Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud

Mr. Bentsen: "Well, my time is up, but Mr. Chairman, it is like three blind mice running around and their fingerprints are all over the place. The board agrees to the parts and everything else. Either nobody was looking at the sum of the parts or everybody was looking the other way."
Mr. Powers: "Well, we would agree that people were not minding the store."[1]

I. INTRODUCTION

The exchange above captures the frustration shared between a member of the House Financial Services Committee and an Enron director testifying about the problems that led to the corporation's catastrophic fiscal demise.[2] Yet aside from deterrence measures, it is largely the blind mice and absent-minded shopkeepers that Congress counts on to prevent future Enrons.[3] The reliance of the Sarbanes-Oxley Act of 2002 (SOX) on independent directors may introduce a new era of progress, but may just as likely represent the federalization of concepts proved inadequate by the very corporate debacles that occasioned the legislation.[4]

The corporate scandals and bankruptcies of 2001 and 2002 received widespread media coverage, shaking public confidence in the capital markets.[5] The public outcry triggered a response by Congress that in some ways favored the immediacy of politics over long-standing policy.[6] The collapses eliminated

1. *The Enron Collapse: Implications to Investors and the Capital Markets: Hearings Before the House Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. of the Comm. on Fin. Servs.*, 107th Cong. 85-86 (2002) [hereinafter *Enron Hearing*] (statements of Representative Bentsen, Member, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, and William C. Powers, Jr., Director of Enron Corporation).

2. *Id.* (discussing failure of corporate board's oversight function).

3. *See infra* notes 43-44 and accompanying text (outlining Sarbanes-Oxley Act's audit committee requirements).

4. *See infra* notes 50-52 and accompanying text (discussing independent director oversight failures).

5. *See* Howard Witt & Cam Simpson, *Enron's No. 3 Exec Pleads Guilty*, CHI. TRIB., Jan. 15 2004, at C1 (observing Enron's impact on public confidence in stock market).

6. *See* R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 830-31 (2003) (arguing congressional impatience for action brought redundant legislation insensitive to federalism concerns). Prior to the WorldCom Inc. debacle in June 2002, proposed Enron-induced reforms appeared limited to congressional accounting and ERISA regulations, enhanced SEC disclosure requirements, and reforms by the self-regulated securities exchanges. *Id.* When WorldCom filed for bankruptcy, Congress acted hastily in response to the resulting political pressure, casting aside decades of "sound policy . . . of deference to SEC and state regulatory

35,000 jobs and wiped out $1 billion in employee pensions.[7] Enron's bankruptcy alone represented a $29 billion loss to shareholders and former workers, while the failure of WorldCom cost shareholders a staggering $200 billion.[8] In each instance, corporate officers perpetrated frauds on company shareholders and the investing public by falsifying financial disclosure while supposedly independent auditors remained complacent.[9]

Prior to the Enron crisis, the steady rise of the securities markets over the previous decade had reinforced public trust in America's corporate governance system.[10] Largely the province of the states, corporation law generally vests a company's board of directors with policy and oversight responsibility while corporate officers manage the company's day-to-day affairs.[11] The breakdown of the board and audit committee's monitoring functions at Enron and WorldCom was an unnerving common thread running through congressional inquiries into those companies' downfalls.[12]

In championing the cause of the American investor, congressional committees focused their investigations primarily on the accountability of high-ranking corporate officers.[13] This emphasis resulted in SOX's requirement that

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prerogatives." *Id.*

7. David E. Rovella, *Charges Unlikely for Top Execs at Enron, Worldcom, Will Justice be Served?*, L.A. BUS. J., Aug. 25, 2003, at 18.

8. *Id.* (providing Enron shareholders' loss total); Press Conference, Oklahoma Attorney General W.A. Drew Edmondson, Criminal Charges Filed Against Former WorldCom Inc. Executives (Aug. 27, 2003) (detailing harm to WorldCom shareholders).

9. *See Enron Hearing*, *supra* note 1, at 69-72 (prepared testimony of William C. Powers, Jr., Director of Enron Corporation) (detailing conclusions of special investigative committee of Enron's board of directors); *Wrong Numbers: The Accounting Problems at WorldCom: Hearing Before The House Comm. on Fin. Servs.*, 107th Cong. 1-2 (2002) [hereinafter *WorldCom Hearing*] (opening statement by Representative Oxley, Chairman, House Committee on Financial Services) (alleging senior WorldCom executives doctored balance sheets to hide true earnings performance). Once the fraud perpetrated by WorldCom executives was revealed to the public, WorldCom's stock value plummeted. *WorldCom Hearings*, *supra*, at 2.

10. *See* Robert W. Hamilton, The Crisis in Corporate Governance: 2002 Style, Seventh Annual Frankel Lecture at the University of Houston Law Center (Nov. 14, 2002), *in* 40 HOUS. L. REV. 1, 50 (2003) (theorizing rising security prices fueled widespread confidence in corporate self-regulation). At the end of the 1990s, however, the fact that the SEC's corporate governance enforcement workload had grown beyond its staff's capacity to investigate governance failures had not gained significant recognition. *Id.*

11. *See*, *e.g.*, CAL. CORP. CODE § 300(a) (Deering 2004) (allowing board delegation of day-to-day operations provided board ultimately directs business and affairs); N.Y. BUS. CORP. LAW § 701 (Consol. 2004) (stating board responsible for managing business of corporation); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02, cmt. d (A.L.I. 1994) (observing corporate boards serve general oversight function, selecting officers and monitoring their performance).

12. *See Enron Hearing*, *supra* note 1, at 72 (statement of William C. Powers, Jr., Director of Enron Corporation) (describing lapse of board oversight as one cause of Enron bankruptcy); *WorldCom Hearing*, *supra* note 9, at 3 (opening statement of Representative LaFalce, Member, House Committee on Financial Services) (deriding failure of auditors and board to protect shareholders).

13. *See* S. REP. NO. 107-146, at 11 (2002) (stating congressional action necessary to deter corporate malfeasors who do not fear punishment). Senators were cognizant that a majority of voters rely on capital investments to achieve future financial goals. *Id.* They were similarly sensitive to the public's desire that corporate malfeasance be punished according to the seriousness of the particular fraud, emphasizing that federal sentencing guidelines failed to account for aggravating factors present in serious fraud cases that should

principal corporate officers certify the accuracy of their company's financial statements.[14] The attempt to thwart fraud through deterrence is the main thrust of SOX, leaving the audit committee comprised of independent directors as the last line of defense in circumstances where officers have conspired to falsify financial statements.[15]

This Note will explore possible problems with SOX's reliance on the independent directors who comprise public companies' audit committees to minimize the potential for corporate fraud.[16] Independent director monitoring has failed in the past, often lacking the effectiveness to detect and prevent fraud committed by determined insiders.[17] Additionally, the increased time commitment likely required to meet regulators' expectations for audit committee members, combined with the potential increase in outside directors' liability exposure under the new regulatory framework, may serve to deter those most qualified from serving.[18] In the end, the costs of compliance may

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result in lengthier sentences. *Id.* at 7. At the beginning of congressional investigations into the Enron collapse, the criminal code's lengthiest imprisonment for securities fraud, absent criminal intent, was five years. *Id.* at 6. Senator Patrick Leahy's report to the Senate Judiciary Committee concluded that Congress's job was to prevent future Enrons and provide more serious consequences for such malfeasance. *Id.* at 11. During the questioning of Enron Corporation Director and Dean of the University of Texas Law School William C. Powers, Jr., one congressman could not refrain from asking for Mr. Powers' opinion on whether Enron officers could be held criminally liable, revealing a legislative pre-occupation with accountability even at the preliminary fact-finding stage. *See Enron Hearing*, *supra* note 1, at 76 (statement of Representative Castle, Member, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises).

