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ADDRESS

THE CRISIS IN CORPORATE GOVERNANCE: 2002 STYLE*

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I. INTRODUCTION

This Address concentrates on the events relating to corporate governance[1] during the period from November 2001 to November 2002. This has been an astonishing period in many respects. It began with the completely unexpected collapse of Enron Corporation in November 2001, followed almost

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* This Address, presented at the Seventh Annual Frankel Lecture at the University of Houston Law Center on November 14, 2002, covers events and developments through November 8, 2002. Portions of this Address were presented under a similar title at the annual Godfrey Lecture at the University of Maine Law School in October 2002.

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1. "Corporate governance" is a term that refers generally to the management and control of publicly held corporations. *See* The Encyclopedia About Corporate Governance, *What Is Corporate Governance?, at* http://www.encycogov.com/WhatIsGorpGov.asp (last visited Mar. 11, 2003) (listing definitions of corporate governance including "the system by which business corporations are directed and controlled").

immediately thereafter by widely publicized downward profit restatements and bankruptcy filings by a significant number of telecommunications companies. Since then there has been public reporting of scandals involving fraud and misconduct by officers and directors of a significant number of other publicly held corporations. Finally, there has been disclosure of instances in which corporate officers and directors of well-known companies have enriched themselves by hundreds of millions or even billions of dollars at the expense of their shareholders. Indeed, if one regularly reads the *Wall Street Journal* and the *New York Times*, one feels that there has been a steady drumbeat of embarrassing disclosures since November 2001.

Not surprisingly, these unexpected developments contributed to a sudden and sharp decline in stock prices[2] and to a significant decline in consumer confidence in the honesty and efficiency of both the securities markets and American business generally. These developments also have had, to a lesser extent, an impact on the Bush Administration itself. One suspects that attention being paid to Iraq and terrorism may in part be an attempt to divert attention away from unpleasant domestic problems, epitomized by a recent *Wall Street Journal*/NBC poll indicating that 71% of Americans believed "'more should be done' to crack down on corporate fraud."[3]

One unexpected result of these developments is that a proposed statutory revision of corporate governance rules, largely developed by Democratic Senator Paul A. Sarbanes of Maryland

2. Dow Jones Indexes, *Dow Data: 2000–2009*, *at* http://www.djindexes.com/jsp/avgDecades.jsp?decade=2000 (last visited Mar. 11, 2003). While securities prices have recovered to some extent in fall 2002, the market is still significantly below the level of the 2000–2001 period. *Id.*

3. Bob Davis, *History Lessons: Past Crises Offer Hope for Economy, Warnings to Watch*, WALL ST. J., Sept. 26, 2002, at A1. A nationwide study conducted by a Washington, D.C. nonprofit group, the Minority Corporate Counsel Association, in partnership with consulting firm DecisionQuest, further indicated that 76% of respondents believe the system of corporate governance promotes corruption, 78% believe companies will destroy documents to avoid trouble, and 85% believe large corporations hide the truth about the dangers of their products. Galina Davidoff, *National Juror Perception Survey Warns that People of Different Color Have One Thing in Common: Distrust Toward Corporations*, DIVERSITY & THE BAR, Feb. 2003, *available at* http://www.mcca.com/site/data/magazine/coverstory/jurorperception0203.htm (last visited Feb. 9, 2003). "The typical juror today is not willing to accept that there are only a few bad apples . . . . The good companies, not the bad ones, are considered the exception." Tamara Loomis, *Scandals Rock Juror Attitudes: Enron / WorldCom Ripple Seen Across the Board*, NAT'L L.J., Oct. 21, 2002, at A30 (quoting Arthur Patterson, a psychologist with DecisionQuest). While President Bush has publicly stated that there should be a crackdown on corporate fraud, his options appear to be limited. In a recent radio broadcast, however, President Bush stated that he placed equal emphasis on the war against terrorism and corporate governance issues. Refer to note 279 *infra* and accompanying text.

but clearly going nowhere in the face of widespread business and conservative opposition, suddenly acquired legs. As stories about scandals and fraud in corporate governance multiplied, Republicans in Congress quietly dropped their opposition to the legislation, and President Bush, who a few weeks earlier had publicly dismissed concerns about corporate governance with the statement that it involved only a "few bad apples,"[4] now signaled that he would be delighted to sign the pending bill when it was presented to him.[5] The result was that the bill, now renamed the Sarbanes-Oxley bill, was approved without significant amendment virtually unanimously by Congress and was immediately signed into law by President Bush.[6] While this new statute makes significant changes in corporate governance rules in several areas,[7] as discussed in some length in the latter portion of this Address, its actual impact can only be described as uncertain. Indeed, its initial implementation has been so controversial that there is some doubt whether it will have any influence at all.[8]

The closest historical analogy to these startling events is the enactment of the Securities Act of 1933[9] and the Securities Exchange Act of 1934,[10] both of which were adopted back in the depths of the Great Depression, when the modern securities regulation system was being formed.[11] What makes the current events so astonishing is that they were both totally unexpected and extremely substantial in character. Rarely has the mood in

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4. Exchange with Reporters in Orlando, Florida, 38 WEEKLY COMP. PRES. DOC. 1064, 1064–65 (June 21, 2002) (suggesting that the vast majority of corporate America is honest with only a few exceptions).

5. Refer to notes 262–78 *infra* and accompanying text (chronicling the reactions of President Bush and the Republican-led House of Representatives to public concern about corporate fraud).

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.). The renaming of the bill to include Representative Michael G. Oxley, Republican of Ohio, Chair of the House Financial Services Committee, is discussed briefly in note 308 *infra*. The background of the legislation itself is discussed in Part XI *infra*.

7. The Sarbanes-Oxley Act is discussed in detail in Parts XI–XV *infra*.

8. Refer to Part XII *infra* (discussing initial responses to the enactment of Sarbanes-Oxley).

9. 15 U.S.C. § 77a (2000).

10. *Id*. § 78a.

11. The events in 2002 differ from those of the early 1930s in one important respect. The 1930s-era statutes were enacted after long study and careful consideration. *See* Elisabeth Keller & Gregory A. Gehlmann, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 338–42, 347–48 (1988) (describing the drafting and debate process that led to the enactment of both acts). The same cannot be said for the Sarbanes-Oxley Act of 2002. Refer to Part XI *infra* (discussing the hasty nature of the Sarbanes-Oxley enactment).

America changed so quickly and so completely as during the period from the collapse of Enron on November 9, 2001, to the enactment of the Sarbanes-Oxley Act by Congress on July 30, 2002.

II. BACKGROUND

In order to set the stage for these current dramatic events, it is first necessary to describe governmental and public attitudes toward corporate governance issues prior to the collapse of Enron in November 2001. Following a brief market decline in the mid-1980s, the securities markets had risen steadily for more than ten years, fueled in part by the development of computerization, the Internet, and the telecommunications boom.[12] The public's general attitude was one of optimism, faith in the American corporate governance system, and a widespread belief that the American system was superior to any other in the world.[13] This optimism was fueled by a steady rise in securities prices and the widespread belief that they would continue to rise "as far as the eye can see."[14] Professor Bratton neatly captured this attitude when he wrote in 2002 that "[i]n the 1990s, corporate self-regulation [in the United States was] widely thought to have reached a high plateau of evolutionary success due to proliferating good practices and sophisticated institutional monitoring."[15] At the time it was not widely known that the workload of the Securities and Exchange Commission (SEC), the principal enforcer of governance standards, had increased significantly, while the size of its staff had increased only slightly.[16]

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12. Other factors also contributed to this rise: globalization, the end of the Cold War, the decline of trade barriers, and the freer movement of capital. *See* William Dickneider, *Battle of the Bull Run (Part 2)*, IN THE NEWS!, Oct. 26, 1998 (noting that the bull market of the 1990s was fueled in part by the collapse of the Soviet Union, which in turn contributed to increased trade between nations across the globe), *available at* http://www.sia.com/about_sia/sifee/vol15-2.pdf (last visited Feb. 9, 2003).

13. *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1282 (2002) [hereinafter Bratton, *Enron and the Dark Side*] (commenting on views of corporate self-regulation in the 1990s).

14. *See* Jacob M. Schlesinger & Nicholas Kulish, *A Century of Booms, and How They Ended—The Usual Causes of Death—Inflation and Inept Policies—Aren't Afoot in America Yet*, WALL ST. J., Feb. 1, 2000, at B1 (examining potential problems that might bring an end to "the great turn-of-the-millennium boom" but noting that "[m]ost folks . . . see nothing but sunny skies well into the future").

15. Bratton, *Enron and the Dark Side, supra* note 13, at 1282.

16. This was apparently not widely appreciated during this period. For example, in the 1980s, the SEC reviewed in depth each company's filings only once every three years; by 2000, its workload had grown to the point that it was possible for the SEC to make an in-depth study of a company's filings only once every seven years. Stephen Labaton,

For many, the paradigmatic example of the superiority of the U.S. system was Enron Corporation. Formed in 1985 by the merger of two interstate pipeline companies,[17] Enron had, in fifteen years, grown by merger and acquisition to rank as the seventh largest American company in terms of revenue.[18] Furthermore, it had restructured itself from an asset-heavy gas supplier to a lean "virtual" company that actively made markets and traded in natural gas, electricity, broadband services, and other energy-related products.[19] It was named the "Most Innovative Company in America" by *Fortune Magazine* each year from 1995 to 2000.[20] In January 2001, Enron was listed by *Fortune Magazine* as number twenty-two in a survey of the one hundred best companies to work for in America.[21] In 2000, Enron's chief executive officer (CEO), Kenneth Lay, was named the "second best Chief Executive Officer in the United States" (the first being Steve Ballmer of Microsoft).[22]

Enron's economic collapse into bankruptcy in November 2001 thus came as a total shock (except, presumably, for the handful of persons who were familiar with the reality of Enron's position). Enron's common stock had peaked at about $90 per share in 2000; thereafter, it had gradually declined to the range

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S.E.C. Is Suffering from Nonbenign Neglect, WALL ST. J., July 20, 2002, at C1. Filings had grown from 61,295 in 1991 to 98,745 in 2000, but the SEC staff had grown only from 125 to 161. *Id.* (citing a recent study by the General Accounting Office). There was also some relaxation of strict regulatory standards by the SEC during this period, indicating confidence in both the basic regulatory structure and the good faith of corporate management. *Cf.* Bratton, *Enron and the Dark Side*, *supra* note 13, at 1334–40 (reporting the tightening of regulatory standards and accepted auditing practices by the SEC following the collapse of Enron). Two important events that had significant adverse consequences on corporate governance were (1) the decision authorizing public accounting firms to sell management and tax services to companies at the same time they were providing auditing services, and (2) enactment of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 104 Stat. 737 (1995), and the Securities Litigation Uniform Standards Act, Pub. L. No. 105-357, 112 Stat. 3227 (1998), which placed significant roadblocks in the way of class action suits brought by plaintiffs claiming fraud or misconduct in connection with corporate transactions. *See* Edward A. Fallone, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71, 81–88 (1997) (describing the Reform Act).

17. Mitchell Pacelle & Rebecca Smith, *Enron's Lay Resigns as Chairman, CEO*, WALL ST. J., Jan. 24, 2002, at A3.

18. *The Five Hundred Largest U.S. Corporations*, FORTUNE, Apr. 16, 2001, at F-1.

19. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1288.

20. *Id*. at 1276 & n.2.

21. Robert Levering & Milton Moskowitz, *The 100 Best Companies to Work For*, FORTUNE, Jan. 8, 2001, at 148, 152.

22. April Witt & Peter Behr, *Dream Job Turns Into a Nightmare; Skilling's Success Came at High Price*, WASH. POST, July 29, 2002, at A01 (reporting that Skilling "had been Enron's chief executive all of two months" when *Worth* magazine released its rankings).

of $50 to $60 per share by summer 2001.[23] Even though its stock price had declined significantly, Enron remained a major player in the energy and California electricity markets and continued to record increases in earnings.[24] It also continued to pay huge salaries and bonuses to its officers and directors.[25]

However, there were symptoms of problems to come. Enron consistently used aggressive accounting principles to place its financial statements in the most positive light;[26] it had been classified by its accountant, Arthur Andersen, LLP, as a "maximum risk" client—meaning that it adopted and used the most aggressive permissible accounting principles.[27] However, Enron was Andersen's second biggest client, and it turned out that Andersen was itself conflicted when dealing with Enron and did not take effective steps to avert a collapse.[28] In the year 2000, Andersen provided consulting services to Enron that totaled $27 million, an amount that was greater than the amount charged by Andersen for all its auditing services for Enron.[29] While Andersen questioned some of Enron's aggressive accounting principles, it ultimately acquiesced in several questionable accounting practices.[30] In addition, after Enron's collapse, Andersen directly participated in a document-shredding program for Enron documents that ultimately resulted in Andersen being convicted of obstruction of justice.[31]

For years, Enron had opaque financial statements that were at best difficult to understand and, at worst, impenetrable. The statements sometimes defied analysis by all but the most competent outside accounting experts. Enron had created more

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23. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1276, 1318.

24. *See id*. at 1278, 1288 (noting Enron's primary concentration in energy trading prior to its attempt in 2001 to leave the energy industry behind "to become a pure financial intermediary"); Rebecca Smith & John R. Wilke, *Leading the News: Enron Ex-Trader Admits to Fraud in California Crisis*, WALL ST. J., Oct. 18, 2002, at A3 (noting Enron's role in the manipulation of California's electricity market).

25. Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers $681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002, at B1 [hereinafter Kranhold & Pacelle, *Top Managers*].

26. *See, e.g.*, Bratton, *Enron and the Dark Side*, *supra* note 13, at 1305–16 (detailing Enron's financial manipulations).

27. *See* SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 18 (Comm. Print 2002) [hereinafter ENRON'S COLLAPSE], *available at* http://www.gpo.gov/congress/senate/senate12lp107.html (last visited Mar. 14, 2003).

28. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1348–51.

29. *Id*. at 1349. In 2000, Enron paid Andersen about $25 million for accounting services. *Id*.

30. *See* ENRON'S COLLAPSE, *supra* note 27, at 17–20.

31. Mary Flood & Tom Fowler, *Andersen, or What's Left, to Learn Its Penalty Today; Large Fine Possible in Obstruction Case*, HOUS. CHRON., Oct. 16, 2002, at 1B.

than two thousand separate business entities[32] and actively entered into transactions with many of them. Many were special purpose entities (SPEs) that were created to hold assets and liabilities of Enron but were not to be included in Enron's financial statements.[33] As described graphically in the more than fifteen studies that discuss the reasons for Enron's collapse,[34] essentially these SPEs permitted Enron to place significant liabilities in the accounts of the SPEs and not in its own financial statements;[35] at the same time Enron included revenues from the very same transactions in its own profit and loss statements.[36]

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32. *See* ENRON CORP., 10-K (filed with the SEC on April 2, 2001) (listing Enron's various subsidiaries), *available at* http://www.enron.com/corp/investors/ (last visited Mar. 13, 2003). Enron routinely used fanciful names for its separate entities including JediCapital, Big Doe, Sundance, Little River, Yosemite, OB-1, Peregrine, Kenobe, Braveheart, Mojave, Chewco, Condor, Osprey, Zenith, Egret, Caches, Big River, and Raptor. *Id.*

33. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1306–08.

34. *E.g.*, ENRON'S COLLAPSE, *supra* note 27, at 3; WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002), *available at* 2002 WL 198018; Margaret M. Blair, *Post-Enron Reflections on Comparative Corporate Governance* (Georgetown Univ. L. Ctr. 2002 Working Paper Series in Bus., Econ., & Regulatory L., Working Paper No. 316663, 2002), *available at* http://papers.ssrn.com/paper.taf?abstract_id=316663 (last visited Mar. 15, 2003); Bratton, *Enron and the Dark Side*, *supra* note 13, at 1275; Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure and Enron*, 89 CORNELL L. REV. (forthcoming 2003); Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* (Working Paper, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181 (last visited Mar. 15, 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 (2002); Steven L. Schwarcz, *Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures* (Duke L. Sch. Pub. L. & Legal Theory Research Paper Series, Research Paper No. 28, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=306820 (last visited Mar. 15, 2003); Symposium, *Panel Discussion: Enron: What Went Wrong?*, 8 FORDHAM J. CORP. & FIN. L. S1 (2002).

35. Andrew Fastow subsequently testified that about two-thirds of Enron's debts were not disclosed in its financial statements. *See* John R. Emshwiller, *Enron May Have Started Earlier on Its Off-Balance-Sheet Deals*, WALL ST. J., Sept. 30, 2002, at A3. The cited *Wall Street Journal* article discusses the "Cactus Hydrocarbon III Production Payment Trust," an SPE that was "part of a complex structure that appears to have held several hundred million dollars of off-balance-sheet debt. The documents describe Cactus III as a '$500+ million permanent funding facility.'" *Id.* (quotation marks omitted). An article in the *New York Times* the following day states that former Enron CFO Andrew Fastow received millions of dollars from Enron entities. Kurt Eichenwald, *Secret Deal Part of Tangle in Enron Case*, N.Y. TIMES, Oct. 1, 2002, at C1 [hereinafter Eichenwald, *Secret Deal*]. Fastow was later indicted for securities fraud in connection with these transactions. Rebecca Smith, *The Economy: Fastow, Former Enron Officer, Indicted by U.S.*, WALL ST. J., Nov. 1, 2002, at A2.

36. Ribstein, *supra* note 34, at 5.

This treatment permitted Enron to claim that its revenues and profits appeared to be increasing when in fact the company's financial position was declining.[37] Other transactions of questionable legality also occurred. Several high-level Enron executives entered into transactions with Enron on behalf of the SPEs that permitted millions of dollars of profits to be diverted from Enron and allocated to the executives personally rather than to Enron.[38] Other tactics that benefited Enron for a time seem plainly improper under any analysis. For example, loans to Enron from outside sources were booked as revenue, and then "churned" by transfers to and from SPEs and booked again as profits by both Enron and the SPEs, even though they took place at the same price and plainly had no effect on actual revenues.[39] Enron also manipulated California's electricity market in 2001 by submitting false data to the state's electric grid operation.[40]

Enron's time ran out in October 2001, when Enron was forced to restate its earnings and return to its own accounts many of the liabilities that had been hidden in the SPEs.[41] The result was that Enron reported a $500 million accounting loss and a $1.2 billion reduction in shareholder equity.[42] Within a few

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37. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1306–16.

38. *See* Eichenwald, *Secret Deal*, *supra* note 35 (reporting that Enron executives Andrew Fastow and Michael Kopper, among others, "schemed to use their influence over Enron and its partnerships to divert millions of dollars that belonged to the company into their own pockets").

39. Professor Lawrence A. Cunningham states that "Enron was essentially a Ponzi scheme, diabolically engineered and disguised by a few pathological fiends." Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 36 CONN. L. REV. (forthcoming 2003) (manuscript at 10) [hereinafter Cunningham, *Sarbanes-Oxley Yawn*] (B.C. L. Sch. Pub. L. & Legal Theory Research Paper No. 01, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337280 (last visited Feb. 17, 2003).

40. Timothy Belden, the former head of Enron's energy trading desk, has pleaded guilty to wire fraud. Smith & Wilke, *supra* note 24. Belden testified that he "was trying to maximize profit for Enron" and that, in doing so, he "deliberately submitted false data" to California's grid operator. *Id.*; *see also* John R. Wilke & Robert Gavin, *Brazen Trade Marks New Path of Enron Probe—Alleged Fraud Is Tied to Windfall Profits in 3 Western States*, WALL ST. J., Oct. 21, 2002, at C1 ("Mr. Belden's testimony is expected to lead to criminal charges against other former executives at Enron, and some of its trading partners.").

41. Accounting principles permitted transactions by SPEs to be excluded from the parent corporation's financial statement if third parties independently provided at least 3% of the necessary risk capital to fund the SPE. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1306–07. Enron placed shares of its own common stock with approximately the same market value in the SPE. *Id.* at 1308. It is doubtful that this constituted compliance with the 3% requirement, but in any event the value of Enron shares thereafter declined to the extent that it was clear the 3% requirement was not being met, and that the accounts of the SPE had to be combined with Enron's own accounts.

42. *See* Ribstein, *supra* note 34, at 4 (noting Enron's disclosure that it was taking "a

weeks thereafter, Enron shares had declined to less than one dollar per share, and Enron filed for bankruptcy reorganization.[43]

Shortly before Enron's bankruptcy filing, the company had distributed significant amounts of funds to favored corporate officers and employees. Kenneth Lay—the former CEO who had resigned a few months earlier—received at least $67.4 million, and numerous other senior directors and officers received payments of more than $10 million each.[44] Still others received "retention bonuses" of more than a million dollars each to assure they would remain with Enron.[45] Deferred compensation plans for Enron's senior executives were structured so that about forty top employees received their entire deferred compensation in cash shortly before Enron's bankruptcy filing—an option that was not available to lower-level employees.[46] It was subsequently reported that, overall, Enron paid out $681 million in cash payments and stock awards to its senior officers and executives in the period between its restatement of earnings and its bankruptcy filing.[47]

Not surprisingly, these payments created outrage on the part of lower-level Enron employees who were offered severance

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half-billion dollar after-tax charge against earnings and $1.2 billion reduction of shareholders' equity"). The probe of the collapse of Enron focused originally on the role of accountants and securities analysts. In August 2002, however, the focus shifted to the role of financiers and financial companies. Three major financial firms—Citigroup Inc., J.P. Morgan Chase & Co., and Merrill Lynch & Co.—apparently provided financing to Enron that enabled it to hide debt in its accounts and thereby mislead investors. Paul Beckett et al., *Enron Probe Shines Harsh Light on Financiers*, WALL ST. J., Aug. 13, 2002, at C1. J.P. Morgan announced that it planned to create a Policy Review Office specifically to consider proposed transactions in light of potential risks to the bank's reputation. Jathon Sapsford, *J.P. Morgan to Review Deals for Risks to Bank's Reputation*, WALL ST. J., Aug. 13, 2002, at C5. For a description of a complex transaction with Merrill Lynch involving the sale and subsequent repurchase of Nigerian barges that operated as floating power stations, see Beckett et al., *supra*. A former Merrill Lynch employee declined to answer questions about this transaction at a Senate hearing, invoking his Fifth Amendment privilege against self-incrimination. *Id*.

43. Bratton, *Enron and the Dark Side*, *supra* note 13, at 1276–77; *see also* John R. Emshwiller & Kathryn Kranhold, *A Year Later, Enron Ex-CEO Skilling Is Awaiting His Fate*, WALL ST. J., Aug. 14, 2002, at C1. Mr. Skilling, the principal architect of the makeover of Enron, resigned in August 2001. *Id*. In reviewing this history, "Donald P. Jacobs, former dean of Northwestern University's Kellogg School of Business and a governance watcher. . . . [somewhat ruefully commented,] 'We thought there had been an enormous increase in the quality of boards, but Enron has shaken the hell out of that confidence.'" *The Best and Worst Boards: How the Corporate Scandals Are Sparking a Revolution in Governance*, BUS. WK., Oct. 7, 2002, at 105.

