

THE SARBANES-OXLEY ACT AND FIDUCIARY DUTIES

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I. INTRODUCTION

This article explores the implications of the Sarbanes-Oxley Act of 2002¹ (Sarbanes-Oxley) on fiduciary duty analysis in corporate law. Sarbanes-Oxley contains several provisions that pointedly bear on corporate governance.² These include, for example, provisions directing the Securities and Exchange Commission (SEC), national securities exchanges including,

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

2. See *infra* Part II (discussing major corporate governance provisions of Sarbanes-Oxley).

importantly, the New York Stock Exchange (NYSE), and securities associations (the Nasdaq) to establish standards relating to audit committees;³ requiring senior officers to make certifications pertaining to a reporting company's disclosure controls and procedures and its internal controls and procedures for financial reporting;⁴ and prohibiting personal loans to officers and directors⁵ and mandating forfeiture of senior officer bonuses and profits from securities sales in the event of an accounting restatement due to misconduct.⁶ In these areas, Sarbanes-Oxley, as federal law, preempts *inconsistent* state law. Although not specifically addressing director and officer fiduciary duties, Sarbanes-Oxley will, we argue, only modestly preempt this area—historically governed by state law—but will nonetheless be highly and pervasively influential, even where it does not preempt.

We develop in some detail, and for the first time,⁷ exactly how Sarbanes-Oxley may alter state fiduciary duty law. In doing so, we note, as others have,⁸ that Sarbanes-Oxley makes unprecedented federal inroads into the area of corporate governance. It does this through amendments to federal securities law, thereby blurring what was previously thought to be a clear demarcation between *federal securities law* and *state corporate law*.⁹ Although federal

3. See Sarbanes-Oxley Act § 301, 116 Stat. at 775 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m) to the Securities Exchange Act of 1934); *infra* Section II.A.

4. Sarbanes-Oxley Act §§ 302, 404, and 906, 116 Stat. at 777, 789, and 806 (to be codified at 15 U.S.C. §§ 7241, 7262, and 18 U.S.C. § 1350, respectively). See *infra* Sections II.B.2.a and II.B.2.c.

5. Sarbanes-Oxley Act § 402(c), 116 Stat. at 787 (to be codified at 15 U.S.C. § 78m) (adding subsection 13(k) to the Securities Exchange Act of 1934). See *infra* Section II.B.1.d.

6. Sarbanes-Oxley Act § 304, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243). See *infra* Section II.B.2.b.

7. Others have raised or touched on this subject, and some have briefly suggested in a general way how Sarbanes-Oxley may alter state fiduciary duty analysis, but no one has developed such an analysis in depth. See, e.g., John C. Coffee Jr., *Corporate Securities—Post-Enron Jurisprudence*, N.Y.L.J. 5 7/17/2003 (col. 1); Martha E. McGarry, *Director Liability: Dawn of a New Era?* 7 THE M & A LAWYER 1 (May 2003).

8. Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 4/01/03 REGULATION 26 (Spring 2003); Robert B. Thompson and Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189 (2003). See Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work)*, 35 CONN. L. REV. 915 (2003).

9. See Lyman Johnson, *Sovereignty Over Corporate Stock*, 16 DEL. J. CORP. L. 485,

incursion into corporate governance is important in its own right, the more intriguing issue concerns the eventual interplay between federal and state law. Specifically, on various subjects will federal law wholly supplant, or merely supplement, state law?⁹ In addressing this question with specific regard to the impact of Sarbanes-Oxley on state fiduciary duty law, we draw attention to two overarching features of this federal mandate as compared to state fiduciary duty law. First, Sarbanes-Oxley is legislative and administrative in origin,¹⁰ whereas corporate fiduciary duty concepts, although having some statutory basis, largely derive from equity and are created by judges.¹¹ Second, Sarbanes-Oxley adopts a rules-based approach to corporate governance, in contrast to the more fluid standards and duties-based approach of judicial fiduciary analysis under state law. We think these two differences in the *nature* of federal and state law approaches to corporate governance will prove significant to understanding how Sarbanes-Oxley will (and will not) alter judicial crafting of state law fiduciary duties.

Part II identifies and elaborates on provisions of Sarbanes-Oxley most likely to raise fiduciary duty issues for corporate officers and directors. These provisions include those specified above and certain others.

Part III addresses state law fiduciary duties of directors and officers. It first describes the three fiduciary duties applicable to corporate directors—due care, loyalty, and good faith. Special attention is given to the obligation of good faith because recent judicial decisions,¹² which are highlighted, as well as commentary by influential Delaware judges¹³ suggest a willingness to read that duty more broadly in the post-Enron era. This is significant because breach of good faith, like breach of loyalty—but unlike breach of due care—allows the imposition of liability for money damages on directors. Part III further examines several facets of this fluid, emerging duty, as it is likely to be a doctrinal vessel for injecting certain mandates of Sarbanes-Oxley into state fiduciary duty law. Part III then recalls the oft-overlooked status of corporate

491-502 (1991).

10. See *infra* Part II (discussing legislative, administrative agency, and self-regulatory organization provisions).

11. See *infra* Part III (discussing state fiduciary duty concepts).

12. See *infra* notes 266-77 and accompanying text.

13. See *infra* notes 258-63 and accompanying text.

officers as agents who owe fiduciary duties to the corporation as principal. We describe their various fiduciary duties in that capacity and note critical differences between breach of fiduciary duty claims against officers and such claims against directors.

Part IV assesses how the federally mandated corporate governance provisions of Sarbanes-Oxley will (and will not) change how state judges equitably evaluate officer and director conduct under traditional state fiduciary duty strictures. Sarbanes-Oxley itself is silent on this question, just as it is largely silent on the ability of private litigants to bring a right of action.¹⁴ The federal impact on state fiduciary duties will, we believe, be varied, not singular. We identify those few specific areas where Sarbanes-Oxley preempts inconsistent (and weaker) state fiduciary concepts, either in whole or in part. We also identify areas where the mandates of Sarbanes-Oxley, though lacking preemptive force, will be highly influential in state fiduciary duty analysis. We conclude, however, that state law will remain preeminent in the fiduciary duty area. This is because, first, the standards-based approach of state law remains the *lingua franca* into which Sarbanes-Oxley's mandates must inevitably be translated for fiduciary duty purposes. We reject the view that Sarbanes-Oxley has somehow "federalized" the area of corporate fiduciary duty law. To be sure, federal law now plays a more significant role in corporate governance. That law, however, evinced no intention to displace state law concepts designed to accord corporations and their stockholders a remedy for director and officer breaches of duty. Sarbanes-Oxley created additional obligations to curb and redress corporate wrongdoing; it did not eliminate state law notions aimed at achieving the same result. Federal law will likely influence the scope and content of fiduciary duties, but those duties will remain rooted in state law.

