

THE LEGISLATIVE AND JUDICIAL RESPONSE TO RECENT CORPORATE GOVERNANCE FAILURES – WILL IT BE EFFECTIVE – PART II?

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I would like to start by saying that I have picked up so many little pieces of experience along the way, and that it has been a very interesting journey. One of the things that I would like to share with you today is a perspective based on over thirty years of working with both corporate boards and those who have tried to model corporate governance practices, ranging from the New York Stock Exchange and the Model Business Corporation Act to, more recently, Congressional legislation.

Hopefully, during this presentation I will give you some perspective about factors that have influenced both where we are today with what I would call a mail-storm frenzy about corporate governance and what I perceive to be the right balance, through a check-and-balance system, for corporate America. Having the right balance will give investors a sense of confidence and the marketplace a sense of

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Mr. Cheek has lectured widely at numerous symposiums and institutes, including those sponsored by the SEC, the New York Stock Exchange, ALL-ABA, PLI, and others. In his practice, Mr. Cheek represents a number of public and private companies, as well as investment banking firms, in a variety of capital raising and merger acquisition activities. He also acts as counsel to the boards of directors and various committees of boards on corporate governance and legal matters.

responsibility that senior management and boards will apply their fiduciary duties.

Overview

It is hard to believe that a little over two years ago the corporate governance scene was quite calm. In a relatively short period of time, a dramatic set of events has profoundly intensified the view of good corporate governance. We are only two years past Enron. Enron was the leading edge of a number of financial frauds that caused a crisis in overall confidence, resulting in legislative and regulatory reactions. These reactions have impacted what corporate governance is today. We are only one year past the anniversary of the Sarbanes-Oxley Act:² federal legislation reflecting that Congress, for the first time since the thirties, determined to weigh in on how corporations are to be structured and governed. Sarbanes-Oxley marked a major shift of historic direction of regulatory influence.

It is difficult to pick up a newspaper without seeing a whole section on corporate governance and how to be a good director. There are more institutes and programs going on every week than you can hope to count on twenty hands; it is the issue of the day. While it is important to recognize the “trees” of that issue, it is also important to recognize the “forest” that surrounds those issues, which is what I am going to try to relate today.

Counseling Corporate Directors

In your role as a corporate director or as a counselor advising corporate directors, there are two things which I would suggest to you are fundamental parts of any good corporate governance scheme. First, the legal fiduciary duties of directors have not changed. Those duties have been around for a long time. While we have a subset of specific responsibilities that new legislation, new listing standards, and new judicial decisions have imposed on those directors, the over-arching fiduciary duty is the same: to be awake and to pay attention to what is going on. The second fundamental duty requires that a director not only pay attention, but that he or she becomes fully-informed. This second prong is what I see missing in a lot of boardrooms, and what historically continues to be refined in the new system of corporate governance.

² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 at 403 (2000) (codified in scattered sections of 11, 15, 18, 28, and 19 U.S.C.).

Being fully informed means that you know what decisions you are being asked to make, and that you know what responsibilities you have with respect to those decisions. It is not just showing up, having a book presented to you in the middle of a board meeting, and making a decision based on a ten-minute presentation by a senior manager on a major issue. You must pay attention, be informed, and apply that informed judgment with a dose of healthy skepticism about what you are hearing from management, particularly if there is a personal interest or conflict associated with the matter that is presented to you.

Independence

That principle goes to the next paradigm of how a director is supposed to act. A director is supposed to act in the best interest of the shareholders without conflict of personal interest. That is where we get into the notion that is the focus of the press and all the regulators: the rubric of independence. We will talk a little bit about how that notion is being shaped. Apart from the legal and judicial definition, this notion reflects coming to an issue with an independent mind and a focus on what is going to be in the best interest of the shareholder on the basis of an informed judgment. As I previously stated, that is the first principle and it has not changed. It has been the standard for a long time.

Corporate Culture

The second standard of board responsibility is to understand the culture of the business that board members are directing. I cannot emphasize this enough. In most financial frauds, the business culture stinks, and it mostly stinks from the top down. You can see this in situations like Enron, Tyco, Adelphia, and HealthSouth, for example. A driven CEO or entrepreneur, even with the most tremendous business plan in the world and a great instinct for leadership, can drive an organization to bad things if that individual creates a culture of not doing the right thing. A board has the responsibility to understand the culture and to influence that culture in a way that assures accountability and responsibility in the organization.