44. Kranhold & Pacelle, *Top Managers*, *supra* note 25.

45. Kathryn Kranhold & Mitchell Pacelle, *About Those Big Enron Bonuses . . .*, WALL ST. J., June 12, 2002, at C1.

46. John D. McKinnon, *Senate Panel Will Vote on Executive-Pay Curbs*, WALL ST. J., Sept. 19, 2002, at A5.

47. Kranhold & Pacelle, *Top Managers*, *supra* note 25.

payments that were capped at $13,500 per employee.[48] To make matters even worse, many Enron employees had invested their 401(k) funds in Enron stock at the recommendation of the corporation.[49] However, Enron had locked down these accounts before the events described above were announced, so that lower-level employees who had faithfully invested 401(k) funds in Enron stock watched helplessly while their retirement funds steadily declined in value.[50] During this period, newspapers and television reports unfavorably contrasted the generous retention bonuses being received by upper-level officers and employees with the treatment being accorded lower-paid employees.[51]

In September 2002, the court-appointed examiner in the Enron bankruptcy filed his initial report.[52] The report concluded that some executives at Enron "worked to disguise the company's true condition in filings with the [SEC] through complex financing deals involving the partnerships and banks."[53] Nearly a third of Enron's reported income came from misclassification of transactions as revenues.[54] For example, Enron routinely treated as revenues from operations funds that had actually originated as loans made by banks to partnerships set up by Enron.[55]

Shortly thereafter, Enron's former Chief Financial Officer (CFO), Andrew Fastow, was indicted on fraud, money laundering, and conspiracy charges.[56] Fastow had been directly

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48. *See* David Barboza, *Enron Agrees to Increase Severance by $30 Million*, WALL ST. J., June 12, 2002, at C11.

49. The practice of encouraging employees to place their retirement funds in the employer's stock is quite common. In 1998, about 39% of all 401(k) assets in public firms were tied up in company stocks. *See* Jonathan Weisman, *Efforts to Restrict Retirement Funds Lose Steam; Indignation Wanes as Congress Considers Limits on Company Stock Holdings*, WASH. POST, Sept. 7, 2002, at A01. Following the collapse of Enron, Congress proposed amendments to section 401(k) that would restrict overinvestment in employers' stock. *Id*. However, strong opposition both by industry and the U.S. Chamber of Congress has apparently blunted this effort, despite the fact that studies show employees often fail to diversify their retirement investments because the employer encourages investment in its own stock as a matter of loyalty and as a vote of confidence by the employees. *Id*.

50. *Deals & Deal Makers: SEC Offers Rules on Disclosing Earnings*, *Deals*, WALL ST. J., Oct. 31, 2002, at C4. In late October 2002, the SEC announced that it proposed to bar employees from selling stock during any "blackout" period that barred sales from retirement plans by rank and file employees. *Id*.

51. Joann S. Lublin, *As Their Companies Crumbled, Some CEOs Got Big-Money Payouts*, WALL ST. J., Feb. 26, 2002, at B1.

52. Kurt Eichenwald, *The Findings Against Enron: Many Avenues Are Seen for Criminal Investigators*, N.Y. TIMES, Sept. 23, 2002, at C1. As described by the examiner, many transactions entered into by Enron constituted violations of generally accepted accounting principles. *Id*.

53. *Id*.

54. *Id*.

55. *Id*.

56. Alexei Barrionuevo et al., *Leading the News: Enron's Fastow Charged with*

involved in many of the transactions between Enron and the "special-purpose" and similar entities.[57]

III. THE COLLAPSE OF THE DOT-COM AND TELECOM "BUBBLES"[58]

The Enron debacle was merely the first of several massive shocks that rolled through the U.S. economy within a very brief period. At the same time, two other huge business areas were in a virtual state of collapse: the "dot-coms" and the telecommunications industry. The 1990s had been an unprecedented boom period for telecommunications and, in retrospect, the 1996–2000 period was clearly a traditional securities market "bubble" for that industry that burst in 2001. The dot-coms disappeared more quietly, but it is clear with the cruel benefit of hindsight that the hopes and expectations of investors in both of these areas bore little relation to reality. They also might be described as classic examples of "irrational exuberance" (to use Alan Greenspan's description).[59]

The dot-com bubble cratered first.[60] In the 1980s and 1990s, venture capital firms had invested in a wide variety of Internet businesses that competed directly with traditional brick-and-mortar businesses by selling services and products to consumers.[61] With the exception of Amazon.com, e-Bay, and a

Fraud, WALL ST. J., Oct. 3, 2002, at A3.

57. *Id*. The SEC has also filed "its own enforcement action seeking to recover millions of dollars of gains from Mr. Fastow." David Barboza, *From Enron Fast Track to Total Derailment*, N.Y. TIMES, Oct. 3, 2002, at C3.

58. There is some controversy as to whether the events discussed in Part III constitute a classic bubble or a simple (but systematic) failure of regulators to regulate. In a recent draft paper, Professor John C. Coffee Jr. speculates whether the failure of gatekeepers to "bark in the night" when it had become clear that massive fraud was occurring was because of relaxation of deterrence rules resulting from Supreme Court decisions and the Private Securities Litigation Reform Act, or because the market was suffering from a "classic bubble that overtook the equity markets in the late 1990's and produced a market euphoria in which gatekeepers became temporarily irrelevant." John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 BUS. LAW. 1403, 1412 (2002). Since July 2002, a number of commentators have referred to the events of this period as a "bubble," and, after all, what difference does it make what it is called?

59. Alan Greenspan, The Challenge of Central Banking in a Democratic Society, Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research (Dec. 5, 1996), *available at* http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm (last visited Jan. 19, 2003).

60. William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 891 n.1 (2002) ("In the first seven months of 2001, 367 internet companies went out of business, and nearly 83,000 dot-com employees were laid off.").

61. *See, e.g.*, Stephanie N. Mehta, *Drop in Returns Is Expected for Venture-Capital Firms*, WALL ST. J., Nov. 19, 1996, at B2 (noting venture capitalists' continued interest in financing Internet companies). Dot-com companies failed for a variety of reasons. Some had no visible business plan at all; others planned to earn revenues solely by selling ads

handful of other companies, dot-com businesses found it impossible to survive in the increasingly competitive marketplace, and they quietly began to disappear in 2000 as funding was exhausted and venture capital assistance was withheld.[62]

The collapse of the telecommunications ("telecom") industry was much more devastating economically than the collapse of the dot-coms. The telecom industry had been basically deregulated by 1986 after the old AT&T monopoly was broken up.[63] Almost immediately thereafter, money began to "pour[] into the industry . . . . as companies rushed to [install] ultra-fast fiber-optic networks" to carry what was expected to be a tremendous growth in electronic communication.[64] A retrospective *Wall Street Journal* article, commenting on the fallacy that Internet traffic was doubling every three months, describes what actually happened:

> The belief that Internet traffic could grow so quickly—if true, it would have meant annual growth of more than 1,000%—led more than a dozen companies to build expensive networks as they rushed to claim a piece of the next gold rush. The statistic sprouted up in reports by industry analysts, journalists and even government agencies, which repeated it as if it were the gospel truth. "Internet traffic," the Commerce Department said in a 1998 report, "doubles every 100 days."
>
> Except that it didn't. Analysts now believe that Internet traffic actually grew at closer to 100% a year, a solid growth rate by most standards but one that was not nearly fast enough to use all of the millions of miles of fiber-

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that were to be placed on the Internet; and still others adopted business plans that over-estimated the willingness of individuals to purchase professional services and products sight-unseen through the Internet. *See, e.g.*, David P. Hamilton & Mylene Mangalindan, *Angels of Death: Reality Bites Hard as String of Dot-Coms Sees Funding Dry Up*, WALL ST. J., May 25, 2000, at A1 (discussing a dot-com's failure to convince consumers to purchase its online offerings of household and personal items); Jonathan Weil, *Heard on the Street: "Going Concerns": Did Accountants Fail to Flag Problems at Dot-Com Casualties?*, WALL ST. J., Feb. 9, 2001, at C1 (highlighting a failed dot-com's business plan that resulted in more than $55 million in advertising expenditures but only $5.8 million in revenue).

62. At the same time, some venture capital firms continued to make calls on their investors for additional funds with respect to continuing ventures. *See* Lisa Bransten, *Deals and Deal Makers: Venture-Capital Investors Look for Exit Signs*, WALL ST. J., Aug. 7, 2002, at C1. Investors who fail to meet calls face the possible loss of their current investment. *Id*.

63. Yochi J. Dreazen & Rebecca Blumenstein, *Familiar Ring: How Effort to Open Local Phone Markets Helped the Baby Bells*, WALL ST. J., Feb. 11, 2002, at A1.

64. Rebecca Blumenstein, *Lives on Hold: As It Deepens, Telecom Bust Is Taking a Heavy Human Toll*, WALL ST. J., Aug. 19, 2002, at A1.

> optic lines that were buried beneath streets and oceans in the late-1990s frenzy. Nationwide, only 2.7% of the installed fiber is actually being used, according to Telegeography, Inc. Much of the remaining fiber—called "dark fiber" in industry parlance—may remain dormant forever.
>
> That capacity glut has sent bandwidth prices plummeting an average of 65% each of the last two years. It also has led most of the long-haul data-transmission companies to file for Chapter 11 bankruptcy protection. . . .
>
> "This was the clincher, the myth that justified all of the other excesses of the dot-com era," says Andrew Odlyzko, a researcher at the University of Minnesota who was among the first to question the statistic. "The times were good, so why question it? No one wanted to acknowledge that the emperor had no clothes."
>
> The issue isn't simply a matter of setting the historical record straight. The amount of unused capacity is so vast that it will be virtually impossible for any new fiber company, no matter how good its technology or business plan, to raise funds in the foreseeable future.[65]

Thus the collapse was inevitable, and when it came, it came with resounding force:

> Perhaps never before has the efficiency of an industry's technology gotten so far ahead of demand, creating a glut of capacity that will take years to work off—and crippling dozens of companies in the process.
>
> Scientists perfected once-exotic methods for cheaply sending vast amounts of voice and data, such as Internet traffic, over fiber-optic lines. These advances far exceeded the pace of telephone-industry innovation in the 100 years before it. Prior to 1995, telecom carriers could send the equivalent of 25,000 one-page e-mails per second over one fiber-optic line. Today, they can send 25 million such e-mails over the same fiber strand, a 1,000-fold increase. Yet the cost of making that upgrade rose by just a few times over the 1995 price, and in some instances actually declined.
>
> The gap between the capacity of long-distance phone networks and demand is now so great that even if all the Internet traffic among the top 20 U.S. cities were routed

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65. Yochi J. Dreazen, *Telecom Carriers Were Driven by Wildly Optimistic Data on Internet's Growth Rate*, WALL ST. J., Sept. 26, 2002, at B1.

> through Chicago, only one-quarter of that city's available capacity would be used, estimates research house Telegeography, Inc.[66]

During the period of expansion, carriers spent billions of dollars building networks without any assurance that market demand would ever grow to the point that systems would be profitable.[67] Furthermore, new players on the telecom scene such as WorldCom, Inc. and Global Crossing, Ltd. were actively acquiring existing telecommunications systems and combining them into huge national systems.[68] During this period of uncontrolled growth, it has been estimated that the number of telecom jobs doubled from 45,000 to 90,000 in the period between 1995 and 2000.[69]

By early 2001, it had become evident that the telecom industry was not growing as fast as originally predicted and that overcapacity would be a problem for some time to come.[70] At that point, investment in telecom facilities ceased, and the bubble burst dramatically, involving the loss of literally billions of dollars.[71] More than half a million telecom workers have been laid

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66. Dennis K. Berman, *Behind the Fiber Glut: Innovation Outpaced the Marketplace*, WALL ST. J., Sept. 26, 2002, at B1.

67. Sam Ames, *Is Fiber-Optic Construction Creating Overkill?*, CNET NEWS.COM, June 21, 2001, *at* http://news.com.com/2100-1033-268859.html?legacy=cnet (last visited Mar. 15, 2003).

> Many industry observers believe that less than 5 percent of the fiber put in the ground is in use. Future applications and new Internet users may one day fill these networks, but for now most experts say they will handle only a fraction of their capacity.
>
> Making matters worse for carriers, the lack of network traffic has forced them to cut prices for use of their networks.
>
> . . . [A] connection running at 155 megabits per second from Los Angeles to New York cost about $45,000 a month last October. That price fell to $35,000 in March and is expected to slip to $2,450 in January 2002.
>
> Russ Matulich, senior vice president of sales at RateXchange, estimates . . . .
>
> "You could do all the world's long-distance with two or three strands of fiber, and there's thousands of strands in the ground" now . . . .

Id.

68. *See, e.g.*, Rebecca Blumenstein & Steven Lipin, *MCI WorldCom, Sprint Ponder Merger: The Talks Have Picked Up, Though Deal Still Faces Significant Obstacles*, WALL ST. J., Mar. 13, 2003, at A3 (reporting WorldCom's plans to acquire Sprint in order to "boost its heft [in] the global telecommunications industry"); Stephanie N. Mehta, *Technology Journal: Global Crossing Confirms Plans to Buy Frontier*, WALL ST. J., Mar. 18, 1999, at B4 (reporting Global Crossing's plans to acquire Frontier Corp. "in a bid to create an international telecommunications network to rival those of industry giants such as AT&T Corp. and MCI WorldCom Inc.").

69. Blumenstein, *supra* note 64.

70. *See* Steve Pearlstein, *Too Much Supply, Too Little Demand; Businesses Have Few Incentives to Expand or Hire, Economists Say*, WASH. POST, Aug. 25, 2002, at A01.

71. *See, e.g.*, Gregory Zuckerman & Deborah Solomon, *Wrong Numbers: Telecom*

off.[72] There appears to be little prospect that the bulk of funds invested in this nascent industry will ever be recovered.[73] In addition, thousands of skilled workers who were attracted to the new electronic technology have been laid off with limited opportunity to find equivalent jobs.[74]

Much of the accounting in the telecom industry also turned out to be questionable. Between January and June 2002, at least 112 telecom companies were required to restate prior earnings even though public accounting firms had originally given clean bills of health to over 93% of them.[75] In July 2002, Alan Greenspan publicly predicted that even more accounting problems would surface.[76]

IV. THE COLLAPSE HAD WINNERS AS WELL AS LOSERS

Not everyone suffered from the collapse, however. As was the case with Enron, many executives had become aware that the telecom industry was heading for trouble and sold billions of dollars worth of their own shares before the collapse came. For example, Qwest Communications International announced in 2002 that its executives had made about $500 million by selling Qwest shares in the period from 1999 to 2001.[77] One former CEO

Debt Debacle Could Lead to Losses of Historic Proportions, WALL ST. J., May 11, 2001, at A1 (noting the "unprecedented" billions of losses); *cf.* Steven Rosenbush et al., *Scandals in Corporate America*, BUS. WK., Aug. 5, 2002, at 34 (estimating losses as high as $2 trillion as of mid-2002).

72. *See* Jeffrey A. Eisenach, *The Real Telecom Scandal*, WALL ST. J., Sept. 30, 2002, at A16. This article states that these layoffs were "the most" in any industry and, as a result, "once-great companies like Lucent and Nortel have been brought to their knees." *Id*.

73. *But cf.* Dennis K. Berman et al., *Telecom Glut Could Linger as Failed Networks Are Rescued*, WALL ST. J., Aug. 14, 2002, at B1. This article suggests that as companies go through the bankruptcy process, "and the massive debt they incurred to build their lines is wiped away [in bankruptcy], they are in a much stronger position to compete on pricing." *Id*. (quotation marks omitted). Nonetheless, the consequence will apparently be continuing serious financial problems within this industry for many years to come. *See id*.

74. Yuki Noguchi, *Ready to Work, Nowhere to Go; Laid-Off Telecom Workers Stranded by Industry's Fall*, WASH. POST, Nov. 4, 2002, at E01.

75. This datum presumably reflects the fact that several Wall Street firms continued to recommend securities as "buys" or "strong buys" even when it was general knowledge that the companies were having significant financial problems.

76. Michael M. Phillips, *Fed Chief Sees More Profit Revisions: Greenspan Doesn't Expect the U.S. Economy to Suffer, Citing Productivity Growth*, N.Y. TIMES, July 18, 2002, at A2. He suggested that "most business executives will be more scrupulous in their accounting, at least for the moment," stating that "'[t]he trouble, unfortunately, is that the shock of what has happened will keep malfeasance down for a while, ... [b]ut human nature being what it is—and memories fade—it will be back.'" *Id*. (quoting Federal Reserve Chairman Alan Greenspan).

77. David Leonhardt, *Qwest Leaders Unloaded Stock as Books Cooked*, HOUS. CHRON., July 30, 2002, at 1B.

alone had made about $227 million; Qwest's largest single shareholder (a member of Qwest's board of directors but not an officer) had made almost $1.5 billion by selling his shares in May 1999.[78]

An August 12, 2002 story in the *Wall Street Journal*[79] provides a more modest example. It describes how Vincent Galluccio, a fifty-seven-year-old European executive and telecom network builder, left his company in 2000, well before the collapse, and liquidated his stockholdings for about $27 million.[80] He used the proceeds to buy a "160-acre winery known for its Chardonnays."[81] The article continues:

> The telecommunications industry, once a safe stock haven for "widows and orphans," became a gigantic poker game during the late 1990s, a competitive, high-growth business drawing billions of dollars of fresh capital. Supported by bullish Wall Street analysts and investment banks eager to reap big stock-offering fees, industry executives helped the pot grow bigger and bigger with talk of telecom's endless growth possibilities. Then, by the hundreds, they folded their hands at what turns out to have been the peak.
>
> Starting in 1997, telecom insiders directly cashed out over $14.2 billion in shares . . . . Add in shares sold by venture capitalists, executives' trusts and private investment vehicles, and the number soars to roughly $18 billion.[82]

On August 25, 2002, the *New York Times* published a list of the one hundred largest telecom "bubble beneficiaries"[83]—individual executives and corporate insiders of telecom companies that had successfully "cashed out" before the collapse. The five largest sellers and their profits from sales of company stock were listed as follows:

Philip F. Anschutz, Qwest, $1,453,000,000;

John C. Malone, AT&T, $340,151,649;

78. *Id.*

79. Dennis K. Berman, *Dialing for Dollars: Before Telecom Industry Sank, Insiders Sold Billions in Stock*, WALL ST. J., Aug. 12, 2002, at A1.

80. *Id.*

81. *Id.*

82. *Id.*

83. David Leonhardt, *Bubble Beneficiaries*, N.Y. TIMES, Aug. 25, 2002, at B10. The sources of this information are stated to be "Thompson Financial" and "the companies." *See id.*

Kevin N. Kalkhoven, JDS Uniphase, $245,910,906;

Joseph P. Nacchio, Qwest, $226,700,000; and

John T. Chambers, Cisco Systems, $223,479,300.[84]

The twelve top sellers each received over $100 million from sales of their company's stock.[85] The ninety intermediate names on the list—those neither in the top five nor the bottom five—had profits ranging from nearly $200 million down to a little over $10 million.[86] If one goes to the bottom of the list, from the ninety-fifth to the one hundredth top seller, the list is as follows:

Betsy J. Bernard, Qwest, $10,600,000;

Bruce D. Day, JDS Uniphase, $10,307,160;

Kevin J. O'Hara, Level 3 Communications, $10,288,102;

James F. Gibbons, Cisco Systems, $10,060,154; and

Blake O. Fisher, Jr., McLeodUSA, $9,554,985.[87]

Most, if not all, of the one hundred sellers in this list were disposing of shares they had acquired through stock grants or options received from their corporations for virtually nothing at the height of the telecom boom.[88] The principal losers were tens of thousands of small individual investors who wrongly assumed that the telecom industry would be the wave of the future and continued to purchase telecom shares during the "bubble."[89]

This "massive transfer of wealth"[90] from small investors to telecom officers and directors must surely be one of the greatest transfers of wealth that ever occurred over a three and one-half year period during a time of peace.

V. THE STORY OF FIVE TELECOMS

In addition to taking advantage of trusting individual investors, the telecom industry engaged in a fair amount of fraud

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84. *Id*.
85. *Id*.
86. *Id*.
87. *Id*.
88. Gretchen Morgenson, *Deals Within Telecom Deals: For Companies, Contracts. For Executives, Stock.*, N.Y. TIMES, Aug. 25, 2002, § 3, at 1.
89. Gretchen Morgenson, *Telecom, Tangled in Its Own Web*, N.Y. TIMES, Mar. 24, 2002, § 3, at 1 ("[S]ome $1.4 trillion in investor wealth has evaporated . . . .").
90. *Id*. (quotation marks omitted) (quoting Paul Elliott, a financial analyst).

and dishonest accounting designed to preserve high stock prices as long as possible. The summaries that follow describe what was done by five telecom companies to preserve high stock prices while their officers, directors, and large shareholders disposed of their shares.

A. WorldCom, Inc.

The first significant public indication of problems in the telecom industry arose in connection with the corporation known as WorldCom. The original developer, Bernard Ebbers, began his career as the owner of a small chain of budget hotels.[91] He funded a local telecommunications company in 1983 called LDDS Communications.[92] Shortly thereafter, he launched a campaign to acquire other companies in the telecom industry, often using the stock of WorldCom as currency.[93] By 2000, he had completed about sixty-five acquisitions,[94] and by 2002, WorldCom reported it had more than $107 billion in assets.[95] Ebbers often intentionally "wrote down" the value of acquired properties to create a secret supply of potential earnings—"cookie jar reserves," as they are sometimes called—that were available to give a boost to earnings if things began to lag.[96]

On October 1, 1997, WorldCom purchased MCI Communications Corporation for $30 billion in WorldCom stock and the assumption of $5 billion in debt.[97] Shortly thereafter, Ebbers offered to purchase Sprint for $129 billion, mostly in WorldCom stock.[98] However, the Department of Justice nixed the Sprint deal under the antitrust laws.[99] Despite this setback, the value of WorldCom stock remained relatively stable until April 2002, when WorldCom unexpectedly announced that it was laying off 4% of its workforce and reducing its revenue projections for the year.[100] On April 30, 2002, it was announced

91. Kurt Eichenwald, *For WorldCom, Acquisitions Were Behind Its Rise and Fall*, N.Y. TIMES, Aug. 8, 2002, at A1 [hereinafter Eichenwald, *WorldCom Acquisitions*].

