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Making Corporate Governance Work

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ABSTRACT

This paper discusses the current state of and issues related to corporate governance in America after the passage of the Sarbanes-Oxley Act of 2002. It suggests additional steps necessary to realize improvement in the ways in corporations govern themselves and regulators must operate to make the system work.

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Keywords: corporate governance, accounting standards, conflicts of interest.

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A wave of corporate misconduct contributed significantly to the 2001-2002 collapse in stock market values and investors' confidence. This was not the first crisis of corporate governance to pass through the markets, but its multi-trillion dollar impact on market values made it by far the greatest. This event occurred after the end of a vigorously speculative period in the stock market when investors' attention was focused on continuously rising prices rather than the quality of corporate governance or of earnings certified by leading accounting firms. Since the peak of the stock market in early 2000[1], several developments have brought about lowered price levels. These include rapid deterioration of business conditions in the technology, telecommunications and other high-growth, "new economy" industries, an economic recession that ended the longest period of economic expansion in American history, the events of September 11, 2001, and a series of reports of alleged exploitative, manipulative and fraudulent actions by senior management of major corporations and by financial service industry professionals.

These four factors together caused market prices to fall sharply from their all time high levels, but by late November 2001, most of the effects of the first three had been absorbed and stock market price levels had recovered to approximately the trading levels of six months earlier. The fourth factor, however – the corporate governance factor – did not seem to have much effect until after the Enron bankruptcy in December 2001, which subsequently attracted intense media coverage and, partly in response, heightened political and regulatory activity. Then, from March 2002 until early July 2002, the S&P 500 index suddenly plunged 32% in panic selling reflected in a record level of mutual fund withdrawals (about $70 billion from May through July)[2], which in turn attracted further public attention to an urgent need for general improvement in the conduct of American corporations.

Enron and its auditor, Arthur Andersen, became symbols of the failure of American corporate governance, which many commentators reported had been infected by excessive greed, exploitation and a corporate culture permissive of, or indifferent to, unethical conduct. After nearly a decade of affording heroic status to leading CEOs, including those from some of the companies now in disgrace, the investing public was shocked and angered by what it was learning about prominent corporations and their now unclothed emperors. These failures were politically important (in an election year) because many state, municipal, union and 401K pension funds were invested in Enron and other troubled companies. The Federal Reserve had reported in 1998 that approximately half of American households owned stocks (mainly through mutual and pension funds), more than ever before.[3] Accordingly, numerous investigations were initiated by Congressional committees, law enforcement agencies and other federal and state governmental bodies (many unconnected to securities regulation). Almost all the leaders of institutions involved with investing, or in overseeing corporate and financial market activity publicly distanced themselves from the miscreant behavior of executives, loudly called for increased regulation by the federal government, and reform of current corporate governance practices. The result of this period of intense focus on the deficiency of corporate governance was the passage of the Sarbanes-Oxley Act of 2002, the most extensive set of new federal securities and business regulations since 1934, which had little support in the Congress in the early part of the summer of 2002 but, then suddenly, was passed in July. But, despite passage of this Act and other moves to enhance regulatory scrutiny by the SEC, the National Association of Securities Dealers and the New York Stock Exchange, all of which sought to signify that appropriate action had been taken to protect investors from future corporate abuse, there was still some skepticism that these actions would do more than close the barn door after the horse had escaped.

Despite the scandals that have embarrassed American capitalism's many supporters, it must be remembered that the essential principle of rewarding managers for creating shareholder value has been successful in creating the growth and prosperity of the modern American economy. Indeed, Alan Greenspan, in an address at New York University in the spring of 2002 on the subject of corporate governance, pointed out that this was a topic he normally did not discuss but because some excesses had occurred that affected the quality of financial markets, he felt he needed to do so. Nonetheless, despite many imperfections that need to be addressed, he said, the American system of market capitalism still clearly worked better for the economy and society than any other. And, American financial markets, characterized by openness, fairness and the efficient distribution of information, have for many years set the standard for the world.

Enron and other cases of corporate failure contain many examples of all of the most troubling forms of governance imperfections suggestion by Mr. Greenspan -- withholding of important information from the markets; obfuscation and manipulation of operating results, earnings and stock prices; excessive compensation and perquisites for executives; excessive participation in political contributions and influence-peddling; and erosion of the independence of board members through cronyism or sweetheart deals. These abuses have been accompanied by comparable failures of certified public accountants to be independent of the companies they were auditing, failures of Generally Accepted Accounting Principles (GAAP) to prevent distortion of financial information through novel accounting positions taken by insistent clients, failures of independent stock and credit analysts to either know what's happening or to speak out about it, and failures of the regulatory agency fully empowered to monitor and control such actions – The Securities and Exchange Commission (SEC) – because of insufficient budgets, inadequate staff, and a lack of will to contend against severe political pressure from members of Congress influenced by vigorous lobbying efforts by corporations and accounting firms. (Some of these Congressmen were among those most actively advocating reform after Enron collapsed). Altogether, the events of the past two years, according to Arthur Levitt, a former SEC chairman, caused "an emerging… crisis of confidence in our [financial] market [system]. What has failed is nothing less than the system for overseeing our capital markets."[4]

This market system recognizes substantial conflicts exist naturally in the American economy between the interests of managers and owners, conflicts that need appropriately to be managed and controlled for fear of developing hazards for all pubic market investors. The essence of the corporate governance system in America is how effectively executives are restrained from corporate actions that either exploit or endanger investors. The federal government, through regulations related to the securities market, provides rules and penalties for wrongdoing that appropriately mark the boundaries of impermissible conduct and thus deter the vast majority of executives from crossing those boundaries. The exact locations of the boundaries, of course, are constantly being questioned because of changing market situations, technology, and innovation. Ultimately the burden of restraining corporations falls upon investors themselves and the markets in which they trade. They, after all, are the ones to gain or lose from the market's actions and they must look after themselves. Credit markets in America are almost entirely made up of banks and sophisticated bond market investors. Approximately 70% of stock market trading is performed by equally knowledgeable institutional investors. These investors not only had access to information and analysis sufficient to warn them of deteriorating investment conditions in many companies in which they were invested, but, collectively, they also possess massive amounts of voting power with which to express their wishes for correct governance procedures. It is clear now that these investors did little to protect themselves during the last few years. [5]

Assessing the Damages

From mid 2001 onward public attention was drawn to series of corporate disasters that were best represented by the bankruptcies of Enron and WorldCom[6] and the liquidation of Arthur Andersen, one of America's five largest accounting firms following criminal conviction for obstructing justice by destroying documents.[7] Enron and WorldCom however, were only two of many large corporate bankruptcies that occurred in 2001 and 2002. Others included Global Crossing, Kmart, Adelphia Communications, NTL, Finova, Reliance Insurance, and Consolidated Freightways. Some of America's highest paid executives were among the leaders of the bankrupt companies.[8] Further, executives of several of these and other high profile companies have been arrested and face criminal charges; other companies that have avoided bankruptcy (including AOL Time Warner, Computer Associates, Imclone Systems, Rite-Aid, Tyco International and Qwest) have also undergone criminal investigations. But the problems of failed corporations extended much further than these high profile cases. In 2001, 171 large corporate bankruptcies involved total liabilities of $230 billion, more than twice the level of liabilities in 2000, the previous record year for bankruptcies, and by August 31, 2002 87 additional bankruptcies involving liabilities of $223 billion had occurred suggesting that 2002 will significantly exceed the extraordinary level of bankruptcies in 2001.[9] In addition, instances of accounting failures (in the form of "restatements" of prior audited financial results) nearly quadrupled in the three-year period 1998-2000 to 643 cases.[10] As a result, plaintiff lawsuits seeking damages from officers, directors and advisers of bankrupt companies and those with restate financials exploded. More than 480 such suits were filed in 2001, as compared to an average of 194 filings per year during the three years prior to passage of the Private Litigation Reform Act of 1995, a bill that was designed to substantially limit the number of such lawsuits.[11] Many of these lawsuits were the consequence of stock prices that fell rapidly, causing losses (damages) to investors, when such stock price declines followed sudden news of changed financial information.