Second, the equity and standards-based approach to fiduciary

14. The Sarbanes-Oxley Act of 2002 expressly includes rights of action for whistleblower retaliation, Pub. L. No. 107-204, § 806(a), 116 Stat. 745, 803 (2002) (to be codified at 18 U.S.C. § 1514A), and for insider trading during pension blackout periods, § 306, 116 Stat. at 779 (to be codified at 15 U.S.C. § 7244). It also negates the implication of new private rights of action in connection with improper influences on audits, § 303, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7242), and with an extended statute of limitations for securities fraud, § 804m, 116 Stat. at 801 (to be codified at 28 U.S.C. § 1658). Sarbanes-Oxley Act § 308(a)—the "Fair Funds" provision—provides that where a disgorgement fund has been created due to SEC enforcement action, civil penalties paid in the action may be placed in the fund to compensate victims of the violation. 116 Stat. at 784 (to be codified at 15 U.S.C. § 7246).

duties—when coupled with the Delaware judiciary’s adjudicative and hortative functions—is a highly adaptive method for injecting change into corporate governance practices on an ongoing basis. It is superior to legislation and administrative regulation in this respect, and it affords a greater sensitivity to the important element of context in assessing fiduciary performance, a sensitivity lacking in more “universal” legislative governance reform efforts. Finally, many of the specific provisions of Sarbanes-Oxley will require interpretation, first by corporate boards and officers and second by federal and state courts, in determining whether the boards and officers have complied with the law. Such determinations will often be based on whether the directors and officers discharged their duty in attempting to comply with the law. In other words, where Sarbanes-Oxley leaves off, state fiduciary duty analysis must take over. The overall result of Sarbanes-Oxley in the corporate fiduciary duty area, consequently, is greater federal influence in a federalism arrangement still dominated by state law.

II. SARBANES-OXLEY ACT AND CORPORATE GOVERNANCE

On July 29, 2002, Congress passed the Sarbanes-Oxley Act of 2002, which President Bush signed the next day.¹⁵ The impetus to the passage of Sarbanes-Oxley is well known. A host of high-profile public company bankruptcies, including Enron, WorldCom, and Global Crossing, and a stock market that had dropped precipitously for the previous two years had sapped public confidence in the capital markets, public company boards and officers, and market regulators. The perceived facilitation of Enron’s demise by auditing firm Arthur Andersen further eroded public confidence. In a “do-something!” atmosphere, Congress did something, passing what some have called “the most important securities legislation since the original federal securities laws of the 1930s.”¹⁶

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

16. William H. Donaldson, Chairman of the U.S. Securities and Exchange Commission, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002, Before the Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2003), *available at* http://www.senate.gov/~banking/_files/donaldsn.pdf (last visited Apr. 20, 2004) [hereinafter Donaldson Testimony].

A. *General Overview of Sarbanes-Oxley*

Sarbanes-Oxley includes six main initiatives: creating the Public Company Accounting Oversight Board, a private, nonprofit corporation that is overseen by the SEC to “oversee the audit of public companies that are subject to the securities laws”;¹⁷ enhancing the independence of public company auditors;¹⁸ regulating corporate governance and responsibility;¹⁹ enhancing financial disclosure;²⁰ regulating securities analyst conflicts of interest;²¹ and adding several new substantive crimes under the securities laws and enhancing penalties for violations of the securities and other laws.²² In addition, Sarbanes-Oxley provided for additional funding of the SEC and enhancement of the SEC’s regulatory authority,²³ commissioned several studies that required reports back to Congress,²⁴ and contained an editorial comment on corporate tax returns.²⁵

Although many of the provisions of Sarbanes-Oxley will have profound, and no doubt unanticipated, effects on corporate law in the future, this article will focus only on those provisions that appear most likely to affect corporate governance and fiduciary duties.²⁶

17. Sarbanes-Oxley Act §§ 101-109, 116 Stat. at 750-771 (to be codified at 15 U.S.C. §§ 7211-7219). *See* S. REP. NO. 107-205 at 12 (2002) (setting forth testimony demonstrating the need “for a strong Board to oversee the auditors of public companies”).

18. Sarbanes-Oxley Act §§ 201-209, 116 Stat. at 771-775.

19. *Id.* §§ 301-308, 116 Stat. at 775-785.

20. *Id.* §§ 401-409, 116 Stat. at 785-791. Several of the provisions in Title IV, however, have corporate governance implications. *See generally infra* section II.B.

21. Sarbanes-Oxley Act § 501, 116 Stat. at 791-793 (to be codified at 15 U.S.C. §§ 780-6 and 78u-2).

22. *Id.* §§ 801-906 and 1101-1107, 116 Stat. at 800-810. Notable among these are sections 806 and 1107, which provide protection for employees of public companies who allege violations of the securities laws; and section 1105, which allows the SEC to prohibit any person from being an officer or director of any public company if such person has violated section 10(b) of the Securities Exchange Act of 1934 and the SEC finds “that person demonstrates unfitness to serve as an officer or director of any such issuer.” *Id.* § 1105.

23. *Id.* §§ 601-604, 116 Stat. at 793-796.

24. *Id.* §§ 701-705, 116 Stat. at 797-800.

25. *Id.* § 1001, 116 Stat. at 807. “It is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.” *Id.*

26. *See* Donaldson Testimony, *supra* note 16, at 6:

The sweeping reforms in the Sarbanes-Oxley Act address nearly every aspect and actor in our nation’s capital markets. The Act affects every

B. Sarbanes-Oxley Provisions that Affect Fiduciary Duty

Only one title of Sarbanes-Oxley, Title III, references corporate fiduciary duty issues, although it does so under the title of “Corporate Responsibility.” However, several other titles have the effect of regulating the conduct of directors and officers of public companies in a manner that is akin to regulating the exercise of their fiduciary duties. In addition to Title III, much of Title IV and section 906 substantively regulate the conduct of officers and directors. Two of these provisions, sections 304²⁷ and 906,²⁸ were self-executing upon effectiveness of Sarbanes-Oxley. The remaining provisions affecting corporate governance required additional rulemaking by the SEC, or the NYSE and Nasdaq. In addition to the required rulemaking, the NYSE and the Nasdaq adopted several other amendments to their respective marketplace rules that have important effects on the corporate governance of listed companies.²⁹

The Sarbanes-Oxley provisions that affect fiduciary duties can be divided into provisions aimed at directors (particularly the audit committee)³⁰ and provisions aimed at officers. We will first examine those provisions of Sarbanes-Oxley, and subsequent rulemaking, that affect the conduct of directors. We will then examine the provisions aimed at officers.

1. Sarbanes-Oxley, NYSE, and Nasdaq Provisions Intended to Regulate the Conduct of Directors.

a. Section 301—Public Company Audit Committees

One major theme of Congress and the SEC in Sarbanes-Oxley and subsequent rulemaking was a sense that public company

reporting company, both domestic and foreign, as well as their officers and directors. The Act also affects those that play a role in ensuring the integrity of our capital markets, such as accounting firms, research analysts and attorneys. The over-arching goals of the Act are far-reaching and include restoring investor confidence and assuring the integrity of our markets.

Id.