92. *Id.*

93. *Id.*

94. *Id.*

95. *See* Simon Romero & Riva D. Atlas, *Extra Level of Scrutiny in WorldCom Bankruptcy*, N.Y. TIMES, July 23, 2002, at C1 [hereinafter Romero & Atlas, *Extra Level of Scrutiny*].

96. Eichenwald, *WorldCom Acquisitions*, *supra* note 91.

97. *Id.*

98. Randall Smith & Deborah Solomon, *Heard on the Street: Ebbers's Exit Hurts WorldCom's Biggest Fan*, WALL ST. J., May 3, 2002, at C1; *Sorry, Wrong Number: Endgame*, WALL ST. J., June 27, 2002, at A12.

99. Eichenwald, *WorldCom Acquisitions*, *supra* note 91.

100. Shawn Young, *WorldCom Plans to Cut 3,700 Jobs from Core Unit*, WALL ST. J.,

that Ebbers had resigned as CEO under pressure from the WorldCom board of directors.[101]

In June 2002, WorldCom announced that it had overstated earnings by $3.8 billion in prior years by the simple expedient of treating certain expense items as capital investments.[102] The resulting restatement of earnings dwarfed the Enron debacle and, at the time, was the largest restatement ever announced by an American company.[103] The announcement also had the effect of reducing WorldCom common stock to "junk" status, as its stock dropped below one dollar per share[104] (even though it was announced at the same time that WorldCom still had assets worth $107 billion).[105] Based on a further internal review within WorldCom, the restatement was increased by the discovery of new expense items that had been improperly classified as revenue, adding more than $3 billion to the downward restatement.[106] On July 21, 2002, WorldCom filed for bankruptcy reorganization under Chapter 11.[107] On November 5, 2002, the SEC filed additional fraud charges against WorldCom, stating that the company had "inflated earnings by almost $2 billion more than it had previously disclosed in accounting manipulations."[108] In addition, the SEC added a charge relating

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Apr. 4, 2002, at B8; *see also Sorry, Wrong Number: Endgame*, *supra* note 98 (reporting that later in April 2002, WorldCom "planned to lay off as much as 10% of its 75,000 workforce").

101. Rebecca Blumenstein & Jared Sandberg, *WorldCom CEO Quits Amid Probe of Firm's Finances*, WALL ST. J., Apr. 30, 2002, at A1. On June 26, 2002, WorldCom also announced that it had dismissed its longtime CFO. Jared Sandberg et al., *WorldCom Admits $3.8 Billion Error In Its Accounting*, WALL ST. J., June 26, 2002, at A1.

102. Susan Pulliam, *WorldCom Memos Suggest Plan to Bury Financial Misstatement*, WALL ST. J., July 9, 2002, at A8; *see also* Kurt Eichenwald & Simon Romero, *Inquiry Finds Effort at Delay at WorldCom*, N.Y. TIMES, July 4, 2002, at C1 (suggesting that the former CFO at WorldCom urged an internal auditor to postpone an audit so that WorldCom could quietly take a write-off and thereby avoid an announcement of its accounting problems).

103. *See* Jared Sandberg et al., *WorldCom Investigations Shift Focus to Ousted CEO Ebbers*, WALL ST. J., July 1, 2002, at A1 ("Already, WorldCom's planned accounting restatement is among the largest in U.S. history, six times as large as that of Enron Corp."); *cf.* Susan Pulliam & Jared Sandberg, *WorldCom to Revise Results Again: New Findings Could Add $2 Billion to Restatement Disclosed This Summer*, WALL ST. J., Sept. 19, 2002, at A3 (indicating that the $7 billion in accounting problems originally disclosed in summer 2002 "was already the largest accounting fraud ever").

104. Rebecca Blumenstein et al., *Questioning the Books: MCI, a Company with a Cause, Has Reputation Hurt by Scandal*, WALL ST. J., June 28, 2002, at A9.

105. Romero & Atlas, *Extra Level of Scrutiny*, *supra* note 95.

106. Pulliam & Sandberg, *supra* note 103.

107. Jessica Hall, *WorldCom Files Chapter 11 Bankruptcy*, REUTERS, July 22, 2002; Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1.

108. Kurt Eichenwald & Seth Schiesel, *S.E.C. Files New Charges on WorldCom*, N.Y. TIMES, Nov. 6, 2002, at C1. On the same day, Richard L. Thornburgh, examiner of the

to the "cookie jar" reserves.[109] Given its remaining assets, it is still possible that WorldCom may ultimately emerge from bankruptcy as a much smaller enterprise.

In July 2002, the Congressional House Financial Services Committee requested that Ebbers and former WorldCom CFO Scott Sullivan appear before the Committee to testify about the relationship of Arthur Andersen, LLP with the collapse of WorldCom.[110] Both refused to testify, invoking their Fifth Amendment right to avoid self-incrimination.[111] On August 2, 2002, Sullivan and another senior WorldCom executive, David F. Myers, were arrested and charged with securities fraud, conspiracy to commit securities fraud, and making false statements to the SEC between May 2001 and May 2002.[112] The complaint alleged that the two defendants had directed that transfers of funds be made to preserve the appearance of profitability, and that in fact WorldCom's public balance sheet bore almost no relation to the actual financial condition of the company.[113] One allegation was that in April 2001, Sullivan had directed Myers to order employees in WorldCom's general accounting department to transfer about $771 million in "line cost" expenses to property, plant, and equipment accounts.[114] Apparently, these transactions were concealed from WorldCom's outside auditor, Arthur Andersen, LLP.[115]

B. Adelphia Communications Co.

The early history of Adelphia is in some ways similar to that of WorldCom. John Rigas operated a movie theater in the small town of Coudersport, Pennsylvania.[116] In 1952, he purchased the local cable franchise and then acquired additional suburban cable

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federal bankruptcy court proceeding, filed a report saying that corporate executives were able to engage in sweeping manipulation transactions "because of a complete breakdown in the controls and oversight at the company." *Id.*

109. *Id.*

110. Simon Romero & Floyd Norris, *2 Former WorldCom Executives Refuse to Testify to Congress*, N.Y. TIMES, July 9, 2002, at C1.

111. *Id.*

112. Mark Hamblett, *WorldCom Executives Arrested, Charged with Massive Fraud*, N.Y. L.J., Aug. 2, 2002, at 1. In September 2002, Myers pleaded guilty to a fraud charge. Deborah Solomon, *WorldCom's Ex-Controller Pleads Guilty to Fraud*, WALL ST. J., Sept. 27, 2002, at A3.

113. Hamblett, *supra* note 112.

114. *Id.*

115. *Id.*

116. Jerry Markon & Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges*, WALL ST. J., July 25, 2002, at A3.

operations as they became available.[117] By the year 2000, Rigas and his two sons, Timothy and Michael, had built the company into the nation's sixth-largest cable operation,[118] with primary systems in upstate New York and the Los Angeles area.[119] Expansion occurred particularly rapidly in 1999; the number of cable subscribers in that year alone doubled to more than five million.[120] On March 27, 2002, however, Adelphia announced that the company had "hidden" $2.3 billion of "off-balance sheet debt," an announcement that caused the price of Adelphia stock to collapse and NASDAQ to delist the stock.[121]

On June 11, 2002, the company announced that it had overstated revenues and cash flow by another $500 million over the previous two years.[122] Following this announcement, two of the new board members resigned, stating that the "ongoing serial disclosures of wrongdoing" at Adelphia "have made it impossible to contribute meaningfully to the process."[123] Shortly thereafter, the company announced that Deloitte & Touche LLP had been dismissed as its auditor because it was "aware" of transactions between the company and the family-controlled entities that had not been disclosed to the new board members.[124]

On July 24, 2002, John Rigas, his two sons, and two non-related officers were arrested and charged with looting the company.[125] They were charged with bank, securities, and wire

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117. *Id*.

118. *See Adelphia to Acquire GS Communications in Cable-Systems Deal*, WALL ST. J., June 14, 2000, at A10.

119. Andrew Ross Sorkin, *Founder of Adelphia and 2 Sons Arrested*, N.Y. TIMES, July 25, 2002, at C1.

120. Markon & Frank, *supra* note 116. *But cf.* Deborah Solomon, *Adelphia Overstated Cash Flow, Revenue Over Past Two Years*, WALL ST. J., June 11, 2002, at B5 (reporting later disclosures that Adelphia had inflated some of its cable-television subscriber numbers).

121. *Id*.

122. Deborah Solomon, *Adelphia Overstated Cash Flow, Revenue Over Past Two Years*, WALL ST. J., June 11, 2002, at B5.

123. *Id*.

124. *Id*.; *see also Business Briefs: Nation & World*, HOUS. CHRON., Nov. 7, 2002, at 2C (suggesting Adelphia's reason for dismissal of Deloitte & Touche as indicated in its legal claim against the firm).

125. Sorkin, *supra* note 119. Also arrested and charged were the former vice president of finance and the former director of internal reporting. Jerry Markon, *Companies: Five Adelphia Officials Arrested; Three in the Rigas Family and Two Other Executives Are Charged with Fraud*, WALL ST. J. EUR., July 25, 2002, at A4. The SEC subsequently filed civil charges against the five men, as well as a third brother, James Rigas, alleging falsification of statistics, inflation of earnings, and "rampant self-dealing." Press Release, U.S. Securities and Exchange Commission, Litigation Release No. 17627 (July 24, 2002), *available at* http://www.sec.gov/litigation/litreleases/lrl7627.htm (last visited Mar. 15, 2003).

fraud,[126] in effect operating a multibillion-dollar scheme to defraud investors and creditors. It was also alleged that the Rigases used company money for personal loans to buy stock, to build a $13 million golf course on land owned by John Rigas, and to provide African safari vacations for family members.[127] In June 2002, Adelphia filed for bankruptcy protection, listing $18.6 billion in debt.[128]

C. Qwest Communications International Inc.

Qwest, the dominant local telephone company in fourteen states from Minnesota to Washington, announced on July 28, 2002, that it would restate its financial results for the period between 1999 and 2001 because it had improperly booked $1.16 billion as current profits rather than capital investments.[129] The company also announced that it was cutting its revenue prediction for the following year by about $1 billion and writing down good will, or intangible assets, another $20 billion to $30 billion.[130] It also announced that it was in jeopardy of violating a stringent covenant in its bank loans.[131] Following these announcements, Qwest entered into settlement negotiations with the SEC; it also may face a criminal investigation by the Department of Justice.[132]

Joseph P. Nacchio, the former Qwest CEO, sold $230 million of Qwest stock before the value of the shares collapsed.[133]

Qwest generally is viewed as being probably the most aggressive of the companies that employed creative accounting strategies for swaps of communications capacity.[134] Enron and Global Crossing also systematically employed creative accounting

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126. Sorkin, *supra* note 119.

127. *Id*.

128. *Id*.

129. Jessica Hall, *Qwest Says Used Improper Accounting in 1999–2001*, REUTERS, July 29, 2002.

130. *Id*.

131. *Id*.

132. Susan Pulliam & Deborah Solomon, *Qwest Moves to Settle SEC Probe*, WALL ST. J., Aug. 1, 2002, at A3.

133. Simon Romero, *Global Crossing Head Offers Workers $25 Million*, N.Y. TIMES, Oct. 2, 2002, at C1 [hereinafter Romero, *Worker Offers*]. Nacchio testified at the same hearing at which Global Crossing chairman Gary Winnick announced his offer to donate $25 million to help Global Crossing employees. *Id.* Refer to note 145 *infra* and accompanying text (discussing Winnick's offer). Nacchio was later named as a defendant in a major lawsuit filed by New York State Attorney General Elliot Spitzer. Romero, *Worker Offers*, *supra*. Nacchio testified that he "sold shares based upon the advice of my financial advisers in order to diversify my holdings." *Id.*

134. *E.g.*, Pulliam & Solomon, *supra* note 132.

strategies for swaps of communications capacity.

D. Global Crossing, Ltd.

Global Crossing was founded in 1997 by Gary Winnick, a former junk-bond salesman for Drexel Burnham Lambert Inc.[135] "In four years, [he] had built an undersea phone network linking 27 countries and 200 cities. At its peak, [Global Crossing] had a market capitalization of $48 billion."[136] However, Winnick went through six CEOs in five years,[137] and the collapse of the telecom industry caused Global Crossing to file for bankruptcy court protection in January 2002, at which time it stated that it owed $12.4 billion to various creditors.[138] On June 24, 2002, the company admitted to shredding documents in February 2002. Although the SEC had requested the documents on February 4, the shredding was not ordered stopped until February 7, three days later.[139]

During Global Crossing's gravy days, Winnick made $735 million from sales of his personal holdings of Global Crossing stock.[140] He built a $95 million mansion in Los Angeles named "Casa Encantada."[141] However, unlike several other telecom entrepreneurs he did not invest his personal funds in the business.[142] Rather, when the stock price began to decline, he purchased "collars" to lock in the value of his Global Crossing shares when they were at or near their high point in value.[143] These "collars" preserved a significant portion of his shares' value when the market for Global Crossing stock collapsed.[144]

On October 1, 2002, Mr. Winnick announced that he would "write a check for $25 million to cover part of the retirement money several thousand employees lost when the stock collapsed."[145] Given the magnitude of Mr. Winnick's personal wealth, this announcement did little to improve his reputation.

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135. Dennis K. Berman & Henny Sender, *Winnick May Kick In Funds to Aid Global Crossing Rescue*, WALL ST. J., June 10, 2002, at A1.

136. *Id.*

137. *Id.*

138. Henny Sender, *Global Crossing Accepts Buyout Bid*, WALL ST. J., Aug. 12, 2002, at B4.

139. Simon Romero, *Global Is Said to Admit Files Were Shredded*, N.Y. TIMES, June 24, 2002, at C1.

140. Berman & Sender, *supra* note 135.

141. *Id.*

142. *Id.*

143. *Id.*

144. *See id.*

145. Romero, *Worker Offers*, *supra* note 133.

E. XO Communications, Inc.

XO Communications was a provider of Internet and long-distance phone service to small and midsize businesses, primarily in the Reston, Virginia area.[146] Like many other telecom companies, it borrowed large amounts of money "to build-out fiber and telecom networks for demand that never materialized."[147] It filed for Chapter 11 reorganization on June 17, 2002, and thereafter decided to close its doors.[148]

VI. NON-TELECOM EXAMPLES: TYCO INTERNATIONAL, IMCLONE, GENERAL ELECTRIC, AND XEROX

During 2001 and 2002, four other well-known and respected companies incurred significant negative publicity. These companies were neither dot-com nor telecom.

A. Tyco International, Ltd.

Tyco "grew from a sleepy industrial company into one of the world's most aggressive deal machines."[149] It acquired approximately seven hundred companies between 1998 and June 2002 "at prices ranging from several hundred thousand dollars to $9.5 billion."[150] Its diverse business interests were eclectic—they included such items as adult diapers, clothes hangers, and water hoses.[151] The driving force behind Tyco was Dennis Kozlowski, its CEO.[152]

Kozlowski unexpectedly resigned his CEO post on June 2, 2002, the day before he was indicted for evading more than $1 million in New York state sales taxes on art purchases.[153] It

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146. Kara Scannell, *XO Is Latest Telecom Company to File for Chapter 11 Protection*, WALL ST. J., June 18, 2002, at C9.

147. *Id.*

148. *Id.*; *cf. Did You Hear? . . .*, WASH. POST, Jan. 20, 2003, at E02 (reporting that XO emerged from Chapter 11 bankruptcy protection in January 2003 with "less debt and a new owner, Carl Icahn").

149. Robert Frank & Robin Sidel, *Overbought: Firms that Lived by the Deal in '90s Now Sink by the Dozens*, WALL ST. J., June 6, 2002, at A1.

150. *Id.*; William C. Symonds, *A To-Do List for Tyco's CEO*, BUS. WK., Aug. 12, 2002, at 37 (stating that Tyco's assets were worth approximately $36 billion, with approximately $12 billion in debt coming due within a little more than a year).

151. Frank & Sidel, *supra* note 149.

152. Mark Maremont & Laurie P. Cohen, *Executive Privilege: How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1.

153. *Id.* It was alleged that Kozlowski had attempted to avoid sales taxes through false invoices and falsely marking boxes shipped to his New Hampshire office as "empty." *See* John Schwartz, *Choosing Whether to Cover-Up or Come Clean*, N.Y. TIMES, July 1, 2002, at C1.

turned out that Kozlowski regularly used Tyco funds for various personal purchases and had received a $19 million non-interest bearing loan from his company for a new home in Florida.[154] Repayment of this loan was subsequently forgiven by Tyco's board of directors without advising its shareholders.[155] Shortly thereafter, Tyco reported a $2.32 billion loss for its fiscal third quarter,[156] a number that itself may have been based on questionable accounting.

On September 13, 2002, it was announced that both Kozlowski and Tyco's former CFO, Mark Swartz, had been indicted and charged with counts of grand larceny, enterprise corruption, and falsifying business records.[157] The potential penalty for these charges is thirty years in prison.[158] The indictment also charged the company's former general counsel with six counts of falsifying business records; he faces up to four years in prison.[159] Kozlowski was charged, among other things, with arranging to have his home purchased by Tyco for $4.5 million, about three times its market value.[160] He also billed Tyco $1 million for flowers, jewelry, clothing, and wine for his personal use.[161] Kozlowski and Swartz also were indicted on the additional charges of stealing more than $170 million from the company, mainly through unauthorized compensation paid to corporate officers.[162]

On September 25, 2002, another story in the *New York Times* suggested that Tyco had suffered a significant economic loss when it was forced to pay an above-market price for an 11% interest in a small company called "Flag Telecom," but had

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154. *See* Maremont & Cohen, *supra* note 152.

155. *Id*.

156. *Tyco Reports a Loss of $2.32 Billion for Quarter*, REUTERS, July 24, 2002.

157. Mark Maremont & Jerry Markon, *Former Tyco Executives Are Charged: New York Prosecutors Say Ex-CEO, Financial Officer Ran "Criminal Enterprise*,*"* WALL ST. J., Sept. 13, 2002, at A3.

158. *Id*.

159. *Id*. The former general counsel is described as "a high-profile [attorney] whose clients included the U.S. Senate's Iran-Contra committee, the National Association of Securities Dealers and former junk-bond king Michael Milken." Laurie P. Cohen, *Tyco's Former Top Lawyer Joins CEO on Hot Seat*, WALL ST. J., Sept. 13, 2002, at C1. He was charged with falsifying business records to conceal more than $14 million of personal loans he obtained from the company. *Id*. Former SEC Commissioner Joseph Grundfest commented that the indictment of a general counsel is "a unique event, much like a dog that doesn't bark," as accounting officers and not attorneys typically engage in such conduct. *Id*. (quotation marks omitted) (quoting Joseph Grundfest). The Sarbanes-Oxley Act contains a provision that requires lawyers to report evidence of violations of securities laws or breaches of fiduciary duty to the board of directors. *Id*.

160. Maremont & Markon, *supra* note 157 (reporting that the purchase was not disclosed to shareholders).

161. *Id*.

162. *Id*.

falsely claimed that the transaction generated a profit of $79.4 million.[163] That false claim was then used to justify bonuses to Kozlowski and Swartz.[164]

B. ImClone Systems, Inc.

ImClone, a publicly traded biotechnology company, had developed an anti-cancer drug, Erbitux, that it claimed held considerable promise in the fight against colorectal cancer.[165] The person behind ImClone (and the developer of Erbitux) was Samuel Waksal, a well-known immunologist and entrepreneur.[166] While Waksal had high hopes for Erbitux (and did not hesitate to publicize it at every opportunity), in December 2001 the Food and Drug Administration (FDA) decided to reject the company's application for marketing approval on the ground that the company had not adequately established the drug's effectiveness through clinical studies.[167]

Waksal was indirectly advised of this decision on December 25, 2001, by a senior official at Bristol-Myers Squibb Co.[168] On December 28, Waksal received the formal notice of decision; ImClone issued a press release later the same day.[169] However, Waksal had begun selling his own shares on December 26 and had advised numerous relatives and friends to sell their shares as well.[170] Predictably, the formal announcement of the FDA decision caused the value of ImClone stock to decline from about $70 per share to about $10 per share.[171] The losses avoided by

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163. Floyd Norris, *Tyco Took Profit on Bad Deal, Then Paid Bonuses to Executives*, N.Y. TIMES, Sept. 25, 2002, at C1.

164. *Id.*

165. *See* Andrew Pollack, *Ex-Chief of ImClone Refuses to Testify to Congress About Testing of Drug*, N.Y. TIMES, June 14, 2002, at C1 (citing congressional accusations that ImClone tried to mislead the Food and Drug Administration in seeking approval of Erbitux).

166. Geeta Anand et al., *Biotech Bust: ImClone's Ex-CEO Arrested, Charged with Insider Trading*, WALL ST. J., June 13, 2002, at A1.

167. Geeta Anand & Vanessa Fuhrmans, *ImClone Directors Meet on Bristol Bid to Revamp Deal*, WALL ST. J., Feb. 12, 2002, at B10 (reporting the FDA's findings that ImClone's clinical trial "'was not adequate and well controlled' and additional studies would be needed to prove efficacy").

168. Chris Adams et al., *Leading the News: Congress Probes Analyst's Alert on FDA Ruling Against ImClone*, WALL ST. J., June 19, 2002, at A3.

169. *Id.*

170. *See id.*

171. *See, e.g.*, Geeta Anand, *History and Science: In Waksal's Past: Repeated Ousters*, WALL ST. J., Sept. 27, 2002, at A1 ("ImClone's stock price has fallen to less than $9 a share from more than $75 in December [2001], just before Dr. Waksal's world began to fall apart.").

Waksal and his family and friends exceeded $9 million.[172]

On June 12, 2002, Waksal was arrested and charged with insider trading in connection with the sale of his own stock and the "tipping" of family and friends about the impending drop in the price of ImClone shares.[173] ImClone itself may also be charged with civil liability for its handling of the disclosures about Erbitux.[174] Waksal resigned as CEO of ImClone and later declined to testify before a congressional committee, invoking his Fifth Amendment protection against self-incrimination.[175] On October 16, 2002, it was announced that Waksal had pleaded guilty to several counts of insider trading.[176]

Among the persons allegedly advised that the Waksal family was selling its shares before ImClone's public announcement was television personality Martha Stewart, a close personal friend of the Waksal family.[177] Rather interestingly, more attention has been paid in the press to Stewart's role in the ImClone affair than to the internal FDA leak or the insider trading by Waksal and members of his family.[178] Stewart sold her ImClone shares on December 27, 2001, one day before ImClone's public announcement.[179] She later explained publicly that her sale of ImClone shares was authorized by instructions previously given to her broker at Merrill Lynch to sell her shares if the market price dropped below $60 per share.[180] She stated that her shares were sold by her broker pursuant to these instructions.[181] However, Merrill Lynch was unable to verify that Stewart had in fact given either oral or written instructions to the broker.[182]

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172. *See id*.

