are paying attention to more pressing matters." *Id.* at 958–59.

123. Cunningham, *supra* note 7, at 269.

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Government regulation directly touches some conflicts of interest, converting them into issues of compliance as well as conflict. One subset of conflicts of interest—those involving related-party transactions—must be disclosed under Item 404 of Regulation S-K.[124] For transactions involving more than $120,000, where a related person[125] has a "direct or indirect material" interest, companies must disclose the name of the related person, the relationship, the amount of the related person's interest in the transaction, and the corporation's process of review, approval, or ratification of the transaction.[126]

Criticisms of the current compliance-based approach abound. Business ethicists fault a misplaced emphasis on rules for the failures of enforcement. Much of the larger ethics literature focuses not on issue-specific positive ethical conduct, but instead on the need to move from a focus on narrow rules to a broader focus on corporate culture and values. A prominent study found that "specific characteristics of the formal ethics or compliance program matter less than broader perceptions of the program's orientation toward values and ethical aspirations."[127] The programs that lawyers favor are what the literature calls "compliance approach[es]," which focus "primarily on preventing, detecting, and punishing violations of the law."[128] In contrast, values-based approaches "aim[] to define organizational values and encourage employee commitment to ethical aspirations."[129] Studies have found the values approach to be more effective, although much depends on the culture of the organization.[130] The corporation should avoid the perception that management is just trying to protect itself from liability.[131]

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124. Regulation S-K, 17 C.F.R. § 229.404 (2008).

125. "Related person" is defined as a director or officer of the corporation, a current nominee for director, or their immediate family members; or a holder of more than 5% of the corporation's securities, or their immediate family members. *Id.* § 229.404(a) instruction 1.

126. *Id.* §§ 229.404(a)–(b). The NASDAQ keys its conflicts requirement off of this SEC regulation:

> Each issuer shall conduct appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis by the company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "related party transaction" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.

NASDAQ Manual § 4350(h) (2008), *available at* http://wallstreet.cch.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F1&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F.

127. Treviño et al., *supra* note 4, at 131.

128. *Id.* at 135.

129. *Id.*

130. *Id.* at 131; *see also* David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1792 (2007); Jason Stansbury & Bruce Barry, *Ethics Programs and the Paradox of Control*, 17 BUS. ETHICS Q. 239, 246 (2007).

131. *See* Stansbury & Barry, *supra* note 130, at 252.

Corporate scholars, on the other hand, focus mainly on compliance and enforcement, rather than on the content of the codes.[132] Compliance codes, and ethics codes to the extent that they are treated as the same, have been criticized as mere "window-dressing."[133] Kimberly Krawiec questions the usefulness of these mechanisms when "the indicia of an effective compliance system are easily mimicked and true effectiveness is difficult for courts and regulators to determine, particularly *ex post*."[134] Indeed, several studies appear to cast doubt on these codes' ability to change employee behavior.[135]

There is even reason to doubt the underlying premise that compliance efforts pay off for corporations—i.e., that the "carrot" exists at all.[136] Frank Bowman III revealed that as of 2004 (after thirteen years under the Guidelines) only three corporations had received a reduction in fines because of the effective compliance factor.[137] Nevertheless, these incentives have spawned an industry focused on advising corporations in the design, implementation, and enforcement of compliance mechanisms.[138] If one counts not only the direct costs of internal controls, but also the expense associated with "false complacency," the cost

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132. Interestingly, although most of the NYSE requirements for listed companies' codes of ethics are negative proscriptions (as one would expect from an entity that provides general governance requirements to for-profit corporations), there is one exception: the NYSE wants corporations to have codes that encourage "fair dealing" with its "customers, suppliers, competitors and employees." NYSE Manual, *supra* note 36, § 303A.10. This goes farther into the positive ethical terrain than does the traditional duty of loyalty. It elaborates that "[n]one should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice." *Id.*

133. Krawiec, *supra* note 7, at 487; *see* Pitt & Groskaufmanis, *supra* note 4, at 1630–31.

134. Krawiec, *supra* note 7, at 491–92; *see also* Ford, *supra* note 95, at 791–92 ("Compliance serves an insurance function against zealous prosecutorial action, and firms purchase only the amount of compliance required to shift liability away from the firm. It would not be in a firm's interest to purchase too-effective compliance structures that could uncover wrongdoing that would otherwise remain undiscovered. Firms may be tempted to follow compliance requirements in a minimal, even cynical, way." (footnote omitted)).

135. Krawiec, *supra* note 7, at 511 ("Despite the pervasiveness of ethics codes in corporate America and the insistence by many legal compliance professionals on their importance as a deterrence tool, little evidence exists to support the theory that ethics codes modify employee behavior."). Although Krawiec uses the term "ethics code," her argument centers on compliance, and she does not make the compliance/ethics distinction that this Article makes. Krawiec observes that studies finding a significant relationship between ethics codes and employee behavior have methodological flaws. *Id.*

136. John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 CORNELL L. REV. 310, 317 (2004) ("The so-called 'carrot and stick' approach never had much carrot to it, however. If a company adopted a compliance program and self-reported violations, it received no guarantee of leniency. On the other hand, the failure to pursue the carrot 'voluntarily' virtually guaranteed being hit with the stick in the event of a corporate conviction." (footnote omitted)).

137. Bowman, *supra* note 7, at 684.

138. *Id.* at 679.

multiplies.[139] Lawyers, accountants, compliance consultants, internal compliance and human resources personnel, and other specialists try to convince companies that by implementing their programs, those firms can avoid prosecution or greatly decrease any potential fine.[140] Although the efficacy of these programs is unclear, there is no doubt that they are expensive.[141]

Corporations generally rely on the compliance industry to put in place controls that monitor conflicts. Legal scholars like Lawrence Cunningham, Kimberly Krawiec, and Donald Langevoort discuss the rent-seeking behavior of the compliance industry, which justifies its existence by magnifying the benefits of compliance and the perils of failing to institute all available measures to protect against noncompliance.[142] Cunningham writes that lawyers, in particular, over-rely on these controls.[143] Rather than understanding them (as accountants do) as risk assessments, they expect controls to prevent virtually all problems.[144] Compounding the issue, not all problems can be measured reliably. Rather than addressing these unmeasurables, however, there is a trend towards controls that can be audited or can be measured, rather than toward controls that actually work.[145] These controls thus induce a false sense of complacency, and elevate the control as an end in and of itself.[146]

As discussed, conflicts-of-interest provisions are contained in corporate codes of conduct. Some studies suggest that these codes alone are ineffective in changing employee behavior.[147] A major drawback of ethics programs is that by asserting control, they hamper an employee's ability to make her own moral judgment.[148] Furthermore, there are problems associated with measuring ethics and the effectiveness of ethics codes.[149]

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139. *See* Cunningham, *supra* note 7, at 305 ("In addition to direct costs are the costs associated with creating false complacency. The comfort-sense of systems, controls, and audits obscures the real underlying risks.").

140. Bowman, *supra* note 7, at 680–81; Krawiec, *supra* note 7, at 489. Conscious and unconscious biases lead lawyers, for example, to overstate legal risks. *See* Krawiec, *supra* note 7, at 529. Enterprise indictments are enormously threatening for corporations, not only because of reputational effects, but also because indicted organizations cannot contract with any federal agencies, and may lose federal aid or licensees or permits. Baer, *supra* note 88, at 1062.

141. Bowman, *supra* note 7, at 687.

142. *See id.* at 680–81; Krawiec, *supra* note 7, at 489.

143. Cunningham, *supra* note 7, at 269.

144. *Id*. at 270–71.

145. *Id.* at 270.

146. *See id.* at 304.

147. Krawiec, *supra* note 7, at 511–12.

148. Stansbury & Barry, *supra* note 130, at 239–40.

149. *See* Ford, *supra* note 95, at 791; Newberg, *supra* note 80, at 267 n.83. Common methodological techniques, such as relying on hypothetical problems in lab settings or relying on self-reported instances of observed unethical conduct, are problematic. Krawiec, *supra* note 7, at 511–12.