27. See *infra* section II.B.2.b below.

28. See *infra* section II.B.2.a below.

29. See *generally infra* section II.B.1.b.

30. See S. REP. NO. 107-205 at 24-25 (2002). “Many recent failures have been attributed to close ties between audit committee members and management.” *Id.*

boards of directors had abdicated their oversight responsibilities and that they needed more directors who were independent. Boards were perceived as acting more as caretakers and less as overseers of management.³¹ Section 301 of Sarbanes-Oxley is an attempt to remind directors of their role and responsibilities, and to foster greater director independence.³²

Section 301 amended section 10A of the Exchange Act by requiring the SEC, within 270 days of passage, to have effective rules directing the national securities exchanges and national securities associations to prohibit the listing of companies not meeting the requirements of section 301.³³ Section 301 then provides that the Audit Committee³⁴ of a public company is directly responsible for the appointment, compensation, and oversight of

31. See, e.g., SEC Chairman William H. Donaldson, Remarks at the 2003 Washington Economic Policy Conference, National Association for Business Economics, Washington, D.C. (March 24, 2003):

Over the past decade or more, at too many companies, the chief executive position has steadily increased in power and influence. In some cases, the CEO had become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgments and decisions of the CEO and senior management team. This deference has been an obstacle to directors' ability to satisfy the responsibility that the owners—the shareholders—have delegated and entrusted to them.

Id. See also SEC Commissioner Cynthia A. Glassman, SEC Initiatives Under the Sarbanes-Oxley Act of 2002, Before the College of Business and Economics, California State University, Fullerton, California (Jan. 28, 2003) (stating “[t]oo often, we have seen examples of audit committees that failed abysmally in their oversight responsibilities”).

32. See Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (Apr. 9, 2003), 17 C.F.R. pts. 228, 229, 240, 249, and 247 (2003) available at <http://www.sec.gov/rules/final/33-8220.htm> (last visited Apr. 20) [hereinafter Audit Committee Release]. “Recent events involving alleged misdeeds by corporate executives and independent auditors . . . have highlighted the need for strong, competent and vigilant audit committees with real authority.” *Id.* at 4.

33. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-76 (2002) (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(1)(A)).

34. The Sarbanes-Oxley Act adds a new section 3(a)(58) to the Securities Exchange Act of 1934 and defines an Audit Committee as follows:

(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

§ 205, 116 Stat. at 773-74 (to be codified at 15 U.S.C. § 78c).

the company's auditors.³⁵ The auditor is required to report directly to the audit committee.³⁶ The section also sets a specific standard for the definition of independence of audit committee members, and requires all committee members to be independent.³⁷ Next, the section requires the audit committee to implement an internal complaint system to receive complaints regarding audits, internal controls, and accounting matters from within the corporation, essentially bypassing management.³⁸ Finally, section 301 requires that the audit committee have the authority to engage independent counsel and other advisers as it deems necessary to carry out its

35. Sarbanes-Oxley Act § 301, 116 Stat. at 775 (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(2)). See also Audit Committee Release, *supra* note 32, at § II(B)(1).

One of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. The Commission has long recognized the importance of an auditor's independence in the audit process One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders.

Id.

36. Sarbanes-Oxley Act § 301, 116 Stat. at 776. See S. REP. NO. 107-205 at 23 (2002) ("Recent events have highlighted the failure of companies' internal audit committees to properly police their auditors and have raised awareness of the need for strong, competent audit committees with real authority.").

37. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(3)).

In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.

Id. See also Audit Committee Release, *supra* note 32, at § II(A)(1) ("An audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management.").

38. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(4)). "Management may not have the appropriate incentives to self-report all questionable practices The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences." Audit Committee Release, *supra* note 32, at § II(C). One of the challenges for corporations in complying with this requirement is how, practically, to set up a procedure for employees to communicate information to the audit committee without management intervention—something which is otherwise generally foreign to corporate information flow.

duties, and that the corporation adequately fund the committee.³⁹

On April 25, 2003, the SEC promulgated its final rules "Standards Relating to Listed Company Audit Committees" (Audit Committee Release) and promulgated a new Rule 10A-3 under the Exchange Act.⁴⁰ In the Audit Committee Release, the SEC directed each national securities exchange and national securities association to provide the SEC, no later than July 15, 2003, proposed listing rules or amendments to rules that are in compliance with section 301, with such rules or amendments to be approved no later than December 1, 2003.⁴¹ Public companies are required to comply with such listing rules by the earlier of their first annual shareholders meeting after January 15, 2004 or October 31, 2004.⁴²

In new Rule 10A-3, the SEC added only minor language to the definition of "independence" for purposes of directing the NYSE and Nasdaq to adopt rules.⁴³ In addition, consistent with section 301, the SEC required only that audit committee members be independent,⁴⁴ despite requests by a number of commenters that the SEC impose independence requirements beyond Sarbanes-Oxley.⁴⁵ The SEC had determined to keep the approach it

39. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(m)(5) and (6)).

40. See Audit Committee Release, *supra* note 32.

41. *Id.*

42. *Id.*

43. *Id.*

In order to be considered to be independent for purposes of [the rule], a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee: (A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or (B) Be an affiliated person of the issuer or any subsidiary thereof. *Id.* § VIII; Securities Exchange Act of 1934, § 10A(m)(3)(b)(1), 17 C.F.R. § 240.10A-3(b)(1).

44. See Securities Exchange Act of 1934, § 10A-3(b), 17 C.F.R. § 240.10A-3(b).

45. See Audit Committee Release, *supra* note 32, at § II(A)(1). The commenters requesting added independence requirements included, among others, the AFL-CIO, the California Public Employees' Retirement System, and the Teamsters union. *Id.* at n.41.

proposed in the proposing release and allow the self-regulatory organizations to adopt more stringent governance requirements.⁴⁶ The self-regulatory organizations (the SROs) took this charge from the SEC and proposed and adopted significant changes that go beyond the audit committee's focus of section 301 and Rule 10A-3.

b. NYSE and Nasdaq Proposals on Director Independence

The rules regarding the independence of public company directors by the NYSE and the Nasdaq are perhaps the most far-reaching of their corporate governance initiatives. Each SRO is required by Rule 10A-3 to implement standards for audit committees consistent with that rule, which includes standards for the independence of audit committee members.⁴⁷ However, the NYSE and Nasdaq have each gone beyond Rule 10A-3 and required a majority of the members of the boards of directors of each listed company to be independent, as well as providing for a number of other rules affecting boards and board committees.

(1) NYSE Rules

On August 16, 2002, the NYSE filed its first proposed rule changes with respect to director independence with the SEC, which were amended in filings with the SEC on April 4, 2003 and October 8, 2003. The SEC published the new rules for public comment, which became final on November 4, 2003.⁴⁸ The NYSE adopted

46. *Id.* § II(A)(1). Among others, commenters supporting this approach included the American Bar Association, the American Institute of Certified Public Accountants (AICPA), and the New York Stock Exchange. *Id.* at n.42.

47. *Id.* § II.A.1(a).