The losses experienced during this period were considerable. Bank loan write offs have been in the tens of billions. Publicly traded non-investment grade bond defaults for the eight months ending in August 2002 were over $80 billion, (1.3 times the 2001 full-year defaults, the highest level of such defaults previously recorded). Equity market losses attributable to fears of corporate failures may have been even greater: the S&P 500 index peaked at 1527 in March, 2000 and then fell steadily to 966 in September, 2001, but it recovered by year-end 2001 to nearly 1200. But, even after clear signs of recovery in the economy and in corporate earnings were becoming evident after the early part of 2002, the influences of the Enron bankruptcy in December 2001 and other corporate surprises affected the market and the S&P 500 index reversed direction and fell further. Unlike the periods following recovery from previous recessions, the stock market continued to sag, with the S&P 500 index reaching a five-year low of 798 on July 23, 2002, down 33% for the year, and by more than 47% from its all-time high two and a half years earlier when the equity market capitalization in America was in excess of $17 trillion. For many industries suspected of accounting or governance shortcomings (e.g., telecom, health care, energy services and technology), share price declines were greater. By the end of July 2002, the NASDAQ index had declined more than 75% from its peak, and the Chicago Board of Options Exchange's stock market volatility index (VIX) reached a 14-year high.

Legacies

Adolph Berle and Gardiner Means first called attention in 1932 to the perils of owner-manager agency conflicts that were becoming embedded in our American system of corporate governance. By 1932 Berle and Means had plenty of opportunity to digest the multitude of examples of exploitative conduct by corporate executives and financiers during the bull market period that continued until the stock market crash of 1929. The Roosevelt administration, in order to protect the interests of the public investor in the future, introduced an entirely new legal regime for corporations utilizing the banking and public securities markets. The Banking Act of 1933 separated investment and commercial banking (they were reconnected by the Gramm–Leach-Bliley Act in 1999), instituted deposit insurance and strengthened the regulatory powers of the Federal Reserve System. The Securities Acts of 1933 and 1934 essentially required truthful, complete disclosure of corporate information and audited financial statements for new securities issues, a level playing field in secondary financial markets, and created and empowered the Securities and Exchange Commission to regulate the system and enforce the rules.

Corporate governance issues as such did not appear until the 1960s when companies were urged to select a majority of its members from “outsiders,” i.e., persons who were not employees of the company. For a decade or more after this, the outsiders selected by the insiders were persons with substantial links to the companies they served -- as bankers, lawyers, financial advisers, customers -- and often directors served on each other’s boards, increasing their mutual trust, dependence and loyalty. Prior to this time, many companies selected one person – a prominent shareholder or former executive – as chairman of the board and another, a younger, operating executive as president. In the 1950s and 1960s, however, the concept of the officially designated “Chief Executive Officer” emerged, in which increasing amounts of decision making authority was vested in a single individual. This individual (who usually came to occupy both the offices of chairman of the board and president) was given freedom to take such action as was needed to pursue opportunities without being impaired by having to achieve a consensus first.

The idea was to give greater authority to more dynamic leaders who would accordingly produce better results for shareholders. The effect of this change was to select and empower a key individual who would be fully and loyally supported. This helped establish the notion that board members were expected to be “team players” in their support of management. The CEO, whose de facto powers grew with this allocation of authority, was usually able to control, directly or indirectly, all the elements of governance in the company. Such elements included approval of nominees to the board and board committees, compensation and benefits to executives and board members, the selection of outside service providers, press relations, political contributions and lobbying efforts, and the frequency and agenda of board meetings. The CEOs would have the ultimate authority to determine how shareholder’s interests were to be served. Most CEOs accepted this responsibility as a matter of course and exercised appropriate levels of self-restraint.

There was never any particular plan to do it this way. Once a certain number of companies had established a pattern that seemed successful, others followed. Some boards continued to be more restraining than others, some on the other hand were filled with cronies selected by a charismatic CEO. Even properly independent directors believed that they were not to oppose or make a fuss over the CEOs actions unless something drastic occurred, which usually didn’t. Many companies that had allocated special powers to the CEO, including several who were controversial for their aggressive acquisition practices (including the earliest “conglomerates” such as Litton Industries, ITT, Textron and LTV), enjoyed high levels of success in creating economic value and stock price appreciation for their companies in the long economic boom of the 1960s. Throughout this period and into the 1970s, however, there was one restraining element that CEOs had to face – the availability of finance and accounting services. Commercial and investment bankers and accountants were conservative and then not unduly troubled by competition for their large clients’ business. They were loyal to their clients but spoke freely to them and were uninhibited in telling them what they thought.[12] This would come to be changed in the 1990s as competition in the financial services businesses intensified and exclusive, “house-bank” relationships disappeared.

A landmark legal case affecting corporate governance (*Escott v.BarChris)* was decided in 1968 in a federal court in New York State.[13] In this case involving fraud and false accounting in a company selling securities to the public, the court found against the company’s independent directors, accountants and investment bankers. Under the Securities Act of 1933, underwriters share liability with the company and its advisers for the accuracy of all offering documents. The defendants claimed they had been lied to by management and therefore could not have known of any fraud. The court held, however, that the defendants had failed to demonstrate that they had made a significant effort to find the facts for themselves. Thus they had not been “duly diligent” in making all appropriate efforts to inform themselves of the true facts in the case, thereby breaching their fiduciary duties of care. This case, very importantly, put the burden of proof as to satisfactory due diligence on the defendants. *BarChris* changed the underwriting business fundamentally and lastingly by putting directors and advisers directly on the line. They would all have to be able to demonstrate a due diligence defense if a prospectus should turn out to be defective. This was a worrisome thing – what exactly was satisfactory due diligence? How often did it have to be conducted? To ease the difficulty board members and underwriters began to insist on indemnification by the company for any costs or damages borne by a director while fulfilling his or her duties (except in the case of gross negligence). To insure that this protection was available even if the company was unable to satisfy its indemnification obligations, companies began to acquire liability insurance for officers and directors. Though the due diligence standard remained, the availability of indemnification and insurance actually meant that officers and directors to protect themselves only had to meet the gross negligence test, a comparatively easy one to satisfy.