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The current regime pressures corporations to install ethics or compliance officers.[150] The codes then instruct employees to contact the legal department or ethics office with any concerns.[151] This model presupposes, however, that businesspeople are able to identify a potential conflict in the first place. Studies on hotlines established in corporations have shown that many of the calls are not whistleblowing at all.[152] Instead, the callers are asking for guidance as to what is appropriate and what is not.[153] A basic ignorance exists as to what rises to the level of conflict.[154] Business ethicists also cite the danger of creating ethics experts that make individuals less responsible for their own decisions.[155]

So compliance programs fail conflicts enforcement on two fronts—focus and efficacy. First they do not focus on ethics; their purview is preventing violations of external law. But the solution may not simply be to include ethics more robustly in the scope of compliance measures, because the efficacy of compliance systems themselves is far from clear. Many compliance measures are open to charges of window-dressing. The DOJ memos and the Guidelines notwithstanding, non-disclosure-based federal regulation of conflicts lacks real effect.

2. Perverse Incentives of Sarbanes-Oxley: Theory and Evidence

As seen in the prior section, federal enforcement of conflicts provisions has generally been an afterthought. The only direct federal regulation comes from § 406 of the Sarbanes Oxley Act of 2002, which required the SEC to promulgate rules regarding disclosure of codes of ethics for senior management.[156] The SEC's definition of a "code of ethics" combines both compliance and ethics provisions.[157] The SEC's rules require that public

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150. Bowman, *supra* note 7, at 679 & n.42.

151. Stansbury & Barry, *supra* note 130, at 253.

152. *See* Pitt & Groskaufmanis, *supra* note 4, at 1645.

153. *Id.*; *see* Treviño et al., *supra* note 4, at 134.

154. *See* Stansbury & Barry, *supra* note 130, at 252.

155. *See id.* at 254.

156. Section 406 of Sarbanes-Oxley refers to a code that only applies to senior financial officers: the principal financial officers, comptroller or principal accounting officer, or individuals performing these functions. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 789 (codified at 15 U.S.C. § 7264 (2006)). The SEC rules added the "principal executive officer," reasoning that CEOs should "be held 'to at least the same standards of ethical conduct' as senior financial officers." Newberg, *supra* note 80, at 277 (quoting Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5118 (Jan. 31, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm).

157. For these purposes, ethics provisions are written standards that are "reasonably designed" to prevent "wrongdoing", and also to promote: "Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships." 17 C.F.R. § 229.406(b) (2008). Interestingly, the proposed rule contained an elaboration on conflicts of interest, requiring that an ethics code promote "[a]voidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict."

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corporations disclose whether the company has adopted a code of ethics that applies to the chief executive officer, chief financial officer, and principal accounting officer or comptroller.[158] If the corporation does not have such a code of ethics, it is required to explain why not.[159]

The SEC required further disclosure, as well. First, the code itself must be disclosed, either (1) as an exhibit to the annual report, (2) by posting the code of ethics on its website, having indicated this in its annual report along with the corporation's Internet address, or (3) by providing it, without charge, to any person upon request.[160] Thereafter, any amendments to the code, or waivers of the code for specific transactions or matters, must either be disclosed on a Form 8-K or, if the company has disclosed its intention to do so in its last annual report, it may disclose waivers and amendments to the code on its website.[161] NYSE and the NASDAQ have similar disclosure requirements for listed companies.[162]

Along with the generalized fear that compliance codes and corporate codes of conduct are mere window-dressing, there is a more specialized concern that the disclosure requirements of Sarbanes-Oxley have had the unintended effect of causing corporations to weaken their ethics codes.[163] Absent Sarbanes-Oxley, a corporation might want to apply a strict ethics code to its senior managers.[164] For example, Wal-Mart has a reputation for a rigorous code of ethics for all employees, prohibiting any transaction with vendors.[165] But, presuming that a corporation would like to preserve some flexibility in the application of the code, the fact that all waivers for senior managers must now be disclosed might incline it to soften the language of the code, constricting the universe of prohibition, so that there will be less exposure for failure to disclose a waiver.[166] Indeed, a

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Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47235, 68 Fed. Reg. 5110 (Jan. 24, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm [hereinafter Disclosure Required Release]. The SEC eliminated it as redundant given the first prong of the definition. *Id.*

158. 17 C.F.R. § 229.406(a) (2008).

159. *Id.* Joshua Newberg did not find a single instance of corporations electing not to disclose a code of ethics and providing an explanation why not. Newberg, *supra* note 80, at 285 n.170.

160. 17 C.F.R § 229.406(c).

161. *Id.* § 229.406(d).

162. The NYSE requires listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and to promptly disclose any waivers of the code for directors or executive officers. NYSE Manual, *supra* note 36, § 303(A)(10). The NASDAQ merely requires that listed companies adopt a code of conduct that complies with the requirements of Sarbanes-Oxley and SEC regulations. NASDAQ Manual, *supra* note 126, § 4350(n).

163. *See The Good, the Bad, and Their Corporate Codes of Ethics*, *supra* note 80, at 2135–36.

164. *See id.* at 2136.

165. Bandler & McWilliams, *supra* note 63.

166. *The Good, the Bad, and Their Corporate Codes of Ethics*, *supra* note 80, at 2135–38 ("In light of the new disclosure requirements, general counsel may advise the boards of public companies to draft very narrow codes to avoid ever having any waivers to disclose. The aversion to public disclosure stems from the concern that shareholders and regulators will not give due consideration to the beneficial aspects of otherwise prohibited activities that receive waivers, and

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Practising Law Institute publication counsels that "the less frequently a [c]ompany needs to grant waivers, the better."[167] Having a code in place and failing to enforce it may well be worse than having no code at all, because management could be seen as openly flouting its own rules.[168] Thus, § 406's goal of increasing transparency may be perversely undercut by the Act itself.[169]

Perhaps, however, this concern is overstated. It is unclear whether failure to disclose a waiver, for example, would really increase a corporation's liability risks because investors may have a cause of action based on the undisclosed underlying behavior. For example, it is true that, had § 406 been in place, Enron would have had to disclose the board-approved waivers of its code of ethics that allowed Andrew Fastow to own special-purpose entities in transactions with Enron.[170] Yet as Joshua Newberg points out, failure to disclose these interested transactions and Fastow's role in them also seems to be a material omission, so that "a Rule 10b-5 claim might well exist . . . even without the added disclosure obligation created by § 406."[171]

Given the window-dressing debate, it would be quite useful to be able to quantify the number of waivers from their ethics codes that companies have disclosed. According to Newberg, the change to ethics codes in response to § 406 has been "relatively modest."[172] Unfortunately, because the SEC gave companies the option of website disclosure, a study of 8-K filings alone cannot conclusively answer the question of the number of waivers disclosed.[173] Given this inherent limitation, I conducted a survey

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consequently, that well-informed decisions to grant waivers will be perceived negatively in the market and, even worse, second-guessed in litigation when hindsight proves those business decisions to be poor ones." (footnotes omitted)).

167. Russell J. Bruemmer & Leslie Sturtevant, *The Influence of Corporate Governance and Codes of Conduct on Effective Compliance Programs*, *in* CORPORATE COMPLIANCE INSTITUTE 2004, at 129, 147 (PLI Corporate Law & Practice, Course Handbook Series No. 1418, 2004). The authors do go on to note that "the code of ethics should not be drafted solely with minimizing waivers in mind, or the code may risk running afoul of the SEC, NYSE, and NASDAQ substantive requirements." *Id.*

168. Pitt & Groskaufmanis, *supra* note 4, at 1643. Such criticism resulted in the well-publicized Wal-Mart/Roehm dispute where Wal-Mart fired Roehm for having a personal relationship with a subordinate and receiving gifts, "including liquor and lavish dinners[,]" from suppliers. Bandler & McWilliams, *supra* note 63. Roehm responded by suing the company, claiming that it applied a double standard and that Wal-Mart's CEO had also received gifts from vendors. *Id.*

169. *The Good, the Bad, and Their Corporate Codes of Ethics*, *supra* note 80, at 2136, 2140. ("Companies will include only the bare minimum needed to comply with the SEC's suggested topics for a code, and the public filing of codes will not matter because investors will be unable to distinguish one vague, boilerplate code from another.").

170. Newberg, *supra* note 80, at 281.

171. *Id.*

172. *Id.* at 284.