48. Self-Regulatory Organizations, NYSE and NASD Rulemaking: Relating to Corporate Governance, Order Approving Proposed Rule Changes, Exchange Act Release No. 34-48745 (Nov. 4, 2003), 68 Fed. Reg. 64154 (Nov. 12, 2003), available at <http://www.sec.gov/rules/sro/34-48745.htm> (last visited Apr. 20, 2004) [hereinafter SRO Final Order Release]. See Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, Exchange Act Release No. 34-47672 (Apr. 11, 2003), 68 Fed. Reg. 19051 (Apr. 17, 2003), available at <http://www.sec.gov/rules/sro/34-47672.htm> (last visited Apr. 20, 2004) [hereinafter NYSE Governance Release]. It is important to note that many of the requirements of section 303A discussed below have been in existence for some time, including certain rules regarding audit committees. However, such rules have been substantially revised as a direct result of Sarbanes-Oxley. In addition, several of the rules, such as the rule requiring that a majority of the board of directors be independent, are entirely new. See *infra* notes 50-61 and accompanying text.

amendments to section 303A of the corporate governance standards in its Listed Company Manual.⁴⁹

Section 303A(1) requires that most⁵⁰ NYSE listed companies have a board, a majority of whose members are independent directors.⁵¹ Section 303A further requires that the board of directors must affirmatively determine that a director has “no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)” for the director to be independent under the rule.⁵² That section goes on to provide: “The basis for a board determination that a relationship is not material must be disclosed in the company’s annual proxy statement or on Form 10-K”⁵³

Although the board is required to make a general determination that directors are independent, section 303A(2)(b) lists several relationships that would prevent a director from being independent:

- (i) A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.
- (ii) A director who receives, or whose immediate family

49. New York Stock Exchange, Listed Company Manual (2003), *available at* www.nyse.com/listed/listedcomanual.html (last visited Apr. 20, 2004) [hereinafter NYSE Listed Company Manual].

50. Section 303A exempts from certain of its requirements listed companies that are “controlled companies” (companies that are more than 50% owned by a single individual, group, or another company), limited partnerships and companies in bankruptcy, closed-end mutual funds, business development companies, open-end mutual funds, certain types of trusts, and, to a certain extent, foreign private issuers (as such term is defined in Rule 3b-4 under the Securities Exchange Act of 1934), and companies that list only preferred or debt securities on the NYSE (with certain exceptions). *Id.* § 303A(00).

51. *Id.* § 303A(1). In the commentary, the NYSE provides that “[e]ffective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.” *Id.* § 303A(1) cmt.

52. *Id.* § 303A(2)(a). “Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is *independence from management*, the [NYSE] does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.” *Id.* § 303A(2)(a) cmt. (emphasis added).

53. *Id.* § 303A(2)(a) cmt.

member receives, more than \$100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than \$100,000 per year in such compensation.

(iii) A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not “independent” until three years after the end of the affiliation or the employment or auditing relationship.

(iv) A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serve on that company’s compensation committee is not “independent” until three years after the end of such service or the employment relationship.

(v) A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company’s consolidated gross revenues, is not “independent” until three years after falling below such threshold.⁵⁴

Section 303A(3) also requires that the “non-management directors of each company must meet at regularly scheduled executive sessions without management.”⁵⁵ The listed company is also required to disclose its procedures for how it chooses the head

54. *Id.* § 303A(2)(b).

55. *Id.* § 303A(3).

“Non-management” directors are all those who are not company officers (as that term is defined in Rule 16a-1(f) under the Securities Act of 1933), and includes such directors who are not independent by virtue of a material relationship While this Section 303A(3) refers to meetings of non-management directors, if that group includes directors who are not independent under this Section 303A, listed companies should at least once a year schedule an executive session including only independent directors.

Id. § 303A(3) cmt.

of such meetings.⁵⁶ In addition, “[i]n order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for parties to communicate directly with the presiding director or with the non-management directors as a group.”⁵⁷ Consistent with its position on the importance of independent directors, the NYSE also required in section 303A that each listed company have (1) a nominating/corporate governance committee⁵⁸ and (2) a compensation committee,⁵⁹ each composed entirely of

56. *Id.*

57. *Id.* See also NYSE Governance Release, *supra* note 48, § II.A (discussing the requirement for information to be transmitted to the audit committee set forth in Sarbanes-Oxley § 301).

58. NYSE Governance Release, *supra* note 48, § 303A(4)(a).

The nominating/corporate governance committee must have a written charter that addresses: (i) the committee’s purpose—which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation; (ii) the committee’s goals and responsibilities—which must reflect, at a minimum, the board’s criteria for selecting new directors, and oversight of the evaluation of the board and management; and (iii) an annual performance evaluation of the committee.

Id. § 303A(4)(b). The nominating/corporate governance committee “is also responsible for taking a leadership role in shaping the corporate governance of a corporation.” *Id.* § 303A(4) cmt.

59. *Id.* § 303A(5)(a).

The compensation committee must have a written charter that addresses: (i) the committee’s purpose—which, at minimum, must be to discharge the board’s responsibilities relating to compensation of the company’s executives, and to produce an annual report on executive compensation for inclusion in the company’s proxy statement, or, if the company does not file a proxy statement, in the company’s annual report filed on Form 10-K with the SEC, in accordance with applicable rules and regulations; (ii) the committee’s duties and responsibilities which, at minimum, must be to: (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals and objectives, and have sole authority to determine the CEO’s compensation level based on this evaluation; and (B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and (iii) an annual performance evaluation of the compensation committee.

Id. § 303A(5)(b).

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that

independent directors.

As to the audit committee, the NYSE narrowed the definition of “independence” found in section 303A(2) by adding the requirements of Exchange Act Rule 10A-3(b)(1).⁶⁰ The Rule also requires a company to have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.⁶¹ Section 303A, however, adds a requirement that the audit committee must have a minimum of three members,⁶² all of whom must be independent directors, as such term is set forth in section 303A(2).⁶³ The commentary to section 303A(6) also encourages audit committee members, and boards, to reduce the number of audit committees on which they sit.⁶⁴

Finally, section 303A(7)(b) requires audit committees to have a written charter that addresses the committee’s purpose.⁶⁵ Part

the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

Id. § 303A(5) cmt.

60. See Securities Exchange Act, *supra* note 43 and accompanying text. Understanding the higher burden that is on audit committee members, the NYSE stated that it “supports additional directors’ fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but does not believe that any member of the audit committee should receive any compensation other than such director’s fees from the company.” NYSE Governance Release, *supra* note 48, § 303A(6) cmt.

61. NYSE Governance Release, *supra* note 48, § 303A(6). For Rule 10A-3, see Securities Exchange Act, *supra* note 43 and accompanying text.

62. NYSE Governance Release, *supra* note 48, § 303A(7)(a).

63. *Id.* § 303A(7)(b).

64. See *id.* § 303A(6) cmt.

Because of the audit committee’s demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC.

Id.

65. *Id.* § 303A(7)(b)(i). The committees purpose, at a minimum, must be to: (A) assist board oversight of (1) the integrity of the company’s financial statements, (2) the company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications

(ii) of section 303A(7)(b) details “the duties and responsibilities of the audit committee”⁶⁶ which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act,⁶⁷ as well as to:

(i) at least annually, obtain and review a report by the independent auditor describing: the firm’s internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor’s independence) all relationships between the independent auditor and the company;⁶⁸

(ii) discuss the company’s annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company’s disclosures under “Management’s Discussion and Analysis of Financial Condition and Results of Operations;”⁶⁹

(iii) discuss the [company’s] earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;⁷⁰

(iv) discuss policies with respect to risk assessment and

and independence, and (4) the performance of the company’s internal audit function and independent auditors; and (B) prepare the report required by the SEC’s proxy rules to be included in the company’s annual proxy statement

Id.