Influences on Corporate Governance

Some factors have clearly driven the new regime of corporate governance. The most obvious ones, the most media-focused ones, the ones that make all of the wonderful sound bites that we hear, are the set of financial fraud scandals that

started with Enron and Arthur Anderson. At that point in time, this was a complex accounting fraud that had a lot of different parts as it unraveled. But at the time of Enron, many debated about whether Enron's accounting techniques really had been within the letter of accounting literature.

Enron had the absolute perfect governing system imbedded in its board at that time. The majority of Enron's board was thought to be independent, it had all the right committees, it had all the right governance principles, and it also had codes of ethics. However, at the top, it had really greedy, dominant people who created a system of earnings management that was very sophisticated and complex. After the start of the Enron scandal, there was no hewing cry. There was concern and a little bit of pause, then came the bill by Senator Sarbanes.³ In the Senate, the bill had no legs and did not go anywhere; we did not have massive change. If the Enron scandal was the only one of its kind, I do not think we would have had the massive change in corporate governance that we see today.

But Enron was not isolated. We saw failure after failure with Tyco, WorldCom, Adelphia, and so forth. Together, these scenarios created a political issue in Congress and in the White House that demanded quick resolution. Fall elections were looming and Congress wanted to have a response to the public about what Congress was doing about these massive financial frauds that had been uncovered. At that point, there was the most frenzied legislative reaction that I have seen in the history of Congressional action on corporate matters.

Typically, you have a process, where lobbyists and drafting experts weigh in and a lot of legislative history is built in. However, the Sarbanes-Oxley Act went very quickly through Congress; there is very little legislative history and there was no careful drafting of that bill. The language throughout the Act is difficult to understand, yet it was passed. Just before its passage, a hundred and twelve amendments were added with very little language in support of what they were intended to do.

The Act was the product of political fallout resulting in a frenzied governmental and Congressional reaction. Paul O'Neil,⁴ the Treasury Secretary, said that we ought to hang all the scoundrels from the highest trees to insure proper

³ U.S. Senator Paul S. Sarbanes of Maryland.

⁴ Paul H. O'Neil served as Treasury Secretary from January 2001 until December 2002.

corporate governance. All of this rhetoric took place at a time when there was no stopping the momentum of change. Therefore, these first and perhaps most dramatic set of events set us off on the course of where we are currently.

As these facts unveiled, there resulted a series of outrageous instances of senior executives, who had the fiduciary trust as an officer of a corporation, wrestling away all kinds of personal benefits from the coffers of the corporation. Kozlowski,⁵ who is on trial in connection with all the excessive amounts of payments that were made to him and personal expenses that he off-loaded on the corporation, is the most visible one now.

Although curious, Dick Grasso⁶ has had more influence on regulations than Kozlowski or other officers. People were outraged and offended by Grasso's compensation package of \$139.5 million to run the New York Stock Exchange. Grasso's influence is curious because the New York Stock Exchange is not public: Grasso did not steal from the shareholders or even from the members that own the New York Stock Exchange. Grasso fully negotiated his compensation package, which was reviewed and approved because he was doing a great job, a very unusual set of circumstances. The New York Stock Exchange has two components: a regulatory side and a market side. The members of the Exchange are associated with the market side and they set Grasso's compensation. Yet, Grasso still had regulatory policing responsibilities over the members which, coupled with the size of his compensation package, created ripple implications throughout the compensation world in corporate governance. The board then went public saying that they did not know what Grasso was making and did not understand his contract. These were horrific statements for any board person to make, but it was their public spin on how to avoid the feeding frenzy approaching them.

Compensation committees are now more focused on the size of compensation packages and on their own lack of knowledge about such packages. They do not just rubber-stamp every complex deferred compensation plan that comes to them anymore. These committees are getting outside consultants to come in to advise them as to what each plan says; this is a governance change. Compensation packages are now under much higher scrutiny, which is due in large part to Grasso.

⁵ L. Dennis Kozlowski was formerly CEO of Tyco International Ltd.

⁶ Dick Grasso is the former chairman of the New York Stock Exchange.

Shareholder Influence on Governance

Another factor to consider is that the public and regulatory outcry has resulted in increased pressure and activism of institutional holders. Now, it is not just public retirement plans like CalPERS⁷ that are active. Other funds, like Fidelity and Vanguard, are beginning to exercise some shareholder muscle in order to affect good governance practices.