In the 1970s a round of scandals emerged related to the practices of some American companies to pay bribes to officials of foreign governments in order to obtain important contracts. Lockheed

Corp. was accused of bribing high officials of the Japanese government to secure a large order of aircraft, and subsequent Congressional investigations discovered that many other corporations engaged in similar practices. The result was the passage of a tough Foreign Corrupt Practices Act in 1977, which has been amended and updated several times. The bribery problems have subsided. Also in the 1970s, a number of large corporations (Gulf Oil was one) were found to have made secret and illegal political contributions. After this, legislation was passed to restrict such payments.

In the 1980s and early 1990s, the Federal Deposit Insurance Corporation was required to expend more than a $100 billion in deposit guarantees for failing savings and loan associations and other banks. Like the present scandal, a public furor resulted and Congress in 1989 passed the Financial Institutions Reform, Recovery and Enforcement Act that tightened regulations, increased deposit insurance premiums and established new enforcement and financial recovery measures. Among these was the establishment of the Resolution Trust Company to recover funds advanced by the FDIC to insure deposits. Over a six-year period, the RTC liquidated banks, sold assets and routinely sued officers and directors of the failed organizations on the grounds that they had failed in their fiduciary duties to depositors. According to L. William Seidman, Chairman of RTC during this time, approximately 1,000 such directors of savings and loan corporations were sued, and substantial sums were collected from them, mainly by "outsourcing" the legal work to private sector law firms.[14] Those against whom judgments were brought were directors who were unable to convince juries that they had been duly diligent in informing themselves about the affairs of the banks, or had not put their own interests before those for whom they were expected to perform fiduciary duties.

"Corporate governance" became a term in general public use (perhaps for the first time) in the 1980s, when the corporate "raider" appeared with the intention of acquiring companies thought to be underperforming and thus undervalued. Boards rallied behind their CEOs in loyal opposition to virtually all such efforts, but many raiders succeeded nonetheless through unsolicited cash tender offers (at a premium price to the prevailing market) sufficient to purchase a majority of the stock and vote in a new board. This was an era of colorful tactical maneuver – but it was an era in which shareholders began to see more clearly that a challenge to management might be in their own interest, i.e., to increase the value of their shares. By the end of the decade, “hostile bids” no longer had a pejorative element to them. These simply became “contested bids” in which one side would make an offer, the other would try to block it, usually by producing a shareholders’ rights plan, or “poison pill,” that would prevent an offer being accepted by shareholders without first obtaining the consent of the board.[15] Thus deadlocked, the two parties would sue each other, usually in the state court in which the company was incorporated. As many important public companies were incorporated in Delaware, and that state’s Chancery Court heard and decided a large number of these cases. The Delaware court would conduct a trial, hear from all sides and then produce a ruling (often with a completed appeal) all in the course of a month or two. These rulings focused on the powers of boards acting on behalf of shareholders to obstruct offers to acquire control of their companies. During the 1980s, hundreds of such cases were heard and resolved, and a pattern of case law governing the rules for takeovers (and hence limiting the powers of boards to obstruct) was developed. Much of this case law rested on the idea that in the case of an “ownership” issue such as a change of control, the actions of the board would be judged by a higher standard than in an ordinary commercial matter. The higher standard put the burden on the board of the target company to demonstrate that it had performed its fiduciary duties of care and loyalty to its shareholders. To protect themselves against charges of unreasonable entrenchment and adverse court rulings, boards began to make major changes in their methods of governing themselves during takeover bids – independent directors, not CEOs, would make crucial decisions and to do so they would be afforded their own outside counsel and financial advisors. They probably did not want or ask for this additional power, but found it forced on them by court rulings. But the rulings clearly reduced the agency conflicts. So, supposedly, did the “golden parachute” a devise to reward CEOs and some other top management of target companies with a substantial, guaranteed payment in the event of a change of control. Such a payment was meant to assure their “objectivity,” i.e., to keep them from opposing deals or not bringing them to the attention of the board at all. These parachutes may have been the beginning of the practice of corporations allocating substantial benefits, protections and financial rewards to insure the loyalty of senior employees. As a result of these measures, the market for corporate control was substantially freed from management entrenchment, and substantial economic added value was demonstrated through corporate restructuring transactions designed to increase shareholder value. However, by the end of the 1980s, extensive corporate lobbying had persuaded many state legislatures to pass anti-takeover laws that limited the ability of investors to make contested bids for companies.

The takeover boom in the 1980s, and the developments described above, also heightened the attention of board members of several poorly performing large companies (such as General Motors, Eastman Kodak, Sears Roebuck that were too large to be taken over through a hostile bid) to question the actions of CEOs and to demand greater consideration of the protection and enhancement of shareholder value. Some of the boards fired their CEOs, others accelerated their departures and began executive searches for "new blood" from the outside. Many of the new CEOs that were recruited were expected to reform their companies, to modernize their economic potential. CEOs like Lee Iacocca, who took over at Chrysler in 1979, became celebrities, inspiring a demand for charismatic CEOs. By the end of the 1980s, many board members of Fortune 500 companies had experienced an involuntary replacement of a CEO and the search for a charismatic one. This was thought by students of corporate governance to be a major step forward in making huge, insular, indifferent corporations more response to shareholder interests.

But, the 1980s also produced new players in the corporate game – entrepreneurial financiers who demonstrated they could make fortunes for themselves and their investors by organizing leveraged buyouts, issuing junk bonds, engaging in merger arbitrage and options trading, and managing hedge funds. Some of these entrepreneurs earned many times what CEOs of large corporations did, and CEOs began to look for ways to catch up. As the growth-stock market of the 1990s developed, the way for them to so was to cause the company's stock price to rise, and arrange to share directly in the value thereby created. So, many CEOs committed their companies to high-growth, acquisition-based strategies with robust executive compensation programs that would reward them and other company managers handsomely for gains in their company's market capitalization. A committee of the board made up of outside directors was made responsible for developing the company's incentive compensation programs. Usually this involved hiring a consultant to check out all other companies that had such programs to be sure nothing was missed, and to prepare a comparison to other companies that justified awarding to their company's officers the same sort of plans that other companies had in place. Compensation plans were reviewed periodically to be sure that they were "competitive," i.e., so their CEO would not quit and have to be replaced, though not many were likely to do so. Thus, whenever company A increased its CEO's compensation, companies B-Z could be expected to do so soon. In the 1990s a number of mischievous, complicated and obscuring compensation practices quietly worked their way into the system and were copied elsewhere in the interest of remaining competitive. Among these were a number of overlapping compensation elements and benefits which made actual compensation totals difficult to understand; option programs that were created without an understanding or disclosure of their economic cost to the company; resetting stock option exercise prices at lower levels after a major drop in the stock price; allowing options to replace themselves automatically when exercised; making large personal loans to CEOs to invest in company stock or homes and other non-company assets and allowing company stock to be sold back to the company to repay the loans; and payment of large "special bonuses" to top executives for some one-off corporate action taken (such as a large merger) before any value to shareholders was demonstrated, and extensive post-retirement consulting payments and other perquisites. Thus Berle/Means agency conflicts in the area of executive compensation were developing rapidly – the agents had come to control the reward mechanisms to be distributed to themselves – at the expense of the owners (shareholders) of the companies.