173. At least one publication has recommended posting the code on the company's website, because it is easier to amend. *See Corporate Conflicts of Interest, American-Style*, *supra* note 112,

of the 8-Ks filed dealing with codes of ethics filed in the first half of 2007.[174] The goal was not methodological soundness—after all, we can say nothing conclusive about the frequency of waivers actually granted from the 8-Ks filed—but rather some insight into the kinds of waivers some corporations choose to disclose. Nineteen amendments to codes of ethics were disclosed in the first quarter of 2007, and twenty-two companies filed new codes of ethics.[175] In the second quarter, thirty-seven companies disclosed amendments, and twenty new codes were filed.[176]

In the first quarter, only two waivers were disclosed via 8-K filings.[177] One involved authorizing two officers to set up a 10b5-1 plan, allowing them to trade in the company's securities according to a predetermined scheme over which the officers themselves would have had no control.[178] In order to implement this plan, the company waived a provision in the code of ethics forbidding trading during blackout periods.[179] The second waiver also involved a trade occurring in a blackout period, outside a designated trading window.[180] The board justified its waiver because (1) the sale involved only the transfer of one block of shares to a single institutional investor, (2) financial results from the prior year had been disclosed just seven days before, and (3) the plan required five months between trading windows.[181]

During the second quarter, once again only two corporations disclosed waivers of their codes of ethics on Form 8-K.[182] The board of one corporation granted a waiver of its insider trading policy to permit the company chairman and CEO to make a charitable donation of common stock during a regularly scheduled blackout period, a time at which he would otherwise be unable to trade or donate stock.[183] The disclosure specified that the board had determined that the CEO was not aware of any

at 98.

174. Study details and results on file with the author.

175. *Id.*

176. *Id.*

177. Am. Capital Strategies, Ltd., Current Report (Form 8-K) (June 11, 2007) [hereinafter Am. Capital 8-K]; Nat'l Coal Corp., Current Report (Form 8-K) (Mar. 30, 2007) [hereinafter Nat'l Coal 8-K].

178. Am. Capital 8-K. Rule 10b5-1 of the Securities Exchange Act of 1934 permits such plans which, if set up while an insider has no knowledge of material non-public information, should shield him or her from insider trading charges. 15 U.S.C. § 78(j)(b) (2006); Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10(b)(5) (2008).

179. Am. Capital 8-K.

180. Nat'l Coal 8-K.

181. *Id.*

182. Open Solutions Inc., Current Report (Form 8-K) (Jan. 23, 2007) [hereinafter Open Solutions 8-K]; PriceSmart, Inc., Current Report (Form 8-K), (Jan. 29, 2007) [hereinafter PriceSmart 8-K].

183. Open Solutions 8-K.

material nonpublic information, and that the timing of the donation was for "tax planning purposes."[184]

The second waiver indicated that managers had "[f]rom time to time" used a private plane owned in part by officers and stockholders of the corporation.[185] This scenario looks like a classic self-dealing transaction: the corporation chose to rent a plane owned by its own insiders and stockholders. According to the disclosure, however, it appears that the corporation paid market price, or less, for the executives' airfare.[186] In a second related-party transaction, the corporation bought a one-sixteenth interest in a corporate jet from the management-owned company, but asserted that it was a better rate than the corporation would have received from another supplier, NetJets.[187]

Given the possibility for disclosure via website, it is impossible to know whether these waivers per quarter are representative of post-Sarbanes-Oxley departures from corporate codes of ethics. Fully acknowledging this limitation, it seems safe to hazard that the reformers who hoped that disclosure of such waivers might lead to more meaningful information for investors may be disappointed. These waivers all seem routine, innocuous, and mundane. Certainly none of them rise to the level of the Enron board permitting Fastow's self-dealing.[188] Of course, § 406 may serve a preventative effect, forcing boards not to grant waivers that they may have freely granted in the past. It is as likely, however, that waivers (particularly implicit waivers)[189] are not being disclosed when made, despite the disclosure requirement. Either way, § 406 hardly appears to offer investors assurance of robust enforcement of corporations' codes of ethics.

3. Enforcement of Conflicts via State Law

There is, of course, a mechanism by which many conflicts of interest are already policed: state corporate law. Using Delaware as an example,[190] the act of taking a corporate opportunity without first offering it to the corporation, or engaging in self-dealing or related-party transactions without availing oneself of the safe harbors afforded under Delaware law,[191] already constitutes a breach of the duty of loyalty that gives rise to

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184. *Id.*

185. PriceSmart 8-K.

186. *Id.*

187. *Id.*

188. *See The Good, the Bad, and Their Corporate Codes of Ethics*, *supra* note 80, at 2129–30.

189. An "implicit waiver" is a "failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer." Disclosure Required Release, *supra* note 157.

190. Delaware is the dominant source for corporate law in the United States. Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617, 619 (2005).

191. DEL. CODE ANN. tit. 8, § 144 (2008).

liability. This raises two questions: (1) Do conflict-of-interest provisions serve only as a tool for compliance with external law? and (2) Why should corporations implement and enforce conflicts provisions when state-law enforcement mechanisms are already in place?

Both questions can be answered by describing the problematic nature of current enforcement of Delaware fiduciary law. A corporation will almost always have the sole cause of action in a conflicts case.[192] If the corporation is willing to pursue the cause of action against the faithless agent, there is no problem: the corporation can sue. If an owner is concerned about faithless agents capturing the management and board of the corporation, however, then the ability of the board to sue an employee will be but cold comfort.[193] After all, the board is ultimately in charge of the business decision of suing or not suing, and if it decides not to sue, its business judgment will generally be respected.[194] A shareholder-plaintiff angry that an insider transaction has occurred must make a demand on the board that it sue, unless she can argue that the demand requirement is excused because it would be futile.[195] Demand is only excused if the board upon which the demand would have been made is not disinterested or independent,[196] or the underlying transaction was not the product of a valid exercise of business judgment.[197] These thresholds are generally quite challenging, and the obstacles presented by the demand requirement are substantial.[198]

Federal securities laws do offer a potential end-run around the derivative suit problem. Shareholders can file class-action suits based not on the conflicting interest transaction itself, but instead on failure to

192. The notable exception being a buyout or acquisition, where because the shareholder is being deprived of his or her status as shareholder, there is a direct cause of action. *E.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

193. Even presuming no management capture, however, corporations should be interested in improving implementation and enforcement of conflicts rules. After all, reducing agency costs results in savings to the corporation and to shareholders as a whole.

194. Grimes v. Donald, 673 A.2d 1207, 1220 (Del. 1996), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). It can only be attacked by showing that the board's refusal to sue on the underlying claims was "wrongful." *Grimes*, 673 A.2d at 1220.

195. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 976–77 (Del. 2003).

196. *Id.* at 977 (citing Rales v. Blasband, 634 A.2d 927, 930 (Del. 1993)).

197. *Id.*

198. For states following the Model Business Corporation Act, the result is much the same, although the mechanism is slightly different. *See* MODEL BUS. CORP. ACT § 7.42 (2007) ("No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period.").

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disclose it if it is material.[199] In terms of corporate governance, however, this claim is a blunt tool that sweeps in only in the most egregious cases. It does not provide a reliable ex ante assurance for shareholders.

As for the second question, whether Delaware already provides enforcement mechanisms for conflicts, one must note that Delaware's law, unlike the DOJ memos or the Guidelines, offers no incentive for having a compliance provision in place to *prevent* conflicts of interest.[200] *In re Caremark International Inc. Derivative Litigation*'s[201] facts dealt with violations of federal and state rules and regulations pertaining to health-care providers making referral payments.[202] Its language describes the "increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations."[203] Given this trend, it says, part of the board's duty is "to reach informed judgments concerning both the corporation's compliance with law and its business performance."[204] The focus of both the court's holding and language is on compliance with "external legal requirements."[205] Corporate fiduciary duties are discussed only in the context of the duty to monitor for this compliance with outside rules.

I am not denying that monitoring for managers' conflicts of interest is part of the board's fiduciary duty. Indeed, the board should ensure that internal controls are in place to train employees to recognize and report conflicts as they arise.[206] But Delaware's jurisprudence on the duty to

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199. 17 C.F.R. § 240.10(b)(5) (2008).