This last year's proxy season saw the largest number of shareholder proposals ever, and the largest number of shareholder proposals that were approved by a majority vote. Traditionally, you have a very low percentage of those that ever get approved. Now, a whole host of new weapons for aggressive institutional shareholders are being imbedded in the governance system, and these with mutual fund voting policies.

One of the reasons Fidelity and Vanguard are getting in this game is that the SEC now mandates that every mutual fund publicly disclose how it will vote on certain issues. Therefore, this puts pressure on the mutual funds to adopt a "white hat" shareholder-protective stance in their voting policies on issues like poison-pilled plans and stock option plans. This new additional pressure is now a part of the system.

The SEC published, for public comment, a new proposal that permits shareholders, if they leap a few hurdles, to include competing nominees for board positions in company proxy material. Historically, the only way a group like Fidelity or CalPERS could change a board composition was to launch a proxy fight, which meant they had to go to the expense of doing proxy solicitation. Now, under this proposed new rule, companies will be able to submit competing nominees in their company materials. This practice is going to change the dynamics of corporate governance.

Lastly, institutional shareholders are more willing to litigate governance issues than in times past. One of my clients is HCA, a major hospital company in Nashville. The New York State Teacher's Retirement Fund brought a derivative action against HCA regarding some fraudulent activities that occurred in that

⁷ CalPERS, or the California Public Employees Retirement System, is the largest public pension fund in the United States.

company many years ago. That action settled when HCA accepted the wholesale adoption of new and sweeping corporate governance guidelines. So, litigation is another tool that aggressive shareholders can and do use to impact corporate governance.

Battling Regulators

Now, we have the battling regulators. New York Attorney General Elliott Spitzer embarrassed the Securities and Exchange Commission on a level not often seen. Through a network of tips, Spitzer aggressively pursued and unveiled frauds, mostly in the mutual fund arena, that the SEC had chosen to ignore. Now, governmental agencies face internal pressures to outdo each other by enhancing their appearance as being tough, forceful regulators. This will impact how enforcement actions are settled and how regulations are developed in the future. As an aside, it is interesting to note that a number of U.S. Attorneys have been taking on a tougher enforcement attitude in the criminal arena in order to build up their public image.

Business Opportunities Under the New Regime

From an entirely different perspective, the new regime of governance has created many productive business opportunities for lawyers. I have advised an increasing number of boards on governance practices over the last two years. The new regime of governance has also created many continuing legal education programs (“CLEs”) for the profit-oriented CLE provider. The New York Stock Exchange’s new standards mandate corporate director education programs, and many CLE providers are offering such programs.

In addition, the industry has experienced an upsurge in shareholder rating services. ISS⁸ is both the leading advisor on how institutional shareholders should vote their shares and the leading provider of shareholder rating services. For a fee, ISS will review a public company’s governance practices and give it a score. These scores have taken on a life of their own. Institutional holders tend to invest more in higher-rated scores believing that good corporate governance leads to good corporate performance. This is not always the case, but these services have proliferated to the extent that they are now a major factor in how boards and companies structure themselves in order to obtain and maintain a good score.

⁸ Institutional Shareholder Services; information available at <http://www.issproxy.com>.

Therefore, shareholder rating services are another factor to consider in this discussion.

Effects of Sarbanes-Oxley

As previously mentioned, Sarbanes-Oxley was legislation passed about a year ago which created a significant number of changes in the corporate governance regime. The American Society of Corporate Secretaries recently conducted a survey on public companies that reflected the range of changes and practices that Sarbanes-Oxley has dictated.

With all of these new responsibilities and new processes, people have been slow to recognize the impact of the Public Company Accounting Oversight Board (“PCAOB”). The PCAOB is a new and independent regulatory board; it is not a branch of the SEC. The PCAOB has its own general counsel, its own staff, its own investigative authority, and its own cost structure. The PCAOB was designed to create a public oversight organization to deal with auditor independence.

Like every other regulatory body, the PCAOB is moving toward empire status and will impose enormous costs on public company life. One obvious cost is that of running the agency, a cost paid for by public companies. More importantly is the hard cost that PCAOB’s regulatory rules, which are designed to improve and enhance auditing processing and internal control, will impose on public companies.