These mechanisms, however, followed the conventional wisdom of aligning manager's interests with those of the shareholders. The more invested in the company's stock a manager was the greater would be the manager's interest in seeing the stock price rise, to the benefit of the rest of the shareholders. True, but the manger was not putting any money up for stock options. If things went well, the manager would be as wealthy as an LBO entrepreneur, but if things went badly, the manager (unlike the stockholder) would lose nothing. And, if options were granted frequently, they would mature and be exercised frequently, allowing executives to take cash out of the company on a regular basis. Many executives who were striving to expand their businesses and cause the stock price to rise, and who were constantly promoting the stock to analysts and employees, were at the same time hedging their bets by selling stock on a regular basis. Thus a CEO, now possessing an unprecedented amount of corporate power, had huge incentives to make the stock go up, but unlike the common shareholder the CEO had nothing to lose if the stock stayed where it was or went down.[16] Such arrangements contained potentially toxic levels of moral hazard – CEOs were encouraged to risk shareholders' capital aggressively, perhaps even recklessly, because they would be made enormously rich if their actions succeeded but would not lose much of their own money if they failed.

Companies therefore adopted strategies to achieve rapid growth and increased scale, often based on aggressive acquisition programs that involved a number of risky, and often very large acquisitions that were difficult for the market to evaluate, especially when several occurred over a short period of time. CEOs encouraged belief that their companies could sustain rapid rates of growth indefinitely by continuing to acquire other companies, especially by exchanging their relatively high priced stock for the stock of the companies to be acquired.[17]

Stock prices went up (for this and other reasons) but the CEOs knew they had to meet the future expectations that they themselves had encouraged market analysts to form. Sometimes (especially after business conditions began to deteriorate in the early 2000s) a little nudging of earnings from reserves or into the current quarter from the next was necessary to do this. In time, some companies found that a small earnings management last quarter required a larger one this quarter, and in time the game (like a Ponzi scheme) became very difficult to manage.[18] Either all had to be revealed, or the game of managing earnings had to continue indefinitely, escalating from quarter to quarter, hopefully to be covered by an especially good quarter sometime in the future. Some companies believed, however, that if it were possible to persuade their auditors that an accounting treatment was (even at a stretch) permissible under GAAP, the fabrications wouldn't really be fabrications at all -- they would be creative innovations that could extract them from the Ponzi dilemma. The accountants were the ultimate experts and if they certified the audit, who could fault the company or its executives for being too aggressive?

The accounting industry thus found itself being asked to sign off on all sorts of creative accounting ideas. Possibly in earlier times they might have refused, on the grounds of clear-cut professional standards. This time, however, the standards were far less clear – GAAP had been considerably relaxed or confused and the industry's Financial Accounting Standards Board (FASB) was far behind in bringing them up to date and continuing to keep them clear-cut. And, the company might remind accountants reluctant to accommodate accounting changes of the considerable amount of consulting services it was purchasing from the auditor, services that rapidly were increasing to become the majority of the auditor's revenues. Thus an increasing demand for creative accounting encountered a reduced level of independence among auditors, all of which had substantial consulting activities.

During the last two decades corporate governance experts have tried to restrict excessive concentration of powers in management. They attempted to do this by insisting on a majority of independent, non-management directors, by tightening the duties and standards of the audit and compensation committees, and by increasing disclosure of management conflicts of interest, compensation and benefits. A variety of proposals have surfaced over the years to augment these provisions (though few have been widely adopted), including the designation of a "lead" outside director, performance reviews and term limits for directors, and solicitation of feedback and suggestions from institutional investors. In retrospect it may be seen that whatever reforms were adopted or suggested, they were not sufficient to restrain the conduct of some CEOs and managers that shareholders had willingly empowered and generously incentivized over the years. While we know that only a minority of CEOs took inappropriate advantage of the powers and incentives granted to them, it seems clear that it governance systems in place did not in any way hold them back.

Sorting Out the Mess

The most rapid and meaningful corrective remedies for market abuse are affected by the markets themselves -- by the actions of investors and those connected to them. They extract heavy penalties where they count the most, among investors who have to suffer the losses or explain to their clients why they lost so much of their money. Hundreds of billions of dollar of market capitalization of stocks and bonds have been lost by debt and equity investors, including bank lenders, in those companies that have experienced corporate governance failures. And the market losses have extended to other companies in the industries in which the offending companies operated – e.g., there are no unaffected energy trading or telecom companies. The market has also taken a toll on suppliers of professional services to the companies involved – banks and law firms, as well as accountants, have been named in civil lawsuits. Banks have watched their own shares prices decline sharply, and analysts from brokerage firms and rating agencies have been professionally discredited if not punished directly. And finally, but not least, regulators, prosecutors and the plaintiffs' bar have come out looking, perhaps recklessly, to find persons they can blame for the financial carnage that has occurred. This may be fitting for those who are guilty, but for others who are caught up in the turmoil and have to defend themselves against serious charges, the process can be a nightmare. Criminal charges, though very difficult to prove, can be devastating to corporate executives, even those later determined to be innocent of the charges. Civil lawsuits can also be dangerous as they reach across the shattered remains of companies involved directly in misconduct to less directly involved firms and individuals with deeper pockets to extract payment for the losses of clients. Indeed, such broadly defined market forces have the power to punish effectively, though these forces can be crude, undiscerning and perhaps unfair.

In the Enron case, within six months of filing for bankruptcy the company has virtually disappeared. Its investors have endured large losses, and some asset managers investing in Enron stock have been sued by their clients for mishandling their funds.[19] The officers and directors of Enron and WorldCom have been ruined and civil litigation may strip all or many of them of all or most of their personal wealth before the matter comes to closure. Some may face jail terms. Enron's principal law firm, several banks and limited partners in the special purpose entities have been sued for contributing to investment loses and for failing to tell all to other banks that participated in loan syndicates. Citigroup, J.P. Morgan Chase and Merrill Lynch have all come under intense pressure for appearing to have aided and abetted Enron's financial obfuscations through their structured finance transactions, despite the fact that these banks were substantial creditors and investors. By mid July 2002, the stocks of all of these banks had declined to a yearly low, having lost about 40% of their equity market capitalization in the first six months of 2002. Other investment banks have become involved in investigations of their conduct in connection with developments at Enron and WorldCom. The entire financial services industry soon knew perfectly well that the questioned actions involving arrangement of off-balance sheet deals, as well as the allegations of misconduct in securing investment banking business, over-promoting the stocks of client companies, and misallocating initial public offerings were objectionable to their clients and investors and therefore could not be continued, regardless of what the regulators might or might not do.

Surely no accounting firm anywhere in the world missed the news of, and the reasons for, Arthur Andersen's demise. Even before Andersen reached its end, most of the other major accounting firms had announced plans to divest themselves of their large consulting operations, which the Sarbanes-Oxley Act now requires. Clients seeking financial relief in the future through consent to creative accounting treatment will surely find their accountants much tougher to deal with.

Institutional investors have also suffered extensively from the backlash of market forces. They are of course supposed to be the most skilled, well informed and wise of all American investors. Managing large sums of other peoples' money is their profession, yet a great many of them were seen to be gullible, naïve, and greedy themselves. They have the resources to be well informed about investments they make, and the power of their collective influence in the market is enormous. But they never used it to insist on higher standards of financial accounting or corporate governance. Surely these painful lessons will be remembered for some years and affect the investment actions of portfolio managers in the future.