200. *Compare* DEL. CODE ANN. tit. 8, § 144 (2008) (offering no incentive for having compliance provisions in place to prevent potential conflicts of interest), *with* THOMPSON MEMO, *supra* note 92 (offering an incentive), *and* MCNULTY MEMO, *supra* note 93 (offering a very similar incentive), *and* U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (2007) (offering a similar incentive).

201. 698 A.2d 959 (Del. Ch. 1996).

202. *Id.* at 961–62.

203. *Id.* at 969.

204. *Id.* at 970.

205. *Id.* at 969.

206. Indeed, the International Corporate Governance Network Principle 5.1(6) includes among the board's "duties and responsibilities and key functions," the following: "Monitoring and managing potential conflicts of interest of management, board members, shareholders, external advisors and other service providers, including misuse of corporate assets and abuse in related party transactions." Int'l Corp. Governance Network, ICGN Statement on Global Corporate Governance Principles, http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.pdf (last visited Nov. 9, 2008). Interestingly, the California Public Employee Retirement System, a major U.S. pension fund, does not specify a concern with managerial conflicts in its own Core Principles of Accountable Corporate Governance, but does, in its Global Principles of Accountable Corporate Governance, embrace the principles of the International Corporate Governance Network. *See* Cal. Pub. Employees' Ret. Sys., Global Principles of Accountable Corporate Governance 9 (2007), *available at* http://www.calpers-governance.org/principles/international/global/downloads/global-corpgov-principles.pdf (describing the duties of the board as similar to those laid out by the

https://scholarship.law.ufl.edu/flr/vol61/iss1/1

monitor focuses solely on putting in place controls to monitor for violations of external law. There is no Guidelines or DOJ memo structure in place to reward the diligent, vigilant corporation. Avoidance of conflict is its own reward.

Another roadblock to addressing conflicts of interest among officers (not directors) is the problem of obtaining the power to sue them at all. As Robert Thompson and Hillary Sale described, Delaware, the major state for corporate law, needed to amend its jurisdictional statute in order for courts to assert jurisdiction over officers.[207] In a 2004 amendment, the Delaware legislature extended personal jurisdiction to officers of Delaware corporations.[208] This relatively recent amendment helps to explain why almost all Delaware litigation to date has focused on the duties and liability of the directors, even though they are not the day-to-day decisionmakers of the corporation.[209]

Many state laws do have a mechanism for sanitizing conflicts of interest, such as Delaware's § 144, which provides that no transaction between a corporation and its director or officer, or in which a director or officer has an interest, is voidable solely for that reason, if the material facts are disclosed, and the transaction is approved by the majority of disinterested directors, or by vote of the shareholders, or is fair to the corporation and approved by the entire board.[210] But this measure will hardly reassure a prospective investor-owner who is concerned about management conflicts of interest. Instead, it provides a mechanism to deal with conflicts because presumably some conflicts are ultimately beneficial to the corporation. Section 144 is not a self-operative mechanism; it presupposes that managers are (1) able to identify conflicts and (2) willing

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International Corporate Governance Network).

207. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 906 (2003).

> In 1977, the U.S. Supreme Court rejected Delaware's use of quasi in rem jurisdiction to reach corporate directors and officers, holding that the shares in a Delaware-based corporation did not meet the constitutional minimum contacts standard. The opinion distinguished Delaware's quasi in rem jurisdiction from jurisdiction based on fiduciary status. The Delaware legislature responded by passing a statute stating that the corporation's registered agent serves as the directors' agent, thereby creating a form of implied jurisdiction. The statute, however, does not apply to officers.

Id. (footnotes omitted).

208. DEL. CODE ANN. tit. 10, § 3114(b) (2008).

209. Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*, 63 BUS. LAW. 147, 147–48 (2007).

210. DEL. CODE ANN. tit. 8, § 144 (2008). Section 5.02 of the A.L.I. Principles of Corporate Governance similarly covers both directors and officers. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, *supra* note 41, § 5.02. But the Model Business Corporation Act's Subchapter F, §§ 8.60–8.63, explicitly covers only director conflicts. MODEL BUS. CORP. ACT §§ 8.60–8.63 (2007).

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to disclose the particulars to the corporation's board or shareholders. If either presumption is false—if managers cannot recognize conflicts, or are unwilling to disclose them (perhaps because they are unmotivated by existing governance mechanisms)—then § 144 has no effect.

The prospective investor-owner worries most about management taking from the corporation. The importance of this problem depends largely upon the extent to which one believes that reported cases of conflict are the tip of the iceberg, or the entire iceberg. Believers in efficient markets will trust that corporations that tolerate unchecked conflicts of interest will ultimately lose out: the markets for products and corporate control will reward corporations that are better able to restrain managers from taking from the corporation. Non-believers can cite (1) the failure of sanitizing provisions like § 144 to flush out conflicts ex ante, (2) states' focus on the board of directors and the structural impediments to sue associated with the derivative suit, (3) the focus of federal enforcement via the Guidelines and DOJ memos on compliance, and (4) the inefficacy of disclosure in regulating conflicts. No matter which view one accepts, it is clear that corporations currently lack a reliable way to signal credibly an intention to follow a strict conflicts policy.

IV. POSSIBLE SOLUTIONS AND THEIR PROBLEMS

As we have seen, although appropriate handling of conflicts of interest is vital to an organization's governance, current enforcement of conflicts-of-interest provisions is haphazard at best. Most federal regulation understandably focuses on compliance with external laws, but at the same time at least ostensibly seeks to encourage the creation and enforcement of codes of ethics that contain conflicts provisions. Sarbanes-Oxley's disclosure requirement encourages the adoption of codes of ethics,[211] but perhaps only in a watered-down form. Data is difficult to obtain, but it appears that the disclosure-of-waiver requirement might not be providing investors with the information the law intended. This Part will survey various possible regulatory approaches.

A. *Potential Approaches*

1. Disclosure

Transparency, the requirement that the subject matter of the regulation be disclosed, is theoretically one of the least intrusive means of regulation. The SEC's entire regulatory regime is premised on disclosure.[212]

211. 15 U.S.C. § 7264 (2006).

212. Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 82 (2005).

Presumptively, disclosure of information has several benefits: first, it creates a more informed individual investor, who will therefore make better investment decisions;[213] second, it creates a more accurate market, because the market as a whole will factor the disclosed information into the price;[214] and third, as articulated so memorably by Louis Brandeis, it will deter fraud because "'[s]unlight is said to be the best of disinfectants.'"[215]

As discussed in Part III.B.2, § 406 of Sarbanes-Oxley requires disclosure of codes of ethics for the CEO, CFO, and comptroller, and any waivers granted from the code to these individuals.[216] Although it is too soon to draw conclusions, it does appear that this requirement may be having the perverse effect of diluting ethics codes. The best-case scenario is one in which the disclosure requirement triggers a serious internal examination of why a corporate insider is seeking a waiver in the first place, which culminates either in avoiding the conflict or making the transaction as fair as possible to the corporation. Worse scenarios involve weakening the code, which probably applies not only to the CEO, CFO, and comptroller, but to other executives. Thus, we have a situation where high-level executives outside this inner circle—if they need to obtain waivers from an already lax code of conduct—need not disclose them. Thus, an internal governance document focused on concerns about collecting information on and ultimately deterring agency costs, may be perverted into an inconvenient disclosure obligation prompting only the desire to minimize liability exposure.

2. External Monitoring

a. Mandatory: PCAOB

Before Sarbanes-Oxley, enforcement mechanisms for accountants, like those for attorneys, were relatively weak.[217] Accountants could be externally disciplined in one of three ways. The American Institute of Certified Public Accountants has long had the power to discipline its members—but in practice censure rarely occurs.[218] One reason is that not

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213. Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 479 (2007).

214. *Id.*

215. *Id*. at 479–80 (quoting LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (1914)).

216. *See supra* notes 156–89 and accompanying text.

217. Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 983–84 (2005).