Costs of Compliance

Some have estimated the cost of complying with Sarbanes-Oxley at over ten million dollars. Others have placed the number between one and five million dollars. Most surveys have showed that compliance costs have at least doubled since Sarbanes-Oxley. These costs include director and officer’s liability insurance costs, accounting and legal costs, public relations costs, board compensation costs, and other personnel and investor costs. All of these things are added as hard-dollar costs.

In addition to these hard-dollar costs, there are other costs to consider. Some in the industry comment that “the reformers have decided that the solution is to drive a wedge between the CEO and the board, with separate meetings set up, to make sure they don’t all get too cozy with each other.” That aspect of driving the wedge is what I call the relationship cost imbedded in Sarbanes-Oxley.

Sarbanes-Oxley contains individual certification requirements designed to have the CEO and CFO certify the correctness of the financial and text information in certain ballots filed with the SEC.⁹ This has proliferated into separate disclosure and internal control committees that give certifications up to the CEOs and CFOs. As a result, committee members, as well as advisors to public companies, have to go on the line in a way that they have never had to in the past, causing more tension.

For the first time, the lawyers are subject to reporting obligations imposed by the SEC, in effect federalizing professional conduct standards of lawyers representing public companies. This creates a tension in the attorney-client relationship. This tension is also apparent in the accountant-management relationship. The comptroller committee of the board, not the management, hires and compensates the accountants.¹⁰ The audit committee has oversight responsibility over the accountants. Therefore, auditors, under PCAOB's standards, have to give a report card to the audit committee about how well the audit committee is performing.¹¹ So Sarbanes-Oxley incorporates these well-intentioned checks and balances that I see possibly creating relationship tensions that did not exist before.

In addition to the federal legislation, which included a number of regulatory and SEC rule-making authority provisions, we have major markets such as the New York Stock Exchange and the NASDAQ.¹² The SEC finalized the proposed rules that the NYSE and NASDAQ submitted, which were the result of a long negotiating process between the two markets and the SEC to try to build a common platform of standards. The NYSE tried to put itself at a higher level than the NASDAQ. The NASDAQ believed that it needed more flexibility due to the wider range of company sizes listed on its market.

In the end, the two markets were sort of pushed together. They are not identical, but they generally have the same tone: a majority of independent directors;

⁹ See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

¹⁰ *Id.* at §301(m)(2).

¹¹ See *id.* at §204.

¹² National Association of Securities Dealers Automated Quotation (System).

specific independence criteria; a board that makes affirmative determinations of independence; regular executive sessions of non-management directors; committee structures made up entirely of independent directors; written charters; and specific responsibilities and report card obligations requiring the committees to evaluate how well they have done and how effectively they have performed their duties.

Publicly available corporate governance guidelines must be on a website or otherwise be publicly available.¹³ Additionally, codes of business-conducting ethics must be adopted and made publicly available.¹⁴ As I have previously mentioned, the CEO has to go on the line each year and certify to the SEC that all of these things have been done. The NASDAQ is very similar, but it has a little more built-in flexibility. One feature which the NASDAQ possesses that the NYSE does not is the requirement of specific audit-committee approval of related party transactions. This feature provides a check-and-balance with respect to potential conflicts that exist in related party transactions.

Judiciary Influence on Governance

Other factors having a significant impact on the way that boards structure their governance practices are the occurrences in judicial decisions in what I call special investigation reports. This year there has been a trio of Delaware cases that have focused on governance issues and on the issue of when a director might be deemed to be independent for the purpose of determining, in the course of a special litigation committee, whether a derivative litigation should be dismissed. The *Oracle*¹⁵ and *HealthSouth*¹⁶ cases relate to those two issues.

In *Oracle*, the Delaware Vice-Chancellor¹⁷ found that the special litigation committee could not be independent because of the close relationships between the company, its directors, Stanford University, and Oracle, the target of the derivative

¹³ See generally *id.* at §103.

¹⁴ *Id.* at §101(g)(3).

¹⁵ *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

¹⁶ *In re HealthSouth Corp. S'holders Litig.*, 2003 WL 2276905 (Del. Ch. Nov. 24, 2003).

¹⁷ The Honorable Leo B. Strine, Jr., Vice Chancellor of the Delaware Court of Chancery.

litigation.¹⁸

Oracle and Larry Ellison¹⁹ had made charitable contributions to Stanford University, where two of the three special litigation committee members were professors or administrative officials.²⁰ The Vice-Chancellor found a truly independent review to be unlikely due to the impact of the charitable contributions.²¹ Two years ago, most people would have seen this as an arguable case of a disabling relationship.