So, the system may be capable of righting itself without further assistance. Much of the alleged abuse occurred in a wildly speculative market that has since returned to its senses. But the thought of self-correction has not been reassuring to those who lost money investing in companies that misled the markets and would like to see justice done. Nor is it satisfactory to policy makers, officials and others who believe that the integrity of American capital markets is one of the country's most important economic resources and must be protected by effective regulation. As in the time of previous scandals, there have been a number of proposals for broad-gauged institutional proposals to fix the system. This time around these proposals include an accounting oversight board, mandatory separation of accounting from consulting services, assurance of "true" independence of outside directors, greater transparency in financial reporting, various reforms to executive compensation practices and the reporting of them, the appointment of some directors by institutional investors and increasing the penalties and statute of limitations for fraud. A "Blue Ribbon Committee" appointed by the SEC in 1999 (whose recommendations were adopted by the NYSE) also suggested higher standards of "financial literacy" by members of audit committees.

Although there may be usefulness in these proposals (some of which have been adopted by the Sarbanes-Oxley Act), the greater likelihood is that whether or not they are fully implemented, they will make comparatively little difference in the long run, though they will, add considerably to the burden and cost of financial regulation in the United States.

These proposals wont matter much because they don't get to the heart of the matter – CEOs will still have most of the power and incentives they need to get themselves and their investors into trouble, and there is no sufficient institutional force at present willing or capable of restraining them. Indeed, the powers of CEOs go so far as to be able successfully to lobby the accounting industry (to keep accounting principles vague and friendly) and the Congress to keep the SEC at a safe distance. Regulatory measures certainly can and do punish errant CEOs, once they are caught, but it is not clear that fear of these forces is an effective deterrent to highly motivated CEOs trying to get ahead quickly or (maybe more often the case) desperate ones trying to fix things when they go badly wrong. And when these CEOs find regulations that are unclear or ambiguous, they may be able to reduce their effectiveness further, as Enron apparently was able to do, by projecting their political influence directly onto the regulators.

Broad new accounting industry reforms (such as the accounting oversight board included in the Sarbanes-Oxley Act) may not be necessary, as George J. Benston and Al L. Hartgraves point out in a recent article in the *Journal of Accounting and Public Policy.* The failures, they say, were caused by something that does not need new regulation to fix. "U.S. GAAP, as structured and administered by the SEC, the FASB and the American Institute of CPAs, are substantially responsible for the Enron accounting debacle," and, they add, inadequate accounting (not auditing) principles probably were behind most of the record number of restated corporate audits that have occurred since 1996. Over the years GAAP have become so detail-ridden and checklist oriented that accountants have lost sight of the true purpose of the audit, which is to certify that the substance of the financial condition of the company is "fairly presented." The FASB, a self-regulating but accommodating body of accounting industry professionals (untouched by Sarbanes-Oxley), has periodically retreated from dealing with such important issues as the consolidation of off-balance sheet "special purpose entities," accounting for derivatives, and the expensing of stock options. In the absence of clear and rigorous GAAP, companies and their auditors have to work out their own treatment of the transactions, and thus have been invited to become excessively creative. Under such vagueness, companies could argue that almost anything they were doing was within their scope. And, an auditor could hardly deny to Company X that which it (or some other auditor) had previously agreed to do for Company Y in a similar situation.

Benston and Hartgraves go on to say that under the Securities Acts of 1933 and 1934, the SEC already has the requisite legal authority to prevent such accounting circumstances. The SEC may reject any accounting principle it doesn’t like, and it has always had the power to discipline or decertify auditors. It just has to use these powers in order to function as a legitimate restraining force. However, Arthur Levitt reminds us that the full powers of the SEC are difficult to assert against vigorous lobbying efforts by accounting firms and corporations that are able to influence Congress and whatever Administration is in office to prevent the SEC from changing accounting principles or tightening the auditing and accounting regime.[20] If such lobbying powers have indeed become so great, then ultimately any new regulatory reforms instituted in the wake of Enron, may be a waste of effort. Indeed, it is difficult to see how the establishment of an accounting oversight board, reporting to the SEC, helps. The board may in the end dilute and confuse the original authority over accounting issues granted to the SEC in the 1933 and 1934 Acts, and thereby weaken it further. Of course, immediately following a crisis, Congress is much less likely to pressure the SEC or other regulators for using the authority they already have, but once the crisis has dissipated, Levitt’s experience warns us, the problem of Congressional interference with the SEC may reappear.

Many of the other provisions of the Sarbanes-Oxley Act and those adopted shortly afterwards by the New York Stock Exchange are also likely to be counterproductive or ineffective in practice. A major New York law firm recently published a memo to clients in September 2002 setting forth a checklist of items to be complied with by all public companies – the memo was 15 single spaced pages in length and clearly indicates the extent of the administrative issues that need to be addressed by thousands of companies. For many smaller companies such an administrative burden could be excessive and a serious deterrent to becoming or remaining a public company. Foreign companies being forced to comply with the CEO/CFO certification and independence standards of audit committees of the Sarbanes-Oxley Act may prefer to withdraw the trading of their securities from the United States markets -- indeed even some American companies may prefer in the future to have their securities traded in the increasingly competitive Euromarket. Further, the increased criminal penalties may so deter CEOs that many will (as Scott McNeeley of SunMicro Systems has said) spend excessive amounts of their time on accounting and compliance rather than driving the company to meet its business objectives. More rapid reporting of material information might be nice, but it may actually result in an obscuring blizzard of trivial disclosures that bend over backwards to be compliant. Some provisions of the Act related to corporate loans, compensation, disgorgement, and conduct of attorneys that are already ambiguous and difficult to understand, may also be unconstitutional if courts agree with some scholars who have claimed that such issues are exclusively within the jurisdiction of state corporation laws, not of the federal securities laws.

Many companies will have to change directors to meet new independence standards, recruiting new ones at a time when both qualified and useful directors will be hard to attract. However, some of the provisions related to the independence of board members and the qualifications of audit committees may not make much difference to the quality of corporate governance. Indeed, Benston and Hartgraves point out that SEC’s Blue Ribbon Committee did not provide reform where it was needed. They claim that Enron’s audit committee, for example, was in compliance with the financial literacy tests required by the committee and adopted by the exchanges. Enron’s other outside directors were mostly as high standing and financially savvy as any director that might have been mandated by enhanced standards of independence or nominated by an institutional investor, yet the board was subservient to its CEO’s wishes right until the end.

Enron's CEO and CFO did in fact certify the company's financial statements when they filed them with the SEC -- it has long been a felony to falsely report information to the government.

<u>Making Corporate Governance Work</u>

We can accept that market forces do punish misconduct once it has occurred and repair damages done after the fact, but there is a question as to their usefulness as a deterrent to future misconduct. The memory of punishment is powerful when the incident is fresh, but then it seems to fade. And misconduct has a way of reappearing later in different forms and places, ones not so clearly associated with previous history. Regulatory reforms, on the other hand, require institutionalization of new procedures designed to prevent misconduct that can become redundant, superfluous, and expensive to administer. Both market forces and regulation leave something to be desired as deterrents against future misconduct. If they had been effective deterrents, the current accounting failures and corporate overreaching (after a decade of serious effort to improve corporate governance in America and elsewhere), would not have occurred to the extent that they did.