14. 15 U.S.C.S. § 7241(a) (Law. Co-op. 2003) (setting forth certification requirement); Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 33-8124, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (containing SEC regulation requiring certification pursuant to SOX), *available at* http://www.sec.gov/rules/final/33-8124.htm.

15. *See* 15 U.S.C.S. § 78j-1(m) (containing SOX audit committee requirements); Hamilton, *supra* note 10, at 50 (noting SOX reliance on enhanced oversight by independent directors). In essence, the SOX audit committee requirements are not a significant advancement, but rather a federalization and extension of rules requiring independent audit committees to be responsible for overseeing the audit process. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 947-48 (2003) (noting SEC approval in 1977 of stock exchange rules requiring "audit committee responsibility and independence").

16. *See* Hamilton, *supra* note 10, at 50 (arguing independent directors have little incentive and minimal access to information); *see also infra* notes 32-36 and accompanying text (detailing arguments devaluing independent director contributions).

17. *See infra* notes 50-52 and accompanying text (discussing independent director oversight failures). Proponents of relying on independent directors as internal watchdogs, such as the American Bar Association Task Force on Corporate Responsibility (ABA Task Force), however, continue to argue that successful corporate governance depends "upon the active and informed participation of independent directors . . . who act vigorously in the best interests of the corporation and are empowered effectively to exercise their responsibilities." *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 54 MERCER L. REV. 789, 796 (2003) [hereinafter *ABA Task Force Report*]. The ABA Task Force notes that while management of company operations must rest with corporate officers, oversight by outside directors is necessary to check officers' temptation to serve selfish wealth-maximizing interests. *Id.*

18. *See* James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1078 (2003) [hereinafter Cox, *Conflicts of Interest*] (discussing high expectations for independent directors); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 IOWA J. CORP. L. 441, 444 (2003)

outweigh any tendency to prevent future corporate fraud.[19]

II. HISTORY

A. Historical State Dominance

Until SOX, corporate governance law was largely state-dominated.[20] State corporation law vests in the board of directors the responsibility to select a company's management team and monitor its activities, assuring that proper controls and procedures are in place.[21] State law does not, however, provide guidance on board composition beyond the means by which directors may be elected and removed.[22] Rather than providing guidelines for an ideal board member's attributes, such as expertise or independence, state law generally relies on the fiduciary duty owed by directors to shareholders.[23] Furthermore, to ensure that corporate directors perform their oversight functions properly, shareholders may use their power to remove directors where this duty is breached.[24] States suffer from a conflict of interest in formulating and enforcing corporate law because their incentive to be management-friendly in order to attract corporations and the tax dollars they represent often trumps any desire to reform the governance process by reducing management's influence.[25]

(arguing Enron fallout and SOX deters qualified individuals from becoming directors): John C. Coffee, Jr., *Sarbanes-Oxley Act Coming Litigation Crisis*, NAT'L L. J., Mar. 10, 2003, at B8 (predicting audit committee members face increased liability due to authority SOX invests in committee).

19. *See infra* notes 61-63 (analyzing outside directors' ability to prevent fraud); *infra* note 101 and accompanying text (addressing costs of SOX compliance).

20. *See supra* note 11 and accompanying text (listing state treatments of corporate governance issues).

21. *See supra* note 11 and accompanying text (discussing general oversight function of board). Under traditional governance models, the board formulates company policy on behalf of company shareholders with corporate officers merely executing a course of action determined by the directors. *See* JAMES D. COX ET AL., 1 CORPORATIONS § 9.1-.2 (2002). In reality, however, boards most often serve in a "legitimizing" capacity, placing their stamp of approval on senior management's policy decisions. *See id.* § 9.2, .4; Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, at 1 (remarking common board function differs substantially from role originally contemplated by corporation law).

22. *See* Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 788 (1994) (noting state law silence on issues impacting value of director oversight). Most state corporate governance statutes provide for shareholder election of directors, as reflected by the Delaware and model statutes. *See* DEL. CODE ANN. tit. 8, § 211(b) (2004) (mandating shareholder election of directors); MODEL BUSINESS CORPORATION ACT § 8.03(c) (1984) (containing requirement that shareholders elect corporate directors).

23. *See infra* note 24 and accompanying text (discussing director's fiduciary duties).

24. *See* Loewenstein, *supra* note 22, at 788-89 (labeling approach as "legitimate" but "less than ideal"); *see also* MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 169 (8th ed. 2000) (noting state courts allow shareholders to remove director for cause without statutory provision). Professor Loewenstein observes that the fiduciary duties of loyalty and care have eroded under state law and that shareholders face substantial economic obstacles in removing a director favored by corporate management. *See* Loewenstein, *supra* note 22, at 789; *see also* COX, *supra* note 21, § 9.2, .5 (commenting shareholders seldom play effective role in director selection because management controls proxy solicitations).

25. *See*, *e.g.*, EISENBERG, *supra* note 24, at 101-07 (detailing "race to the bottom" in competition among

Ultimate oversight by directors independent of management is therefore not required under state corporate governance regimens.[26]

B. Debating the Value of Director Independence

The notion that board member independence from management is crucial to the board's effectiveness in monitoring corporate affairs has become a core plank in the corporate reform platform.[27] Beginning with the corporate scandals and audit failures in the 1970s, a movement emerged to enhance the corporate board's monitoring function.[28] As the monitoring model gained favor, the idea that proper oversight of management is best conducted by directors free from management's influence began to take hold.[29] Proponents of director independence believe that independent directors, particularly those with high-level corporate experience, are able to provide a learned perspective free from the personal entanglements that may cloud senior executives' policy decisions.[30] While those that urge corporate reform agree that the power to

states for incorporations); Loewenstein, *supra* note 22, at 787 (noting "minimalist" approach of state law with respect to corporate governance); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 109 (2003) (describing corporation statutes' approach to corporate governance as "libertarian"). Delaware, as the state of incorporation for over half of the Fortune 500 companies, not only governs a majority of large public corporations, but also serves as a fair proxy on issues of corporate governance law due to the general lack of variation between states on governance issues. *See* Thompson, *supra,* at 108-09. *But see* CONN. GEN. STAT. § 33-753(c) (2003) (making Connecticut only state to require audit committee). Many believe Delaware's laissez-faire attitude contributed greatly to the gap between the legal ideal of management accountability to shareholders through the monitoring board and today's corporate reality, where most management teams function unimpeded by active board oversight or meaningful shareholder involvement. *See* COX, *supra* note 21, § 9.3, .7-.8 (relating industry observers' frustration with state complacency in face of governance problems). *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (calling for federal standards of conduct governing public corporations); Charles W. Murdock, *Delaware: The Race to the Bottom—Is an End in Sight?*, 9 LOY. U. CHI. L.J. 643 (1978) (deriding Delaware's pro-management legislative tendencies).

26. *See* Loewenstein, *supra* note 22, at 788 (citing lack of state statutory requirements designed to ensure boards perform oversight function effectively); Thompson, *supra* note 25, at 109 (noting statutory silence on independence of board members).

27. *See* Cox, *Conflicts of Interest*, *supra* note 18, at 1077-78 (tracing increasing prevalence of independent directors from 1970s to commonplace status in 1990s).

28. *See* Loewenstein, *supra* note 22, at 785 (listing various 1970s management abuses accentuating need for effective board oversight); Joel Seligman, The New Corporate Law*,* Lecture at the Fifth Abraham L. Pomerantz Lecture, *in* 59 BROOK. L. REV. 1, 53 (1993) (noting prominent 1970s audit failures and consequent SEC pressure on NYSE to require audit committees).