HealthSouth is another case involving a special litigation committee. An outside law firm conducted a special investigation of Mr. Scrusby²² for insider trading. The initial investigation cleared Scrusby of any wrongdoing. The chair of the special litigation committee issued a press release, saying that he was delighted that Mr. Scrusby had been cleared of any wrongdoing, and that the company was moving forward with Mr. Scrusby as CEO. The Vice-Chancellor found the statement of the chairman of the special litigation committee to be inappropriate. He also found the review of Mr. Scrusby was not adequately independent. The Vice-Chancellor later found Scrusby guilty of unjust enrichment and equitable fraud.²³

*Walt Disney*²⁴ was the first of the trio of cases to be decided. This case involved a very lucrative compensation arrangement that had been put into place for a friend of the CEO. The Chancellor²⁵ found that the board of directors breached

¹⁸ See *supra* note 15.

¹⁹ Lawrence “Larry” Ellison was a member of Oracle’s board of directors.

²⁰ See *supra* note 15.

²¹ *In re Oracle*, 824 A.2d at 948.

²² Richard M. Scrusby was HealthSouth’s former Chairman and CEO.

²³ See *supra* note 16.

²⁴ *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

²⁵ The Honorable William B. Chandler, III, Chancellor of the Delaware Court of Chancery.

the duty of good faith with the compensation arrangement.²⁶ This was the first Delaware case, at least in recent memory, to find that a board breached a duty of good faith. This decision is important because it sets a precedent for stripping away the protections that the Delaware statute provides against monetary damages resulting from the negligent conduct of a board director. Basically, if the director does not act in good faith, she will not be protected by the Delaware statute. So, there is enormous potential for ramifications.

The *Chancellor Group*²⁷ case was the first SEC enforcement action against an outside director solely on the basis of the director's failure to respond to the red flags raised around the soundness of the corporate entity's accounting methods. The director had no direct involvement in the fraud, nor did he profit a single dollar through the fraud; he was merely the chairman of the audit committee. The SEC imposed sanctions and significant money penalties on the director. This reflects the shifting tide of holding directors more personally accountable.

Other Considerations

Richard Breeden²⁸ proposed a very radical set of governance proposals that are getting some legs in the media and in actual practice. One of his proposals requires that there be at least one new director each year. Another proposal requires that there be at least eight board meetings per year. Breeden also proposed that there be caps on executive comptrollers set by the board.

These types of proposals are what I like to call "creeping legs." They are put out there by a credible source as a result of massive fraud and people begin to consider them as they shape their corporate governance principles. Even though they have no statutory or legislative basis and are not being mandated by shareholders, people begin to weave them into their structures. Ultimately, they become a part of the fabric of what we are discussing.

All of this has had an impact upon directors' and officers' liability insurance.

²⁶ See *supra* note 24.

²⁷ SEC v. Chancellor Group, Inc., 1998 SEC LEXIS 2729 (D.D.C. 1998).

²⁸ Richard Breeden, Corporate Monitor of WorldCom. Mr. Breeden served as Chairman of the SEC from 1989 to 1993. Mr. Breeden also served as a senior financial and domestic policy advisor to President George H.W. Bush during his tenure as Vice President and President.

The market has gotten much more expensive, and now insurance policies have many more exclusions built into them. One must be very careful, if involved with a public company, in making sure that the policy is as solid as it seems.

Being a Lawyer for a Corporate Client

One more topic needs to be addressed in this discussion. The whole role of being a lawyer for a corporate client is shifting in terms of the depth of responsibilities that the lawyer possesses. §307 of Sarbanes-Oxley,²⁹ a late amendment by Senator Edwards,³⁰ initially drove the change. The amendment came only one day before the legislation was enacted. §307 states:

Not later than 180 days after July 30, 2002, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule:

- (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
- (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.³¹

²⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 at §307.

³⁰ Senator John Edwards of North Carolina.

³¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 at §§307(1) & (2).

So, with that authority, the SEC put forth a set of rules in §205,³² which is very broad in its applicability and reach, and is designed for attorneys appearing and practicing before the Commission. This includes not only securities lawyers, but also anybody who touches a public filing that a corporate entity files with the SEC, as well as anybody who has a communication with the SEC. So, it also includes litigators, tax lawyers, and real estate lawyers. It has a very broad reach, and firms throughout the country are setting up coordinating procedures; it is an individual lawyer's responsibility, but firms are setting up procedures to help lawyers meet that responsibility.