218. Benston, *supra* note 74, at 1345.

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all CPAs are members of the organization.[219] In addition, enforcement by membership organizations like the AICPA is difficult because of a lack of resources and a vulnerability to lawsuits.[220] The SEC can discipline accountants, most pointedly by denying them the right to attest to financial statements filed with the SEC.[221] State boards of accounting have the potentially significant power to revoke accounting licenses.[222] Again, however, license revocations rarely occur in practice, and then only in the most egregious cases.[223]

Public company accountants now face a separate regulatory body, the Public Company Accounting Oversight Board (PCAOB).[224] In Sarbanes-Oxley, Congress created this new entity to register accounting firms that audit public companies, inspect firms regularly for compliance, and investigate firms for violations of its rules.[225] In addition, PCAOB was charged with setting ethical rules for public company accountants.[226] Rule 3520 requires that auditors be independent.[227] Independence is defined by not providing tax services to the client,[228] overseeing financial reporting for the client,[229] or receiving a contingent fee from the client.[230] PCAOB also enforces the SEC rules on independence, which require auditor rotation, and a "cooling off" period before an audit firm employee can go in-house at a public company.[231]

It is unclear whether the PCAOB has been or will be any more effective at enforcing ethics violations than its companion regulatory bodies. Of the seventeen disciplinary proceedings listed on the PCAOB

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219. *Id.*

220. *Id.*

221. *Id.* at 1346.

222. *E.g.*, TEX. OCC. CODE ANN. § 901.151 (2007).

223. For an instance in which a state board of accounting revoked a license, see *Texas State Board of Public Accountancy v. Arthur Andersen, L.L.P.*, No. 457-02-3095 (State Office of Admin. Hearings Aug. 16, 2002), *available at* http://www.tsbpa.state.tx.us/pdffiles/AAENRON6.pdf.

224. For an insightful discussion of the PCAOB, see generally Nagy, *supra* note 217.

225. 15 U.S.C. §§ 7211(a), (c) (2006).

226. *Id.* § 7211(c).

227. PCAOB, Bylaws and Rules of the Public Company Accounting Oversight Board, Rule 3520 Auditor Independence, 51 (2007), *available at* http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_3.pdf.

228. *Id.* at Rule 3522.

229. *Id.* at Rule 3523.

230. *Id.* at Rule 3521.

231. Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47265, Investment Company Act Release No. 25915, 68 Fed. Reg. 6006 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm.

Rodrigues: From Loyalty to Conflict: Addressing Fiduciary Duty at the Office

website,[232] only three detail ethics violations (although there are two associated proceedings, one against individual accountants, one against a firm).[233] Most proceedings concern auditor failures to exercise "due professional care" and "professional skepticism" with respect to client financial statements;[234] one faults the auditor for failing to take remedial action when its name was improperly used by a client.[235] Given this track record, PCAOB ethics enforcement may be more a matter of theory than practice. Still, the accountant model is clearly one that emphasizes enforcement over education.[236]

b. Voluntary: ISO

Even without a mandatory external monitor such as PCAOB, regulating conflicts for senior corporate officers could begin to be seen as best practices, and therefore widely adopted.[237] For example, Margaret Blair, Cynthia Williams, and Li-Wen Lin have studied the third-party assurance industry, in particular the International Organization for Standardization (ISO), a non-governmental organization based in

232. PCAOB, Disciplinary Proceedings, http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/index.aspx.

233. *In re* Goldstein & Morris, CPAs, P.C., No. 105-2005-001 (PCAOB May 24, 2005) (censuring an entire firm because the auditor concealed documents from the board that would have revealed that it had provided non-audit services, in violation of federal securities law), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2005/05-24_Goldstein_and_Morris.pdf; *In re* Goldberger, No. 105-2005-002 (PCAOB May 24, 2005) (disciplining two individual accountants), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2005/05-24_Goldberger_and_Postelnik.pdf; *In re* Susan E. Birkert, No. 105-2007-003, (PCAOB Nov. 14, 2007) (disciplining an accountant for attempting to invest in an audit client), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2007/11-14_Birkert.pdf; *In re* Kantor, Geisler & Oppenheimer, P.A., Steven M. Kantor, CPA, and Thomas E. Sewell, No. 105-2007-009, (PCAOB Dec. 14, 2007) (disciplining an accountant for auditing a client in which his parent had a material financial interest), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2007/12-14_Kantor.pdf.

234. *See, e.g.*, *In re* Wieseneck, Andres & Co., P.A., Release No. 105-2008-001 (PCAOB Apr. 22, 2008), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2008/04-22_Wieseneck.pdf.

235. *In re* Reuben E. Price & Co. Pub. Accountancy Corp., No. 105-2005-005 (PCAOB Apr. 18, 2006), *available at* http://www.pcaobus.org/Enforcement/Disciplinary_Proceedings/2006/04-18_Ruben_E_Price.pdf.

236. Aspiring certified public accountants must fulfill numerous requirements. They must pass a demanding multi-part exam, obtain a bachelor's degree with a specified number of accounting and business courses, and practice for a minimum number of years. Benston, *supra* note 74, at 1329. There is no separate professional responsibility licensing exam, as there is for attorneys. *See id.*

237. For an intriguing discussion of how common practices become enshrined as "best practices," see David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 297–98 (2006).

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Geneva.[238] They show how ISO started by establishing technical standards and facilitating accreditation of those standards.[239] It expanded to management systems, and then in 1996 it issued environmental management systems standards called the ISO 14000 series.[240] Corporations could participate in a similar voluntary program of third-party certification. This model holds the added appeal of providing a means for enforcement as well as education.

A midway point between voluntary and mandatory conflicts monitoring could come by means of pressure from ratings agencies like RiskMetrics Group's ISS Governance Services or Standard & Poor's.[241] If these agencies accord weight to corporations whose senior officers have obtained conflicts licensing, then the practice will spread in advance of any SEC or exchange mandate (as did, for example, the practice of a majority independent board of directors).

An obvious objection is that if such voluntary certification was a valuable signal for a firm, it would have evolved already. Corporations, after all, are free under state law to structure governance as they wish. There are several potential explanations for the failure for such a system to emerge. First, to the extent that a certification must have a critical mass to be valuable, collective action problems might prevent a certifying body from gaining traction. If we liken such a voluntary certification regime to private ordering, Amitai Aviram's work helps explain the difficulty of spontaneous formation of private legal systems.[242] Without an immediate benefit to obtaining voluntary certification, there is no incentive for an individual actor to do so.

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238. Margaret M. Blair, Cynthia A. Williams, Li-Wen Lin, *The New Role for Assurance Services in Global Commerce*, 33 J. CORP. L. 325 (2008).

239. *Id.* at 330–31; *see also* Murphy, *supra* note 104, at 414. The standards require a company to make available its environmental policy, which must include compliance with local laws. Murphy, *supra* note 104, at 414–15. There must be internal monitoring of its compliance with the standards and internal or external audits. *Id.* at 415.

240. Blair, Williams & Lin, *supra* note 238, at 332; Murphy, *supra* note 104, at 414.

241. Organizations like RiskMetrics Group's ISS Governance Services and Standard & Poor's Corporation rate corporations on their corporate governance. For more information on ISS, see Business Definition for: Institutional Shareholder Services (ISS), http://www.allbusiness.com/glossaries/institutional-shareholder-services-iss/4950922-1.html. For information on Standard & Poor's Corporation ratings, see www2.standardandpoors.com (follow "Ratings" hyperlink; follow "About Us" under Ratings Home); *see* Paul Rose, *The Corporate Governance Industry*, 103–06, 119–20 (Berkeley Elec. Press Legal Series, Working Paper No. 1597, 2006), *available at* http://law.bepress.com/expresso/eps/1597.

242. Amitai Aviram, *A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems*, 22 YALE L. & POL'Y REV. 1, 1 (2004) (proposing that private legal systems cannot form spontaneously, but rather must evolve in stages that begin with "facilitating activities that are unrelated to regulating behavior").

Second, especially if one believes that managers often dominate the boards that are supposed to monitor them, it might be too much to expect a corporation's agents to initiate a program that would restrict their ability to exploit conflicts of interest and claim ignorance of the rules. Even if there is no board capture, management may be unwilling, particularly as first mover, to disclose an unusual interest in ethics that could signal a reluctance to be as aggressive as its competitors.