66. *Id.* § 303A(7)(b)(ii).

67. *Id.* § 303A(7)(b)-(c).

68. *Id.* § 303A(7)(d)(i).

In making its evaluation, the audit committee should take into account the opinions of management and the company’s internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

Id. § 303A(7)(d)(i) cmt.

69. *Id.* § 303A(7)(d)(ii).

70. *Id.* § 303A(7)(d)(iii).

risk management;⁷¹

(v) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;⁷²

(vi) review with the independent auditor any audit problems or difficulties and management's response;⁷³

(vii) set clear hiring policies for employees or former employees of the independent auditors;⁷⁴ and

(viii) report regularly to the board of directors.⁷⁵

71. *Id.* § 303A(7)(d)(iv).

While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken.

Id. § 303A(7)(d)(iv) cmt.

72. *Id.* § 303A(7)(d)(v).

73. *Id.* § 303A(7)(d)(vi).

74. *Id.* § 303A(7)(d)(vii).

75. *Id.* § 303A(7)(d)(viii).

The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

Id. § 303A(7)(d)(viii) cmt. The general commentary to section 303A(7)(d) states:

While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as

Section 303A(7)(b) requires “an annual performance evaluation of the audit committee.”⁷⁶ In addition, the NYSE audit committee rules provide that each NYSE company must have an internal audit function.⁷⁷

The NYSE next requires that all listed “companies must adopt and disclose corporate governance guidelines.”⁷⁸ The commentary to 303A(9) provides that the guidelines must address:⁷⁹ director qualification standards;⁸⁰ director responsibilities;⁸¹ director access to management and, as necessary and appropriate, independent advisors;⁸² director compensation;⁸³ director orientation and

review any financial information and earnings guidance provided to analysts and rating agencies.

Id. § 303A(7)(d) gen. cmt.

76. *Id.* § 303A(7)(2)(b)(iii).

77. *Id.* § 303A(7)(e). “Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control. A company may choose to outsource this function to a [third party service provider] other than its independent auditor.” *Id.* § 303A(7)(e) cmt.

78. *Id.* § 303A(9).

No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company’s website must include its corporate governance guidelines and the charters of its most important committees (including at least the audit, and if applicable, compensation and nominating committees).

Id. § 303A(9) cmt.

79. *Id.*

80. *Id.* “These standards should, at minimum, reflect the independence requirements set forth in Sections 303A(1) and (2). Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.” *Id.*

81. *Id.* “These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.” *Id.*

82. *Id.*

83. *Id.*

Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors’ independence may be raised when directors’ fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should

continuing education;⁸⁴ management succession;⁸⁵ and annual performance evaluation of the board.⁸⁶

Finally, section 303A requires listed foreign private issuers to “disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.”⁸⁷ Each company chief executive officer must “certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards,”⁸⁸ and “[t]he NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.”⁸⁹

As we have discussed, the NYSE rules in response to Sarbanes-Oxley go far beyond the specific requirements of that law and the subsequent SEC rulemaking. The changes proposed by the Nasdaq and approved by the SEC are no less far-reaching in their scope.

critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

Id.

84. *Id.*

85. *Id.* “Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.” *Id.*

86. *Id.* “The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.” *Id.*

87. *Id.* § 303A(11).

88. *Id.* § 303A(12)(a). The intent of this provision is to “focus the CEO and senior management on the company’s compliance with the listing standards.” *Id.* § 303A(12)(a) cmt. Subsection (b) requires that “[e]ach listed company CEO must promptly notify the NYSE [in writing] after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this section 303A.” *Id.* § 303A(12)(b). This has the effect of forcing the CEO to put into place a continuous reporting regime that would disclose such information up the ladder to the CEO.

89. *Id.* § 303A(13).

Suspending trading in or delisting a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to a company that it determines has violated a NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties.

Id. § 303A(13) cmt.

(2) *Nasdaq Proposal*

On October 9, 2002, the Nasdaq submitted to the SEC its initial rule proposal on corporate governance.⁹⁰ The Nasdaq subsequently filed amendments to the rules on March 11, 2003,⁹¹ July 16, 2003,⁹² and October 10, 2003.⁹³ In the SRO Final Order on November 4, 2003, the SEC approved the proposed Nasdaq rules and amendments.⁹⁴ In the releases, the Nasdaq proposed amendments to NASD Rules 4200 and 4350 “to provide greater transparency regarding the definition of independence and to increase the roles and responsibilities of independent directors and independent board committees.”⁹⁵

Stating that “[i]ndependent directors . . . play an important role in assuring investor confidence,”⁹⁶ the Nasdaq has required that “[a] majority of the board of directors must be comprised of independent directors as defined in Rule 4200.”⁹⁷ The Nasdaq states that “[t]hrough the exercise of independent judgment, [independent directors] act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors empowers such directors to more effectively carry out these responsibilities.”⁹⁸

NASD Rule 4200(a)(15) defines “independent director” as “a

90. SRO Final Order Release, *supra* note 48.

91. *Id.*

92. *Id.*

93. *Id.* See Letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulations, Securities, and Exchange Commission, dated October 9, 2003, available at http://www.nasdaq.com/about/SR-NASD-2002-141_Amendment_3.pdf (last visited Apr. 20, 2004) [hereinafter October 2003 Nasdaq Letter].

94. SRO Final Order Release, *supra* note 48.

95. October 2003 Nasdaq letter, *supra* note 93, at 2.

96. October 2003 Nasdaq Letter, *supra* note 93, at 49 (discussing IM 4350-4, Board Independence and Independent Committees).

97. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, Exchange Act Release No. 34-47516, 68 Fed. Reg. 14,451, 14,452 (Mar. 17, 2003). See The Nasdaq Stock Market, Inc. Corporate Governance Rules 4200, 4200A, 4350, 4350A and 4360, and Associated Interpretive Material, at 10 available at <http://www.nasdaq.com/about/corporategovernance.pdf> (Dec. 31, 2003) (last visited Apr. 20, 2004) [hereinafter Nasdaq Corporate Governance].

98. 68 Fed. Reg. at 14,453. See Nasdaq Corporate Governance, *supra* note 97, at 28.

person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors,⁹⁹ would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."¹⁰⁰ NASD Rule 4200(a)(15) defines in detail who would not be considered independent:¹⁰¹

(A) a director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company;

(B) a director who accepted or who has a Family Member who accepted any payments from the company or any parent or subsidiary of the company in excess of \$60,000 during the current or any of the past three fiscal years, other than the following[:]

(i) compensation for board or board committee service;

(ii) payments arising solely from investments in the company's securities;

(iii) compensation paid to a Family Member who is a non-executive employee of the company or a parent or subsidiary of the company;

(iv) benefits under a tax-qualified retirement plan, or non-discretionary compensation; or

(v) loans permitted under Section 13(k) of the

99. 68 Fed. Reg. at 14,452. See October 2003 Nasdaq Letter, *supra* note 93, at 22 ("Nasdaq has . . . added a requirement that companies identify in their proxy those directors that the board has determined to be independent because Nasdaq believes this enhances transparency and investor confidence.").