29. *See* Thomas A. D'Ambrosio et al., *Special Project: Director and Officer Liability*, 40 VAND. L. REV. 599, 706-07 (1987) (pointing to monitoring model as "spurring" push for outside director oversight). The term "outside director" is generally understood to mean a director who, aside from his board duties, is unaffiliated with, or independent of, the corporation. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 21 (1989) (defining outside director).

30. *See* Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 33 (1987) (commenting on experienced independent directors' value as audit and compensation committee members). Committees composed of outside directors to monitor audits, set management compensation and nominate new directors are said to "facilitate free and open discussion that might be inhibited if committee members are personally involved in the matters under discussion." *Id.* at 21-22

control day-to-day affairs is appropriately vested in senior executives, reformers believe outside director monitoring is necessary to keep officers from using such power for illegal or personal ends in contravention of shareholders' best interests.[31]

Opponents of independent oversight argue that outside directors are ill-equipped or simply unnecessary to accomplish effective corporate governance.[32] Some critics argue that unless outside directors spend most of their time at the corporation, they will never possess the knowledge necessary to perform their monitoring function effectively.[33] Others assert that, in addition to time limitations and knowledge deficiencies, outside directors lack incentive to enforce management integrity.[34] Additionally, the "Wall Street Rule" holds that shareholders are disinterested in governance issues because they effectively monitor and vote on management's performance through buying or selling the corporation's shares.[35] Some criticize the adversarial approach of using outsiders to monitor senior officers as inefficient and thus in conflict with the ultimate corporate goal of maximizing profits.[36]

Nonetheless, through American Law Institute (ALI) and American Bar Association (ABA) best practice guidelines, SEC action, and stock exchange regulations, a trend towards increased monitoring by independent board

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(outlining American Bar Association corporate governance best practices).

31. *See ABA Task Force Report*, *supra* note 17, at 796 (arguing effective governance relies on "active and informed participation" of outside directors); Loewenstein, *supra* note 22, at 784 (stating outside directors necessary to proper monitoring of management activity).

32. *See* Pease, *supra* note 30, at 33 (citing disagreement over outside director usefulness); Gregory S. Rowland, *Earnings Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 183 (2002) (noting academics' varying positions on outside director monitoring).

33. *See* Frank H. Easterbrook, *Managers' Discretion and Investors Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 555-56 (1985) (arguing replacement of well-informed insiders with outsiders lacking knowledge counterproductive); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282 (1982) (opining those lacking familiarity necessary for everyday decisions similarly incapable of making broad policy).

34. *See* Victor Brudney, *The Independent Director: Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597, 616-22, 642-59 (1982) (questioning value of director independence in light of obstacles to effective oversight).

35. *See* Walter Werner, *Corporation Law in Search of Its Future*, 81 COLUM. L. REV. 1611, 1643-44 (1981) (asserting shareholder ambivalence regarding director independence).

36. *See* Fischel, *supra* note 33, at 1283 (suggesting cost of monitoring committees may outweigh benefits); Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 550-51 (1984) (declaring approach appropriate for politics but costly and counter to corporate culture); *see also* Bradley & Schipani, *supra* note 29, at 22 (clarifying Fischel's arguments). In the past, placing truly independent persons on boards has been problematic due to the widespread practice of management selection of new directors. *See* COX, *supra* note 21, § 9.3, .4-.5, .7 (lamenting such directors' inability to exercise independent judgment). One mutual fund industry commentator harshly described independent directors as "sort of a bad joke," incapable and unwilling to go against the wishes of fund managers. Jeffrey J. Haas & Steven R. Howard, *The Heartland Funds' Receivership and Its Implications for Independent Mutual Fund Directors*, 51 EMORY L.J. 153, 184-85 (2002).

members is evident over the last thirty years.[37] The ALI recognized the need for reform in the 1980s when it appeared that lack of management accountability had become the norm in large corporations.[38] An early draft of the 1994 ALI Principles of Corporate Governance (ALI Principles) recommended that corporate boards possess a majority of independent members.[39] In the end, however, the ALI jettisoned this controversial proposal, leaving a suggestion in the final version that companies have audit committees comprised of independent directors whose charge is to "implement and support the board's oversight function."[40]

C. The New Federal Formula

Corporate scandals such as Enron and Worldcom ended decades of congressional complacency with state dominance of governance issues.[41] In search of an expedient solution, Congress relied heavily on best practice guidelines and existing SEC and stock exchange regulations in formulating SOX's governance provisions.[42] This reliance resulted in Congress's emphasis

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37. *See* D'Ambrosio, *supra* note 29, at 707 (noting American Law Institute's preference for audit committee composed of independent directors); Karmel, *supra* note 36, at 534 (citing American Bar Association 1976 guidebook suggesting delineation between outside and inside directors); Rowland, *supra* note 32, at 185 (observing increased manifestation of active, independent monitoring model in practice despite academic doubters); Seligman, *supra* note 28, at 52 (summarizing 1977 SEC approval of NYSE rule requiring audit committees). The SEC has endorsed and utilized independent board member oversight in addressing various problems for over three decades. *See* Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977); Rowland, *supra* note 32, at 185 (noting SEC embrace of monitoring model); Seligman, *supra* note 28, at 52 (describing SEC response 1970s audit failures). The NYSE began to require audit committees comprised solely of independent directors in 1977. *See* Seligman, *supra* note 28, at 52 (noting advent of NYSE rule in response to audit failures). The American Stock Exchange (AMEX), after initially recommending listed companies have audit committees in 1980, mandated independent audit committees in the early 1990s. *See* Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 332 (2001).

38. *See* COX, *supra* note 21, § 9.2, 9.4-.5 (noting board monitoring ineffectiveness).

39. *See* COX, *supra* note 21, § 9.3, 9.13-.15 (describing controversy over ALI proposals); D'Ambrosio, *supra* note 29, at 707-08 (noting deletion of majority requirement from final version); Marjorie Fine Knowles & Colin Flannery, *The ALI Principles of Corporate Governance Compared with Georgia Law*, 47 MERCER L. REV. 1, 14 (1995) (stating ALI audit committee recommendation). The ALI Principles suggested eight duties for independent audit committees to perform, including selecting independent accountants to perform audit functions, appointing the internal executive responsible for the audit process, facilitating communication between the auditors and the board, reviewing independent and internal audit reports, reviewing financial statements and related disputes between the independent auditors and management, consulting independent auditors on adequacy of internal controls, and considering any necessary changes to audit procedures. *See* Knowles & Flannery, *supra*, at 15.

40. Knowles & Flannery, *supra* note 39, at 14; *see* D'Ambrosio, *supra* note 29, at 707-08 (noting deletion of majority requirement from final version).

41. *See supra* notes 12-15 and accompanying text (describing congressional action in response to corporate scandals).

42. *See* Cunningham, *supra* note 15, at 947-48 (deeming congressional response to scandals "formalization" of existing practices and requirements). Companies that followed best practice guidelines, such as the ALI Principles, had already formed outside director audit committees that served the monitoring function reformers sought to make a formal federal requirement. *See* Claire Moore Dickerson, *Ozymandias as*

on audit committees comprised of independent directors in concocting a regulatory formula for the internal prevention of corporate fraud.[43] Chief among audit committee responsibilities under SOX is the appointment and oversight of the accounting firm that serves as the corporation's independent auditor.[44] This requirement establishes a relationship free of the barriers to forthright discussion that may exist where management insiders are responsible for the accounting firm's continued employment by the corporation.[45]

D. The Role of Outside Auditors

The federal securities laws, enacted as part of the New Deal in the 1930s, require publicly owned companies that disclose certain financial information to engage an independent auditor to verify the accuracy and completeness of such disclosures.[46] The high profile audit failures of the 1970s resulted in the SEC's

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Community Project: Managerial/Corporate Social Responsibility and the Failure of Transparency, 35 CONN. L. REV. 1035, 1054 (2003). SOX thus represents a culmination of the monitoring model trend in corporate governance reform. *See supra* notes 27-31, 37-40 and accompanying text (discussing trend towards increased monitoring by independent directors).