Sarbanes-Oxley builds upon the concept of a chief legal officer, where a person within the corporate entity is designated to receive concerns from in-house or outside lawyers; either type might have a concern about a breach of fiduciary duty or a material violation of the law. Their responsibility is to report those concerns to the CLO and in turn, the CLO has to take appropriate action and then report back to the reporting attorney on what the CLO has done. If the CLO fails to do that, or if the reporting attorney does not believe that the CLO's reaction is appropriate, then the reporting attorney has to go all the way up to the board of directors with the information.

There is an alternative concept integrated in this process: a corporate governance concept that says rather than going to the CLO, a corporation can decide, in the boardroom, to have a qualified legal compliance committee, such as a corporate governance committee. Qualified legal compliance committees are designed to receive the concerns of reporting attorneys.

Reporting Out Obligations

I have put, as a final bullet, "reporting up and out obligations." I have already discussed the reporting up obligations, which means reporting up, within the corporate client, to the board of directors. One proposed rule, which has the possibility of becoming final, is if the board fails to take appropriate action, then the lawyer must report the legal concern out to the SEC. Of course, this rule has tremendous implications for the profession in terms of the duty of confidentiality between the lawyer and the client. When you are mandated to report out a concern, the board is not pleased, and the ability of the lawyer and client to have a free and informed discussion about issues is impeded.

³² See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 at §205.

The ABA created a task force on corporate responsibility that deals with the issues of the proposed rule and tries to keep the Commission within its legislative mandate of only doing a reporting up rule and not going to a reporting out model. The task force published a report which can be obtained on the “Business Law Section” of the ABA website.³³

In August 2003, the House of Delegates of the ABA adopted three principle recommendations as ABA policy. The first, and perhaps the most important of the three, is a set of governance principles designed to assure that lawyers are kept in the loop and have the opportunity to be part of a checks and balances system within a corporate entity to assure corporate accountability and responsibility. Some of the principles include the concept that lawyers be able to meet in an executive session with a committee of independent directors and communicate freely, without fear of retribution, about the concerns that the lawyer has about the system of corporate governance.

Ethics Rule Changes

The ethics rule changes are two-fold. One change concerns Rule 1.13, which relates to the corporate entity as the client. This change leaves a lot of professional judgment to the lawyer about material violations of law that have a substantial financial impact on the client.

The more controversial of these rules is Ethics Rule 1.6 which deals with the duty of confidentiality. This was a hotly contested proposal in the ABA House of Delegates. At the end of the day, it passed, 218 to 201, a fairly thin margin. The rule changed the duty of confidentiality which permits, but does not mandate, a lawyer to take action that would prohibit a client from using the lawyer’s services to commit a crime or fraud that clearly would result in substantial financial harm to third parties. Though this idea has never been a part of the ABA model rules, it is a part of professional rules of practice in forty-two states.

³³ American Bar Association, Business Law Section, at <http://www.abanet.org/buslaw/home.html>.

The things discussed above are specifically unique to lawyers, as the lawyer participates in this system of corporate governance. And with that, Dr. Neel,³⁴ I will take any questions.

DR. NEEL: Do you think that we have moved too far in Sarbanes-Oxley, and if we have moved so far as to make it such an onerous activity now to comply, have we precluded some firms that would normally be thinking about seeking public capital to either delay or abandon that decision simply because of the inability or the expense of compliance?

MR. CHEEK: USA Today published an article called, “Sarbanes-Oxley: Dragon or White Knight.”³⁵ In that article, the sub-headline is, “Law may be beneficial, but CEOs complain that red tape wastes time, brain, and resources.”³⁶ And one of the quotes in here is, “As a general rule of thumb, any bill that passes the United States Senate 97-0 is probably a horrible idea.”³⁷

One of the things the article focused on was the cost impact that I have talked about, and the cost of compliance is very difficult for small cap companies to deal with. This whole regimen of disclosure controls and internal controls is more easily absorbed by a larger business than a smaller business. One of the suggestions in the article was that the cost of compliance and the cost of interference of relationship issues would drive companies from not going public, and encourage companies that were public to go private.³⁸

The facts do not support that contention. Going public is far more driven by market conditions than cost of compliance issues. There is a resurgence of initial public offerings now, including small cap companies, which would be subject to this

³⁴ C. Warren Neel, Director of the Center for Corporate Governance at the University of Tennessee. From 1977 to 2000, Dr. Neel served as Dean of the College of Business Administration at The University of Tennessee in Knoxville. Dr. Neel is also a director of Saks, Inc., and a former director of Clayton Homes, Inc. He served as the Commissioner of Finance for the State of Tennessee from June 2000 until January 2003.