100. 68 Fed. Reg. at 14,452. "The board has a responsibility to make an affirmative determination that no such relationship exists through the application of Rule 4200." October 2003 Nasdaq Letter, *supra* note 93, at 5.

101. 68 Fed. Reg. at 14,452. See also October 2003 Nasdaq Letter, *supra* note 93, at 22:

While several commenters [to previous releases of the rules] suggested that Nasdaq's independence thresholds should be subject to a presumption that can be rebutted or otherwise be subject to the board's judgment, Nasdaq declined to follow these suggestions, as Nasdaq believes that clear, enforceable standards will give investors greater confidence that only directors who meet these standards can be held out as independent, and such an approach also eases administration by companies, and monitoring compliance by Nasdaq. Nasdaq also declined to adopt suggestions from commenters that there be lower standards for small companies, as Nasdaq believes that this could have an adverse impact on investor confidence.

[Securities Exchange Act of 1934].

(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer

(D) a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following[:]

(i) payments arising solely from investments in the company's securities; or

(ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the listed company who is, or has a Family Member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the listed company serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during the past three years.¹⁰²

Much like NYSE section 303A,¹⁰³ NASD Rule 4350(c)¹⁰⁴ lists many activities that the independent directors are required to perform. Rule 4350(c)(2) requires that "[i]ndependent directors must have regularly scheduled meetings at which only independent directors are present ('executive sessions')." ¹⁰⁵ Rule 4350(c)(3)(A)-(B) provides that, with respect to the compensation of all officers of the company, including the chief executive officer,

102. 68 Fed. Reg. at 14,452.

103. *See supra* Section II.B.1.

104. 68 Fed. Reg. at 14,452.

105. *Id.* at 14,452. "Regularly scheduled executive sessions will encourage and enhance communication among independent directors. It is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings." *Id.* at 14,453.

“[c]ompensation . . . must be determined, or recommended to the Board for determination,¹⁰⁶ either by: (i) a majority of the independent directors, or (ii) a compensation committee comprised solely of independent directors.”¹⁰⁷ Rule 4350(c)(4)(A) requires the same process with respect to the nomination of directors of the company.¹⁰⁸ Concerning such nominations, “[e]ach issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.”¹⁰⁹ Furthermore, “[i]ndependent director oversight of director nominations shall not apply in cases where the right to nominate a director legally belongs to a third party. However, this does not relieve a company’s obligation to comply with the committee composition requirements in Rule 4350(c) or Rule 4350(d) [the audit committee rule].”¹¹⁰ It is important to note that Rule 4350(c)(4) “is not applicable to a company if the company is subject to a binding obligation that

106. A committee’s ability to recommend certain actions to the board, rather than simply making the outright determination, is necessary because of certain limitations that state corporate laws place on committees, including, as to certain determinations, Delaware. *See* October 2003 Nasdaq Letter, *supra* note 93, at 50.

107. 68 Fed. Reg. at 14,452. “Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board’s responsibility to maximize shareholder value. The rule is intended to provide flexibility for an issuer to choose an appropriate board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions.” *See* October 2003 Nasdaq Letter, *supra* note 93, at 50.

108. 68 Fed. Reg. at 14,452 (requiring director nominees to be selected, or recommended for the Board’s selection, either by: (i) a majority of the independent directors, or (ii) a nominations committee composed solely of independent directors). *See also* October 2003 Nasdaq Letter, *supra* note 93, at 50 (“Independent director oversight of nominations enhances investor confidence in the selection of well-qualified director nominees, as well as independent nominees as required by the rules.”).

109. October 2003 Nasdaq Letter, *supra* note 93, at 10.

110. *Id.* at 11.

This rule does not apply in cases where the right to nominate a director legally belongs to a third party. For example, investors may negotiate the right to nominate directors in connection with an investment in the company, holders of preferred stock may be permitted to nominate or appoint directors upon certain defaults, or the company may be a party to a shareholder’s agreement that allocates the right to nominate some directors. Because the right to nominate directors in these cases does not reside with the company, independent director approval would not be required.

Id. at 50-51.

requires a director nomination structure inconsistent with [the] rule and such obligation pre-dates the . . . rule.”¹¹¹ Finally, Rule 4350(c)(5) provides that “[a] Controlled Company¹¹² is exempt from the requirements of this Rule 4350(c), except for the requirements of subsection (c)(2) which pertain to executive sessions of independent directors. A Controlled Company relying upon this exemption must disclose in its annual meeting proxy statement . . . that it is a Controlled Company and the basis for that determination.”¹¹³

Nasdaq Rule 4350(d) addresses the requirements with respect to audit committees.¹¹⁴ Rule 4350(d)(1) first requires each company to “certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis.”¹¹⁵ The charter must specify the following:

- (A) the scope of the audit committee’s responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;
- (B) the audit committee’s responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee’s responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or

111. *Id.* at 11.

112. A Controlled Company is a company of which more than 50% of the voting power is held by an individual, a group, or another company. NASD Rule 4350(c)(5), 68 Fed. Reg. 14,553.

113. October 2003 Nasdaq Letter, *supra* note 93, at 11.

This exception recognizes that majority shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. In order for a group to exist for purposes of this Rule, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D [under the Securities Exchange Act of 1934]). A Controlled Company not relying upon this exemption need not provide any special disclosures about its controlled status. It should be emphasized that this controlled company exemption does not extend to the audit committee requirements under Rule 4350(d) or the requirement for executive sessions of independent directors under Rule 4350(c)(2).

Id. at 51.

114. *See* October 2003 Nasdaq Letter, *supra* note 93, at 45-50.

115. NASD Rule 4350(d)(1), 68 Fed. Reg. at 14,453.

services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor;

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer; [and]

(D) the specific audit committee responsibilities and authority set forth in Rule 4350(d)(3).¹¹⁶

Rule 4350(d)(2)(A)¹¹⁷ next addresses the composition of the audit committee, requiring that each company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must:

(i) be independent as defined under Rule 4200(a)(15);¹¹⁸ (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the [Exchange Act] (subject to the exemptions provided in Rule 10A-3(c));¹¹⁹ (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight

116. Nasdaq Corporate Governance, *supra* note 97, at 11-12. *See infra* notes 127-130 and accompanying text (discussing Rule 4350(d)(3)).

117. NASD Rule 4350(d)(2)(A), 68 Fed. Reg. at 14,553.

118. *See supra* notes 99-102 and accompanying text (defining "independence").

119. *See* October 2003 Nasdaq Letter, *supra* note 93, at 52.