43. *See* 15 U.S.C.S. § 78j-1(m)(2) (Law. Co-op. 2003) (specifying audit committee responsible for appointment and monitoring of accounting firm); Hamilton, *supra* note 10, at 50 (noting SOX reliance on enhanced oversight by independent directors). Audit committee members must also satisfy certain independence requirements to qualify for service. *See* 15 U.S.C.S. § 78j-1(m)(3) (disqualifying directors who accept certain fees from or who are affiliated with issuer). Finally, audit committees must establish whistle-blower procedures to promote reports of misconduct and protect reporting employees, and corporations must provide their audit committee with funds necessary to retain independent audit committee counsel and other advisors. *Id.* SOX requirements mirror those the SEC had previously enacted through the stock exchanges and applied to investment companies, as well as those recommended by the ALI Principles. *See supra* notes 37-40 and accompanying text. SOX also requires that audit committees adopt a charter formally detailing their duties and responsibilities. Karessa Cain, *New Efforts to Strengthen Corporate Governance*, 2003 COLUM. BUS. L. REV. 619, 632 (2003). Finally, SOX's independent counsel requirement provides audit committees with an experienced advisor not beholden to company management. *See* 15 U.S.C.S. § 78j-1(m)(5).

44. *See* 15 U.S.C.S. § 78j-1(m)(2) (mandating direct audit committee responsibility for independent auditor selection, fees, and monitoring). *But see supra* notes 37-40 and accompanying text (describing stock exchange rules and best practice guidelines).

45. *See* Commissioner Harvey Goldschmid, Post-Enron America: An SEC Perspective, A.A. Sommer, Jr. Annual Lecture on Corporate Securities and Financial Law at Fordham Law School, *in* 8 FORDHAM J. CORP. & FIN. L. 335, 346 (2003) (predicting greater effectiveness of independent director oversight will result from more "candid" relationship). This is a change that will require outside directors to make decisions previously left to the discretion of senior officers. *See* John D. Cornet, *Bank Governance: An Independent Director's Perspective*, 7 N.C. BANKING INST. 1, 7 (2003) (recognizing directors must not overstep SOX audit duties and management must relinquish audit control).

46. *See* Securities Act of 1933, 15 U.S.C. § 77aa(25) sched. A (2000) (requiring independent accountant certification of balance sheets and profit and loss statements in registration statements); Securities Exchange Act of 1934, 15 U.S.C.S. § 78m(a)(2) (authorizing SEC rule requiring annual reports to contain independently certified financial statements). The SEC adopted rules requiring auditor independence and has, since its creation in 1934, shown the willingness to enforce such rules. *See* 17 C.F.R. § 210.2-01(b) (2004) (noting SEC refusal to recognize independence of accountants where it does not exist in fact); *In re* Cornucopia Gold Mines, 1 S.E.C. 364, 369 (1936) (issuing registration statement stop order due to auditor's lack of independence). The SEC has also stressed the duty independent auditors owe to shareholders and others who rely on audited financial data. *See* Qualifications and Reports of Accountants, Proposed Amendment of Rules Regarding Independence of Accountants, Securities Act Release No. 6430, [1982 Transfer Binder] Fed. Sec. L. Rep.

push for audit committee oversight of a company's outside accounting firm.[47] More recently, the role independent auditor Arthur Anderson (Anderson) played in the Enron scandal highlighted the need for further reform with respect to the audit process.[48] Audit committee responsibility for the selection and oversight of the outside audit firm under the SOX framework is therefore complemented by rules enhancing auditors' independence from management control.[49]

E. Monitoring Failures

Critics of SOX's governance solutions point out that monitoring by independent directors and audit committees has failed to prevent fraudulent activity in the past, most notably in the cases of Enron and Worldcom.[50] For

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(CCH) ¶83,263, at 85,403 (Oct. 14, 1982) (stating auditors' duty to investors to assure utmost objectivity in audit process). Independence is also recognized within the accounting profession as essential to the proper functioning of the audit process. *See* Daniel L. Goelzer, *The SEC and Opinion Shopping: A Case Study in the Changing Regulation of the Accounting Profession*, 52 BROOK. L. REV. 1057, 1059 (1987) (citing CPA auditing standards that highlight need to avoid doubt regarding objectivity).

47. *See* Seligman, *supra* note 28, at 52 (citing SEC request for NYSE audit committee listing requirement in response to accountant failures). In requesting the audit committee listing requirement, the SEC was reacting to audit failures where accountants, despite facial independence, became complicit in, or intertwined with, the fraudulent activity of company management. *See id.* at 51-52 (describing auditor criminal participation in fraud and acceptance of oversees bribes). The stock exchange requirement did not, however, represent a significant change in prevailing corporate practice, and therefore did not address the root cause of auditor independence problems. *See id.* at 52 (noting ninety percent of large companies already used audit committees in 1976 when SEC requested listing rule). Independent auditors' reliance on management for their continued employment gave senior officers the ability to shop for the accounting opinion that best suited their financial disclosure needs. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 187 (1976) (labeling management's discretion as institutional failure compromising independent accountant objectivity); Goelzer, *supra* note 46, at 1058-59 (noting practice of "opinion shopping" and management's increasing willingness to change auditors). Additionally, accounting firms acting as independent auditors often earned more compensation from corporations for providing non-audit services than for performing their audit function, thus further compromising the auditors' objectivity. *See* JOHN C. COFFEE & JOEL SELIGMAN, SECURITES REGULATION 1503 (9th ed. 2003) (describing vulnerability of auditors' independence due to economic pressures created by providing non-audit services).

48. *See In re* Enron Corp. Secs., 235 F. Supp. 2d 549, 667 (S.D. Tex. 2002) (noting Anderson's opinion approving fraudulent Enron financial reporting). During the reporting period in question, Anderson provided non-audit services to Enron for which it received fees exceeding those paid for audit services. COFFEE & SELIGMAN, *supra* note 47, at 1504 (noting Anderson fees and concern for auditor objectivity where auditors receive significant non-audit compensation).

49. *See* 15 U.S.C.S. § 78j-1(m)(2) (Law. Co-op. 2003) (requiring selection of independent auditors by audit committee rather than by management); *id.* § 78j-1(g) (prohibiting provision of certain accounting firm services tending to compromise auditor independence); *id.* § 78j-1(h) (mandating audit committee pre-approval of any other non-audit services provided by independent auditor). The SEC rules promulgated in accordance with SOX also require companies to disclose information regarding the accounting firm's audit and non-audit services, and prohibit an accounting firm partner from participating on the firm's audit team for a particular company for more than five or seven years, depending on the partner's level of involvement in the audit process. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 33-8183, 68 Fed. Reg. 6,006 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm.

50. *See* Hamilton, *supra* note 10, at 50 (contending monitoring model SOX adopted has proved

instance, at the time its financial statements were falsified, WorldCom's audit committee had supposedly reviewed the financials, the work of the independent auditors, and the company's internal accounting procedures.[51] Similarly, despite being an example of corporate governance best practices, Enron's audit committee ignored its responsibility to review certain questionable transactions, allowing Enron's ill-intentioned officers to engage in fraudulent behavior.[52] While SOX strengthens the best practices audit committee model utilized by these companies through auditor independence enhancements and the audit committee independent counsel requirement, problems such as the compromising of director independence through compensation packages and personal relationships with senior officers remain.[53] In light of the various constraints outside directors face in exercising independent judgment, Vice Chancellor Strine of the Delaware Court of Chancery suggests that the law "cannot assume . . . that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk."[54]

SOX attempts to address the outside director competency issue by pressuring corporations, through an SEC disclosure requirement, to have at least one financial expert on their audit committee.[55] Financial experts for

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insufficient to deter fraudulent activity); *ABA Task Force Report*, *supra* note 17, at 796-97 (acknowledging independent monitoring model shortcomings demonstrated by recent governance failures).