³⁵ Del Jones, *Sarbanes-Oxley: Dragon or White Knight?*, USA Today, Oct. 20, 2003, at 1B.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

compliance. Indeed, what is interesting is that a company has to be in compliance with Sarbanes-Oxley before filing a registration statement. So, a company must set up all these systems before it knows whether it will be successful in doing a public offering.

The frustration of how to take a company private is clear for many people. So, it may be too early to really answer that, but I really do not think there is going to be a lot of grumbling and a lot of impact on people. However, I also do not think the result will be a diminution of public companies.

GUEST: Do you think that the results of the Delaware cases on publicly-traded companies will have any impact on Tennessee statutes regarding the liability of directors on non-public companies?

MR. CHEEK: That is an interesting question because our task force went around the country and conducted public hearings on the West and East Coasts and in the Midwest. Because our governance principles applied to non-public as well as public institutions, we heard from a lot of people, both public advocates as well as people institutions like labor unions. I think the Delaware cases will have an impact on the way non-public corporate entities are being governed where there are other constituencies.

I am seeing more and more cases that deal with issues of governance relating to labor unions and major charitable organizations that seem to have gone awry. There have been several United Way cases in the last several years. So, I think all this will slowly ripple over. I do not think the effects will necessarily be statutory, but more likely emerge through societal pressure and judicial decision-making.

MR. KUNEY³⁹: I want to follow up with one from a legal standpoint. As far as large law firms that represent the public companies, is there talk about liability for the firms themselves?

MR. CHEEK: Yes. The insurance carriers are having a lot of discussion with their insureds about setting up a procedure by which there can be a consistent application of approach to very sensitive issues. When one lawyer goes one direction

³⁹ George W. Kuney, Associate Professor of Law and Director of the Clayton Center for Entrepreneurial Law, The University of Tennessee College of Law.

and another lawyer goes another direction, there is a quality control issue and a liability issue because it creates that differential that plaintiffs lawyers can explore so well. So, the Attorneys Liability Assurance Association, which insures most lawyers, strongly recommends at least a four-person §307 compliance committee, with a maximum of one corporate or securities lawyer. The other members are a litigator, a risk management person, the person that is in charge of the insurance, and a management personnel that has overall supervisory responsibility within the firm. This way, firms have a multi-set of experiences that are brought to those issues. It is too early yet to know how well this system will work. I think there is going to be one bad poster child case; everyone just hopes that the poster child is not them.

DR. NEEL: When Mr. Reed⁴⁰ announced the first eight of what may become twelve board members, it would seem that he is addressing the governance issue, not the regulatory issue. And while being a fine line, just a casual glance at the appointees, at least two or three are probably independent and the remainder, in all likelihood, will have some conflict if they met the same standards of the New York Stock Exchange list of companies. What do you see is going to be the challenge of Mr. Reed with regard to maintaining the New York Stock Exchange regulatory role?

MR. CHEEK: I think he is going to lose the battle. I think Mr. Reed has been convinced by the staff at the New York Stock Exchange that that model does work as well for the New York Stock Exchange as it does for the NASDAQ, because of the specialty system on the floor and the way that market has historically been regulated.

The facts are that the regulatory arm of the New York Stock Exchange has clearly been softer than the regulatory arm in the post NASDAQ settlement era in the NASDAQ. Bill Donelson, Chairman of the Commission, is being convinced by his staff that that model is what needs to happen. Therefore, I think Mr. Reed is dancing a political tightrope there from which he will fall because he cannot sustain it in today's public world. But, we will see. There is no regulatory authority, other than the ongoing relationship authority, that they have to impose it on them.

DR. NEEL: Thank you for speaking with us today.

MR. CHEEK: Thank you very much.

⁴⁰ John S. Reed. On April 1, 2004, the New York Stock Exchange Board of Directors appointed Mr. Reed Chairman of the NYSE until its 2005 annual meeting.