In addition to satisfying the independent director requirements under Rule 4200, audit committee members must meet the criteria for independence set forth in Rule 10A-3(b)(1) under the [Securities Exchange Act of 1934] . . . they must not accept any consulting, advisory, or other compensatory fee from the company other than for board service, and they must not be an affiliated person of the issuer.

Id. *See also supra* text accompanying note 43 (discussing Rule 10A-3(b)(1)).

responsibilities.¹²⁰

Rule 4350(d)(3) provides specific direction on audit committee responsibilities and authority, providing that:

The audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the [Exchange Act] . . . , concerning responsibilities relating to: (i) registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing matters, (iii) authority to engage advisors, and (iv) funding as determined by the audit committee.¹²¹

Rule 4350(m), much like NYSE section 303A(11),¹²² requires that “[a]n issuer must provide Nasdaq with prompt notification after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the requirements of this Rule 4350.”¹²³

Finally, in a separate, but related, rulemaking initiative, the Nasdaq approved Rule 4350(h), which affects the board’s, and more particularly the audit committee’s, duties by requiring that each issuer

conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and all such transactions must be approved by the company’s audit committee or another independent body of the board of directors. For purposes of this rule, the term “related party transaction” shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.¹²⁴

120. See October 2003 Nasdaq Letter, *supra* note 93, at 52 (“A director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K . . . is presumed to qualify as a financially sophisticated audit committee member under Rule 4350(d)(2)(A).”). See also *infra* text accompanying notes 131-144 (discussing financial expert requirements of Item 401(h) of Regulation S-K).

121. Nasdaq Corporate Governance, *supra* note 97, at 14. See *supra* note 43 and accompanying text (discussing requirements of Rule 10A-3(b)).

122. See *supra* note 87 and accompanying text.

123. See October 2003 Nasdaq Letter, *supra* note 93, at 16. “[S]uch disclosure is required under Rule 10A-3 with respect to audit committees, and Nasdaq believes it is appropriate to expand this disclosure to all corporate governance requirements.” *Id.* at 24.

124. SRO Final Order Release, *supra* note 48, (c)(12); Letter from John D. Nachman, Senior Attorney, Nasdaq, to Katherine A. England, Securities and Exchange Commission (October 2, 2003), at http://www.nasdaq.com/about/SR-NASD-2002-80_Amendment_2.pdf (last visited Apr. 20, 2004). See also Board

c. Disclosure of Audit Committee Financial Expert

Section 407 of Sarbanes-Oxley directed the SEC to issue rules requiring each public company to disclose “whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the [SEC].”¹²⁵ Section 407 outlined certain considerations for the SEC in its rulemaking, but left the final definition to the SEC.¹²⁶ Although Sarbanes-Oxley inserted section 407 in the section entitled “Enhanced Financial Disclosures,” with other provisions aimed at financial disclosures, the effect of the section is to require each public company audit committee to have at least one financial expert, because most public companies would not wish to disclose that they did not have a financial expert. In addition, the section, together with the SEC’s, NYSE’s, and Nasdaq’s subsequent rules, has the effect of determining at least one person who is qualified to sit on the board of a public company.

On March 3, 2003, the SEC promulgated an amendment to Item 401(h) of Regulation S-K (Item 401(h)), which is the rule implementing section 407.¹²⁷ Item 401(h) requires public companies to disclose whether they have at least one financial expert on their audit committee, and if not why not, in their next annual report following July 15, 2003.¹²⁸ Item 401(h) also defines “audit committee financial expert,” including a listing of the means by which the person must have come to such expertise.¹²⁹ The

Duties, SEC Release No. 48,137 (proposed July 8, 2003), 68 Fed. Reg. 42,152, 42,152 (posting the original language for comment).

125. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (2002) (to be codified at 15 U.S.C. § 7265(a)). “The Committee believes the effectiveness of the audit committee depends in part on its members’ knowledge of and experience in auditing and financial matters.” S. REP. NO. 107-205 at 32 (2002).

126. 116 Stat. at 790 (to be codified at 15 U.S.C. § 7265(b)).

127. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 17 C.F.R. pts. 228, 229, and 249 (2003), *available at* <http://www.sec.gov/rules/final/33-8177.htm> [hereinafter Section 407 Release] (last visited Apr. 20, 2004); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002; Correction, 17 C.F.R. pts. 228 and 229 (2003), *available at* <http://www.sec.gov/rules/final/33-8177a.htm> (last visited Apr. 20, 2004).

128. Section 407 Release, *supra* note 127, at §§ II(A)(2) and II(E). The company must also disclose the name of the audit committee financial expert. *Id.* at § II(A)(2).

129. *Id.* The SEC adopted the term “audit committee financial expert” rather

SEC's definition of an audit committee financial expert utilized and expanded on the guidance provided by Congress in section 407.¹³⁰ To ensure that the designated audit committee financial expert did not face greater liability than any other board members,¹³¹ the SEC clarified that the audit committee financial expert would not be subject to greater duties or obligations under the securities laws, and declared that such person is not deemed an "expert" for purposes of section 11 of the Securities Act of 1933.¹³² The board of directors is charged with making the determination of whether a person qualifies as the audit committee financial expert.¹³³

In commentary in the NYSE Governance Release, the NYSE went beyond section 407 and the mere disclosure requirement of Item 401(h) and stated that "[e]ach member of the committee must be financially literate, as such qualification is interpreted by

than "financial expert," as section 407 had used. *Id.* § II(A)(1).

130. *Id.* The SEC's definition of "financial expert" in the proposing release proved to be one of the more controversial aspects of the SEC's rulemaking under Sarbanes-Oxley. *See* Proposed Rule: Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 33-8138 (proposed Oct. 22, 2002), 68 Fed. Reg. 42,152, 42,152-53 *available at* <http://www.sec.gov/rules/proposed/33-8138.htm> (last visited Apr. 20, 2004). Many commenters expressed concern that the SEC's definition of financial expert was "too restrictive." Section 407 Release, *supra* note 127, § II(A)(4)(b). Indeed, at least one commenter pointed out that successful businessman Warren Buffet, who might be the envy of any audit committee, would not meet the definition as originally proposed. SEC Commissioner Cynthia A. Glassman, Address at the National Economists Club (Apr. 7, 2003), *at* <http://www.sec.gov/news/speech/spch040703cag.htm> (last visited Apr. 20, 2004).

131. Several commenters noted this concern. *See* Section 407 Release, *supra* note 127, § II(A)(5).

132. *Id.*

We find no support in [Sarbanes-Oxley] or in related legislative history that Congress intended to change the duties, obligations or liability of any audit committee member, including the audit committee financial expert, through [section 407] Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law.

Id.

133. *Id.* § II(A)(6).