51. *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 403 (S.D.N.Y. 2003). In reality, the audit committee was either aware of the fraudulent nature of the financial statements or "recklessly disregarded information which would have led them to discover the fraud." *Id.*

52. *See* WILLIAM C. POWERS, JR. ET AL., ENRON CORP., REPORT OF INVESTIGATION 148 (2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/chapter7.pdf (detailing oversight failures of Enron's board and audit committee); Marianne M. Jennings, *A Primer on Enron: Lessons From A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 197-98 (2003) (identifying Enron as model of corporate governance). Although the plaintiff ultimately failed to establish the scienter element of his claim, one complaint filed against Enron alleged that its independent directors actually "ignored obvious signs of potential or actual fraud." Newby v. Lay, 258 F. Supp. 2d 576, 624 (S.D. Tex. 2003) (ruling on shareholder suit against Enron directors). Professor Jennings suggests, however, that Enron's model governance apparatus suffered from its procedure for selecting members. *See* Jennings, *supra*, at 198 (revealing Enron priorities in board member selection). Specifically, "[b]oard members were selected for the appearance of depth and possible connections that they brought for Enron." *Id.* Others note that Enron's outside directors themselves claim they lacked the expertise and knowledge necessary to thwart the frauds perpetrated. *Lessons from Enron: A Symposium on Corporate Governance Transcript—Morning Session*, Oct. 17, 2002, 54 MERCER L. REV. 683, 699 (2003) [hereinafter *Lessons from Enron*] (quoting Enron directors claiming ignorance and lack of information). Some argue that Enron's director compensation package was so substantial that it compromised their ability and incentive to function as independent monitors. *See* Faith Stevelman Kahn, *What are the Ways of Achieving Corporate Social Responsibility?: Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud and September 11, 2001*, 76 TUL. L. REV. 1579, 1606-07 (2002) (describing Enron outside directors' financial conflicts of interest).

53. *See supra* note 43 and accompanying text (listing SOX audit committee rules including independent counsel provision); *supra* note 49 and accompanying text (outlining auditor independence enhancements under SOX); *supra* note 52 and accompanying text (noting conflict created by Enron director compensation package).

54. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003).

55. *See* 15 U.S.C.S. § 7265(a) (Law. Co-op. 2005); Disclosure Required by Sections 406 and 407 of the

SOX purposes are those audit committee members who (1) understand generally accepted accounting principles as they apply to financial statements, (2) are experienced in the preparation of financial disclosure for or auditing of similar companies, (3) are experienced with accounting controls and procedures, and (4) are familiar with audit committee responsibilities.[56]

F. *Increased Liability Potential*

Another concern stemming from SOX's reliance on outside directors for preventing corporate fraud is whether such directors face increased liability exposure as a result of their audit committee responsibilities.[57] The prevailing standards for director culpability under state law, combined with the widespread practice of maintaining liability insurance to cover director errors and omissions, have largely shielded directors from liability absent evidence of gross negligence.[58] At the very least, the scandals that prompted SOX's enactment have caused substantial increases in the premiums corporations pay for liability coverage.[59] More serious consequences, however, may indeed result from independent director failures in the post-SOX environment due to their expanded responsibilities and increased access to information.[60]

Sarbanes-Oxley Act of 2002, SEC Release No. 33-8177, Exchange Act Release No. 34-47235, 68 Fed. Reg. 5,110 (Jan. 31, 2003). While SOX stops short of requiring financial experts on audit committees, the NYSE, Nasdaq, and the American Stock Exchange (AMEX) go further, mandating either that the listed company audit committee have at least one financial expert (in the case of NYSE and Nasdaq) or that the committee chair be appropriately sophisticated in financial matters (in the case of AMEX). *See* Cain, *supra* note 43, at 631 (contrasting SOX and stock exchange requirements). Professor Cunningham points to SOX's relative laxity in this respect as further support for his contention that the legislation as a whole is not a significant advancement. *See* Cunningham, *supra* note 15, at 948 (asserting SOX expert requirement lacks substance and describing it as "another dose of weak tea").

56. 15 U.S.C.S. § 7265(b).

57. *See Lessons from Enron*, *supra* 52, at 738 (2003) (noting with approval possible increased independent director accountability following governance reforms); Tom Becker, *Delaware Judge Warns Boards of Liability for Executive Pay*, WALL ST. J., Jan. 6, 2003, at A14 (suggesting broadening of duty of good faith); Coffee, *supra* note 18, at B8 (suggesting increased responsibility of information received by outside directors raises increased liability potential). Professor Coffee theorizes that outside directors' heightened knowledge of corporate affairs resulting from their SOX duties makes them similar to inside directors, who have been more likely than outsiders to face liability in the past. *See* Coffee, *supra* note 18, at B8.

58. *See* EISENBERG, *supra* note 24, at 544-45 (setting forth business judgment rule applied where director duty of care violation alleged); *id.* at 590-92 (describing coverage of director liability insurance policies and stating over ninety percent of corporate boards insured). Traditionally, provided a director can prove he fulfilled his duty to monitor and make an informed decision in good faith, the director's decision itself need only be rational to meet his duty of care. *Id.* at 546 (examining business judgment standard of review for director decisions). While a reasonable person might have chosen another course of action, unless the director's choice lacks a coherent explanation, he will not be found liable for negligence. *Id.*

59. *See* Stephen Taub, *Enron Insurance Fallout: D&O Premium Surge* (Feb. 22, 2002), *at* http://www.cfo.com/article/1,5309,6697,00.html?f=related (reporting premium increases of fifty percent in wake of Enron scandal).

60. *See* Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 936-37 (2002) (observing SOX imposes "greater regulation

III. ANALYSIS

Considering that corporate governance practice at the time of the Enron and Worldcom scandals already relied greatly on oversight by outside directors, SOX's increased emphasis on their role is misplaced.[61] In situations where SOX's deterrence measures fail to check management, it is unlikely that independent director monitoring will prove sufficient to prevent fraud from occurring.[62] Independent directors, even if acting diligently and in good faith, are generally not equipped to prevent corporate fraud, especially where auditors collude with management.[63]

A. Independent Director Shortcomings

SOX's dependency on audit committees for fraud prevention conflicts with the time and information constraints faced by committee members.[64] Audit committee meetings are too infrequent to allow outside directors to review audit reports and financial statements critically with their peers and counsel present.[65] The ability of members to discuss potential financial reporting issues with independent trustee counsel and any financial experts sitting on the committee is especially important for those directors lacking financial experience.[66] Many independent directors, even if they possess the time,

on . . . behavior deemed minimally necessary" to satisfy duty of care).

61. *See* 15 U.S.C.S. § 78j-1(m) (Law. Co-op. 2003) (containing SOX independent director oversight provisions); Hamilton, *supra* note 10, at 50 (questioning SOX's dependence on outsiders lacking incentive and information); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 3 (2002) (criticizing SOX reliance on directors with meager incentives and little access to information); *supra* notes 50-54 and accompanying text (describing Enron and Worldcom director oversight failures). *But see* Neil H. Aronson, *Preventing Future Enrons: Implementing The Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 142 (2002) (suggesting audit committee oversight provides greatest chance to prevent future frauds).