As Aviram's work suggests, a way to encourage voluntary adoption of such a system would be to provide a benefit for doing so.[243] Because state law governs conflicts of interest, perhaps according business judgment rule protection to officers who have been certified would provide the appropriate incentive. Current law is unclear as to the impact of the business judgment rule on officers, however, because the case law focuses on how the rule operates to protect board members.[244]

3. Structural Regulation: Independent Directors

Another regulatory possibility is to create corporate structures to handle conflicts. Congress and the self-regulatory organizations (SROs) have relied largely on independent directors to serve this role. While Sarbanes-Oxley requires an independent audit committee,[245] the NYSE and NASDAQ mandate independent compensation and nominating/governance committees, plus a majority-independent board.[246] All these requirements involve attempts to anticipate areas in which conflicts with management will emerge: Non-management nominating and governance committees, for example, reflect an effort to ensure that management is not in charge of board succession or rulemaking; non-management audit committees are mandated to help ensure that management cannot improperly influence the audit reports that are supposed to help the board monitor management performance; and non-management compensation committees ensure that management is not setting its own salary.

Independent directors serve an important purpose,[247] but are not well suited to monitor for conflicts. They are part-time representatives, often

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243. *Id.*

244. Johnson & Ricca, *supra* note 5, at 665–69. Still, basic agency law principles impose fiduciary duties on officers. Johnson & Millon, *supra* note 12, at 1601.

245. Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (to be codified at 17 C.F.R. pt. 240).

246. NYSE Manual, *supra* note 36, § 303(A) cmt.; NASDAQ Manual, *supra* note 126, §§ 4200, 4350.

247. *See* Rodrigues, *supra* note 39, at 466–67 (arguing that although director independence is especially important in conflict situations, independence should be redefined).

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with challenging full-time jobs.[248] The forces that pressure them to monitor—the Guidelines, the DOJ memos, and *Caremark*-style case law—all focus on *external* compliance, not internal conflicts of interest. Therefore, while it would be beneficial to the corporation for the board to ensure that conflicts are identified and properly handled, directors face no liability for not doing so.[249] Still, while independent directors cannot be counted on to flush out conflicts of interest, once these transactions have been identified, a truly independent and disinterested board (or board committee) is the best mechanism for assessing the harm of the conflict to the corporation.

4. Internal Monitoring

a. By Delegation

The Guidelines, DOJ memos, and other compliance regulations often describe themselves as involving corporate "self-regulation."[250] In fact, they are more a form of delegation—that is, governmental deputization of the corporation to enforce criminal laws.[251] Government regulators claim that the nature of the "carrot and stick" approach makes it a less intrusive, more self-regulatory approach. They are reluctant to impose particular provisions on corporations.[252] The non-substantive nature of these rules also makes them more politically palatable.[253]

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248. *See* Dorothy K. Light, *SOAPBOX; Directors' Cut*, N.Y. TIMES, Sept. 8, 2002, at 19.

249. One could tinker with these incentives by increasing the liability of independent directors. The typical concerns raised with these solutions are that they would discourage prospective directors from serving on the board, or would make the board unduly risk-averse.

250. Griffin, *supra* note 7, at 316.

251. Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377, 388–91 (2006); *see also* Bowman, *supra* note 7, at 688–89 (arguing popularity of compliance due in part to its ability to help federal prosecutors do their job while shifting costs to the corporation); Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings*, 70 BROOK. L. REV. 1287, 1301–02 (2005) ("Companies benefit when they can develop self-regulatory strategies that encourage their employees to take increased responsibility for rule following."). For a critique of the public/private regulatory partnership model as applied to corporate criminal prosecution, see Griffin, *supra* note 7, at 343.

252. For example, in adopting a disclosure rule on codes of ethics, the SEC stated: "We continue to believe that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company." Disclosure Required Release, *supra* note 157.

253. With specific regard to internal controls, one commentator noted that, "[d]espite substantial mandates and incentives to use internal controls, there is little specification of their required content . . . . The availability of these broad-brushed mandates in control prescriptions reinforces the appeal of this response to particular crises. The simplicity of the directive makes it

The key role of delegation becomes even more apparent when a corporation enters into a deferred prosecution agreement with the government.[254] Kimberly Krawiec, in particular, discusses the "negotiated governance" associated with compliance.[255] This delegation represents a form of government intrusion into the governance of the corporation, a way for the government to enforce its laws by leveraging the resources of the corporation. This delegation is ultimately part of shifting the cost-benefit analysis to ensure that corporations comply with the law.

Conflicts present a question of internal corporate governance. Ethics codes do not seem the place for intrusive, compliance-style regulation-by-delegation.[256] Indeed enforcement of ethics codes by the government has been almost incidental to its main focus on legal compliance. The DOJ memos, the Guidelines, and Sarbanes-Oxley all leave ethical enforcement to the corporation.[257]

b. Without an Intermediary

Another species of regulation of conflicts would be direct regulation, whereby an outsider is empowered to monitor and enforce conflicts of interest policies directly.[258] There have been examples of this model in both for-profit and non-profit settings. Typically an outside regulator places an individual within the organization itself.[259] The triggering event for appointment of an outside monitor is generally some bad act by the

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easier to impose." Cunningham, *supra* note 7, at 289.

254. These agreements "effectively deputize corporate counsel and auditors as government agents; corporations are expected not only to raise the hue and cry when misconduct occurs but also to assist in identifying, apprehending, and prosecuting viable employee targets." Griffin, *supra* note 7, at 336 (footnote omitted). The appointment of independent compliance monitors is often a feature of deferred prosecution agreements that the DOJ enters into with corporations in lieu of prosecution. *Id.* at 323. Several commentators have pointed out how problematic this government practice of "prescribing what is good corporate governance rather than just prohibiting wrongful conduct" is. *Id.* at 324.

255. Krawiec, *supra* note 7, at 516–23.

256. Attorneys and accountants also self-regulate, although for different reasons and in different ways. Lawyers justify self-regulation in part as maintaining independence from state power, a crucial status given our adversarial system. David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799, 812–13 (1992). Giving the executive or legislative branches the power to regulate lawyers might intimidate lawyers defending the individual against the state. *Id.* at 813. Through Sarbanes-Oxley, public company accountants have ceded some self-regulation, since the Public Company Accounting Oversight Board now establishes accounting standards (including ethics standards) and regularly inspects auditing firms for compliance. Disclosure Required Release, *supra* note 157.

257. Krawiec, *supra* note 7, at 500–02.

258. *See id.* at 519.

259. *See id.* at 496.

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organization. In the case of the financial aid offices scandal, for example, part of the settlement with Columbia University was a commitment to report to the New York Attorney General for the next five years "'all policies and procedures relating to student lending' and [laying out] 'any conflicts or violations of the Code of Conduct.'"[260] Even more intrusively, a deferred prosecution agreement with KPMG permitted the DOJ to appoint an "independent monitor," who would review and monitor KPMG's compliance with the agreement, and its maintenance and execution of its compliance and ethics programs for three years.[261] The monitor was empowered to review all employee correspondence and to interview any KPMG partner, employee, or agent.[262]

The reasons that weigh against applying internal monitoring via delegation apply even more forcefully to direct internal monitoring. Placing an outsider in the role of conflicts monitor is too blunt an instrument for conflicts enforcement. Conflicts are not always bad for the corporation; this observation is the reason for sanitizing mechanisms such as Delaware's § 144. The danger would be too great that an outsider would impose costly measures that failed to monitor for conflicts at an optimal level.

5. Liability Rule: State Corporate Law

A liability rule would provide no upfront regulation, but instead allow shareholders to sue when an improper conflict arises. State law in fact provides the primary conflicts enforcement mechanism in current practice. Because of the nature of the derivative suit—where the decision whether to sue is left solely in the board's hands, unless the board is not independent or is interested—relying on this approach seems highly problematic. How problematic depends upon how much one trusts the management of corporations to police their own agency costs, or owners of a corporation to set up rules that will allow for robust policing.

B. *The Proposal*

In publicly held firms, with their widely dispersed ownership, exercise of control over conflicts of interest is a key concern.[263] The current system

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260. Press Release, Office of the N.Y. State Attorney Gen., Attorney General Cuomo Announces Agreements with Columbia University and The National Association of Student Financial Aid Administrators (May 31, 2007), *available at* http://www.oag.state.ny.us/media_center/2007/may/may31a_07.html.

261. Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 855 (2007).

262. *Id.* at 865.

263. Of course, many firms in the United States are privately owned. Leonard M. Baynes, *The Q-626 Report: A Study Analyzing the Diversity of the 626 Largest Businesses, and the 105 Largest Minority-Owned Businesses, in Queens*, 80 ST. JOHN'S L. REV. 1007, 1026 n.86 (2006). Presumably

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does not require public corporations to train their officers in conflicts of interest; only disclosure of the code of ethics that applies to senior officers is mandated.[264] As seen in Part III.A, a code of ethics may be swept into the internal controls requirements or be part of a corporation's attempts to avoid Sentencing Guidelines penalties or escape entity-wide prosecution. Still, there is no guarantee that a code of ethics will be implemented, much less that it will be meaningfully communicated to employees or enforced.

One remaining approach offers real promise: education. Corporate employees may not even be aware of the duties they owe their employers in a conflict-of-interest situation. Evidence indicates that basic understanding of what constitutes conflict may, indeed, be a problem for corporate executives. One obvious solution would be to encourage or mandate training in conflicts for the executives of public companies. Certification of the upper tiers of management by an outside entity might provide real value to a corporation's investors.[265] This Part will conclude by recommending conflicts licensing for senior officers of public corporations. It will first examine the attorney educational model, and then offer preliminary thoughts on implementation mechanisms, both mandatory and voluntary.

1. The Attorney Model

One example of the educational approach is the attorney model for dealing with conflicts. Although professional conflicts are different from intra-corporate conflicts of interest, there is a common thread. In each case, the concern is ethical duties owed by one individual to another. In the case of the corporation, the relationship at issue is between employee and corporation. In the case of attorneys, the relationship is between professional and client.

The Model Rules of Professional Conduct for attorneys include specific provisions that deal with conflicts of interest. They forbid

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the owners of such firms are both incentivized and able to police managers for conflicts of interest. Of course, nothing would prevent private owners from requiring certification of their managers if they chose.

264. Sarbanes-Oxley Act, Pub. L. No. 107–204, 116 Stat. 789 (codified at 15 U.S.C. § 7264 (2006)); s*ee also supra* Part II.A.

265. A question that comes up about any disclosure is the value to existing investors. For example, in the case of Enron, existing investors might not have wanted the financial misconduct at the company disclosed, or disclosed so abruptly. For a discussion of whom the securities laws are intended to protect, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1280–81 (1999). Beforehand, conflicts should be something that all corporations wish to avoid. Although certainly the inaccurate pricing caused by agency costs can be guarded against with a diversified portfolio, these conflicts of interest remain a "dead-weight social loss" that should be avoided whenever possible. Langevoort, *supra* note 7, at 964.

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representation where

> (1) the representation of one client will be directly adverse to another client; or
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.[266]

Note that both conflicts between clients and those between the lawyer's self-interest and that of the client are forbidden, both in this rule and in separate ones elaborating on the notion of conflict.[267]

Lawyers are licensed by state government. They must have a bachelor's degree, and most must attend a three-year law school and pass the bar exam for the state in which they wish to be licensed.[268] Each state's bar association administers a bar exam, composed both of a standard multi-state test and a state-specific test.[269] Most states require continuing state bar membership.[270] In terms of ethical education, the ABA mandates that students at accredited law schools complete a course on professional responsibility that covers the rules of professional conduct.[271] Almost all states require a separate ethics test, the Multistate Professional Responsibility Examination.[272]

Lawyers seem better at education than enforcement. Indeed, as Benjamin Barton observes,

> [b]etween the MPRE and the ABA's accreditation requirement that law schools teach a mandatory professional

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266. MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002).

267. Specifically, Rule 1.8 forbids lawyers from entering into business transactions or "knowingly acquir[ing] an ownership, possessory, security or other pecuniary interest adverse to a client unless" certain requirements are met. *Id.* at R. 1.8(a). Lawyers may not solicit gifts from clients, acquire literary or media rights regarding the representation, provide financial assistance to a client, accept payment for representation from a third party, limit their own liability for malpractice, acquire a "proprietary" interest in the cause of action of litigation, or engage in a sexual relationship with a client except under limited exceptions. *Id.* at R. 1.8. Another rule governs duties to former clients. *Id.* at R. 1.9.

268. Jonathan Macey, *Occupation Code 541110: Lawyers, Self-Regulation, and the Idea of a Profession*, 74 FORDHAM L. REV. 1079, 1096 (2005).

269. American Bar Association, Bar Admissions Basic Overview, http://www.abanet.org/legaled/baradmissions/basicoverview.html (last visited Oct. 3, 2008).

270. *See* Bradley A. Smith, *The Limits of Compulsory Professionalism: How the Unified Bar Harms the Legal Profession*, 22 FLA. ST. U. L. REV. 35, 36–39 (1994).

271. Benjamin H. Barton, *The ABA, the Rules, and Professionalism: The Mechanics of Self-Defeat and a Call for a Return to the Ethical, Moral, and Practical Approach of the Canons*, 83 N.C. L. REV. 411, 456 (2005).

272. *Id.*

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> responsibility class, law students receive at least some message that the bar is serious about law students learning the Rules of Professional Conduct . . . . Given that actual enforcement of these minimum standards among licensed attorneys is minimal, the MPRE may actually be the single most important practical application of the black letter Rules.[273]

In general, enforcement mechanisms for attorney conflicts of interest are relatively weak, and for this reason, I classify attorney conflicts regulation as falling under the education model.[274] True, attorneys face sanctions from state agencies acting under the supervision of state supreme courts,[275] but these penalties are generally administered by fellow lawyers who impose sanctions rarely, and harsh sanctions more rarely still.[276] Courts are equally reluctant to impose sanctions.[277] Particular agencies, such as the SEC, can also sanction attorneys that appear before them.[278] Clients can, of course, sue their attorneys over improper conflicts, but they may lack the sophistication or information to enforce their right to conflict-free representation. An attorney can seek to disqualify an opposing attorney for conflicts reasons,[279] but again, this enforcement is haphazard at best.

Lawyers are vulnerable to the criticism that their elaborate initial licensing requirements operate less to gate-keep and more to bar entry to maintain their professional "cartel" status.[280] One downside to requiring specific education, training, or licensing is the risk that these requirements are more about maintaining exclusivity than about true education and training. The lack of enforcement of certain rules may exacerbate this sense that "professionalism" is more about exclusionary rules than about maintaining standards.[281]

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273. *Id.* at 456–57 (footnote omitted).

274. Of course, liability in the form of malpractice suits is another disciplining mechanism. *See* Wilkins, *supra* note 256, at 806–07 (stating malpractice litigation is becoming an increasingly viable alternative to professional discipline due to a number of developments, including relaxation of the rule prohibiting claims by non-clients).

275. *Id.* at 805.

276. Macey, *supra* note 268, at 1085.

277. *Id.* at 1086.

278. Wilkins, *supra* note 256, at 807–08.

279. *See supra* notes 266–67 and accompanying text.

280. Benston, *supra* note 74, at 1328–29; *see also* Macey, *supra* note 268, at 1096 ("The admissions requirements to enter the profession . . .; the restrictions on nonlawyers practicing even the most rudimentary aspects of law; the mandatory rules of confidentiality for lawyers, but not accountants and other competitors (nonlawyer consultants and advisers); and restrictions on marketing all benefit individual lawyers at the expense of clients and the profession as a whole.").

281. Macey, *supra* note 268, at 1096.

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2. Education's Superiority to Enforcement

Enforcement of conflicts policies is a tricky matter for corporations. Concerns about confidentiality, opening the corporation up to liability, and the problem of what baseline to use to judge a well-functioning conflicts system all complicate any direct enforcement effort by a third party. Thus education presents an attractive alternative to outside enforcement.