173. *See id*.

174. Chris Adams, *Leading the News: ImClone May Face Civil Action for Handling of Erbitux Disclosure*, WALL ST. J., June 20, 2002, at A3 (reporting that the SEC has sent ImClone a "Wells notice" indicating that the agency is considering whether to recommend action against the company).

175. Pollack, *supra* note 165.

176. Jerry Markon & Geeta Anand, *Waksal Pleas Guilty as U.S. Widens Probe*, WALL ST. J., Oct. 16, 2002, at C1. The guilty plea was unexpected because Waksal apparently had not negotiated terms designed to protect members of his family from possible indictment. *See id*.

177. *See* Jerry Markon, *Leading the News: Stewart, Broker Differ on ImClone Sale*, WALL ST. J., June 17, 2002, at A3 [hereinafter Markon, *ImClone Sale*].

178. *See, e.g.*, Editorial, *Martha, Martha, Martha*, WALL ST. J., Oct. 24, 2002, at A16 (describing Martha Stewart as a "human sacrifice to our overreaching insider trading laws").

179. *See* Matthew Rose, *Martha, Martha, Martha: With Her Name Emblazoned on All Her Wares, Stewart Could Put Company at Risk*, WALL ST. J., June 19, 2002, at B1.

180. *See* Markon, *ImClone Sale, supra* note 177.

181. *See id*.

182. *See* Charles Gasparino & Suzanne Craig, *Merrill Worker Questions Pact in Stewart Sale*, WALL ST. J., June 24, 2002, at C1 (reporting that a sales assistant to

Investigation revealed the following: on the morning of December 27, 2001, Waksal's daughter, Aliza, asked Merrill Lynch stockbroker Peter Bacanovic to sell all of her stock in the company; within an hour of the sale of Aliza's stock, Bacanovic was trying to reach Stewart.[183]

> Stewart, however, was unreachable. She was on a private plane, on her way from Connecticut to San Antonio, Texas. As they waited for Stewart's plane to land, Bacanovic and his assistant, Douglas Faneuil, swapped e-mails . . . .
>
> At 1:17 p.m., Bacanovic wrote: "Has news come out yet? Let me know." . . . When Stewart's plane landed at 1:30 p.m., she called her office, where her assistant had earlier noted in the message log: "Peter Bacanovic thinks ImClone is going to start trading downward." Almost immediately, Stewart called Bacanavic's [sic] office, and 11 minutes later, the broker was selling all of Stewart's ImClone stock. In the last of the Dec[ember] 27 e-mails . . . , Faneuil wrote: "Dear Mrs. Stewart, You sold your remaining (3,928 imcl) shares at an average price of 58.43(25). As always, feel free to call me with any questions . . . [.]"[184]

Faneuil has agreed to testify against Stewart, and Stewart remains under investigation for violation of the insider trading prohibition.[185] Because of this continuing controversy, shares of her publicly traded company, Martha Stewart Living Omnimedia, have declined significantly in value.[186]

C. General Electric Co.

John F. Welch Jr., the former CEO of General Electric, is widely "credited with building [General Electric] into one of [the] most highly valued conglomerates in the nation."[187] Welch's success

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Stewart's broker was "unaware of any agreement" when he placed the order to sell stock).

183. Dan Harris, *Trading Downward: E-mails and Phone Calls May Shed Light on Stewart's Dumping of ImClone Shares*, ABCNEWS.COM, Aug. 9, 2002, *at* http://abcnews.go.com/sections/GMA/GoodMorningAmerica/GMA020809Stewart_Emails.html (last visited Mar. 13, 2003) (reproducing a story first reported on *Good Morning America*).

184. *Id*. (fifth alteration in original).

185. *See* Jerry Markon, *Martha Stewart Could Be Charged as "Tippee,"* WALL ST. J., Oct. 3, 2002, at C1.

186. *See* Tracie Rozhon, *Stewart Quits as a Director of Big Board: Her Company's Shares Then Tumble Over 8%*, N.Y. TIMES, Oct. 4, 2002, at C1. The concern that she may be indicted for insider trading was also a factor in Stewart's decision to resign as a director of the New York Stock Exchange. *See id*.

187. Michael Barbaro, *A King's Ransom in Retirement Benefits: GE Pays Ex-CEO Millions a Year in Pension, Perks*, WASH. POST, Sept. 7, 2002, at E01.

was largely based on his ability to downsize the enterprise and sell off underperforming portions of the business.[188] When he retired, however, he was awarded lucrative post-retirement benefits that were not fully disclosed by management to its shareholders.[189] Welch's receipt of $9 million as a severance payment was disclosed; in addition, General Electric stated in general terms that it planned "'to provide him continued lifetime access to company facilities and services comparable to those which are currently made available to him.'"[190] It turns out that this included almost all the ongoing expenses of Welch's home in New York City; computers at his office and at five of six homes (including technical support); floor-level tickets to New York Knicks home games; a box at the Metropolitan Opera; a skybox at Fenway Park; a box behind the dugout at Yankee Stadium; VIP seating at Wimbledon and at both the U.S. and French Open; country club dues and initiation fees at Augusta and other golf clubs; flowers, food, wine, and a staff at his New York City home; satellite TV in every home (except Palm Beach); free tax and financial planning services; free use of a Boeing 737 business jet, helicopters, and limousine with expenses paid; all expenses paid on a leased 2003 Mercedes; and cell phones in four other cars.[191] A small portion of these expenses may relate to the continued consulting services that Welch provides (and for which he receives additional cash compensation),[192] but the sheer magnitude and variety of the benefits provided is startling.[193]

On September 15, 2002, the *New York Times* editorialized

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188. *Id*.

189. *Id*. Information about Welch's retirement benefits became public as a result of a divorce dispute with his former wife, who complained that he had canceled a joint credit card and limited her funds to $35,000 per month, an amount she found "'patently inadequate to maintain the marital standard of living.'" *Id*. (quoting court documents).

190. *Id*. (quoting the company's March 1997 proxy statement).

191. Barbaro, *supra* note 187; *see also* Geraldine Fabrikant, *G.E. Expenses for Ex-Chief Cited in Filing: Divorce Case Describes Enormous Living Costs*, N.Y. TIMES, Sept. 6, 2002, at C1; Editorial, *Courtside Tickets for Life*, N.Y. TIMES, Sept. 15, 2002, § 4, at 14 [hereinafter *Courtside Tickets*]. Mr. Welch has since publicly relinquished most of these benefits, stating that he rarely used many of them. Philip Kennicott, *Rich with Irony: When Golden CEO Jack Welch Stepped Down, It Was into the Mud*, WASH. POST, Oct. 14, 2002, at C01.

192. Barbaro, *supra* note 187 (noting that Welch receives an annual retainer of $86,000 for his consulting services that covers a minimum of five working days per year).

193. Once stories like these surface, other examples quickly appear. *E.g.*, Joann S. Lublin, *How CEOs Retire in Style: Many Former Chief Executives Get Lush Perks and Fat Fees for Limited "Consulting" Work*, WALL ST. J., Sept. 13, 2002, at B1 (discussing former CEO Ronald W. Allen's retirement package from Delta Air Lines). When Allen retired at the age of sixty, Delta gave him a $765,600 annual pension, a $4.6 million lump-sum severance payment, a car, club dues, and an office on the other side of town that cost $408,776 to design, build, and furnish. *Id*. Allen also was given a consulting contract that provides a "sizable annual advisory fee—until at least July 2004—even if he . . . is totally disabled" and unable to provide consulting services, or even deceased. *Id*.

that most "executive compensation experts found Mr. Welch's richly accessorized retirement-to-grave security package [to be] grotesque."[194] The SEC subsequently announced that it had launched an "informal investigation" into Mr. Welch's retirement package.[195]

D. Xerox Corp.

In late September 2002, the *Wall Street Journal* carried a front page story that Xerox, a company that had earlier settled an SEC civil investigation, was facing a criminal prosecution by the Department of Justice on essentially the same basic facts.[196] The earlier civil proceeding alleged that Xerox had "misbooked $6.4 billion of equipment revenue, and overstated its pretax income by 36%, or $1.41 billion," from 1997 through 2001.[197] In addition, Xerox allegedly had failed to disclose a one-time sale of receivables that helped to pump up profits and had used "cookie jar reserves" (designated to be used for paying merger costs) to help meet earnings expectations.[198] The SEC also alleged that Xerox senior management had received over $5 million in performance-based stock and over $30 million in profits from the sale of stock.[199]

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194. *Courtside Tickets*, *supra* note 191. A *New York Times* story indicated that the extent of the benefits had not been previously disclosed. Fabrikant, *supra* note 191. There is not a great deal of information available about the personal perquisites available to CEOs and CFOs of major publicly held U.S. companies. Information about the "perks" available to Welch became public only as a result of a dispute over a contested divorce. Barbaro, *supra* note 187. While General Electric disclosed Welch's total compensation in the year before his retirement ($16.7 million in 2000), it did not mention numerous other pricey benefits. Fabrikant, *supra* note 191. The privileges have continued even in retirement though the court papers place no value on these benefits. *See id*; Barbaro, *supra* note 187.

195. Matt Murray, *SEC Investigates GE's Retirement Deal with Jack Welch*, WALL ST. J., Sept. 17, 2002, at B1 (suggesting that the SEC may consider stiffening its reporting requirements for retirement packages in the future).

196. James Bandler, *Xerox Faces Criminal Inquiry Tied to Financial Restatement*, WALL ST. J., Sept. 24, 2002, at A1 [hereinafter Bandler, *Xerox Faces Criminal Inquiry*]. The earlier civil investigation had been settled by the payment of a $10 million fine and a restatement of Xerox earnings from 1997 to 2000. *Id.*; *see also* Amy Borrus et al., *Corporate Probes: A Scorecard*, BUS. WK., June 10, 2002, at 42. Xerox also agreed to the creation of a panel to review its accounting procedures. Borrus et al., *supra*.

197. Bandler, *Xerox Faces Criminal Inquiry*, *supra* note 196.

198. *Id*.

199. *Id*. On September 30, 2002, the *Wall Street Journal* announced that the former treasurer of Xerox was "being investigated for possible civil violations by the [SEC]" and was being "reassigned . . . to a post in Canada." James Bandler, *Xerox Treasurer Is Reassigned*, WALL ST. J., Sept. 30, 2002, at B5.

VII. OTHER DISCLOSURES OF CORPORATE MISCONDUCT

The examples of questionable accounting practices given in some detail above appear to be the tip of an iceberg. Numerous other publicly held companies have publicly admitted that they adopted questionable accounting practices in the period between 1997 and 2002 that were designed to improve the bottom line and prop up the stock price. Examples include: (1) Lucent Technologies, which "booked $679 million in revenue from sales to its distributors before the distributors were able to . . . sell the products";[200] (2) Kmart, which allegedly "underreported 2001 losses by at least $1.7 billion";[201] (3) Merck & Co., which "recorded $12.4 billion in revenue from [its] pharmacy-benefits unit" that it "never actually collected";[202] (4) Rite Aid Corporation, whose executives admitted that they developed an earnings inflation scheme that increased net income by $1.6 billion in the late 1990s;[203] and (5) Mirant Corporation, the biggest North American natural gas trader, which issued a press release on August 14, 2002, announcing that an accounting review had revealed its balance sheet had been improperly inflated by $1.1 billion.[204] Prior to this announcement, Mirant's balance sheet reflected $22.8 billion in assets.[205]

VIII. THE CUMULATIVE IMPACT OF THESE DISCLOSURES

These announcements of improper conduct and improper accounting by a substantial number of publicly traded companies shocked and angered both the business community and ordinary investors. Tom Stickel, chairman of the California Chamber of Commerce, is quoted as saying: "Until we see a CEO and general counsel march off to jail together—for a long, uncomfortable and noncountry club sentence—capitalism is at risk, because people are losing confidence."[206] Investors began to bail out of securities

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200. Borrus et al., *supra* note 196 (cataloguing companies and issues under investigation by the SEC).

201. *Id.*

202. Barbara Martinez, *Merck Booked $12.4 Billion It Never Collected*, WALL ST. J., July 8, 2002, at A1 (reporting Merck's assertion that its revenue-recognition policy conforms to generally accepted accounting principles).

203. Scott Kilman, *Rite Aid Ex-Officials Charged in Accounting-Fraud Probe: Former CEO, Two Others Are Accused of Directing Earnings-Inflation Scheme*, WALL ST. J., June 24, 2002, at A2 (reporting that federal grand jury indicted three former top Rite Aid executives in this scheme).

204. *Mirant's $1.1 Billion Error Defended as "Honest Mistakes*,*"* HOUS. CHRON., Aug. 15, 2002, at 3C.

205. *See id.*

206. Abraham C. Reich & Michelle T. Wirtner, *What Do You Do When Confronted*

holdings. The sharp drop in securities prices that followed appears to have been caused in part by disgruntled investors leaving the securities market in large numbers.[207]

In many of these incidents, managers of publicly held corporations clearly took advantage of their positions to increase their own personal wealth at the expense of shareholders. The millions of dollars of profits earned by managers of publicly held telecom companies who sold stock while artificially maintaining the stock price as long as possible are impossible to justify on any equitable or rational basis. The same thing can be said of the amounts paid by Enron to its officers and employees as that company moved towards bankruptcy.[208] Alan Greenspan captured the attitude of many corporate executives when he stated that "an infectious greed seemed to grip much of our business community" that overcame a basic sense of good judgment among some CEOs, "leading to a loss of investor confidence in the markets."[209]

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with Client Fraud?, BUS. L. TODAY, Sept./Oct. 2002, at 39, *available at* http://www.abanet.org/buslaw/blt/2002-09-10/reichwirtner.html (last visited Mar. 13, 2003); *see also* Jonathan Weisman, *Efforts to Restrict Retirement Funds Lose Steam; Indignation Wanes as Congress Considers Limits on Company Stock Holdings*, WASH. POST, Aug. 7, 2002, at A01 (observing that the devastated retirement accounts of employees from Enron and WorldCom "initially fueled a wave of indignation among lawmakers in Washington and solemn vows to protect" their constituents in the future).

207. *See* Anthony Bianco, *The Angry Market: The Blunt Message: Investors Are Repricing Stocks to Reflect a More Honest Picture of Earnings, Options, and the Future. Ultimately, That's Good*, BUS. WK., July 29, 2002, at 32. It is also probable that the drop in securities prices has been exacerbated by efforts of management to dispose of their holdings before prices dropped further.

208. Many individuals were doubtlessly at fault for not discovering and preventing what happened in these various situations. The failures were widespread and include many participants in the U.S. financial system. That system has long relied on "professional gatekeepers" who act as independent reviewers of corporate activities and therefore limit or publicize failures. Coffee, *supra* note 58, at 1405. These "gatekeepers" include the independent outside auditor who certifies the accuracy of financial statements prepared by publicly held companies, the debt rating agency that evaluates the creditworthiness of companies, the securities analyst who evaluates the desirability of specific transactions as well as the overall strength of companies, and the investment banker who reviews and evaluates proposed financial transactions. *Id*. Certainly, many gatekeepers failed in their basic duties in the current period. *See id*. at 1405, 1408–09. Perhaps the most serious failures were by (1) the independent auditors, who have responsibility for evaluating and verifying the accuracy of the company's financial statements, and (2) the securities analysts, many of whom kept "strong buy" recommendations in effect long after it became apparent that the company was in serious financial difficulty. *Id*. Litigation involving the failures of auditors and securities analysts is currently being widely pursued.

209. Bill Blackmore et al., *Wild Day at the Markets: Greenspan Fails to Soothe the Street*, ABCNEWS.COM, July 16, 2002, *at* http://www.abcnews.com/sections/business/DailyNews/markets_020716.html (last visited Mar. 13, 2003) (quoting Alan Greenspan's report on monetary policy before the Senate Banking Committee). Greenspan added, "[a]lthough we may not be able to change the character of corporate officers, we can

IX. THESE EVENTS BRING INTO QUESTION BASIC PREMISES ABOUT CORPORATE GOVERNANCE

It has long been accepted doctrine that the primary goal of publicly held corporations should be to maximize the wealth of shareholders.[210] While corporate directors and officers should be amply compensated and provided with substantial incentives, their basic goal in managing the corporation should be to maximize the value of the corporation and thereby the wealth of shareholders. This proposition is accepted dogma in law and finance textbooks and is taught in law and business schools throughout the country.[211] However, recent events indicate that many corporate executives have long had a quite different goal of maximizing their own personal wealth.[212] Corporate theorists apparently have assumed that the professionalism of corporate officers and directors will by itself ensure fidelity to corporate goals and the corporate entity, rather than to personal aggrandizement. However, while lip service continues to be paid to the principle of shareholder wealth maximization, it is clear that the goal of many corporate executives in the last several years has been personal profit maximization for themselves, other directors, high level executives, and their friends.[213] The

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change behavior through incentives and penalties." *Id*. (quotation marks omitted).

210. *See, e.g.*, Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1277, 1282 (1991) (discussing this "fundamental principle" and three conflicting understandings of it).

211. This proposition is often put forth in connection with the "nexus of contracts" theory, which states that publicly held corporations should be viewed as a web or nexus of contractual relationships which together constitute the corporation. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. (forthcoming 2003), *available at* http://papers.ssrn.com/s03/papers.cfm?abstract_id=300860 (last visited Feb. 16, 2003) (illustrating a careful rationalization of the importance of the board of directors in the modern publicly held corporation).

212. CEOs of publicly held corporations have long received aggregate annual compensation in the tens or hundreds of millions of dollars per year. In the year 2000, for example, John Reed, CEO of Citigroup, who retired in April of that year, received $5.4 million in salary and bonus and $287.6 million in long-term compensation, and Sanford Weill, successor CEO of Citigroup, received $19.9 million in salary and bonus and $204.9 million in long-term compensation. *Id*. For each of the twenty top-paid executives in the year 2000, the aggregate compensation was in excess of $72.5 million per year. *See id*. These princely salaries were not widely criticized at the time because stock prices were generally high and increasing during most of 2000.

213. Theoretical studies suggest that persons who desire to become corporate executives are more willing than the average person to break the rules of the game in order to obtain financial benefit. An executive search firm, Russell Reynolds Associates, gave more than 1400 executives twenty-eight true-or-false questions designed to test their levels of integrity. A significant percentage of these individuals—one in eight—were determined to be "high risk," meaning they were likely to break rules when they believed it was practical for them to do so in order to further their own self-interest. *See id*.

number of individual "bad apples," to use President Bush's offhand description,[214] is obviously much greater than the theoretical literature recognizes.

On June 5, 2002, Henry Paulson, Chairman and CEO of the Goldman Sachs Group, delivered a strongly worded speech to the National Press Club in Washington, D.C. Paulson said:

> In my lifetime, American business has never been under such scrutiny. And to be blunt, much of it is deserved.
>
> . . . .
>
> . . . [T]he Enron debacle and subsequent revelations have revealed major shortcomings in the way some U.S. companies and those charged with their oversight have gone about their business. And it has, without doubt, eroded public trust."[215]

On July 16, 2002, the American Bar Association (ABA) Task Force on Corporate Responsibility issued a preliminary report.[216] The Introduction and Overview starkly presented its assessment of the current scene:

> Few events in business history since the Great Depression have had the public impact of the stunning collapse of Enron Corp. and other major companies in the past year. . . . [Enron's collapse] is merely one of the most notorious in a disturbing series of recent lapses at large corporations involving false or misleading financial statements and alleged misconduct by executive officers. Investor confidence in the quality and integrity of public company corporate governance is compromised, and the pace of calls by the President, Congress, the SEC, stock markets and other interested groups for regulatory reform has quickened dramatically.
>
> . . . At the very least, [the definition of] "corporate

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214. Refer to note 4 *supra* and accompanying text.

215. Henry Paulson, Speech at the National Press Club (June 5, 2002) (transcript available through the Federal News Service, June 5, 2002, LEXIS, Nexis Library, Federal News Service file). It is somewhat ironic that the Goldman Sachs Group, Inc. had earlier given prominent executives of twenty-one American corporations "hot" shares in more than one hundred initial public offerings managed by Goldman Sachs. Randall Smith, *Goldman Gave Hot IPO Shares to Top Executives of Its Clients*, WALL ST. J., Oct. 3, 2002, at A1. Many of these shares were then immediately resold into the market at a profit. *Id*.

216. *See* JAMES CHEEK III ET AL., AM. BAR ASS'N, PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 1 (2002) [hereinafter ABA PRELIMINARY REPORT], *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf (last visited Mar. 13, 2003). The task force was created by Robert Hirshon, President of the ABA, on March 28, 2002, to consider the developments in corporate governance that were being widely reported. *Id*.

> responsibility" . . . include[s] behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders. . . .
>
> . . . [T]he system of corporate governance at many public companies has failed dramatically. It is a clear failure of corporate responsibility, for example, if a corporation belatedly and precipitously discloses that the equity on its balance sheet has been overstated by *billions* of dollars. It is a clear failure of corporate responsibility if employees whose retirement amounts are heavily invested in the corporation's stock are assured by management of the corporation's financial prospects and then discover that the value of that stock has promptly vanished as a result of earnings misstatements and self-dealing by corporate officers. It is a clear failure of corporate responsibility if executive officers aware of potential accounting irregularities sell millions of dollars of stock to public investors who are unaware of such information. It is a clear failure of corporate responsibility for insiders to borrow enormous amounts from their companies without adequate security beyond inflated stock of the company itself. And it is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover—and sometimes actually condone or contribute toward the creation of—the grossest of financial manipulations and fraud.
>
> At least with the benefit of hindsight, the 1990's can be seen to have created a potent recipe for failures of corporate responsibility.[217]

Many sophisticated observers of modern American business were as shocked as the man on the street when the transactions described above became public knowledge.[218] On July 8, 2002, the

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217. *Id*. at 3–7 (footnotes omitted).