62. *See* Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1138 (2003) (arguing boards lack incentive to oversee complex financial strategy); Hamilton, *supra* note 10, at 50 (asserting director monitoring cannot prevent frauds by "highly-motivated insiders"); *supra* note 14 and accompanying text (citing SOX deterrence measures); *see also supra* note 15 and accompanying text (discussing reliance on deterrence with board as gatekeepers); *supra* notes 32-34 and accompanying text (citing independent oversight deficiencies); *supra* notes 50-54 and accompanying text (describing recent frauds perpetrated despite audit committee oversight).

63. *See* Gordon, *supra* note 62, at 1138 (doubting directors' ability to halt scheming managers); *supra* note 48 and accompanying text (noting Arthur Anderson's collusion in Enron fraud). According to Professor Gordon, "[m]anagement and its advisors have the capacity to create endless shells under which to hide and move the peas." Gordon, *supra* note 62, at 1138.

64. *See* COX, *supra* note 21, § 9.2, .4 (listing difficulties outside directors face in performing governance tasks effectively); Douglas M. Branson, *When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform*, 48 VILL. L. REV. 989, 1006 (2003) (asserting SOX requirements make independent directorship "full time job"); *supra* notes 33-34 and accompanying text (noting impact of time and knowledge deficiencies on outside director performance).

65. *See* KORN/FERRY INTERNATIONAL, 13TH ANNUAL BOARD OF DIRECTORS STUDY 15 (1986) (noting audit committee meetings averaged three per year).

66. *See* Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A*

knowledge, and information necessary, are not qualified to process financial data in the manner SOX contemplates.[67]

Directors that are truly independent, accomplished in business or law, and genuinely motivated to protect shareholders' interests, are an invaluable piece of the governance puzzle.[68] Unfortunately, finding individuals who possess these attributes that are willing to serve as independent directors is a difficult task.[69] The biggest hurdle for compliance-conscious corporations is electing directors who are truly, rather than facially, independent of management.[70] SOX depends on a disconnect between director and management interests that may be impossible to achieve.[71] Ironically, the effective performance of the enhanced oversight function that the ALI proposed and SOX implemented may necessitate more personal contact between outside directors and corporate insiders than existed under previous practices.[72] Corporate directors are influenced by relationships and self-motivated to the same extent as other persons.[73] The law should not expect otherwise.[74]

Tool to Focus Reform, 35 WAKE FOREST L. REV. 153, 175-76 (2000) (recognizing many directors lack sufficient expertise to perform oversight function SOX relies on).

67. *See* Stabile, *supra* note 66, at 175-76 (observing outsiders often unable to properly assess corporate situations); *supra* note 52 and accompanying text (evaluating ability of Enron's model board to prevent fraud). Non-financial experts may lack the ability to raise red flags that would prevent future frauds. *See* Stabile, *supra* note 66, at 175-76.

68. *See supra* notes 27-31 and accompanying text (discussing arguments supporting outside director oversight).

69. *See* STEPHEN M. BAINBRIDGE, THE FEDERALIST SOCIETY FOR LAW AND PUBLIC POLICY STUDIES, A CRITIQUE OF THE NYSE'S DIRECTOR INDEPENDENCE LISTING STANDARDS 7 (Aug. 1, 2002), *available at* http://www.fed-soc.org/pdf/NYSEStandards.pdf (citing time demands and liability potential as deterrents to board service); *supra* note 18 and accompanying text (noting factors causing reluctance to serve as outside directors); *supra* notes 33-34, 64 (examining time deficiencies suffered by outside directors); *supra* notes 57-60 and accompanying text (examining potential for increased director liability); *infra* note 93 and accompanying text (discussing independence requirements as board service deterrent).

70. *See* COX, *supra* note 21, §9.3, .4-.5, .7 (lamenting outside directors' inability to exercise independent judgment); Brudney, *supra* note 34, at 611-12 (recognizing social and psychological factors hampering outside director independence); Kahn, *supra* note 52, at 1606-07 (describing Enron outside directors' financial conflicts of interest).

71. *See* BAINBRIDGE, *supra* note 69, at 20 (arguing independent directors' "predisposed" to favor management). One basis for Professor Bainbridge's theory is the tendency of many outside directors to be current or former corporate officers themselves, thus creating at least a sub-conscious identification with management. *See id.*

72. *See*, *e.g.*, Branson, *supra* note 64, at 1006 (asserting director duties under SOX "full time job"); Easterbrook, *supra* note 33, at 555 (arguing directors' monitoring will fail unless they work "substantially full time" at corporation); Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT'L L. & COM. REG. 725, 812 (2003) (asserting time spent at corporation to perform SOX function exposes directors to "management manipulation"); *see also supra* note 39 and accompanying text (listing ALI audit committee responsibilities adopted by SOX requiring increased contact between directors and management).

73. *See*, *e.g.*, Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 ARIZ. ST. L.J. 91, 124 (1994) (asserting director desire for "agreeable social relations" breeds conformity with management decisions); Stabile, *supra* note 66, at 177 (arguing even "truly" independent directors compromised by social factors); *supra* note 54 and accompanying text (quoting Delaware chancellor on director vulnerability to social pressures).

A further problem with SOX's dependence on outside directors is the extent to which they are considered the ultimate solution to governance issues.[75] While their participation in the governance process is valuable, there are many sound arguments backed by statistical analysis that suggest outside directors are not vital enough to good governance to justify the role SOX requires them to play.[76]

SOX's financial expert measure is not likely to have a significant impact on the ability of audit committees to detect and prevent fraud.[77] While audit committee members who meet the financial expert designation criteria are more capable of identifying financial reporting issues than other directors, many directors fit the definition by virtue of a livelihood that does not leave them with adequate time to apply their expertise to their oversight duties.[78] Additionally, the independence requirements for audit committee financial experts may not be realistic in light of the nature of their new responsibilities.[79] Finally, despite SEC statements to the contrary, financial experts may be held to a de facto higher standard of care than non-expert audit committee members, thus limiting the pool of independent directors willing to assume the label.[80]

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74. *See supra* note 54 and accompanying text (asserting law must be cognizant of social pressures facing directors). Many directors are retired persons whose opportunity to serve stems from a prior relationship with an existing board member or corporate officer. *See* Ford, *supra* note 73, at 121-22 (citing prior relationships common between independent directors and management); *id.* at 124 (noting many outside directors are retired executives). When these factors are combined with a director's desire to continue service and perhaps to serve on additional boards controlled by the same officers, directors naturally hesitate to take positions adversarial to management. *See* William L. Cary & Melvin A. Eisenberg, Cases and Materials on Corporations 156-57 (6th ed. 1988) (noting outside director inability to exercise true independence due to ties to corporation); Lucian Arye Bebchuk et al., *Management and Control of the Modern Business Corporation: Executive Compensation & Takeovers: Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751, 771 (2002) (suggesting director's interest primary in maintaining board seat and election to further boards).

75. *See* 15 U.S.C.S. § 78j-1(m) (Law. Co-op. 2003) (containing SOX provisions relying on outside director oversight); Cox, *Conflicts of Interest*, *supra* note 18, at 1078 (asserting expectations for independent director contributions at all-time high).

76. *See* James D. Cox & Thomas Lee Hazen, 1 Corporations § 9.02, at 402 (2d ed. 2003) (stating negative correlation between percentage of independent directors and their utility in governance process); *Corporate Governance Issues*, 8 Fordham J. Corp. & Fin. L. 49, 61-62 (2003) [hereinafter *Governance Panel 2*] (pointing to studies showing inverse relation between shareholder benefit and director independence). *Compare supra* notes 27-31 and accompanying text (offering support for value of outside director oversight role), *with supra* notes 32-36 (criticizing outside director ability to contribute to governance process).