First, reliance on any third-party regulatory body would entail revealing sensitive internal information. A corporation would naturally be concerned about disclosure of confidential information if it were to disclose potential conflicts of interest arising within it.[282] There would also be concerns about shielding itself from liability for disclosure.[283] One common observation is that many calls to corporate "hotlines" are not about reporting misconduct, but rather seeking clarification about the rules and how they apply to gray areas.[284] If all calls to a hotline must be reported externally, a corporation may be more reluctant to put a hotline in place at all.

A separate concern is that, with respect to effective enforcement, the appropriate baseline for conflict detection is unclear. Attempts to measure the success of compliance efforts run into the same problem. An old management mantra counsels that you "can't manage what you can't measure."[285] But it is unclear how an effective conflicts policy might be measured.[286] For example, a commentator asserts that disclosure of how many complaints come in will show which programs are good and which are bad.[287] But how does one measure success: Is the ideal result more or fewer reported complaints? More reported complaints might indicate a greater understanding of conflicts or willingness on the part of employees to report occurrences, and fewer conversely might indicate ignorance, apathy, or fear. On the other hand, more reported complaints could signal a major problem with the culture of the organization.

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282. For a discussion of the possibility of privilege attaching to the products of internal investigations, see generally Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1 (1997).

283. *See id.*

284. Pitt & Groskaufmanis, *supra* note 4, at 1645; Treviño et al., *supra* note 4, at 133–34.

285. Steve Lohr, *New Economy; Researchers seem confident that technology has made American workers more efficient. Now some think they even know why*, N.Y. TIMES, Feb. 2, 2004, at C6 (stating "[t]here is something to the business adage that you can't manage what you can't measure").

286. So in evaluating a commentator's praise of the role of whistleblowers as reporting "roughly one-third of fraud and other economic crimes against businesses," the "one-third" must necessarily only be of reported fraud. Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107, 1117 (2006).

287. *Id.* at 1173.

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A recent article indicates that education of corporate officers on these ethical issues would, even standing alone, be a valuable accomplishment. In *(Not) Advising Corporate Officers about Fiduciary Duties*, Lyman Johnson and Rob Ricca find that lawyers generally do not advise corporate officers about fiduciary duties, including the duty of loyalty.[288] They begin their article with a provocative quotation from Disney's CFO: "I was not aware that it was a breach of the duty of loyalty to place one's own interests ahead of the interests of shareholders."[289] Although *Disney* may be an extreme case, there may, indeed, be a lack of basic knowledge on the part of senior officers of their duty to avoid conflicts of interest, and exactly what conflicts of interest entail. Even if the Disney CFO's response was disingenuous, an initial licensing mechanism for corporate officers of public companies, similar to that required for attorneys and accountants, could at least prevent protestations of complete ignorance as to the basic duties owed.

There is reason to believe that education is needed. Part of the problem is a lack of understanding of the nature of conflicts of interests and how to handle them. Conflicts are a complicated and nuanced area. For example, it may not occur to a corporate actor that a business opportunity presented to her constitutes a corporate opportunity that by right should be offered to the corporation. One can draw an analogy to the field of sexual harassment law, where different cultural backgrounds can lead to different understandings of appropriate behavior, and where education is therefore important.[290] Neither compliance enforcement, Sarbanes-Oxley, nor state law currently offers any incentive for officers to learn about conflicts rules and to avoid conflicts of interest.

The work of business ethicists reveals the importance of a culture of ethics, and a focus on more than mere compliance.[291] If the social norms of a corporation encourage fraud or a failure to report misconduct, a code of ethics, even if in place will not be effective.[292] As David Hess writes:

> In large business organizations, the pressures to conform and the uncertainty surrounding any decision can be significant[] . . . . Inexperienced managers must rely on local norms for guidance in periods of uncertainty, which can lead to the continuation of wrongful activity. As one employee in a risk-management position at Enron stated:
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> "If your boss was [fudging], and you have never worked

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288. As they observe, the boundaries of corporate officers' duties are unclear, but some duty of loyalty must exist. Johnson & Ricca, *supra* note 5, at 665.

289. *Id.* at 663.

290. Niloofar Nejat-Bina, *Employers as Vigilant Chaperones Armed with Dating Waivers: The Intersection of Unwelcomeness and Employer Liability in Hostile Work Environment Sexual Harassment Law*, 20 BERKELEY J. EMP. & LAB. L. 325, 353–54 (1999).

291. Treviño et al., *supra* note 4, at 139–40.

292. Hess, *supra* note 130, at 1797.

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> anywhere else, you just assume that everybody fudges earnings . . . . Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"[293]

The presence of an outside organization offering an alternate account of ethics could help to combat the problem of faulty local norms.

Finally, the danger of cartelization that educational certification poses, and the historical exclusion of disfavored groups such as women and racial and religious minorities that exists with the licensing of professionals like lawyers is less of a concern for public company officers for several reasons. First, because business is not a traditional profession with a concomitant requirement of a license or certification, individuals with no formal education start businesses every day. Secondly, while it would be difficult to argue that the high-level officers of today's corporations are diverse by any measure, the barriers to entry that prevent women and minorities from filling those offices are already in place. Once an individual has reached the rarefied height of being considered for the highest positions in publicly held corporations, it seems doubtful that a conflicts certification, which would be the result of at most a few days' training and possibly a test, would bar anyone from service.

3. Potential Implementation Mechanisms

To present a real change from the status quo, a third-party organization must administer the licensing. The easiest method would be an exam focused on conflicts administered to all senior public company officers, roughly speaking from the vice-president level up, including the chief executive officer, chief financial officer, and chief operating officer.

Implementing this requirement could take several forms. Most directly, the SEC could make licensing of senior officers mandatory for public companies or require companies to disclose whether senior officers are conflicts-licensed and if they are not licensed, explain why they are not. Alternatively, the NYSE and NASDAQ could make officer conflicts licensing a listing requirement for their respective exchanges. Indeed, as already noted, the NYSE places conflicts of interest first on its list of topics to be included in its listed companies' codes of ethics, so conflicts are already a concern.[294]

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293. *Id.* (second alteration in original) (footnote omitted) (citing John A. Byrne, Mike France & Wendy Zellner, *The Environment was Ripe for Abuse*, BUS. WK., Feb. 25, 2002, at 118, 119).

294. NYSE Manual, *supra* note 36, § 303A(10). The other topics, in order, are (1) corporate opportunities (which I include as a subset of conflict of interest), (2) confidentiality, (3) fair dealing, (4) protection and proper use of company assets, (5) compliance with laws, rules and regulations (including insider trading laws), and (6) encouraging the reporting of any illegal or unethical behavior. *Id.*

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If the SEC or the exchanges do not mandate officer conflicts licensing, other existing institutions can encourage this practice. Adoption by the ISS or Standard & Poor's of licensing as part of corporate governance scoring would spur wider adoption of conflicts education as corporations try to improve their scores and thus attract institutional investors. Insurers providing director and officer liability insurance could tie the price of premiums to the amount of conflicts training senior officers have had.[295] Having the DOJ or the Guidelines consider officer licensing in determining whether to prosecute or what sentence to impose could also encourage the practice.

Finally, patterned on the ISO model, a third-party organization could simply begin to certify officers on its own. This last mechanism will prove least effective because, absent endorsement of conflicts licensing by an outside institution such as RiskMetrics' ISS, Standard & Poor's, the DOJ, or the Guidelines, a certifying organization would have difficulty acquiring the initial legitimacy it would need for officer certification to be worth the effort by a corporation.

V. CONCLUSION

Conflicts of interest represent an essential problem of corporate governance, and ignorance of the nature of conflicts is part of this problem. State law, because of the complexity of the derivative suit, largely depends on corporate self-interest to police conflicts; it fails to focus on the true decisionmakers of the corporation, the officers. Federal mechanisms only obliquely regulate conflicts via disclosure and compliance, and may even exacerbate the problem by making it more risky for a corporation to enforce optimal conflicts policies. Education offers an alternative: it emphasizes the importance of conflicts, and it can prevent some conflicts problems from arising, something current mechanisms fail to do.

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295. *See* Sean J. Griffith, *Uncovering A Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1150 (2006) (suggesting that the directors' and officers' liability insurer was just as much to blame for the Enron collapse as were other gatekeepers). *But see* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1808–14 (2007) (discussing why the D&O insurance market currently does not monitor corporate governance effectively).

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