218. *See* N.Y. STOCK EXCH., REPORT OF THE NYSE CORPORATE ACCOUNTABILITY & LISTING STANDARDS COMM. 1 (2002) [hereinafter NYSE REPORT] (recommending corporate governance and disclosure standards in the "aftermath of the 'meltdown'"), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf (last visited Feb. 16, 2003); Press Release, NASDAQ, Nasdaq Approves Rule Changes to Modify Key Corporate Governance Standards (May 24, 2002) (strengthening corporate governance standards for companies listed on NASDAQ "in light of recent events"), *available at* http://www.nasdaqnews.com/news/pr2002/ne_section02_113.html (last visited Feb. 5, 2003); THE BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE iii–iv (2002) (restating its guiding principles of corporate governance in light of recent "notable exceptions to a system that has generally worked well"); FINANCIAL EXECUTIVES

Business Roundtable, a conservative but influential group of CEOs representing many of the largest companies in the United States, issued a statement that they "have been appalled, angered and, finally, alarmed at the stream of revelations which have emerged in the past six months concerning a number of public companies."[219] The statement continues:

> While the list of affected companies is small in comparison to the more than 11,000 publicly traded U.S. companies, ... [w]e also understand that public confidence in America's system of corporate governance and its trust in our financial reporting mechanisms have been shaken to the core. It will take much more than words to restore that confidence and trust.[220]

Furthermore, the crisis in corporate governance has had negative effects throughout the economy. For example, it was reported that offers to join a public board of directors, once sought-after honors, are now viewed cautiously.[221] The concern is that a company's past violation of accepted principles of corporate governance could lead to a lawsuit resulting in a personal judgment being entered against the board itself and its individual members.

In litigation involving securities fraud, average settlement payments to claimants are increasing.[222] As a result, insurance premiums have increased, while coverage has narrowed. In sectors such as telecommunications and technology, Directors' and Officers' (D & O) liability insurance simply is not being issued by many companies.[223] Furthermore, even if a D & O policy is available, its coverage is limited. For example, the

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INTERNATIONAL, FEI OBSERVATIONS AND RECOMMENDATIONS: IMPROVING FINANCIAL MANAGEMENT, FINANCIAL REPORTING AND CORPORATE GOVERNANCE 1 (2002) (recommending reforms to address a "common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits"); COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES (2002) (establishing guidelines for the effective governance of publicly traded corporations), *available at* http://www.cii.org/corp_governance.asp (last visited Mar. 15, 2003).

219. Press Release, The Business Roundtable, The Business Roundtable Statement on Restoring Investor Trust (July 8, 2002), BUS. WIRE, July 8, 2002, LEXIS, Nexis Library, Business Wire file.

220. *Id.*

221. *See* Emily Thornton & Louis Lavelle, *It's Getting Tough to Fill a Boardroom*, BUS. WK., July 29, 2002, at 80 (reciting a May 2002 survey of nearly two hundred directors showing that 25% turned down a new offer or quit at least in part for liability reasons and that more than 80% felt there was an increasing "significant" threat of liability).

222. Tamara Loomis, *Shrinking Flak Jacket*, DAILY DEAL, Sept. 13, 2002 (reporting that the average settlement had risen from $7 million in 1996 to more than $17 million).

223. *Id.*

insurer may refuse to cover a corporation's defense costs if an executive, a director, or the company itself is found to be criminally responsible.[224] Also, it has become painfully evident that a D & O insurance policy that purports to cover both the corporate entity and the individual directors and officers may not fully protect the latter.[225] When both the officers and directors and the entity itself seek to recover on the insurance policy, policy limits are paid out only once. However, in the litigation following the collapse of Enron, the court allowed the D & O insurer to advance funds for costs to individual directors and officers with the effect that payments to defense counsel were significantly delayed and payments to Enron itself were presumably unavailable.[226]

A *New York Times* article of September 7, 2002, stated that cutbacks in insurance coverage

> are taking the form of higher deductibles and lower limits on overall coverage. But the insurance companies are also demanding that corporations pay part of any court settlements or jury awards out of their own pockets. As a result, corporations in telecommunications, energy, financial services and pharmaceuticals—where the risk of being sued is thought to be highest—could face payments of up to half of the cost of any settlement.[227]

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224. *Id.*

225. *See id.* The article specifically states:

> Although companies routinely buy directors' and officers', or D&O, insurance to protect board members against liability for corporate misdeeds, directors are now seeing that such insurance is hardly bulletproof.
>
> "It used to be that the insurers would simply cut a big check," said Kirk Pasich, a partner at the Los Angeles office of Howrey Simon Arnold & White. "That's all changed."
>
> The scope of coverage has narrowed, premiums have increased and for some sectors such as telecommunications and technology, D&O insurance may not be available, he said. Even more alarming, directors who think they have coverage may find they do not. If an executive, director or the company itself is held to be criminally liable, the insurer will often refuse to cover anyone's defense costs.
>
> The same holds true if the company is found to have lied about its business. The companies that insured Enron Corp.'s directors and executives against shareholder suits, for instance, are trying to rescind $350 million in coverage on the grounds Enron misled them as to its financial health, thus voiding the policies.
>
> "For the first time, we're seeing that the very thing giving rise to liability is no longer covered," Pasich said.
>
> If the company goes bankrupt, directors and officers may find themselves vying for insurance dollars with company creditors or even the bankruptcy trustee.

Id.

226. *See id.*

227. Jonathan D. Glater & Joseph B. Treaster, *Insurers Scale Back Corporate Liability Policies*, N.Y. TIMES, Sept. 7, 2002, at C1. Another article suggests:

An Australian study suggests that the problem in the United States is a fundamental one: "unitary boards"—boards of directors of the American variety in which all authority is vested in a single group—are much more likely to jeopardize the financial integrity of the corporation than compound boards of the European variety, which involve (1) a watchdog board to mediate conflicts of self-interest of directors and any related party dealings with shareholders, and (2) stakeholder councils to provide information independent of management on the integrity of management and the business.[228]

X. RESPONSES TO THE CURRENT CRISIS

The immediate response to the current crisis was of course the enactment of Sarbanes-Oxley on July 30, 2002.[229] The distinctly mixed course that developments under this bill have followed since the bill's enactment is discussed in the following section.

In addition to Sarbanes-Oxley, there are several studies and investigations of the current crisis underway by various agencies and committees.[230] There are also numerous stories appearing in major newspapers, including the *New York Times*, *Wall Street Journal*, and *Washington Post* about former business executives who are facing investigations and possible criminal prosecution.[231]

> Restatements create an insurance issue because the company's financial statements are supplied to the carrier as part of the insurance application. If the statements are admittedly false—and, the argument goes, the restatement itself is such an admission—then the insurance has been issued based upon a false application. In the view of some carriers, this means that the insurance policy is void and subject to rescission. . . . [T]here are restatement cases where carriers have actually filed proceedings seeking rescission of the policy, and have in some cases succeeded in doing so.

Michael H. Diamond, *D & O Insurance: Pitfalls in a New World*, NAT'L L.J., Aug. 26–Sept. 2, 2002, at A22.

228. Diamond, *supra* note 227; Shann Turnbull, *Why Regulation of Financial Institutions Cannot Be Assured with a Unitary Board* (forthcoming) (manuscript at 2–5, 11–14), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=310501 (last visited Feb. 16, 2003). The author recognizes that the mere presence of a single dominant and active shareholder in effect creates a compound board. *Id.* (manuscript at 2).

229. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

230. *E.g.*, ENRON'S COLLAPSE, *supra* note 27 (conducting an in-depth investigation of the Enron collapse); Michael Schroeder, *SEC Proposes Rules to Strengthen Boards*, WALL ST. J., Jan. 9, 2003, at C10 (noting the SEC's impending deadline for "a handful of studies ordered by Congress under the Sarbanes-Oxley Act").

231. *E.g.*, Kilman, *supra* note 203; Brooke A. Masters, *Credit Suisse Puts Banker on Leave: E-Mail Suggests He Was Aware of Probes*, WASH. POST, Feb. 4, 2003, at E01; Romero & Norris, *supra* note 110 (discussing ongoing investigations by the House

On July 12, 2002, President Bush met with his new "corporate-crime task force," created to coordinate criminal prosecution of fraud cases.[232] The task force includes U.S. attorneys, the Federal Bureau of Investigation, the Treasury Department, the SEC, postal inspectors, and other law enforcement personnel.[233]

The SEC has announced that it is considering rule-making to prevent "spinning"—the receipt by favored executives of shares of attractive initial public offerings.[234] It is also seriously considering regulations that would eliminate any links in brokerage firms between research departments and investment banking and trading operations.[235] The plan would also require members of the research department to disclose shares they receive from investment banking firms.[236] The actual implementation of these proposals will be difficult, given the longstanding relationships between the people involved in these activities. Moreover, Chairman Pitt had also proposed to separate further investment banking operations from research.[237]

The ABA Task Force on Corporate Responsibility's preliminary report sets forth a general standard: "corporate responsibility" embraces "ethical behavior beyond that demanded by minimum legal requirements."[238] It quotes and relies on section 2.01(a) of the American Law Institute's *Principles of Corporate Governance* to the effect that the "'corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain. . . . [C]orporations are generally entitled, and *indeed obligated*, *to*

Financial Services Committee). Refer to Parts V–VII *supra* (detailing recent investigations into accounting irregularities at various companies and citing numerous recent newspaper accounts).

232. *See* John R. Wilke, *President Praises Work of Task Force on Business Crime*, WALL ST. J., Sept. 27, 2002, at A4.

233. *Id*.

234. *See* Susan Pulliam et al., *SEC May Punish Some Executives Who Snared IPOs*, WALL ST. J., Sept. 27, 2002, at C1.

235. *See id*.

236. *See id*.

237. Chairman Pitt had been quoted as saying:

> [L]awyers who represent public companies must use their legal acumen to pursue only those goals whose sole purpose is to further legitimate corporate interests, not the interests of individual managers—even if management's individual goals arguably are supportable by a literal reading of the law.
>
> . . . Although some lawyers believe the roles of outside auditors and corporate lawyers are vastly different, lawyers representing public companies have responsibilities quite similar to those of outside auditors.

Sue Reisinger, *Rules on Reporting Affect GCs: Like CEOs, Some Signed Off on Filings*, NAT'L L.J., Aug. 19, 2002, at A9 (first alteration in original) (quotation marks omitted).

238. ABA PRELIMINARY REPORT, *supra* note 216, at 5.

seek to maximize their wealth for the benefit of their shareholders.'"[239]

Major deficiencies in current corporate governance practices, the Task Force report continues, include: (1) the widespread belief that every corporation should publish results that meet or surpass Wall Street analysts' predictions; (2) the extensive reliance on equity-based executive compensation, particularly stock options, that cause the interests of management to diverge from, rather than be aligned with, the interests of shareholders; and (3) the ability of accountants and lawyers to adjust economic data in order to meet arbitrary goals set by management.[240] The result is that "judgments at all levels of the governance system [have been] compromised and, in too many instances, seriously flawed."[241] The report suggests that while most corporate officers are honest, there is always the temptation on the part of executive officers and other employees of public companies to "succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being."[242] This conduct may be prevented by relying on "the active oversight and advice of independent participants in the corporate governance process, such as the outside directors, outside auditors, and outside counsel."[243] However, "the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short."[244] The Task Force report concludes that implementation of its recommendations "would significantly enhance corporate governance practices and ethical principles [and] make it more likely that the system of checks and balances . . . will work effectively."[245]

On June 6, 2002, the Corporate Accountability and Listing Standards Committee of the New York Stock Exchange (NYSE) submitted a detailed report dealing with issues of corporate governance to the NYSE's board of directors.[246] On August 1, 2002, the board of directors formally submitted proposed

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239. *Id.* at 6 n.4 (emphasis added) (quoting and discussing AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 2.01(a) (1994)).

240. *Id.* at 7–9 (arguing that these deficiencies create a "potent recipe for failures of corporate responsibility").

241. *Id.* at 9.

242. *Id.*

243. *Id.*

244. *Id.* at 10 (emphasis omitted).

245. *Id.*

246. NYSE REPORT, *supra* note 218, at iii.

corporate governance standards based on this report to the SEC and simultaneously published them for comment by the securities industry.[247] These standards include the following:

> (1) Every board of directors of a publicly held corporation must have a majority of independent directors;
>
> (2) Listed companies must have audit, compensation, and nominating committees composed entirely of independent directors;
>
> (3) Non-management directors must regularly have executive sessions with management not present;
>
> (4) "Independent" is defined to mean that the person has "no material relationship" with the corporation, and the board of directors is to determine who meets this standard;
>
> (5) Former employees of the corporation and outside auditors of the corporation are not to be considered independent for a period of five years after the employment or provision of auditing services ends;
>
> (6) Directors' compensation must be the sole remuneration received from a listed company by audit committee members;
>
> (7) All listed companies must have an internal audit function;
>
> (8) Shareholders must approve all stock option plans (except employment-induced and merger-inherited plans);
>
> (9) Listed companies must have and disclose governance guidelines, codes of business conduct, and charters for their audit, compensation, and nominating committees;
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> (10) Foreign private issuers must disclose significant ways in which their governance practices differ from NYSE rules; and
>
> (11) The NYSE is specifically authorized to issue "public reprimand letter[s]" to listed companies in addition to the more draconian action of delisting a company.[248]

These proposals had "widespread support, [with] strong endorsements from President Bush, SEC Chairman Harvey Pitt, members of Congress, CEOs of listed companies, institutional

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247. *See NYSE Approves Measures to Strengthen Corporate Accountability: New Standards Aim to Restore Investor Confidence*, THE EXCHANGE, Aug. 2002, at 1–2, *at* http://www.nyse.com/pdfs/xnlv9n08.pdf (last visited Feb. 16, 2003).

248. *Id.* at 2.

investors, state pension funds, representatives of the financial-services industry, and organizations such as the Business Roundtable and the Council of Institutional Investors."[249]

In support of these proposals, Dick Grasso, the Chairman and CEO of the NYSE, stated that "[i]nvestors have had their faith in corporate America badly shaken in recent months . . . . Their confidence and participation are essential to the strength of our market and our economy."[250] "These [proposals]," Grasso added, "are the most significant corporate-governance initiatives in the 210-year history of the Exchange . . . . The size and breadth of the public response served to strengthen our resolve to recast our listing requirements with meaningful and substantive change."[251]

The Conference Board's Commission on Public Trust and Private Enterprise has also "called for stricter rules on stock options and stronger oversight by corporate boards over executive pay" that should be "linked to long-term company performance."[252] This report quotes Warren Buffett, Chairman of Berkshire Hathaway Inc., as saying: "There has been a tendency not to put Dobermans on the compensation committee, but to put cocker spaniels."[253]

In a surprising development, in May 2002, Eliot Spitzer, the attorney general of New York, negotiated a $100 million settlement from Merrill Lynch based on considerable evidence that Merrill Lynch brokers had retained favorable "buy" or "strong buy" recommendations in order to generate more banking fees for Merrill Lynch, even though they were well aware that the recommendations were not justifiable from an investment standpoint.[254] Relying on the eighty-one-year-old Martin Act, Spitzer successfully argued that prosecutors "[did] not have to prove [an] intent to commit securities fraud, [but] merely that fraud occurred because investors were not given all of the information they needed to make informed decisions."[255] Spitzer's

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249. *Id.*

250. *Id.* at 1 (quotation marks omitted).

251. *Id.* at 3 (quotation marks omitted).

252. Ken Brown, *Deal & Deal Makers: Another Panel Targets Executive Pay*, WALL ST. J., Sept. 18, 2002, at C5 (characterizing the commission's recommendations as "yet another report . . . with the goal of ridding the world of the problems caused by greedy corporate executives").

253. *Id.* (quotation marks omitted).

254. Patrick McGeehan, *States Talk Tough, Wall Street Sweats*, N.Y. TIMES, Oct. 20, 2002, § 3, at 1 (revealing that "a posse of state regulators" are attempting similar investigations against Morgan Stanley, Lehman Brothers, Bear Stearns, and UBS PaineWebber).

255. *Id.*

success has led to investigations of the policies followed by thirteen other major securities firms.[256] These investigations, modeled after the success of Spitzer's foray against Merrill Lynch, are being conducted by regulators from ten different states.[257] Shortly thereafter, Spitzer and SEC Chairman Pitt announced the broad outline of a "radical plan" for Wall Street firms to provide customers with independently developed stock research (in addition to that provided by their own analysts' recommendations).[258]

While these studies and investigations are ongoing, additional examples of misconduct, fraud, and opportunism continue to appear from time to time in newspapers, though in a volume that is considerably smaller than that of the 1999–2001 period.

XI. ENACTMENT OF THE SARBANES-OXLEY BILL

By July 2002, the list of publicly held companies with major accounting scandals had broadened to include Enron, WorldCom, Adelphia, Tyco, Global Crossing, Qwest, Xerox, Rite Aid, ImClone, and Merck, among others.[259] Lists of these fallen high-fliers in reports and newspapers often ended with a statement that other additional, unnamed, examples also existed. As stock prices continued to be buffeted by the steady source of bad news, both President Bush and the Republican-controlled House of Representatives recognized that the mood of America, with respect to corporate governance, had changed radically.[260] An immediate legislative response was viewed as essential.[261]

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256. *Id*.

257. *Id*. at 12. Among these efforts are settlement talks between Spitzer and Citigroup Inc. Paul Beckett, *Outsider Aims to Restore Citigroup's Luster*, WALL ST. J., Oct. 31, 2002, at C1.

258. Charles Gasparino & Michael Schroeder, *Pitt and Spitzer Butted Heads to Overhaul Wall Street Research*, WALL ST. J., Oct. 31, 2002, at A1. To meet the criticism that securities firms had "misled small investors by hyping research on companies that were also investment-banking clients," the plan contemplated independent research panels financed by as much as $1 billion. *Id*.

259. *See* Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1587 (2002) (discussing the wave of high-profile accounting scandals among large corporations).

260. *See, e.g.*, Ken Fireman et al., *Taking It to Wall Street: Bush Vows Tougher Penalties Against Corporate Fraud, but Dems Unimpressed*, NEWSDAY, July 10, 2002, at A03 (reporting President Bush's declaration that "[r]estoring confidence in a business world shaken by revelations of abuse" is the nation's greatest economic problem).

261. On July 9, 2002, House Minority Leader Dick Gephardt, a Democrat, commented that "[s]o far the administration's approach has been a familiar strategy—use harsh rhetoric to condemn wrongdoers while delaying and watering down whatever reforms might come out of Congress." *Id*.

The only piece of legislation in the pipeline dealing with corporate governance in 2002 was the Sarbanes-Oxley bill, which had been cobbled together by Senator Sarbanes and Representative Oxley (largely by Senator Sarbanes and his staff).[262] Many of the ideas and proposals in that bill had been discussed from time to time prior to the corporate governance crisis; however, they had not been seriously considered or studied by publicly held corporations, the Republican party, organizations with continuing interest in the corporate governance area, or the White House itself. Indeed, until the crisis arose, the bill was generally viewed as having no chance of enactment.[263] As a result, it had not gone through the complex legislative process that is almost always applied by Congress when it considers important business-related legislation. There had been very limited consideration by congressional committees and subcommittees; there were no studies of the probable operation of detailed provisions of the legislation; and there had been little or no study by the affected industries themselves. As a result, members of Congress had very limited sources of information as to the likely impact on their affected constituencies. Things had simply begun moving far too fast for affected businesses to gear up and review or significantly affect the proposed legislation. When President Bush announced his plan to sign the bill, Professor John Coffee commented: "I don't think he (Bush) can claim credit at all . . . . [The Republicans] resisted it until they saw a tidal wave forming. They had the good judgment not to stand in the way of a Tsunami."[264]

After it had received virtually unanimous approval in both the House and the Senate,[265] President Bush signed into law the Sarbanes-Oxley Act of 2002 on July 30, 2002,[266] the same day it

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262. *See* David S. Hilzenrath et al., *How Congress Rode a "Storm" to Corporate Reform*, WASH. POST, July 28, 2002, at A01 (chronicling the sequence of events surrounding the creation and enactment of Sarbanes-Oxley and noting that the collaboration between Sarbanes and Oxley resulted in few changes to Sarbanes's original bill).

263. *Id.* (revealing that only weeks before the enactment of Sarbanes-Oxley, "few people gave Sarbanes much chance of bringing his bill to the Senate floor, much less passing it into law," but that later reports of WorldCom's accounting misstatements renewed public anger over corporate misdeeds that had faded since Enron's collapse a few months earlier).

264. Randall Mikkelsen, *Bush to Sign Corporate Crackdown Legislation*, REUTERS, July 30, 2002 (quotation marks omitted) (noting that Professor Coffee helped Senate Democrats on the measure).

265. *See* Mike Allen, *Bush Signs Corporate Reforms into Law; President Says Era of "False Profits" Is Over*, WASH. POST, July 31, 2002, at A04 (indicating that the bill passed the Senate by a vote of 99 to 0 and the House by a vote of 423 to 3).

266. Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified at scattered sections of

was presented to him. Not surprisingly, President Bush put the best spin he could on the event. He made an effort to overcome the very common impression that he valued "big corporations over ordinary Americans" and strongly "[c]hallenged . . . the perception that his administration is too close to big business."[267] President Bush recognized that he was acting "amid public outrage at recent staggering stock market losses"[268] and stated that "'[a]t this moment, America's greatest economic need is higher ethical standards, standards enforced by strict laws and upheld by responsible business leaders.'"[269] Earlier he had stated that "[i]f you're a CEO and you think you can fudge the books in order to make yourselves look better, we're going to find you, we're going to arrest you and we're going to hold you to account."[270] As he signed the bill into law, he added that there is "[n]o more easy money for corporate criminals. Just hard time."[271] President Bush also strongly criticized the excesses of the previous few years; he said that corporate corruption offended "the conscience of our nation."[272]

Referring specifically to Sarbanes-Oxley, the President said: "My administration [has] pressed for greater corporate integrity, [and] a united Congress has written it into law . . . . There will not be a different ethical standard for corporate America than the standards that appl[y] to everyone else. . . . No boardroom in America is above or beyond the law."[273] On

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11, 15, 18, 28, and 29 U.S.C.).

267. Patricia Wilson, *Bush Says Law Means "Hard Time" for Corporate Crooks*, REUTERS, July 31, 2002.

268. *Id.* (suggesting that President Bush was under political pressure to sign the bill).

269. Remarks on Corporate Responsibility in New York City, 38 WEEKLY COMP. PRES. DOC. 1158, 1158 (July 9, 2002). President Bush challenged corporate America "to put an end to all company loans to corporate officers" and challenged

> every CEO in America to describe in the company's annual report, prominently and in plain English, details of his or her compensation package, including salary and bonus and benefits. And the CEO, in that report, should also explain why his or her compensation package is in the best interest of the company he serves.

Id. at 1161–62.

270. Mikkelsen, *supra* note 264 (quotation marks omitted) (quoting President Bush in a South Carolina speech). President Bush made similar statements weeks later, after signing the bill, at a hastily called "Texas Forum" at Baylor University. Elisabeth Bumiller & Edmund L. Andrews, *Economic Outlook Is Positive, Bush Tells Texas Forum*, N.Y. TIMES, Aug. 14, 2002, at A1.

271. Wilson, *supra* note 267 (quotation marks omitted). Sarbanes-Oxley does impose harsh sanctions—for example, up to twenty years' imprisonment for wire fraud and up to twenty-five years' imprisonment for specified securities fraud crimes. *Id.* However, it is unlikely that sentences of this magnitude will actually be imposed.