We need to look at issues needing further improvement and steps that we can take to make the system work better.

<u>Accounting Issues</u> It is true that the accounting industry needs to be regulated by a knowledgeable, credible authority. The SEC is knowledgeable, credible and already has the authority it needs to regulate, though it has often shied from using the powers it has and has been acutely sensitive to political pressures. Throughout most of 2001 and 2002 when the market panic was occurring, the SEC was not considered effective, responsive or confidence engendering by many critics inside and outside of government. So the Public Company Accounting Oversight Board was created by the Sarbanes-Oxley Act as if to stand in for the SEC to oversee the auditing profession and to adopt quality control, ethics, independence, and other standards regarding auditing. All firms conducting audits of public companies (there are close to

10,000 of these, and each requires an audit every year) must now be registered with the Board, which is to be comprised of five full-time members (only two of whom may be accountants) appointed by the SEC. The Board is in effect created as a wholly owned but semi-independent subsidiary of the SEC, which must approve its budget and lend its enforcement powers to the Board. The intent of the law appears to be to have the SEC delegate its direct authority over auditing, and over a variety of related but unspecified accounting issues, to the Board. However competent and earnest this new Board may be, its existence confuses and diminishes the power of the SEC to regulate accounting issues, and it may not have any greater ability to resist lobbying efforts when they resume. And, the problems of inadequate accounting *principles* (GAAP) are not directly affected by Sarbanes bill. [21] The presumption is that the Board gets responsibility for everything related to accounting except for accounting standards and principles. This leaves GAAP where they were, to be established by FASB but approved and accepted by the SEC. It is hard to see how much practical accounting reform can occur if the deficiencies in GAAP are not addressed, and addressed quickly, but it is not at all clear how this is to happen, especially if the mandate for control of accounting issues is confused between the Board and the SEC.

<u>Civil Lawsuits</u> Civil litigation plays a large, if controversial, part in the American corporate governance system. Civil actions can extract monetary damages from defendants, when successful, but even when they are not, they tie up corporate time and expense and are greatly disliked by many companies. These suits are brought by law firms experienced in civil litigation that represent investors with substantial losses, often on a contingent fee basis. The plaintiffs have to make a case that misconduct by management caused the losses their clients incurred. Their lawyers then look to the funds available for settlement (money available in the company or from individual defendants, insurance amounts, and other deep-pocketed parties that might be brought into the suit) and then negotiate for the best settlement deal they can get. This deal they report to the judge handling the case and then attempt to convince the judge to approve an appropriate fee for them, usually between 10% and 30% of the amount collected, but

sometimes more. Reported settlement amounts may seem large to the public but usually they represent only a token recovery for individual shareholders, often less than a dollar a share. Plaintiffs' lawyers, however, are not regulators and they have no obligations to anyone other than themselves and their clients. They benefit only when they can prove misconduct, and therefore many corporations avoid conduct that might provoke such lawsuits, a reasonably effective form of de-facto regulation by market forces. However, plaintiff actions do very little to establish new rules of governance that restrain companies, though they may increase the cost of D&O insurance.[22] Plaintiff lawsuits often are brought in state courts under state incorporation laws that define the fiduciary duties upon which the whole idea of corporate governance is based.

The SEC, being a federal agency, may not bring such suits in state courts, as it is not defending or upholding state corporation laws. The SEC must restrict itself to civil lawsuits in federal court to defend federal securities laws. In the past, the SEC has won many lawsuits doing so and been awarded disgorgements of profits, which were turned over to the Treasury, and penalties which it retained. Sarbanes-Oxley requires that any such civil penalties be turned over and added to the disgorgement funds that are now to be available -- not for the Treasury -- but for the relief of victims. According to the General Accounting Office, the SEC only collected about 14% of all awards made to it in the period 1999-2001 – it was too expensive and labor intensive to do more, apparently. Now, however, the SEC will be accountable to the public, i.e., to victims (for no fee), to secure recovery of disgorgements and collection of penalties accessed. Now that the SEC has been more abundantly funded (by Sarbanes-Oxley) it will be able to increase its collections, but ironically in doing so it is placed in a position similar to a plaintiff's lawyers in trying to find and collect money for victims.

Over the years, the SEC has had an effective, if checkered, record in bringing securities law actions to court. Sometimes important rulings are obtained, such as *BarChist,* that help to illuminate some of the darker shadows of the regulatory universe. On other occasions, the SEC has won its case at trial only to be overturned on appeal. Two significant insider trading cases won by the SEC were overturned by the Supreme Court in the 1980s, and in 1990 an important shareholder voting case brought by the Business Roundtable and won by the SEC in federal court was reversed on appeal. These reversals have helped to cloud the authority of the SEC in the corporate governance and fiduciary duties area. As a result the SEC has preferred a no-lose legal strategy to avoid testing its authority in court and instead has pressured defendants into settlements, hoping these would act as deterrents in the future. So, currently when the SEC brings or threatens a civil action the expected result is an out-of-court settlement so as to avoid a trial and be able to demonstrate a speedy response to a public offense picked up by the press. This was the case in the January 2002 SEC settlement with Credit Suisse First Boston regarding alleged kickbacks in the underwriting of initial public offerings of stock (IPOs). In July 2002, the SEC also announced a settlement with PricewaterhouseCoopers of charges that the firm violated rules requiring auditors to remain independent of their clients. Neither of these matters was admitted by the defendants, nor did they clarify current law affecting the alleged activities (by relating the facts, interpreting the law, and providing an opinion as to whether the facts violated the law). Nor did they establish lasting new public policies, though since then, the NASD has announced its intention to prepare rules to be followed by underwriters of IPOs. Though these firms probably wanted to settle to get the issues behind them, the SEC could have taken the cases to trial and obtained civil judgments that might have provided important case law precedents (like *BarChris*) that would clarify the rules for all market participants.

It might have been informative, for example, if the SEC had gone to trial with PricewaterhouseCoopers or sued another accounting firm for compromising its required independence by performing large amounts of consulting work for their auditing clients. The SEC might still sue Ken Lay, Jeffrey Skilling and their fellow Enron officers and directors, for failing to meet a *BarChris* due diligence test.[23] Can they demonstrate that they were duly diligent in attempting to learn about the accounting practices of the company, practices that resulted in a major restatement of Enron's financial statements and a collapse of investor confidence leading to bankruptcy? Enron's outside directors are claiming to have been misled by management and the company's advisers, but were they (especially the audit committee members) diligent enough in checking what they were told or in challenging management's statements? Indeed, a judge might find that their ability to exercise their fiduciary duties to shareholders in this connection was fatally compromised by excessive loyalty to management, personal compensation arrangements, loans, charitable contributions or other conflicts of interest. If so, how would the company's indemnification of the directors against legal judgments and expenses related to charges of failure to perform their required duties to shareholders hold up? As Enron is bankrupt, the indemnification may fail anyway, in which case, how well would the D&O insurance polices hold up?