77. *See supra* note 55 and accompanying text (examining SOX financial expert requirement).

78. *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 Vill. L. Rev. 1189, 1199 (2003) (predicting financial expert duties will require significant time commitment); Ribstein, *supra* note 61, at 26 (observing directors with financial expertise usually pulled from business field and noting time constraints faced).

79. *See* Markham, *supra* note 72, at 812 (reasoning experts' independence compromised if they spend time at corporation necessary to perform duties adequately).

80. *See* Mitchell, *supra* note 78, at 1199 (predicting that experts' increased access to information will heighten legal responsibility despite SEC assurances).

B. Impact of SOX's Auditor Independence Enhancements and Counsel Provision

Despite the ability to appoint and oversee the accountants directly, outside directors must still rely substantially on others to perform their gatekeeper function.[81] The effectiveness of SOX's governance measures, therefore, hinges on auditors being more than facially independent.[82] SOX's rules intended to enhance auditor independence from management should increase auditors' reliability as the eyes of the audit committee.[83] Accounting firms had motivation without legislative action, however, to avoid the audit practices that led to Arthur Anderson's collapse.[84] Assuming legislation was indeed necessary, Congress could have done more to ensure that auditors' ties to management were broken.[85] So long as auditors are paid by the corporations they audit, an inherent conflict-of-interest will persist.[86] If Anderson's role in the accounting scandals is evidence of pervasive laxity within the profession, re-evaluation of accepted accounting practices is necessary, especially in light of the external forces that influence auditors' discretion.[87]

Perhaps the most worthwhile aspect of SOX's governance regime is the requirement that corporations provide audit committees with funds to hire independent legal counsel.[88] Prior to SOX, the SEC recognized the wisdom of independent counsel in the mutual fund context, requiring in 2001 that outside directors of funds taking advantage of safe harbors available for conflict-of-interest transactions receive legal advice from firms with no significant

81. *See* Andres V. Gil, *Legal Duties and Responsibilities of Corporate Directors and Controlling Persons of U.S. Publicly-Owned Companies*, 3 U.S.-MEX. L.J. 1, 22 (1995) (recognizing director dependency on financial auditors to shield them from liability for fraudulent disclosure); Ribstein, *supra* note 61, at 29 (recognizing outside directors necessarily dependent on auditors to spot fraud).

82. *See* Ribstein, *supra* note 61, at 29 (identifying success of auditor independence enhancements as key to audit committee effectiveness); *supra* notes 47-48 and accompanying text (discussing historical auditor failures including Anderson's Enron role).

83. *See supra* note 49 and accompanying text (describing SOX auditor independence enhancements).

84. *See supra* note 48 and accompanying text (discussing Anderson role in Enron collapse).

85. *See* Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 1008 (2003) (opining rotation measure fails to prevent relationships between auditors and management); *supra* note 49 and accompanying text (detailing SOX auditor independence requirements including audit partner rotation). In addition to the inadequate partner rotation measure, Professor McCoy argues that the exemption of tax services from the non-audit service provision prohibition creates a sizeable loophole compromising the proscription's effectiveness in enhancing auditor independence. *See* McCoy, *supra*, at 1008 (suggesting mandatory rotation of accounting firms is only way to ensure true auditor independence).

86. *See* Darin Bartholomew, *Is Silence Golden When it Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 89-90 (2002) (noting conflict persists between auditors' duties and their working relationship with management).

87. *See* McCoy, *supra* note 85, at 1008 (alleging "highly elastic" Generally Accepted Accounting Practices and incentives to favor management troublesome combination).

88. *See supra* note 43 and accompanying text (outlining SOX requirements including independent counsel provision). Professor Cunningham points out, however, that prior to SOX, state law granted audit committees the power to retain such outside advisors as the committee deemed necessary. *See* Cunningham, *supra* note 15, at 947-48 (suggesting SOX measure significant but not truly reform).

connection to management.[89] At about the same time the investment company rule went into effect, Enron's outside law firm, which received seven percent of its yearly revenue from the company, was advising the Enron directors to waive the company's Code of Ethics with respect to the special purpose entity transactions that eventually triggered Enron's collapse.[90] In situations where auditors are sufficiently independent to disagree with management on a financial reporting issue, or at least to bring the issue to the audit committee's attention, advice from counsel without ties to corporate management will certainly benefit outside directors searching for the right course of action.[91]

C. Who Wants This Job?

Those best qualified to serve as independent directors under the SOX framework may be deterred or precluded from serving by the potential for liability, time constraints, and burdensome independence requirements.[92] Directors serving on the boards of large companies with numerous affiliates must spend a significant amount of time and energy simply ensuring that their independence is not compromised by the actions of a family member or previous employer.[93] Of particular concern to current and potential outside directors is whether SOX increases their exposure to liability.[94] The oversight

89. *See* Cox, *Conflicts of Interest*, *supra* note 18, at 1087-89 (outlining investment company independent counsel requirement). While the SEC investment company rule did not set forth specific criteria for counsel independence, the SEC made clear that lawyers who advise directors should "not be compromised by an historical relationship with the fund's advisor." *Id.* at 1088-89.

90. *See* Cox, *Conflicts of Interest*, *supra* note 18, at 1093-94 (noting firm refrained from informing Enron's board of its misgivings concerning transactions).

91. *See* Letter from Independent Directors of Merrill Lynch Cluster A Funds to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commisssion (Jan. 27, 2000), *available at* http://www.sec.gov/rules/proposed/s72399/crum1.htm (asserting value to independent directors in oversight responsibilities of trusted counsel of their choosing). If counseled by a lawyer employed solely to protect their interests in the fulfillment of their oversight responsibilities, the Enron directors may have hesitated to accept auditor assurances that its aggressive interpretations of accounting rules were within the law. *See* Cox, *Conflicts of Interest*, *supra* note 18, at 1094-95 (suggesting Enron directors may have benefited if advised by counsel unencumbered by conflicts of interest); Jennings, *supra* note 52, at 207 (describing Enron directors' failure to understand level of risk entailed in auditors' accounting interpretations).

92. *See* BAINBRIDGE, *supra* note 69, at 7 (citing time demands and liability potential as deterrents to board service); *supra* note 18 and accompanying text (commenting prospective board members possibly deterred by scandals and SOX requirements); *supra* notes 33-34, 64 (examining time deficiencies suffered by outside directors); *supra* note 43 and accompanying text (noting SOX independence requirements); *supra* notes 57-60 and accompanying text (discussing potential for increased liability for directors due to SOX role).

93. *See* 15 U.S.C.S. § 78j-1(m)(3) (Law. Co-op. 2003) (setting forth SOX director independence requirements); BAINBRIDGE, *supra* note 69, at 7 (summarizing problems with meeting NYSE-proposed independence requirements as adopted by SOX); Veasey, *supra* note 18, at 444 (stating SOX independence requirements' specificity may "drive away good directors").

94. *See* Bartholomew, *supra* note 86, at 90 (observing some companies' attempts to disclaim audit committee liability in wake of SOX reform); Robert J. Jossen, *Using Sarbanes-Oxley in Civil Litigation*, 173 N.J. L.J. 877, 877 (2003) (describing director liability exposure as "perverse effect" of SOX attempt to improve corporate governance); *supra* notes 57-60 and accompanying text (examining liability exposure under SOX framework).

duties delegated to the audit committee under SOX will necessarily result in outside directors receiving greater exposure to the preparation and review of financial disclosure.[95] This increased access to information, along with the raised awareness of their monitoring role that is a byproduct of SOX requirements, will make it easier to prove that outside directors were on notice of a potentially misleading financial report, and had a duty to prevent the report's publication.[96] Additionally, SOX's oversight responsibilities may raise the standard for good faith monitoring necessary to receive the benefits of the business judgment rule.[97] Even if liability standards remain the same, independent directors likely face an increasing number of lawsuits due to the enhancement of their gatekeeper role in preventing fraud.[98]

D. Is This All Worth It?

The benefits of outside director oversight may not be worth the cost to shareholders of SOX compliance and the federalism concerns SOX's enactment has raised.[99] Whether the benefits to shareholders which stem from independent director oversight are actually enhanced by SOX requirements is doubtful.[100] The cost to corporations, and thus to shareholders, of complying with SOX and insuring directors is substantial.[101] SOX's disregard for the

95. *See* 15 U.S.C.S. § 78j-1(m) (setting forth SOX oversight responsibilities).