272. *Id*. (quotation marks omitted).

273. *Id*. (quotation marks omitted).

August 7, 2002, in a speech in Mississippi, he again railed against accounting scandals, asserting that "we're not going to let fraud undermine [our economy]" and that his administration was "investigating, arresting, and . . . prosecuting" errant executives.[274]

President Bush also suggested that the Democrats were partially responsible for the current crisis: "When I took office, our economy was beginning a recession. . . . Then our economy was hit by terrorists. Then our economy was hit by corporate scandals. But I'm certain of this[:] we won't let fear undermine our economy, and we're not going to let fraud undermine it either."[275] Needless to say, these comments were in sharp contrast with his dismissive comments about a month earlier that the only real problem with corporate governance today was a few "bad apples."[276]

Shortly after signing the Sarbanes-Oxley bill into law, President Bush turned his attention to world events—though he has continued to refer to corporate governance problems from time to time. In a weekly radio broadcast in early October 2002, he is quoted as saying: "Confronting Iraq is an urgent matter of national security. America's economic security, especially the creation of good jobs, is also an urgent matter requiring Presidential and congressional action."[277] The matter of honesty in corporate governance was not mentioned.

In October 2002, the Senate proposed an increase in the SEC annual budget of nearly $300 million.[278] President Bush had previously suggested an increase of $100 million[279] but signaled

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274. Remarks at Madison Central High School in Madison, Mississippi, 38 WEEKLY COMP. PRES. DOC. 1319, 1322 (Aug. 7, 2002).

275. *Id*. Predictably, Democrats in Congress viewed President Bush's performance as just show. Refer to note 262 *supra* (quoting House Minority Leader Dick Gephardt's comment that Bush's approach is to "use harsh rhetoric to condemn wrongdoers while delaying and watering down whatever reforms might come out of Congress").

276. Refer to note 4 *supra* and accompanying text.

277. The President's Radio Address, 38 WEEKLY COMP. PRES. DOC. 1753, 1753 (Oct. 12, 2002).

278. *See* Michael Schroeder & John D. McKinnon, *Under Pressure from Democrats, Bush Offers to Increase SEC Budget*, WALL ST. J., Oct. 23, 2002, at A6 (noting that the Senate Appropriations Committee had approved a budget increase for the SEC from $438 million to $750 million).

279. *See* Michael Schroeder, *SEC Gets a Raise, but Will It Be Enough?*, WALL ST. J., Aug. 12, 2002, at C1 [hereinafter Schroeder, *SEC Gets a Raise*] (observing that while President Bush had signed into law Sarbanes-Oxley's authorization of a $776 million SEC budget, due to "juggling [of] budget needs," the President later sought funding of "$200 million less than Congress requested").

that he would at least consider a larger increase.[280] The SEC budget the previous year was about $450 million.[281]

XII. INITIAL RESPONSES TO THE ENACTMENT OF SARBANES-OXLEY

The immediate reactions of commentators following the enactment of the Sarbanes-Oxley Act were not very favorable. The statute has been described as "a nightmare for company executives"[282] because it is a "sparsely worded law [that] is both poorly written and hastily put together so there's little to go on when it comes to interpreting some of its murkier provisions."[283] An attorney with Wilson Sonsini Goodrich & Rosati stated, "I don't think all of the implications of the bill have been fully understood yet."[284] Another commentator remarked that it is "a telling example of the law of unintended consequences. It will have wide-ranging effects on securities, derivative and other shareholder lawsuits."[285]

The initial responses of the academic community to Sarbanes-Oxley generally ranged from extremely negative to mixed, with a smattering of affirmative comments. Professor Larry Ribstein, a well-respected conservative commentator, writing immediately after the enactment of Sarbanes-Oxley, presented the most negative view:

> The Sarbanes-Oxley Act represents a hasty, panicked reaction of an electorate looking for an easy fix to the apparent "problem" that stock prices go down as well as up. Whether or not the Act has provided some short-term relief, in the long run regulatory responses to corporate frauds are unlikely to be more effective in preventing future frauds than existing regulation has been in preventing the current problem, and have a significant chance of imposing substantial costs. . . . [T]he Act will reduce the incentives of both insiders and monitors to increase shareholder value. Even if some highly sophisticated and nuanced regulation theoretically could increase social welfare, it is not likely that this type of reform will arise out of the present highly charged political environment.

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280. Schroeder & McKinnon, *supra* note 278.

281. *See id.*

282. Renee Deger, *New Law Has Corporate Lawyers Scrambling*, THE RECORDER, Aug. 13, 2002, at 1 (suggesting, however, that the "nightmare" will be beneficial to corporate lawyers).

283. *Id*.

284. *Id*. (quotation marks omitted) (quoting Katharine Martin, a partner with the firm).

285. Gregory P. Joseph, *Master Class: Corporate Fraud Act*, NAT'L L.J., Aug. 5, 2002, at B9 (outlining civil litigation implications of the Act).

> The best regulatory response to corporate fraud would have been no new regulation at all. The public needs to understand that falling stock prices and even managerial mistakes are parts of the price we pay for the substantial benefits of free markets. No amount of regulation can bring back lost savings. Rather by damping entrepreneurialism, regulation can only make recouping these funds that much more difficult.
>
> Given the adoption of the Act, [I recommend that persons adopt a] narrow interpretation and application to limit its costs, and closely monitor the effects of the regulation with a view to repeal or modification if these effects are as this article predicts.[286]

In a later revision of this paper, Professor Ribstein sharpens his criticism of the new statute.[287] He elaborates upon his earlier conclusion that there is no justification for a new era of corporate regulation:

> Indeed, the fact that the [current] frauds occurred after seventy years of securities regulation shows that more regulation is not the answer. Rather, with all their imperfections, contract and market-based approaches are more likely than regulation to reach efficient results. Post-Enron reforms, including Sarbanes-Oxley, rely on increased monitoring by independent directors, auditors, and regulators who have both weak incentives and low-level access to information. This monitoring has not been, and cannot be, an effective way to deal with fraud by highly motivated insiders. Moreover, the laws are likely to have significant costs, including perverse incentives of managers, increasing distrust and bureaucracy in firms, and impeding information flows.[288]

Professor Lawrence Cunningham was slightly more optimistic than Professor Ribstein, as reflected by his title: *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*.[289] Professor Cunningham adds,

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286. Professor Ribstein is the Richard W. and Marie L. Corman Professor of Law, University of Illinois College of Law. His comments appear in an early draft of a paper entitled *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, prepared in connection with the 2002 Conference on Regulatory Competition and Economic Integration within the European Union: Company, Securities, Insolvency and Tax Law, Tilburg University, September 5–6, 2002. The quoted draft paper is dated July 29, 2002 (copy on file with the Houston Law Review).

287. The revised draft paper with the same title is dated September 2002. *See* Ribstein, *supra* note 34.

288. *Id*. at 3 (footnote omitted).

289. Cunningham, *The Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 1–2).

> all changes made by the Act had been discussed among corporate governance and accounting devotees for years. Virtually all were already in effect as a matter of custom or practice and/or due to requirements imposed by stock exchanges, regulators, state law, or other provisions of federal law . . . . In this view, the changes may be "sweeping" or "far-reaching," but they are hardly "reforms."
>
> The changes are more likely to have psychological rather than substantive effects.[290]

Professor Richard Painter of the University of Illinois College of Law was somewhat more optimistic. He is quoted as suggesting that there is an "'expressive value' in law apart from actual penalties and sanctions," adding, "'I do think there's a signaling effect here in terms of the corporate culture, and that is a very good thing,'" as the new criminal penalties encourage "'a new emphasis on the accountability of corporate executives.'"[291]

Several commentators focused on the value of enhancing criminal penalties for conduct that is already unlawful but currently subject to less severe penalties. Professor Lawrence Mitchell of the George Washington Law School was skeptical:

> The fact of the matter is that while there are other aspects of the bill that are very helpful, this particular set of provisions is really largely duplicative of existing law . . . . Increasing prison sentences five to [ten] years doesn't mean anything unless you throw people in prison[,] and the likelihood of that is as yet unclear to me in the Bush Justice Department.[292]

David Becker, an attorney at Cleary, Gottlieb, Steen & Hamilton, expressed a similar view: "I don't think there's a whole lot of conduct out there that under current law is legal and that would be made illegal as a result of this."[293] Professor Donald Langevoort of Georgetown University Law Center stated that it is already a crime to violate any provision of the securities laws and that he is "not entirely sure how much change these provisions represent."[294] John Sturc, a former SEC official, is similarly skeptical: "If they're willing to risk five years, they're

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290. *Id*. (manuscript at 19).

291. Marcia Coyle, *Tough New Laws—Substance or Show? Old Ones Are Tough Enough and Easier to Use, Critics Say*, NAT'L L.J., July 22, 2002, at A1 (quoting Professor Painter).

292. *Id* (quotation marks omitted) (quoting Professor Mitchell).

293. *Id*. (quotation marks omitted) (quoting David Becker, a partner at the firm).

294. *Id*. (quotation marks omitted) (quoting Professor Langevoort).

going to risk [ten] years . . . . So do the criminal reforms mean nothing? No one is willing to go that far."[295] However, Professor Thomas Hazen of the University of North Carolina School of Law suggests that "[t]his new felony is a strong message that prosecutors should be using securities laws to deal with corporate fraud . . . . In that sense, it's more than window dressing."[296] Judah Best, an attorney with Debevoise & Plimpton, adds, "What they're really focusing on is the lack of a corporate culture as to the criminality of the conduct. That's the real issue."[297]

XIII. Initial Implementation of the Sarbanes-Oxley Act

The centerpiece of the new statute is Title I, the Public Company Accounting Oversight Board, or "PCAOB."[298] As described in the following section, it is given broad responsibilities in major areas of auditing and securities law. It was the attempted creation of this centerpiece organization that revealed the depths of mistrust that exists in both the political and the economic arenas.

The Sarbanes-Oxley Act states that the PCAOB is to consist of five members,

> appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.[299]

The first step in the process of implementing the PCAOB provision was to select the chairperson; immediately a brutal battle broke out. SEC Chairman Pitt purportedly entered into discussions with John Biggs, the head of the Teachers' Insurance Annuity Association/College Retirement Equities Fund (TIAA/CREF),[300] about becoming the Chairman of PCAOB.[301] Biggs has long been an outspoken critic of public accounting.[302]

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295. *Id*. (quotation marks omitted) (quoting John Sturc).

296. *Id*. (quotation marks omitted) (quoting Professor Hazen).

297. *Id*. (quotation marks omitted) (quoting Judah Best, a securities litigator).

298. Refer to Part XIV *infra* (describing the detailed provisions of Title I).

299. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(e)(1), 116 Stat. 745, 751 (to be codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

300. Michael Schroeder, *SEC's Pitt Faces a Public Battle Over Nominee*, WALL ST. J., Oct. 25, 2002, at A1. The TIAA/CREF is the major retirement fund for academics. *Id*.

301. *Id*.

302. *See, e.g.*, Michael Schroeder & Cassell Bryan-Low, *GOP Objects to Biggs To Run*

Whether or not Chairman Pitt actually offered Biggs the chairmanship is unclear, but Biggs clearly believed he was to be selected,[303] as he announced his retirement from TIAA/CREF in contemplation of becoming chairman of the PCAOB.[304] However, persons in the accounting industry almost immediately communicated their unhappiness with Biggs to Chairman Pitt.[305] Among the persons actively opposing Biggs was Michael Oxley, one of the sponsors of the Sarbanes-Oxley bill.[306] Chairman Pitt

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Oversight Board, WALL ST. J., Oct. 2, 2002, at C12 (reporting accounting firms' complaints to lawmakers based on a "fear [that] Mr. Biggs would impose restrictions on auditors that go beyond changes called for by the legislation").

303. Michael Schroeder, *Accounting Board Rift Bodes Ill for SEC*, WALL ST. J., Oct. 28, 2002, at A4 [hereinafter Schroeder, *Rift Bodes Ill*].

304. Tom Lauricella & Aaron Lucchetti, *TIAA Opposes Plan by SEC to Disclose Funds' Proxy Votes*, WALL ST. J., Nov. 7, 2002, at C1.

305. Schroeder, *Rift Bodes Ill*, *supra* note 303.

306. *See* Gretchen Morgenson, *Pipeline to a Point Man: A Friend of Main St., or Wall St.?*, N.Y. TIMES, Nov. 3, 2002, § 3, at 1. Even though Representative Oxley supported Sarbanes-Oxley and thereby helped write legislation meant to restore investor confidence after the worst spate of misconduct since 1929, his prior experience largely involved support of the accounting industry. According to an article in the *New York Times*, Oxley is

> one of the best friends that the industry has in Washington, has worked hard to keep it from facing new regulation intended to protect investors. Early in the process, he opposed the legislation that would become Sarbanes-Oxley, preferring a softer approach to accounting overhaul. And he shrugged off the conflicts of interest among Wall Street analysts until that issue became unavoidable.
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> . . . .
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> Mr. Oxley's role as reformer, according to people who have dealt with him over the years, is decidedly out of character. As an industry champion, he and his political action committee receive large contributions from Wall Street firms, banks and the accounting profession.
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> . . . .
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> . . . "But everyone in the securities industry recognizes him as a stalwart friend who will stand in the way of almost every investor reform."

Id. (quoting Arthur Levitt, former SEC Chairman). This article also describes how Oxley's name became associated with the Sarbanes-Oxley Act:

> Perhaps most paradoxical was Mr. Oxley's early opposition to the legislation that he is now credited with helping to write. Barbara Roper, director for investor protection at the Consumer Federation of America, saw him battle the bill firsthand after she and her legislative director were asked by lawmakers what investor protection mechanisms to include in the bill.
>
> "We said the first thing you have to do is make auditors independent," Ms. Roper recalled. "They didn't like that argument. The next thing you know they've introduced this bill that reflects nothing from our discussion: nothing on auditor independence and an oversight board with virtually no powers structured in a way that ensures the most control by the accounting industry."
>
> Then WorldCom's accounting debacle exploded onto the scene and President Bush demanded that Congress come up with a bill on corporate accountability by August. When the bill that was to become Sarbanes-Oxley was being completed in conference, Ms. Roper said, Mr. Oxley suggested that it be called the Sarbanes bill because of all the work Mr. Sarbanes had done on it.

unexpectedly announced that the chairmanship in fact had not been offered to Biggs, but that he was still under active consideration for the post.[307] Apparently, however, no further serious consideration was given to Biggs's candidacy.[308]

In late October, the SEC, in a bitter and partisan three-to-two split, selected William H. Webster to be the chairman.[309] Almost immediately, however, Chairman Pitt found it necessary to defend his failure to disclose either to the SEC Commissioners or the White House the fact that Webster had been the chairman of an audit committee for a small publicly held company, U.S. Technologies, Inc., whose CEO was accused of fraud and financial mismanagement.[310] Webster stated that he had disclosed his involvement in this case to Chairman Pitt and had offered to withdraw his candidacy for the chairmanship;[311] "I am not a competitor for this job."[312] Chairman Pitt's staff had looked into the U.S. Technologies situation and assured Webster that the situation "wasn't a disqualifying factor."[313] However, it turned out that neither the White House nor the other commissioners were aware of this involvement.[314] The outside auditing firm for U.S. Technologies stated that Webster's statements were "false

> "Sarbanes gets up and said, 'If that's what you're going to do we should call it Sarbanes-Oxley,' and Oxley slaps his name on a bill he fought every step of the way."

Id.

307. Michael Schroeder, *Bush Defends Pitt Amid Calls for Resignation: SEC Chief Irks Democrats in Flap About Chairman of New Accounting Board*, WALL ST. J., Oct. 10, 2002, at A6.

308. *See* Michael Schroeder & Cassell Bryan-Low, *SEC's Pitt Now Faces Dissent from Within the Commission*, WALL ST. J., Oct. 7, 2002, at A1 (suggesting that, due to tension within the SEC, Biggs "has all but lost the chance to get the job").

309. Schroeder, *Rift Bodes Ill*, *supra* note 303; *see also* Alex Berenson, *Webster's Public Service Image Not Duplicated in Private Sector*, N.Y. TIMES, Nov. 5, 2002, at C1 [hereinafter Berenson, *Webster's Image*]. Mr. Webster is a widely respected former director of the CIA and the FBI. *Id.* Seventy-eight years old, he was then practicing law with a major New York law firm. *Id.* The principal objections to Webster were that he had not had significant exposure to accounting and auditing issues and that Biggs, not Webster, was the ideal person for the chairmanship. *See id.*; Michael Schroeder, *Politics & Policy: Webster Is Favorite for Audit Panel*, WALL ST. J., Oct. 24, 2002, at A4. However, subsequent investigations revealed Webster had considerably more significant contacts with the accounting industry than were first recognized. Refer to notes 309–16 *infra* and accompanying text.

310. Yochi J. Dreazen, *U.S. Technologies Mires the Ambitious and Powerful*, WALL ST. J., Nov. 4, 2002, at B1.

311. *Id.*

312. Stephen Labaton, *3 Inquiries Begun into S.E.C.'s Choice of Audit Overseer*, N.Y. TIMES, Nov. 1, 2002, at A1 (quotation marks omitted).

313. John R. Wilke, *Webster Says He Will Likely Quit as Head of New Accounting Board*, WALL ST. J., Nov. 12, 2002, at A1.

314. Carol Hymowitz, *IN THE LEAD: Arrogance and Refusal to Work with Others Led to Many Failures*, WALL ST. J., Dec. 17, 2002, at B1.

and misleading" and requested an opportunity to disclose the true facts.[315] At the same time, members of the U.S. Technologies audit committee, company executives and investors, and their lawyers all stated that they had been defrauded by U.S. Technologies but were never contacted by anyone at the SEC about Webster's candidacy in light of his involvement with U.S. Technologies.[316]

Undoubtedly, the person who was most humiliated by these events was Chairman Pitt himself, and he resigned as Chairman on November 5, 2002.[317] His resignation was promptly accepted by the White House.[318] Pitt's brief career as Chairman of the SEC had been marked by gaffes. For example, he publicly stated in October 2002 that his goal was to make the SEC "a 'kinder and gentler place for accountants.'"[319] He also met privately with the CEO of KPMG during the time that firm was being directly investigated by the SEC.[320] Also, in July 2002, he privately went to Congress asking for a raise in salary and an elevation in rank of the Chairmanship of the SEC.[321] These requests were met with some amusement within Congress, and of course the incident quickly became public. An editorial in the *Wall Street Journal*, normally a friendly ally of the accounting industry, commented: "We're beginning to admire the White House and other defenders of Harvey Pitt. They've stood bravely by their man, notwithstanding the SEC Chairman's apparent determination to embarrass them."[322] Holman Jenkins Jr. wrote a *Wall Street Journal* editorial entitled *A Cure for Everything: Fire Harvey Pitt!*, in which he stated, "thank God for a Republican . . . at the head of the [SEC], but especially one as politically luckless as Harvey Pitt."[323]

There are indications in the press that these events have

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315. Berenson, *Webster's Image*, *supra* note 309. On November 5, 2002, the *New York Times* carried a story questioning Webster's reputation in the private sphere: "But outside Washington, Mr. Webster's record is less than perfect. Since he retired from the C.I.A. 11 years ago to build a lucrative second career as a corporate lawyer, Mr. Webster has repeatedly taken positions that critics say have been at odds with his reputation." *Id.*

316. *See* Yochi J. Dreazen & Michael Schroeder, *CEO of Firm Tied to Webster Faces Charges*, WALL ST. J., Dec. 20, 2002, at C1.

317. Jeanne Cummings et al., *Rapid Exit: SEC's Pitt Resigns Amid Controversy Over Webster Job*, WALL ST. J., Nov. 6, 2002, at A4.

318. *Id*. (indicating that the White House already had "a short list of potential successors").

319. *Id*.

320. *Id*.

321. *Id*.

322. Editorial, *In the Pitts*, WALL ST. J., Nov. 1, 2002, at A14.

323. Holman W. Jenkins, Jr., *Business World: A Cure for Everything: Fire Harvey Pitt!*, WALL ST. J., Oct. 30, 2002, at A19.

seriously injured not only former Chairman Pitt, but also the SEC and the ordinary citizen's confidence in that highly respected agency. Headlines may be misleading, but the following three indicate the nature of the immediate problem: *A Selection Process Misfires, and Pitt Reels,*[324] *Accounting-Board Rift Bodes Ill for SEC,*[325] and, the most favorable, simply *New SEC Probes Buy Time for Pitt.*[326]

XIV. EXAMINATION OF THE DETAILED PROVISIONS OF SARBANES-OXLEY

Sarbanes-Oxley contains ten titles that make changes in many areas of current law. The discussion of the detailed provisions that follows draws heavily on the thoughtful work of Professors Ribstein and Cunningham.

A. Title I: Public Company Accounting Oversight Board (PCAOB)[327]

Title I creates the PCAOB, a District of Columbia non-profit corporation.[328] The Board's duties include: (1) registering public accounting firms;[329] (2) adopting auditing, quality control, ethics, independence, and other standards for issuers' audit reports;[330] (3) conducting inspections[331] and investigations of accounting

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324. Floyd Norris, *A Selection Process Misfires, and Pitt Reels*, N.Y. TIMES, Nov. 1, 2002, at C1.

325. Schroeder, *Rift Bodes Ill*, *supra* note 303.

326. Michael Schroeder, *New SEC Probes Buy Time for Pitt*, WALL ST. J., Nov. 4, 2002, at A3. This article listed four current investigations concerning Chairman Pitt. *See id.* Presumably, his resignation will make these investigations unnecessary.

327. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101–109, 116 Stat. 745, 751–71 (to be codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

328. *Id.* § 101(b), 116 Stat. at 750.

329. *Id.* § 102, 116 Stat. at 753–55. Only registered accounting firms will be permitted to audit publicly held corporations, beginning six months after the PCAOB is established. *Id.* § 102(a), 116 Stat. at 753. The registration must disclose, among other things, the names of issuers being audited by the firm, annual fees, quality control policies, names and licensing information of all the firm's auditors, legal actions or disciplinary proceedings pending against the firm or associated persons, and documents relating to any accounting disagreements between the issuer and the auditing firm. *Id.* § 102(b)(2)(A)–(H), 116 Stat. at 753–54. The firm must also consent to cooperate and comply with Board orders for testimony or documents. *Id.* § 102(b)(3)(A)–(B), 116 Stat. at 754.

330. *Id.* § 103, 116 Stat. at 755–57. Retention of work papers for seven years is required; there is also mandatory peer review of audits, disclosure of auditors' testing, monitoring of ethics and independence, consultation within auditing firms, and inspection of selected engagements and the firm's quality control system. *Id.* § 103(2), 116 Stat. at 755–56.