Indeed, such indemnification arrangements have been set aside before. In a landmark merger case (*Smith v.Van Gorkom,* Delaware 1985) in which the board of Trans Union Corporation was sued by a plaintiff group for having agreed too readily to a merger proposal.[24] The board reasoned it could always accept a higher bid if one came, and if one didn't it could claim to have got the best possible price at the time. The Delaware Chancery Court, however, held that the board failed to perform its duties of care by failing to conduct a proper analysis of the proposal with the assistance of professional advisers. Indeed, the court held that the board had so neglected its duties as directors that it voided Trans Union's indemnification and D&O insurance policies. In the end the buyer paid the individual judgments against the board members so none suffered personally. Still, for all future takeover cases, the board would have to be able to demonstrate that it had performed its duties carefully by seeking expert advice and conducting a thorough analysis of the proposal. New rules of conduct were set forth, which had to be followed whether you agreed with the ruling or not.

Restraining the CEO We are still left with a system in which powers allocated to the CEO can become dangerous to shareholders unless necessary elements of restrain can be introduced, generally by self-restraint or, in its absence, the determined effort by other members of the board or outside suppliers of services of resources. The climate must be changed permanently to allow board members to more readily exercise their restraining influences without appearing to be disloyal or unsupportive of management. To change the climate will require not just a change in attitude of board members, but also a change in the constraints under which they must do their work. Some of these constraints have been tightened by Sarbanes-Oxley, but more needs to be done.

<u>What the SEC Can Still Do.</u>

The SEC must reassert itself as the principal regulator of the securities industry by rapidly resolving outstanding issues and developing better means to provide guidance to corporations and securities industry professionals subject to its regulation. Once such measures are in place, and publicly understood and relied upon, it is much less likely that Congressional pressure in the future can be mounted by lobbyists and financial backers to quietly strip away accounting or other features that will have become part of the furniture. Among the actions the SEC should contribute are:

1. The SEC can begin by insisting that FASB resolve the many open accounting principles issues that are pending before it, and insist on a fair and effective updating of GAAP. Until the flaws in our system of auditing based on generally accepted accounting principles is rectified, we are vulnerable to another attack of the malady that gave us Enron, WorldCom, Global Crossing and other accounting failures.

2. The SEC should also sue some directors of failed companies under the theories of *BarChris* and/or *Smith Van Gorkom* (translating the fiduciary duty theory from state to federal law), making them defend themselves against charges of having conducted insufficient due diligence and (in the case of the audit committee members) failure to obtain any outside expertise. These cases must be brought to trial to establish useful case law that will then have to be heeded by all in the future. Over time such legal precedents would define much more clearly what directors' duties really are.

3. Until then, the SEC could issue guidelines for corporate directors, indicating what they would need to be able to demonstrate they had done in order to qualify for "safe haven" protection against civil actions by the SEC for corporate governance failures.[25] Once such guidelines are published, well advised directors will insist on the protection of the safe haven, and force their companies to comply with its requirements. Further, the market will observe whether particular companies comply or not, considering those that do not to be riskier than those that do. Such compliance will be reflected in interest and insurance rates made available to the company, and may influence bond rating and stock analysts also. Guidelines can be modified as case law develops.

What Corporate Directors Can Do

If the Enron directors are personally required to disgorge any gains from their service on the board and to share in the restitution of shareholder losses, the word will get out quickly that it can be quite dangerous and expensive to be a corporate director.[26] Indemnification by a bankrupted Enron will be little value to its directors, and the company's $350 million D&O insurance policy (even if not contested by the insurers) may be too little to help in meeting claims for billions of dollars of damages. Henceforth to be a director means one will have to be able to demonstrate one's own due diligence and not rely on indemnification or D&O insurance to protect oneself from personal liability. Indeed, one should not serve on a board (and perhaps D&O insurers may refuse coverage) unless the company provides outside directors the means to assure their independence and to conduct their due diligence satisfactorily. The best way to do this, as the *Smith van Gorkom* case demonstrated, is for the non-management members of the board to have the authority to hire its own independent experts (accountants, lawyers, investment bankers) who would advise them on their duties in different situations and how to perform them appropriately.

This access by directors to independent experts has now been assured by Sarbanes-Oxley (one of its few original ideas) which encourages outside directors be provided with not only the expertise needed to carry out their duties, but also with independent advice as to how they should act in circumstances in which they are pressured to conform to the will of a forceful, but possibly wrongheaded CEO. The provision in the Sarbanes-Oxley Act, that requires corporations to grant to their audit committees the authority and the funding to engage independent counsel and other advisors as necessary to carry out their duties, by itself may justify the entire legislation. It will make it easier for companies to continue to recruit high-grade directors, especially for the audit committees whose responsibilities have been so substantially increased by the legislation and recent events. It will also improve the quality of work performed by audit committees, and in doing so cause a significant cultural change in the character and independence of all important board committees.

Outside board members, even if not illuminated by director guidelines from the SEC or advice from an independent legal advisor, ought to recognize that their own effectiveness and indeed their safety as directors depend on forcing the CEO to share some of the powers related to governing the corporation. Directors ought to insist periodically on obtaining the viewpoints on governance issues from a dozen or more of the company's largest shareholders – they should go visit them if necessary to learn what they need to know and demonstrate their willingness to receive responsible suggestions.

Directors also ought to consider adopting a "code of fidelity to shareholders" under which:

1. They promise to eliminate consulting relationships or other unusual benefits received by all directors, thereby eliminating any conflicts of loyalty.

2. They set term limits for directors' services on particular committees (such as auditing, nominating, finance and compensation) that parallel the requirement of Sarbanes-Oxley to rotate lead audit partners from accounting firms every five years.

3. They commit themselves to simplifying, clarifying and providing a zero-based justification of executive compensation arrangements in their entirety. This should include a fresh review of prior period stock option policies, and prohibition against large corporate loans (now prohibited by Sarbanes-Oxley) to managers, re-pricing of executive stock options after issuance (especially after a market decline), special bonus' paid to corporate executives for actions the value of which has not been demonstrated (such as achieving a merger of a desired company), and allowing officials to sell stock acquired by grants, options or otherwise (except possibly to pay necessary taxes) until they leave the company. Directors' would be completely free to pay executives and themselves as competitively as they need to, but they would agree to do so in a way that was transparent, understandable, and in alignment with shareholder interests. And, the outside board would endeavor to report to shareholders on the annual cost to the company of stock option grants.

What Institutional Investors Can Do

Institutional investors have received little attention in the recent round of regulation, but their beneficiaries are the ones that have been most harmed by the corporate abuses of the past several years, and yet such institutional investors were in the best position to have prevented it and did not do so. Markets don't become excessive unless investors do, and institutionalized investment managers should not be easily susceptible to "irrational exuberance." Part of the problem has been the indifference that institutions have shown to corporate governance issues. Investment managers pick stocks for their expected gains, not for any other reason, and do not wish to be constrained from choosing what they will. Institutions however have both the power and the influence to affect market standards. They could consider steps such as the following:

1. Announce that part of the services they sell are the *preservation* of capital, and accordingly they will not invest in companies that fail to meet certain standards. The standards would include a test as to the integrity of the financial statements, corporate governance procedures and the quantity and quality of investor information provided. Thus the institutions must endeavor to appraise the operational risk of the companies they select for investment, and insist that portfolio managers conform to the requirement

2. Institutions must be willing to devote some time and expense to meeting with companies and with other investors to discuss and evaluate corporate governance practices. It may be possible to share some of these expenses with other investors, or some of the larger ones may be willing to consider such investments as part of the cost of effective market surveillance.