96. *See* Backer, *supra* note 60, at 937 (suggesting SOX increases detail of director fiduciary duty and removes discretion); *supra* notes 57-60 and accompanying text (addressing impact of increased information flow to directors on their liability potential).

97. *See* 15 U.S.C.S. § 78j-1(m) (containing SOX audit committee oversight enhancements); Becker, *supra* note 57, at A14 (noting good faith concept's meaning faces expansion in new regulatory climate according to Delaware judiciary); *Lessons From Enron*, *supra* note 52, at 738 (stressing audit committee cannot "abdicate" audit responsibilities to CEO under new framework); *supra* note 58 and accompanying text (stating business judgment rule available only where monitoring obligations deemed satisfied in good faith).

98. *See* Mae Kuykendall, *A Neglected Policy Option: Indemnification of Directors For Amounts Paid to Settle Derivative Suits—Looking Past "Circularity" to Context and Reform*, 32 SAN DIEGO L. REV. 1063, 1085 (1995) (identifying positive correlation between lawsuits against outside directors and monitoring function's growth).

99. *Compare supra* notes 27-31 and accompanying text (asserting value of independent oversight), *with Governance Panel 2*, *supra* note 76, at 61-62 (citing studies showing negative correlation between director independence and shareholder returns), *supra* notes 32-36 and accompanying text (questioning value of independent oversight), *and infra* notes 101-102 and accompanying text (discussing cost and federalism concerns).

100. *See* Cunningham, *supra* note 15, at 947-48 (deeming congressional response to scandals "formalization" of existing practices and requirements); Dickerson, *supra* note 42, at 1054 (observing companies employing best practices used audit committee monitoring pre-SOX). Some question the absence of any method for monitoring the directors themselves. *See* BAINBRIDGE, *supra* note 69, at 16 (asking "who will monitor the monitors?"); Sam Fletcher, *Sarbanes-Oxley Concerns Dominate U.S. Corporate Governance Issues*, OIL & GAS J., Oct. 13, 2003, at 22 (indicating only seventeen percent of surveyed corporations evaluate director performance).

101. *See* Aronson, *supra* note 61, at 142 (predicting longer hours for lawyers reviewing financial statements); Fischel, *supra* note 33, at 1282 (arguing outside directors' knowledge deficiency makes decision-making process less efficient); Fletcher, *supra* note 100, at 22 (noting half of corporations surveyed hiring compliance consultants, one-third investing in director education); *Governance Panel 2*, *supra* note 76, at 62

federalist formula that delegates corporate governance regulation to the state where a corporation is chartered is also a troubling development.[102] Furthermore, SOX's one-size-fits-all approach to corporate governance disregards the inherent differences between various types of corporations.[103]

E. Alternatives

A governance formula more in tune with corporate reality would de-emphasize the independent director's gatekeeper role.[104] First, allowing an inside director to sit on the audit committee would facilitate better communication between the committee and management and provide the outside directors with a peer not limited by time and information constraints.[105] Second, more effective regulation could ease the conflicts of interest compromising outside auditors, who are ultimately in the best position to uncover fraudulent disclosure before it is released to the public.[106] Finally, to provide further deterrence and a truly independent review of accounting practices, Congress could allocate to the SEC the resources necessary to

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(commenting compliance costs especially burdensome for smaller companies); Dennis E. Ross, *The Regulatory Aftermath: One Year Later, GCs Struggle to Decipher Sarbanes-Oxley*, CORP. LEGAL TIMES, Sept. 2003, at 44 (describing counsel struggling to comply with ambiguous regulations); *supra* note 59 and accompanying text (noting sharp rise in directors' liability insurance coverage premiums following scandals and SOX). *But see* Ide, *supra* note 6, at 833 (arguing outside director oversight will generate shareholder value through better business decisions and public trust).

102. *See* Branson, *supra* note 64, at 1006 (commenting SOX regulation of boards and board committees does "great violence to federalism"); Karmel, *supra* note 36, at 551 (attacking SEC's attempted federalization of monitoring model as unnecessary preemption of state law). The Supreme Court has recognized state supremacy in formulating corporate law, holding that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations." CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987). By creating a uniform standard for certain aspects of corporate governance, SOX eliminates the opportunity for states to experiment with different formulas that may work better. *See* BAINBRIDGE, *supra* note 69, at 27-28 (asserting history proves better corporate law develops through state experimentation).

103. *See Governance Panel 2*, *supra* note 76, at 62 (observing small companies incur substantial costs maintaining board committees); Veasey, *supra* note 18, at 444 (noting SOX independence rules ironically prohibit large individual investors from representing themselves and other shareholders on audit committee). Not only do corporations experience problems relating to management accountability that differ in type and seriousness, many companies would benefit more from one of the many other accountability mechanisms than they will from independent director oversight. *See* BAINBRIDGE, *supra* note 69, at 23-24 (identifying market controls and compensation incentives as more appropriate accountability mechanisms in some circumstances). Further, smaller companies are finding that it takes much longer to fill vacancies on their boards now that SOX is in effect. *See* Lisa Holton, *Help Wanted: Filling Vacancies on Corporate Boards Creates Headaches for In-House Lawyers*, ABAJOURNAL.COM, para. 3 (2004) (on file with author) (noting post-SOX searches for new directors taking twice as long).

104. *See supra* notes 33-36, 64-76 and accompanying text (questioning value of independent director oversight).

105. *See* BAINBRIDGE, *supra* note 69, at 22-23 (asserting insider presence on key committees enhances committee performance).

106. *See supra* note 85 and accompanying text (describing SOX independence enhancement shortcomings).

increase the frequency and depth of its field audits of large publicly-traded companies.[107]

IV. CONCLUSION

While SOX enhances the tools available to independent directors in their oversight role, the new regulatory scheme is essentially a formalization of best practices and rules that were already in place. Considering the inability of this model to prevent the corporate failures that occasioned the legislation, perhaps forcing every public company to comply with these rules is a waste of time and money. Reversion to the pre-SOX governance regime is unlikely. It is not too late, however, to thwart current attempts to further strengthen the monitoring model's hold on corporate governance. Proposals such as mandating independence for board chairs or super-majorities for outside directors are unlikely to result in more effective corporate governance. Amending SOX to allow an independent director-nominated insider to sit on the audit committee is a similarly attainable goal that would lessen the adversarial nature of the present formula and place persons on the committee with a more intimate knowledge of the corporation's affairs. In light of their time and information constraints, outside directors will rarely, if ever, halt corporate insiders determined to commit fraud. Independent directors deserve a place at the boardroom table, but the law should not empower them beyond their utility.

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107. *See* Hamilton, *supra* note 10, at 50 (describing inability of SEC to keep up regular audits under current budget constraints); Stephen R. Howard, *A National Association for Independent Directors of Investment Companies: A Supplement to Current SEC Proposals*, 44 N.Y.L. SCH. L. REV. 535, 536 (2001) (noting ratio of investment companies to investment company field auditors is forty to one).