331. *Id.* § 104, 166 Stat. 757–59. Inspections are required annually for firms doing more than one hundred audits per year and every three years for other firms. *Id.* § 104(b)(1)(A)–(B), 116 Stat. at 757–58.

firms;[332] and (4) where appropriate, imposing sanctions for failing to comply with applicable requirements.[333] The SEC appoints and oversees the Board; it is given broad oversight and enforcement authority over the Board's activities, including the power to approve rules prior to their promulgation by the Board and to amend existing rules.[334]

As stated above, the Board is to consist of five members,

> appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.[335]

Only two members of the Board may be or have been Certified Public Accountants (CPAs).[336] The chairperson, furthermore, if one of the two CPAs, cannot have practiced public accountancy within five years of his or her appointment.[337] Members are appointed for staggered five-year terms[338] and serve on a full-time basis.[339] Only firms registered by the PCAOB may audit registered issuers.[340]

The creation of this new self-regulatory entity offers real possibility for improvement of corporate governance if the PCAOB can get over its growing pains and actually begin its work. For one thing, the PCAOB separates the process of creating generally accepted accounting principles (GAAP) and

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332. *Id.* § 105(b), 116 Stat. at 759–61. Testimony may be required; noncooperation may result in suspension or revocation of registration. *Id.* § 105(b)(2)–(3), 116 Stat. at 760.

333. *Id.* § 105(c)(4), 116 Stat. at 762. Sanctions also may be imposed for firm and individual violations and for failures to supervise. *Id.* § 102(c)(4), (6), 116 Stat. at 762–63.

334. *Id.* § 107, 116 Stat. at 765–68. These powers are specifically preserved for the SEC, as the PCAOB is considered a "registered securities association" governed by § 17(a)(1) and (b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(a)(1) and (b)(1). *Id.* § 107(a), 116 Stat. at 765. The SEC has authority to amend rules of the Board, modify sanctions imposed by the Board, rescind the authority of the Board, or censure or impose limitations on the Board. *Id.* § 107(a)–(d), 116 Stat. at 765–68. Section 108 of the Act provides for SEC recognition of accounting standards as "generally accepted" only if they are created by an organization funded by the Board and a majority of its members have not been associated with an accounting firm for two years. *Id.* § 108(a), 116 Stat. at 768–69. It also directs the SEC to study the possible adoption of a principles-based financial reporting system. *Id.* § 108(d), 116 Stat. at 769.

335. *Id.* § 101(e)(1), 116 Stat. at 751.

336. *Id.* § 101(e)(2), 116 Stat. at 751.

337. *Id.*

338. *Id.* § 101(e)(5)(A), 116 Stat. at 752. There is a two-term limit for reappointments. *Id.* § 101(e)(5)(B), 116 Stat. at 752.

339. *Id.* § 101(e)(3), 116 Stat. at 751.

340. *Id.* § 102(a), 116 Stat. at 753.

generally accepted accounting standards (GAAS) from the control of the American Institute of Certified Public Accountants (AICPA) and its Auditing Standards Boards.[341] For another, the PCAOB has economic independence—it will support itself through funds collected from an annual accounting support fee, registration fees, and the imposition of monetary penalties.[342] The replacement of AICPA and its Auditing Standards Boards by the PCAOB should not significantly lessen the disciplinary powers that the SEC has traditionally exercised in this area.

Whether or not this promise will be realized depends largely on the abilities and backgrounds of the five individuals chosen to serve on the PCAOB.

B. Title II: Auditor Independence

Title II of the Sarbanes-Oxley Act amends section 10A of the Securities Exchange Act of 1934 in several respects. Section 201 adds a new subsection (g) that prohibits auditing firms from providing a variety of specific non-auditing services to their audit clients.[343] Section 202 provides that certain permissible types of non-auditing services may be provided by an auditing firm, but only with the specific prior approval of the firm's audit committee.[344] Section 203 requires that audit partners be rotated at least every five years.[345] Section 204 requires auditors to report to audit committees on: (1) critical accounting policies and practices; (2) alternative GAAP treatment of issues discussed with management; and (3) other

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341. *See id.* § 108(a), 116 Stat. at 768–69.

342. *Id.* § 109(c), 116 Stat. at 769–70.

343. *Id.* § 201, 116 Stat. at 771–72. Prohibited services include: bookkeeping or related services; financial information systems design and implementation; appraisal or valuation services; fairness opinions; actuarial services; internal audit outsourcing services; management functions or human resources; broker, dealer, investment adviser or investment banking services; legal services and expert services unrelated to the audit; and other services that the Board determines to be impermissible. *Id.* § 201(a), 116 Stat. at 771–72 (adding Section 10A(g) to the 1934 Act). The PCAOB is authorized to create exemptions from these prohibitions on a case-by-case basis. *Id.* § 201(b), 116 Stat. at 772. In addition, other types of non-audit services may be provided only if prior approval is obtained from the audit committee. *Id.* § 201(a), 116 Stat. at 772 (adding section 10A(h) to the 1934 Act).

344. *Id.* § 202, 116 Stat. at 772–73 (adding section 10A(i) to the 1934 Act).

345. *Id.* § 203, 116 Stat. at 773 (adding section 10A(j) to the 1934 Act). This provision apparently was designed to avoid the situation that arose at Enron and WorldCom, where lead partners from small offices of Arthur Andersen, LLP were able to develop overly close relationships with the client. *See* Thaddeus Herrick & Alexei Barrionuevo, *Were Auditor and Client Too Close-Knit?*, WALL ST. J., Jan. 21, 2002, at C1. Section 207 of the Sarbanes-Oxley Act requires a study of the desirability of mandatory rotation of Registered Public Accounting firms to address this problem. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 207, 116 Stat. 745, 775.

communications with management on auditing questions, such as the management letter or a schedule of unadjusted differences.[346] Section 206 prohibits a public accounting firm from providing audit services for an issuer if any senior officer of the issuer was employed by the auditing firm and participated in a previous audit of the issuer within the previous year.[347] Section 207 requires the Comptroller General to study the potential effects of requiring mandatory rotation of registered public accounting firms.[348] Professor Cunningham has suggested that these explicit provisions largely restate current law and practice and to some extent "federalize[] common sense and general practice."[349]

Section 208 directs the SEC to promulgate (within a period of 180 days) appropriate regulations to implement these changes in auditor independence.[350]

C. Title III: Corporate Responsibility

Title III imposes new requirements with respect to the audit process itself.[351] Issuers basically have until April 2003 to bring their audit process into conformity with these new requirements, and if an issuer fails to do so, its securities may no longer be listed on any national securities exchange or national securities association.[352]

Section 301 requires the SEC to promulgate a rule directed to the national securities exchanges and associations that prohibits the listing of any security of an issuer "that is not in compliance with" the balance of section 301.[353] It requires the audit committee ("in its capacity as a committee of the board of directors") to be directly responsible for the appointment, compensation, and oversight of the public accounting firm and the auditor employed by the issuer.[354] Each member of the audit committee must be a member of the board of directors of the issuer and must be independent in the sense of not accepting fees

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346. *Id*. § 204, 116 Stat. at 773 (adding section 10A(k) to the 1934 Act).

347. *Id*. § 206, 116 Stat. at 774–75 (adding section 104(l) to the 1934 Act).

348. *Id*. § 207, 116 Stat. at 775.

349. Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 24–25).

350. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 208, 116 Stat. 745, 775.

351. *Id*. §§ 301–302, 116 Stat. at 775–78. The Title III provisions are technically amendments to section 10A of the Securities Exchange Act of 1934 and are codified at 15 U.S.C. §§ 78j-1, 77t, 78u, 78u-1, 80a-41, 80b-9, 7241–7246, 7261, and at 29 U.S.C. §§ 1021, 1132. *See id*.

352. *Id*. § 301, 116 Stat. at 775–77 (adding section 10A(m)(1) to the 1934 Act).

353. *Id*. (adding section 10A(m)(1) to the 1934 Act).

354. *Id*. (adding section 10A(m)(2) to the 1934 Act).

from the issuer or any subsidiary of the issuer for the performance of audit-related functions.[355] These provisions formalize and incrementally extend current requirements.

Section 302 requires the principal executive officer and the principal financial officer to certify in each annual or quarterly report that the officer has reviewed the report and that based on his or her knowledge: (1) the report does not contain any untrue statement of a material fact (or omit to state a material fact necessary to make the statements made not misleading); (2) the report fairly presents in all material respects the financial condition and results of operations of the issuer; (3) the officers responsible for establishing and maintaining internal controls have designed them to ensure that material information is provided to them; and (4) the officers have disclosed to the auditors and the audit committee any significant deficiencies in the design or operation of the internal controls.[356]

Section 303 requires the SEC to develop regulations by April 2003 that protect against any person fraudulently influencing, coercing, manipulating, or misleading an auditor for the purpose of making financial statements materially misleading.[357] These provisions make no change in duties of management or rights of shareholders, but give the SEC express authority to undertake enforcement action for violations.[358]

Section 304 provides that if an issuer is required to restate financials as a result of misconduct, the CEO and CFO must reimburse the corporation for any incentive or equity-based compensation or profits they received from stock sales during the year following the year in which the restated financials are issued.[359] Back bonuses and stock options are also subject to recapture.[360]

Section 305 amends section 21(d)(2) of the 1934 Act[361] to change the test for barring unfit officers from "substantial unfitness" to mere "unfitness."[362] It also amends section 21(d)(5)

355. *Id.* (adding section 10A(m)(3)(A)–(B) to the 1934 Act).

356. *Id.* § 302, 116 Stat. at 777.

357. *Id.* § 303(a), (d), 116 Stat. at 778.

358. *Id.* § 303(b), 116 Stat. at 778. Professor Cunningham comments that this is equivalent to "adding a pair of suspenders to a belted trouser." Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 25).

359. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778.

360. *Id.* § 304(a), 116 Stat. at 778. The SEC is authorized, however, to exempt issuers as it deems necessary or appropriate. *Id.* § 304(b), 116 Stat. at 778.

361. 15 U.S.C. § 78u(d)(2) (2000).

362. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 305(a)(1), 116 Stat. 745, 778–79.

of the 1934 Act[363] to authorize the SEC to obtain equitable relief against securities law violations.[364]

Section 306 prohibits trading by executive officers of an issuer, in securities of the issuer, during any "blackout period" and provides that the issuer or any shareholder may sue to recover any profits obtained during that period.[365] The term "blackout period" is defined.[366]

Section 307 requires the SEC to develop rules by January 2003 to establish minimum standards of "professional conduct" for attorneys practicing before the Commission and to require attorneys to report any violations to the chief legal officer or CEO and to the audit committee if the officer "does not appropriately respond to the evidence" presented.[367] This section imposes a "watchdog" role on attorneys that has no direct precedent in current practice and was described as "uncharted territory" by former SEC Chairman Pitt.[368] The requirement that the SEC should promulgate rules relating to attorney conduct is novel and out of character for the SEC; it is likely to be resisted by members of the bar, though the statutory requirement seems unambiguous. Historically, rules relating to the responsibilities of attorneys have been solely the responsibility of bar associations, not a federal agency.[369]

Section 308 authorizes the SEC to recover both disgorgement and civil penalties for violations of the securities acts.[370] It also authorizes the SEC to accept donations to disgorgement funds and directs it to study whether policies relating to civil penalties or disgorgement may be improved to provide fair restitution to injured investors.[371]

D. Title IV: Enhanced Financial Disclosures

Section 401 amends section 13 of the Securities Exchange

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363. 15 U.S.C. § 78u(d)(5).

364. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 305(b), 116 Stat. 745, 779.

365. *Id.* § 306(a)(1)–(2), 116 Stat. at 779.

366. *Id.* § 306(a)(4), 116 Stat. at 780. Professor Cunningham states that several details of this provision "encroach on state law." Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 30).

367. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784.

368. Shanon D. Murray, *SEC Chairman: Lawyers to Get Closer Scrutiny*, MIAMI DAILY BUS. REV., Aug. 15, 2002, at 9 (quoting then-Chairman Pitt).

369. *Id.*

370. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308(a), 116 Stat. 745, 784.

371. *Id.* § 308(b)–(c), 116 Stat. at 784–85. Section 308 provides that civil penalties shall be added to disgorgement funds.

Act of 1934,[372] now requiring the disclosure of off-balance sheet figures and pro forma figures and adopting rules that prohibit the use of untrue or incomplete statements of material fact with respect to off-balance sheet and pro forma figures.[373] The SEC is also directed to prepare a study of off-balance sheet practices, including specifically a study of special purpose entities.[374]

Section 402 prohibits an issuer from making personal loans to executives, with narrow exceptions for home improvement, consumer credit, and similar transactions.[375] This rather vague prohibition has had an immediate impact on the once common corporate practice of granting loans to permit "cashless" exercise of stock options by its directors and executives.[376] These arrangements involve the advance of corporate funds to permit executives to acquire and exercise "in the money" stock options and sell the shares so acquired into the market.[377] These "loans" rarely involve an advance of funds by the corporation for as long as three days, but they appear to fall squarely within the prohibition of section 402.

Section 403 reduces the time of disclosure of insider transactions under section 16 of the Securities Exchange Act of 1934 from forty days[378] to two days.[379]

Section 404 provides that each annual report required under section 13(a) or 15(d) of the Securities Exchange Act of 1934[380] must include a statement that management has responsibility for establishing and maintaining an adequate control structure

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372. 15 U.S.C. § 78m (2000).

373. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401(a)–(b), 116 Stat. 745, 785–86. Professor Cunningham suggests that these provisions essentially repeat SEC rules requiring quarterly and annual disclosure of off-balance sheet transactions of a significant nature. Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 33).

374. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401(c), 116 Stat. 745, 786–87.

375. *Id.* § 402, 116 Stat. at 787–88 (adding section 13(k) to the 1934 Act). Professor Cunningham suggests that these provisions encroach on traditional state corporate territory. Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 31). He adds: "The loan prohibition is a classic case of overreaction to a few miscreants that is simultaneously underinclusive." *Id.*

376. *See* Joseph B. Treaster & Tracie Rozhon, *Another Blow to Executives on Options: Uncertainty Halts "No Cash Down" Deals*, N.Y. TIMES, Aug. 30, 2002, at C1. The statutory prohibition against loans does not affect loans to corporate employees who are neither directors nor high-level executives. *Id.* However, with respect to covered individuals, the prohibition presumably includes corporate loans for other purposes, for example, to purchase a residence. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 787–88.

377. Treaster & Rozhon, *supra* note 376.

378. 15 U.S.C. § 78p (2000).

379. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 403, 116 Stat. 745, 788–89.

380. 15 U.S.C. § 78m, 780(d).

and procedures for financial reporting, and it further requires the firm's auditor to make an assessment of the performance of that responsibility.[381] The public accounting firm that prepares or issues the audit report must also attest to and report on the assessment made by the board.[382] Section 405 exempts investment companies from this responsibility.[383]

Section 406 requires each issuer to disclose whether it has adopted a code of ethics for senior financial officers, including the comptroller and principal accounting officer.[384] If it has not adopted such a code, it must explain why.[385] It must also disclose all changes made in existing codes of ethics.[386]

Section 407 requires each issuer to always have at least one financial expert on its audit committee (or to justify the failure to have such a person on the committee).[387] The SEC is directed to prepare an appropriate definition of a "financial expert" that must include: (1) "an understanding of generally accepted accounting principles and financial statements," (2) "experience in . . . the preparation or auditing of financial statements of generally comparable issuers[,] and . . . the application of such principles in connection with the accounting for estimates, accruals, and reserves," (3) "experience with internal accounting controls," and (4) "an understanding of audit committee functions."[388]

Section 408 requires "regular and systematic review" of disclosures by issuers of publicly held securities by the SEC, at least every three years, and more often if the issuer has: (1) issued a material restatement of financial results; (2) experienced significant volatility as compared to other issuers; (3) had significant changes in capitalization; (4) had disparities in price to earnings ratios; or (5) experienced other factors

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381. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789.

382. *Id.* § 404(b), 116 Stat. at 789. Professor Cunningham describes section 404 as similar to "an errant cowboy [who] locks the stable after his wild horses have escaped." Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 26). An article in the *New Jersey Law Journal* dated September 2, 2002, comments that "the 'new' mandates related to the role of audit committees impose very few additional duties. Rather, the act merely sets forth what many in the securities bar have long deemed to be best practices." David J. Sorin et al., *Sarbanes-Oxley Act: Politics or Reform? Statute's Effects Are Not as Profound as Legislators Would Have Us Believe*, N.J. L.J., Sept. 2, 2002, at 23.

383. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 405, 106 Stat. 745, 789.

384. *Id.* § 406(a), 116 Stat. at 789.

385. *Id.*

386. *Id.* § 406(b), 116 Stat. at 789.

387. *Id.* § 407, 116 Stat. at 790.

388. *Id.* § 407(b), 116 Stat. at 790. Professor Cunningham states: "This is another dose of weak tea. It requires nothing substantive. In fact, the Act does not go as far as stock exchange rules on the subject." Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 24).

expressly considered significant by the SEC.[389]

Section 409 amends section 13(1) of the 1934 Act[390] to require "real time" disclosure made on a "rapid and current" basis.[391] The disclosure must be in "plain English" and may include trends and "qualitative information and graphic presentations."[392]

E. Title V: Conflicts of Securities Analysts

Section 501 adds a new section 15D to the Securities Exchange Act of 1934 dealing with conflicts of interest by securities analysts.[393] The SEC or a registered securities association or national securities exchange must adopt by August 1, 2002, rules reasonably designed to address conflicts of interest "that can arise when securities analysts recommend equity securities in research reports and public appearances."[394] The rules must address (1) restricting prepublication clearance or approval of research reports, (2) limiting supervision and evaluation of securities analysts to officials who are not themselves engaged in investment banking activities, (3) prohibiting retaliation or threats to retaliate against analysts who make negative reports, (4) ensuring that physical separation is maintained within firm offices between analysts and investment banking personnel, (5) requiring disclosure of specified analyst conflicts in public appearances and research reports, and (6) similar matters.[395]

F. Title VI: SEC Resources and Authority

This title increases appropriated funds for the SEC[396] and grants the agency power to (1) censure persons or prohibit their appearance or practice before the Commission, and (2) establish criteria for qualifications of associated persons of brokers, dealers, and investment advisers who practice or appear before the Commission.[397]

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389. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 408, 116 Stat. 745, 790–91.

390. 15 U.S.C. § 78m(1) (2000).

391. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 409, 116 Stat. 745, 791.

392. *Id.*

393. *Id.* § 501(a), 116 Stat. at 791–93.

394. *Id.*

395. *Id.*

396. Schroeder, *SEC Gets a Raise*, *supra* note 279. The SEC budget was increased by 66% to $776 million, about triple the amount of the increase proposed by President Bush. *Id.* It is doubtful whether the SEC will receive this increase in its first year of operation. *See id.* (discussing the current budgetary problems the SEC faces).

397. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 601–604, 116 Stat. 745, 793–96.

G. Title VII: Studies and Reports

This title directs the Comptroller General to study and prepare a report on the consolidation of public accounting firms.[398] This title also directs the SEC to study and report on credit reporting agencies,[399] violations of SEC regulations between the years 1998 and 2002,[400] and enforcement actions over the five years preceding the enactment of Sarbanes-Oxley.[401]

H. Titles VIII, IX, and XI: Corporate and Criminal Fraud

1. Accountability. Titles VIII, IX, and XI significantly increase the penalties and statutes of limitations for a wide variety of criminal (or near-criminal) activities with respect to corporate securities.

Title VIII is named the "Corporate and Criminal Fraud Accountability Act of 2002";[402] Title IX is named the "White-Collar Crime Penalty Enhancement Act of 2002";[403] and Title XI is named the "Corporate Fraud Accountability Act of 2002."[404] As these titles suggest, the Sarbanes-Oxley Act has a strong criminal bias, even though many persons who will be subject to these provisions probably have never considered their actions to be improper—much less criminal in nature. These rather draconian provisions are summarized briefly in the following paragraphs.

a. Title VIII. Title VIII consists of seven sections.[405] These sections establish criminal penalties for the destruction, alteration, or falsification of records in federal investigations and bankruptcy,[406] including the destruction of corporate audit records or workpapers.[407] One section makes debts incurred in violation of securities fraud laws nondischargeable,[408] and another extends the statute of limitations for securities fraud litigation to five years.[409] Title VIII also increases the maximum penalty for destroying, altering, or falsifying records relating to audits or reviews to a

398. *Id*. § 701, 116 Stat. at 797.
399. *Id*. § 702, 116 Stat. at 797–98.
400. *Id*. § 703, 116 Stat. at 798–99.
401. *Id*. § 704, 116 Stat. at 799.
402. *Id*. § 801, 116 Stat. at 800.
403. *Id*. § 901, 116 Stat. at 804.
404. *Id*. § 1101, 116 Stat. at 807.
405. *See id*. §§ 801–807, 116 Stat. at 800–04.
406. *Id*. § 802(a), 116 Stat. at 800.
407. *Id*.
408. *Id*. § 803, 116 Stat. at 801.
409. *Id*. § 804, 116 Stat. at 801 (to be codified at 28 U.S.C. § 1658).

substantial fine and a maximum of twenty years' imprisonment.[410] Title VIII also provides whistleblower protection for employees of publicly traded companies who provide evidence of fraud.[411] The criminal penalty for commission of a knowingly fraudulent act or for obtaining property under false or fraudulent pretenses is extended to up to twenty-five years' imprisonment.[412]

b. Title IX. Title IX increases criminal penalties for mail and wire fraud to imprisonment from five to twenty years.[413] Title IX also increases criminal penalties for various ERISA violations from $5,000 to $100,000, and in some instances from $100,000 to $500,000, and from one to ten years' imprisonment.[414]

c. Title X. Title X provides that it is the "sense of the Senate" that the federal income tax return of a corporation should be signed by the CEO of the corporation.[415]

2. Certification of Financial Statements. Section 906 provided the first real application of the Sarbanes-Oxley Act. That section requires financial statements to be certified and the certificate to state that they "fully compl[y] with the requirements of section 13(a) or 15(d) of the Securities Exchange Act" of 1934 and that "information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[416] The controversial aspect of this certification requirement was section 906, which amended 18 U.S.C. § 1350 to require that the CEO and CFO of the corporation each submit a written statement that makes the same certification.[417] Furthermore, substantial penalties are imposed on any person who makes this certification containing incorrect information—they may be fined up to $1 million and imprisoned for not more than ten years.[418] If a certification is made by a person "knowing that the periodic report accompanying the statement does not comport with all the requirements" of this section, that person may be fined up to

410. *Id*. § 802, 116 Stat. at 801 (to be codified at 18 U.S.C. § 1519).