3. Institutions should consider collectively forming a pool of seasoned or retired corporate or financial executives, academics or others who could be independent corporate directors of companies in which the institutions have large investments. The names would be pre-screened by a committee of institutions and posted on the Internet for companies in search of directors to review. The appointment of such persons to boards of directors would not involve any obligation to the company (or to its CEO). In some cases, the institutions, as a group, may offer, independent of the company, indemnification against legal expenses or judgments while serving as a director.

All of these suggestions are now well within the present understanding of what the investing public's own interest is, and should be put into place even if all or some of the governance provisions of Sarbanes-Oxley should be amended, repealed or declared unconstitutional.

Then, maybe the focus of attention on the part of officers, directors and advisors will move towards becoming more active, informed and participative directors (instead of passive ones). In addition to assisting CEOs in the performance of their duties, such directors will also be better able to restrain both the powers of the CEO and the expectation of complete loyalty to him or her. Thus the playing field would be leveled and the interests of individual company officials and their advisors would become more closely linked with those of shareholders.

Notes

[1] The Dow Jones Industrial average peaked in December 1999, the NASDAQ index in February 2000, and the S&P500 in August 2000.
[2] Julie Earle, "Stock Funds Hit By Estimated $47 Bn Outflow, "*Financial Times*, August 2, 2002.
[3] Federal Reserve Board, *Survey of Consumer Finances*, 1998
[4] Arthur Levitt, Testimony to Senate Committee on Government Affairs, January 24, 2002.
[5] Frank Partnoy, a professor of law at the University of San Diego, testified before the Senate Governmental Affairs Committee in January 2002 that he had conducted his own investigation of Enron using only published data filed with the SEC and other sources and was able to construct a good understanding of what the company was endeavoring to do with its off-balance sheet transactions, a process Partnoy maintain could equally have been performed by stock market or credit market analysts.
[6] With assets of $63 billion, Enron's bankruptcy in December 2001 was the largest ever recorded until WorldCom, with assets of $104 billion, filed in July 2002.
[7] Andersen's conviction conceivably could be overturned because of the peculiar method used by the jury to determine guilt. Even if it had not been convicted, however, a mere indictment on criminal charges would have perhaps have been fatal to the firm. Very few financial services firms have ever survived a criminal indictment, as clients, employees, creditors and service providers all abandon the firm at once. In any event, Andersen also had many other claims against it to resolve even before addressing the potentially enormous cost to it of settling claims related to Enron.
[8] The *Financial Times* reported (July 31, 2002) that Among America's top 25 bankruptcies since 1999, involving more than $200 billion of lost market value, executive compensation totaled nearly $3.3 billion.
[9] Edward Altman, "Bankruptcy and Default Statistics," NYU Salomon Center, Aug. 31, 2002. The bankruptcies include only those with liabilities of $100 million or more.
[10] Min Wu, "Earnings Restatements: A Capital Market Perspective," Stern School of Business Working Paper, Jan. 2002.
[11] Source: PricewaterhouseCoopers, as published in *Financial Times*, July 11, 2002.
[12] Before the market crash of 1929, investors relied upon powerful bankers and other investors as directors of companies because of they were expected to be able to restrain corporate managers by restricting access to finance. In the 1950s and 1960s bankers were also frequently seen on corporate boards, and equally were presumed to have positive influence on managers.
[13] *Escott v. BarChris Construction Corp*., US District Court, Southern District of New York, 1968 F. Suppl 643.
[14] L. William Seidman, "How Can the US Experience in Removing Bank Bad Debts be Useful in Japan," Sept. 25, 2001
[15] Originally devised in 1984 the shareholders' rights plan issued rights to purchase new shares at a steep discount to all shareholders except the purchaser of more than a specified percent of the company's shares. Such a purchaser would therefore be substantially diluted by the exercise of the rights and would therefore be forced instead to negotiate with the board to be able to buy the shares in exchange for the board's disabling the rights plan. These plans were upheld by most state courts in which they were contested, though the courts could disallow them under certain conditions. Most companies listed on the NYSE had adopted such plans by the end of the 1980s, believing they gave shareholders time to consider the proposed offer before reacting to it. Critics of the plans have asserted that the poison pills only increased the price that an acquirer had to pay for corporate control, and thus was an inappropriate form of market intervention.
[16] Some CEOs, however, even made money when their stocks declined sharply by resetting option strike prices or selling the company and collecting on golden parachutes.
[17] The market accepted the same theory in the late 1960s during the first emergence of the "conglomerates" such as Litton Industries, Textron, LTV Industries, US Industries and several others. These companies were not able to sustain the growth in profits, however, and lost their appeal to the market.

[18] See Joseph Fuller and Michael Jensen, "Just Say No to Wall Street: Putting a Stop to the Earnings Game," *Journal of Applied Corporate Finance,* Winter 2002.

[19] Alliance Capital Management, one of the largest equity fund managers in the US, is being sued by one of its oldest clients, the State of Florida, for having recklessly lost money in Enron.

[20] Levitt stated in testimony in January 2002 before the Senate Governmental Affairs Committee in the Enron investigations that he proposed in 2000 to force accounting firms to divest their lucrative consulting businesses but industry lobbying caused important Congressmen to threaten drastically to cut the SEC's budget if he persisted. Accordingly, he said, he reluctantly gave up the proposal. Also, Floyd Norris reported in the *New York Times* (July 5, 2002) "we knew that companies were using merger reserves to inflate profits, even if we did not know the details. In early 2000, businesses mobilized in opposition to a rule proposed by the SEC to force better disclosure of reserves. The opponents prevailed, and the rule proposal died…"

[21] The Act affirms powers of the SEC to "recognize" what are to be "generally accepted" accounting principles, and requires the SERC, within a year, to prepare a study on the adoption "by the United States financial reporting system of a principles-based accounting system," something many financial professional believe has existed for years.

[22] According to *The Economist* (Aug. 10, 2002), since December 2001, "D&O insurance premiums have risen as much as sevenfold for companies in scandal-prone industries (telecom, technology, financial services)" and may increase further as corporate CEOs and CFOs must certify financial statements. Amounts of deductibles have also increased and other terms of D&O insurance tightened.

[23] *BarChris* was a Securities Act of 1933 case based on failure to provide an accurate prospectus. To sue Enron's officers and directors for failure to realize their company was engaging in fraud and other faulty practices would come under the anti-fraud section of the 1934 Act, a tougher, somewhat vaguer standard to meet. State fiduciary duty laws would not apply in federal court.

[24] *Smith v. Van Gorkom*, 488 A.2d 858, Delaware Supreme Court, 1985.

[25] In 1990 the SEC announced Rule 144a, in which it offered "safe have" (freedom from being charged with an offense if in compliance with the rules that provided the safe haven) for companies issuing unregistered securities in private placements. The Rule has been in use ever since and has resolved numerous ambiguities about what sort of issue was exempt from registration and which were not.

[26] This may be likely, as alleged shareholder losses are in the multiple billions, Enron's indemnification of its directors may be worthless and D&O insurance – to the extent it is not contested by the insurers – is for only $350 million.