411. *Id*. § 806, 116 Stat. at 802–04 (to be codified at 18 U.S.C. § 1514A). This section provides protection against retaliation. *Id*.

412. *Id*. § 807, 116 Stat. at 804 (to be codified at 18 U.S.C. § 1348).

413. *Id*. § 903, 116 Stat. at 805 (to be codified at 18 U.S.C. §§ 1341, 1343). The effect of this provision may be to preserve private resources available to compensate injured persons.

414. *Id*. § 904, 116 Stat. at 805 (to be codified at 29 U.S.C. § 1131).

415. *Id*. § 1001, 116 Stat. at 807.

416. *Id*. § 906(a), 116 Stat. at 806 (to be codified at 18 U.S.C. § 1350(b)).

417. *Id*. (to be codified at 18 U.S.C. § 1350(a)).

418. *Id*. (to be codified at 18 U.S.C. § 1350(c)(1)).

$5 million and imprisoned for up to twenty years.[419]

These provisions were the first parts of the Sarbanes-Oxley Act actually to be implemented; the first round of certifications were to be made in the summer of 2002.[420] As a result, these provisions were widely discussed, and some persons speculated that the specific obligation placed upon the CEO and CFO also would impose upon them a potential liability of uncertain proportions. This liability was uncertain, it was felt, because CEOs and CFOs typically rely on subordinates to prepare financial statements; it was assumed that, because of the new requirement, the CEO and CFO would have to become involved to a significant extent in the preparation of the financial statements themselves if they were to make a reasonably confident certification.[421]

Professor Cunningham rejected this concern. This requirement, he said, "is a yawn" as such certifications have "always been a requirement of the federal securities laws," and CEOs and CFOs are always named as principal defendants in litigation over the accuracy of such certifications.[422] The most this new statutory requirement will do, according to Professor Cunningham, is to require subordinates who are actually involved in the preparation of the financial statements themselves to provide a certificate that meets the Sarbanes-Oxley requirements, and on which the CEO and CFO can rely in good faith.[423]

The requirement in section 906 of the Sarbanes-Oxley Act that the accuracy of corporate financial statements be certified by the corporation's CEO and CFO was first tested on August 14,

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419. *Id.* (to be codified at 18 U.S.C. § 1350(c)(2)).

420. *The SEC's New Certification and Internal Controls Rules Are In Effect Now*, 1343 PLI/CORP. 587, 589 (2002) (indicating that the SEC's new certification rules issued August 29, 2002, became effective immediately).

421. *See, e.g.*, Stephen J. Crimmins et al., *Sweeping Securities Law Reform Affects Issuers, Officers and Directors: With the Sarbanes-Oxley Act Signed into Law, the Cost of Being Public Has Just Gone Up*, N.J. L.J., Aug. 19, 2002, at 29 (advising CEOs and CFOs to "take action well before the date for their certifications to evaluate their record-keeping and systems of internal controls, and to question their management team concerning any possible issues that . . . the SEC may later think they should have known"). Section 302 of the Sarbanes-Oxley Act imposes a second certification requirement on the CEO and CFO: They must certify or affirm that they disclosed any control deficiencies or weaknesses to their outside auditors and the board's audit committee, as well as any fraud involving employees with significant internal control responsibilities. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a)(5), 116 Stat. 745, 777.

422. Cunningham, *Sarbanes-Oxley Yawn*, *supra* note 39 (manuscript at 27). Professor Cunningham states, however, that future certifications involve "the sharpest teeth in the legislation (though exactly how sharp are these teeth remains to be seen)." *Id.* (manuscript at 28).

423. *Id.* (manuscript at 27–28).

2002, when the CEOs and CFOs of roughly seven hundred companies were required to certify for the first time the accuracy of their financial statements.[424] While a handful of companies with known accounting problems announced that they could not meet this requirement,[425] the great bulk of the companies did make the required certification.[426] Several companies executed the certificate but announced that accounting errors existed (including one by Household International that involved a restatement of $386 million for earnings as far back as 1994).[427] The CEO and CFO of AOL Time Warner both signed certificates but added a note that three transactions had been discovered (involving relatively minor amounts) that might require an earnings restatement in the future.[428]

On August 20, 2002, the SEC announced that sixteen certification statements either had failed to conform to its standards or had merely requested extensions.[429] The SEC presumably will review all of these filings and will release the results of its review.

Ultimately, the SEC should receive approximately 15,000 filings per year from publicly held companies pursuant to section 906.[430] Commentators continue to express doubt about the wisdom and desirability of this whole enterprise. Dorothy Coleman, a vice president for tax policy at the National

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424. Elisabeth Butler, *Top CEOs Sign Off on Books to Boost Investor Confidence*, NEW ORLEANS CITY BUS., Aug. 19, 2002, at 13. The SEC did not permit electronic filings, with the result that it was virtually inundated with forms delivered by courier, overnight mail, regular mail, and fax on that day. Michael Schroeder, *Under Gun from SEC, Bristol, Others Divulge Accounting Issues*, WALL ST. J., Aug. 15, 2002, at A1.

425. Several companies that were former clients of Arthur Andersen, LLP—including Enron, Dynegy, Qwest Communications International Inc., and WorldCom—announced they were unable to certify. *"Oath Order" for Top Execs Unearths Little, So Far*, REUTERS, Aug. 17, 2002.

426. *Sarbanes-Oxley: Ignore at Your Company's Peril*, TEX. LAW., Nov. 4, 2002, at S10 (quoting Houston attorney Thomas Ajamie's estimation that "a very high percentage" of the companies got their certifications in on time).

427. Richard Blackwell, *SEC Certification Deadline Passes with No New Scandals: U.S. Executives Sign Off on Financial Results*, GLOBE & MAIL, Aug. 15, 2002, at B1, *available at* http://www.globeand mail.com/servlet/ArticleNews/Pest/TGAM/20020815/RESECC/Headlines/headdex/headdexInternational_temp/1/1/17/ (last visited Jan. 12, 2003).

428. Julia Angwin, *Taking the Pledge: AOL Certifies Results but Includes a Caveat*, WALL ST. J., Aug. 15, 2002, at A7 (reporting a total of $49 million in questionable revenue). The certificate stated that the certificate was accurate "to the best of their knowledge." *Id.*

429. Press Release, U.S. Securities and Exchange Commission, SEC Staff Completes Processing of CEO, CFO Statements (Aug. 20, 2002), *available at* http://www.sec.gov/news/press/2002-125.htm (last visited Jan. 12, 2003); *see also Just 16 of 691 Firms Have Yet to Certify Results with SEC*, WALL ST. J., Aug. 21, 2002, at C9.

430. *Id.*

Association of Manufacturers, stated that this requirement forces CEOs to "certify information over which they have little control."[431] Professor Hazen suggested that the certification program is in effect "trying to eliminate a deniability defense" and that the tougher criminal penalties "are sending the message that corporate fraud—fraud on shareholders—is [a] serious crime."[432] Professor Lawrence Mitchell of George Washington Law School wondered whether a criminal penalty for false certification will turn out to be counterproductive: "[O]nce you say to a guy that you're going to be held liable personally if you're reckless . . . it creates incentive to spend more time on that function of the business, which is not the real function of the CEO."[433]

XV. WHAT SARBANES-OXLEY DOES AND DOES NOT DO

With the enactment of Sarbanes-Oxley, attention has shifted to things that the statute does not, but arguably should, do. Certainly there are additional controversial matters that could have been addressed in this legislation, but for one reason or another were not addressed. Many of these issues will likely be examined in the near future.

A. The Expensing of Stock Options

Certainly the most controversial issue not addressed in Sarbanes-Oxley is the current treatment of stock options awarded to corporate directors, officers, or employees. Their current treatment is that they are essentially expense-free from the standpoint of the issuer.[434] The grant of an option is not an expense to the corporation (because no money is involved in the grant), and its exercise does not affect the corporation's profit and loss statement.[435] The exercise of an in-the-money option

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431. Coyle, *supra* note 291 (quoting Dorothy Coleman).

432. *Id.* (quotation marks omitted) (quoting Professor Hazen).

433. *Id.* (quotation marks omitted) (quoting Professor Mitchell).

434. *See* Helen Dewar & David S. Hilzenrath, *McCain Accounting Proposal Scuttled*, WASH. POST, July 12, 2002, at A01 ("Unlike salaries and cash bonuses, option grants to executives and employees are not counted as an expense on corporate statements.").

435. *See* Howard Gleckman, Editorial, *Commentary: Options: It's Time for Companies to Come Clean*, BUS. WK. ONLINE, Apr. 1, 2002, *at* http://www.businessweek.com/magazine/content/02_13/b3776058.htm (last visited Jan. 12, 2003). This approach has been approved by the Financial Accounting Standards Board (FASB). *See FASB Abandons Bid to Require Expensing of Employee Stock Options*, 26 SEC. REG. & L. REP. (BNA) 1725 (Dec. 23, 1994) (reporting that the FASB "voted not to require the recognition of expense stemming from employee stock options"). Employee organizations are reluctant to address the issue of the proper treatment of grants of in-the-money stock options, as many of their members are eligible to receive such options.

does, of course, dilute to some slight extent the economic interest of the other shareholders. Despite the widespread acceptance of these principles, there has long been an under-current of objection over accounting for options because they are clearly a form of compensation to employees.[436] Compensation may be provided to employees through salary, bonuses, or stock options. However, the employee compensation provided by stock options does not enter into the corporation's financial accounts.[437] Indeed, a corporation that rewards employees entirely through stock options theoretically can claim that its employment expenses are zero.[438]

The issue of expensing stock options is so controversial that the decision was made early on that the issue should not be addressed in the context of the Sarbanes-Oxley Act.[439]

The telecom corporate scandals described earlier in this Address[440] brought the issue of "free" options to a head. During the "bubble" years, it was clear that the grant of huge numbers of options to corporate officers and directors had been an important factor in permitting unconscionable gains by those officers and directors. In effect, it provided them with shares to sell immediately into the market, while at the same time encouraging small investors to retain or increase their holdings. Thus, stock options, rather than aligning the interests of shareholders and management (as traditional theory suggests), were actually having the opposite effect of transferring wealth to

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436. *See, e.g.*, Roberta S. Karmel, *Securities Regulation: The Fuss Over Stock Options*, N.Y. L.J., June 20, 2002, at 3 (noting that Alan Greenspan and the FASB have attacked the failure to treat employee stock options as expenses).

437. *See, e.g.*, *id*.

438. Publicly held corporations have often rewarded corporate officers and directors with "in-the-money" stock options, that is, options with an exercise price below the current market value of the shares. *See generally* FRANKLIN A. GEVURTZ, CORPORATION LAW § 4.2.6, at 360–62 (2000). In some instances, the exercise price is set slightly above the current market price. *See, e.g.*, Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 863–64 (2002) ("Conceptually, stock options could be issued with exercise prices above, below, or equal to the grant-date market value."). These options, furthermore, typically are exercisable immediately, so that the recipients can reduce them to cash either immediately or after a relatively modest rise in the price of the stock. Coffee, *supra* note 58, at 1413, 1414 & n.49 (explaining that the SEC's relaxation of its rules under section 16(b) of the Securities Exchange Act of 1934 resulted in allowing "officers and directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six-month period").

439. *More Companies to Expense Options*, FIN. EXECUTIVE, Sept. 1, 2002, at 10 (indicating that while some proponents in Congress pushed for expensing of stock options, the "expensing provision ultimately was dropped" from the Act).

440. Refer to Part V *supra*.

insiders at the expense of shareholders.[441]

Because of the scandals, a strong movement has developed which demands that companies curb the excessive grant of options by booking their inherent value (determined presumably under the Black/Scholes or a similar formula)[442] as an expense against earnings when options are issued.[443] Given current pressures, it is not surprising that more than twenty major corporations have announced that they plan to expense options when they are issued in the future.[444] A major proponent of expensing options is Warren E. Buffett, the billionaire CEO of Berkshire-Hathaway Inc.[445] He and other proponents theorize that because stock options are in fact a form of compensation for

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441. Refer to Part IV, notes 211–13 *supra* and accompanying text (emphasizing that recent events show corporate executives are maximizing their personal goals instead of the value of the corporation).

442. Howard Gleckman, *The Best Way of Valuing Options*, BUS. WK. ONLINE, July 30, 2002, *at* http://www.businessweek.com/bwdaily/dnflash/jul2002/nf20020730_7808.htm (last visited Mar. 13, 2003) (describing the models companies use to make "educated guesses" as to the value of options). The principal alternative model, the binomial tree model, uses a different mathematical formula and requires more assumptions. *Id.* (explaining that the binomial tree model is a system that not only uses a different mathematical formula, but better takes into account how option restrictions affect price). However, it appears to be more sensitive to changes in variables than the Black/Scholes model. *Id.* Either formula can yield widely varying results with minor changes in assumptions. *Id.*

443. In June 2002, the Conference Board, a research group in New York, created a panel, the Commission on Public Trust. *See* Kenneth N. Gilpin, *Expert Business Panel Puts Stock Options on List of Reforms*, N.Y. TIMES, Sept. 18, 2002, at C1. In September 2002, the panel issued a preliminary report on compensation issues. *Id.* (stating that the report dealt with compensation only, but that the commission intends to produce recommendations regarding corporate governance and accounting as well). The majority of panel members agreed that fixed priced options, which vest without any requirement that performance goals be met, should be treated as an expense. *Id.* Andrew S. Grove, chairman of Intel, opposed this proposal. *Id.* He described the expensing issue as a "red herring," adding: "The solution to this . . . is strong corporate governance—independent directors, a compensation committee with muscle and backbone, and provisions for shareholder approval." *Id.* (quotation marks omitted) (quoting Grove's dissenting comments). In this discussion, Paul A. Volcker, former chairman of the Federal Reserve Board, questioned whether stock options should be issued at all. *Id.* He said, "Stock options reward the good, the bad and the ugly in a booming market and reward nobody in a bear market . . . [Options] are so subject to abuse that there ought to be an extreme bias in public companies against their use." *Id.* (quotation marks omitted) (quoting Volcker's dissenting comments).

444. Companies taking this pledge include Coca-Cola Co., General Electric Co., General Motors Corp., the Washington Post, Computer Associates, Inc., and Bank One. *See* Editorial, *Getting the Message, Finally*, BUS. WK., July 29, 2002, at 116; *see also* Rachel Emma Silverman, *Leading the News: GE to Expense Stock Options Held by Workers*, WALL ST. J., Aug. 1, 2002, at A3. In contrast, Intel Corporation has announced that it will not account for stock option expenses. Associated Press, *INTEL CORP.: Stock Options Not Moving to Expenses*, CHI. TRIB., Aug. 9, 2002, at 2 (explaining that Intel will instead make more information about its program available to investors).

445. *See* Anthony Bianco, *The Angry Market*, BUS. WK., July 29, 2002, at 33, 44–46.

directors and officers, they should be treated as an expense of doing business, even though the award of options does not directly reduce the assets or value of the company.[446] Originally, only a handful of companies treated options as an expense, but the number has increased dramatically as the pressure created by the corporate governance scandal has grown.[447]

The major problem in determining the imputed value of unexercised options is that it is not a precise science. Even when a company agrees that an employee stock option should be viewed as an expense, there are several ways for determining what that expense number should be.[448] Its actual cost to the company cannot be ascertained until the option is exercised some time in the future (at which point one can compare the issue price with the sales price), but the cost must be estimated and entered in the corporate books at the time the option is granted. Also, because the numbers selected are to some extent subjective, valuation may be subject to manipulation; as a result, the income statement of a company that expenses options may be less reliable than the statement of a company that does not. However, the strongest argument for expensing options when they are granted is a pragmatic one: approximately 75% to 80% of all executive pay today is in the form of stock options,[449] and to ignore that fact is to exclude a significant economic factor from consideration. As a consequence, it appears that expensing these options will become more common in the future.

B. Repeal or Significant Modification of the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act

Several commentators have suggested that the current

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446. *See id.* at 45 (outlining why critics, including Warren Buffet, say options should be expensed).

447. John Christofferson, *GE to Expense Stock Options*, AP ONLINE, Aug. 1, 2002. Some publicly held corporations have resisted the trend toward expensing options. Cisco Systems Inc. is one such corporation. On September 19, 2002, it reported that "stock options granted to employees that vested for the fiscal year ended July 27 were valued at $1.52 billion according to statistical models," and that "[e]xpensing those options would have reduced [its] net income to $373 million, or five cents [per] share, from $1.89 billion, or 25 cents [per] share." Scott Thurm, *Cisco Gives Effect of Options*, WALL ST. J., Sept. 19, 2002, at B6. Cisco's controller stated his belief that stock options should not be expensed "because they can't be fairly valued." *Id.* (citing a statement by Dennis Powell, Cisco's controller).

448. Refer to note 444 *supra* and accompanying text (discussing some of the various models employed by companies to estimate the value of stock options).

449. Ray Hylton, Editorial, *An Option to Deceive*, GREENSBORO NEWS & REC., July 25, 2002, at A12.

increase in corporate fraud and misconduct is partially a result of these two statutes that place difficult obstacles in the way of plaintiffs' lawsuits.[450] It is likely that these two statutes have led to the dismissal of some plaintiffs' claims that would have led to recovery had the claims survived motions to dismiss under the two statutes.[451] Sarbanes-Oxley simply does not address these issues. If they are to be considered at all, a frontal legislative attack on the principles set forth in these two statutes will probably be necessary.

C. Congress Might Restore Personal Liability for Aiding and Abetting Fraudulent Conduct in Connection with Publicly Held Corporations

A similar issue is raised by the opinion of the U.S. Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[452] which held that the securities laws do not impose liability on aiders and abetters.[453] The Private Securities Litigation Reform Act of 1995 did restore liability for aiding and abetting in the narrow class of cases involving SEC enforcement actions.[454] A legislative reversal of this holding would open a significant number of cases to judicial review.

D. Congress Might Establish Principles to Rein In the Huge Compensation Packages that Were Common in the Recent Past; This Might Include Making Stock Options and New Stock Offerings at Nominal Prices Available to All Shareholders Generally

While theoretically possible and presumably constitutional, if phrased in terms of regulation of interstate commerce, the development of principles that handle innumerable transactions in a fair way is daunting, to say the least.

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450. *E.g.*, Joel Seligman, *The Nontrial Adversarial Model*, 64 LAW & CONTEMP. PROBS. 97, 101–03 (2001) (discussing some of the obstacles, including elevation of standards for a plaintiff to survive a motion to dismiss).

451. *See id.*

452. 511 U.S. 164 (1994).

453. *Id.* at 175–77 (rejecting the SEC's argument based on the statutory language that Congress "intended to reach *all* persons who engaged, even if only *indirectly*, in prescribed activities"—even those who merely aid and abet securities violators (emphases added)).

454. *See* 15 U.S.C. § 78t(e) (2000) ("[A]ny person that knowingly provides substantial assistance to another person in violation of a provision of this chapter . . . shall be deemed in violation of such provision to the same extent as the person to whom such assistance is provided."). *But cf.* Otis Bilodeau, *Senate Puts Corporate Bar in Its Sights: Angry Relation to Proposal to Expose Lawyers to Liability*, LEGAL TIMES, July 15, 2002, at 1 (describing the difficult statutory requirement that the SEC prove the defendant's knowledge).

E. Congress Might Consider Limiting Conflicts of Interest that Directors May Have When Making Compensation-Related Decisions

A provision that prohibits directors from making compensation-related decisions relating to other directors' compensation presumably would be constitutional. Compensation would then become the responsibility of disinterested participants in the enterprise. Who they would be, and how they would be selected, are questions that raise significant problems.

F. Congress Might Consider Providing Better Protection and Firmer Rules for the Management of Retirement Plans, Particularly 401(k) Plans for Lower-Level Employees

Changes have been proposed by the SEC to extend the "lockdown" to securities transactions by corporate directors and officers.[455]

G. Congress Might Consider Reducing the Amount of Loans Offered to Investors by Officers and Companies; In Addition, the Margin Requirement Might Be Adjusted to Limit the Use of Borrowed Funds to Purchase Shares

H. Congress Might Consider Whether There Should Be More Stringent Regulation of Complicated Derivative Instruments

I. Professor Ribstein's Proposal to Do Nothing at the Present Time[456] Has Its Attractive Aspects

At the present time it is unclear whether additional action is required of Congress. It may be sensible to await the implementation of the full Sarbanes-Oxley program before considering modifying or creating additional governance rules. Perhaps Sarbanes-Oxley will be successful in improving corporate governance (despite its initial false steps) and will demonstrate that further improvements are not really needed.

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455. *See* U.S. Securities and Exchange Commission, Proposed Rule: Insider Trades During Pension Fund Blackout Periods, *available at* http://www.sec.gov/rules/proposed/34-46778.htm (last visited Mar. 3, 2003) (requesting comment on an SEC proposed rule to clarify the Sarbanes-Oxley requirement that trading by officers and directors be suspended during a pension plan blackout period).

456. *See* Ribstein, *supra* note 34, at 3, 61.

XVI. CONCLUSIONS

This Address concludes by considering a fundamental question that must be addressed at some point. It is raised in an important paper by Professor Lucian Bebchuk (Harvard), Professor Jesse Fried (Boalt), and David Walker (an associate at Ropes & Gray), entitled *Managerial Power and Rent Extraction in the Design of Executive Compensation*.[457] This Address suggests that corporate executives today have considerable power to influence their own pay and that they in fact routinely exercise this power quietly to extract extra personal benefits—"rents," in the lingo of corporate theorists.[458] This Address, along with the traumatic events described in earlier sections, raises the legitimate question of whether the fundamental assumption that shareholder primacy exists in modern publicly held corporations should be routinely accepted.

Modern corporate theory is based on the premise that shareholder primacy is the norm, that the goal of the corporation is to maximize shareholder wealth. However, the excessive compensation and millions of dollars of profits obtained by executives in the telecom industry is itself persuasive evidence that some modern business enterprises apparently do not accept this principle. If this trend is widespread, the task of assuring both fair treatment of investors and reasonable levels of executive compensation becomes complex indeed.

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457. 69 U. CHI. L. REV. 751 (2002).

458. *Id.* at 751. One datum that indicates that this power is relatively recent is that in 1980, the average CEO was paid forty-two times the salary of the average worker. Editorial, *CEOs: Why They're So Unloved*, BUS. WK. ONLINE, Apr. 22, 2002, *at* http://www.businessweek.com/magazine/content/02_16/b3779125.htm (last visited Jan. 12, 2003). In the year 2000, the CEO compensation was over five hundred times that of the average worker. *Id.* Undoubtedly, this is in part caused by the widespread grant of stock options to executives while ordinary workers receive only cash compensation. *See id.*