We believe that the board of directors in its entirety, as the most broad-based body with the company, is best-equipped to make the determination. *We think that it is appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.*

Id. (emphasis added).

the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee."¹³⁴ The NYSE also required that all listed companies have at least one member of its audit committee that has "accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment."¹³⁵ In making such determination, the board may presume that a person who meets the requirements of Item 401(e) of Regulation S-K¹³⁶ has such expertise. The Nasdaq similarly expanded on section 407 in its requirements as to audit committee members' financial sophistication.¹³⁷

d. Audit Committee Preapproval Requirements

Section 202 of Sarbanes-Oxley requires that all auditing and non-audit services provided to an issuer by its auditor be pre-approved by the audit committee, except for certain de-minimis exceptions.¹³⁸ Any approvals under this section must be disclosed in the company's periodic reports under the Exchange Act.¹³⁹ Although section 202 does not appear to directly impact the fiduciary duty of audit committee members, it does add to the growing list of items that Sarbanes-Oxley specifically requires directors to address.

e. Enhanced Conflict of Interest Provisions

Section 402 of Sarbanes-Oxley makes it illegal for public companies to directly or indirectly make loans to their officers, except for certain, limited reasons.¹⁴⁰ Although seemingly aimed at prohibiting "abusive" loans to officers of public companies, the effect of section 402 is to limit altogether the ability of a company's board of directors to enter into creative, and otherwise legal, arrangements with the company's officers. In other words, in the

134. NYSE Governance Release, *supra* note 48, § 303(A)(6) cmt.

135. *Id.*

136. *See id.*

137. *See supra* note 128 and accompanying text.

138. Pub. L. No. 107-204, 116 Stat. 745, 772 (2002) (to be codified at 15 U.S.C. § 78j-1) (amending the Securities Exchange Act of 1934, § 10A(i)).

139. *Id.* at 773 (amending the Securities Exchange Act of 1934, § 10(A)(i)(2)).

140. *Id.* at 787 (amending the Securities Exchange Act of 1934, §13(k)).

case of loans to officers, Congress has in essence determined that no reasonable board of directors could make a determination to approve such a loan.¹⁴¹

Having examined the provisions of Sarbanes-Oxley, and related rulemaking, aimed at the board, we now turn our focus to those provisions aimed at executive officers.

2. *Sarbanes-Oxley Provisions Intended to Regulate the Fiduciary Duties of Officers.*

With the exception of section 406,¹⁴² the provisions of Sarbanes-Oxley aimed at management of public companies are intended to specifically regulate the conduct of officers as to certain matters. Sarbanes-Oxley and the related SEC and SRO rulemaking were intended to focus senior management's attention on financial matters and public disclosure.¹⁴³

a. *Corporate Responsibility for Financial Reports*

Because of public perception that many senior corporate officers lacked focus on financial and disclosure matters,¹⁴⁴ section

141. Section 402 was self-executing and required no additional SEC rulemaking. *Id.*

142. *See infra* note 146, section II(B)(2)(d).

143. *See, e.g.*, S. REP. NO. 107-205 (2002). "The bill also requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies." *Id.* at 2.

144. *See id.*

The bill also contains a number of provisions aimed at corporate management. Defects in procedures for monitoring financial results and controls have been blamed for recent corporate failures. The bill therefore requires CEOs and CFOs to certify their companies' financial reports The Committee believes that management should be held responsible for the financial representations of their companies.

Id. at 27 (emphasis added). *See also* Cynthia A. Glassman, Address at the Darden Distinguished Speaker Series (Mar. 26, 2003), available at <http://www.sec.gov/news/speech/spch032603cag.htm> (last visited Apr. 20, 2004).

The new [section 302 and section 906] certification requirements have a few lessons to offer to senior executives First, you have an obligation to understand your business; willful blindness is a dereliction of duty, and ignorance is not an excuse for not knowing what is going on in your company. Second, you need to use the power and prestige of your office to ensure that investor capital you hold in trust is secure; if you tolerate—or, worse, encourage—a corporate culture that allows for large-scale fraud, you will be accountable. Third, you need to make sure that disclosure controls and systems are in place

302(a)¹⁴⁵ of Sarbanes-Oxley requires the principal executive officer and the principal financial officer (or officers) to sign the quarterly and annual reports of the company and to certify that:

1. The officer has reviewed the report;
2. Based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit a statement of material fact;
3. Based on the officer's knowledge, the financial statements fairly present in all material respects the financial condition and results of operations of the issuer;¹⁴⁶
4. That the signing officers
 - (a) are responsible for establishing and maintaining internal controls;
 - (b) have designed such internal controls to ensure that material information is made known to such officers;
 - (c) have evaluated the effectiveness of the issuer's internal controls; and
 - (d) have presented in the report their conclusions about the effectiveness of their internal controls;
5. That the signing officers have disclosed to the auditors and the audit committee
 - (a) all significant deficiencies in the design or

to enable you to provide full and accurate reports to the Board and investors regarding the company's operations and financial condition. And fourth, public disclosure is one of the most important jobs you have as a corporate officer—don't take it lightly.

Id. § IV.

145. Sarbanes-Oxley Act, 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241).

146. See Certification of Disclosure in Companies' Quarterly and Annual Reports, 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, and 274 (2002), available at <http://www.sec.gov/rules/final/33-8124.htm> [hereinafter Section 302 Release].

In its rulemaking under section 302, the SEC stated that this certification is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.

Id. § II(B)(3).

operation of internal controls; and

(b) any fraud that involves management or other employees who have a significant role in the issuer's internal controls; and

6. The signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.¹⁴⁷

Section 302 gave the SEC thirty days to make effective rules implementing the section.¹⁴⁸ On August 29, 2002, the SEC promulgated several rules and items of disclosure to Exchange Act Reports to implement section 302.¹⁴⁹ Interestingly, in discussing the two certifications set forth in section 302(a)(2) and (a)(3), the SEC stated that “[b]oth of the foregoing certification statements are to be made based on the knowledge of the certifying officer. This is not meant to change the current obligations of corporate officers in connection with the discharge of their duties.”¹⁵⁰ Although the SEC stated that the “obligations” of officers were not changed following the adoption of section 302 and the promulgation of the rules under section 302, at least the discharge of the officer's duties would certainly be affected. For example, the officer could not argue that compliance with U.S. Generally Accepted Accounting Principles was sufficient to discharge the officer's duty to report the company's financial affairs to its stockholders. This is particularly the case because a violation of section 302 could subject an officer to liability for violating section 13(a) or 15(d) of the Exchange Act, and to private actions for violation of section 10(b) under that Act and Rule 10b-5 promulgated under that Act.¹⁵¹

The Section 302 Release rules also require that public companies maintain disclosure controls and procedures, much as they are already required to maintain internal controls for financial information.¹⁵² The SEC's intent in promulgating the disclosure

147. Sarbanes-Oxley Act § 302(a), 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241).

148. *Id.* § 302(c).

149. *See* Section 302 Release, *supra* note 146.

150. *Id.* § II(B)(3).

151. *Id.* § II(B)(6).

152. *Id.* (promulgating Securities Exchange Act, *supra* note 43, at 13a-15 and

control rules was “to assist principal executive and financial officers in the discharge of their responsibilities in making the required certifications, as well as to discharge their responsibilities in providing accurate and complete information to security holders”¹⁵³ The new rules also require the company, under the supervision of the principal executive and financial officers, to conduct an evaluation of the effectiveness of the disclosure controls.¹⁵⁴

Section 906¹⁵⁵ of Sarbanes-Oxley, much like section 302, requires officers to make certain certifications, subject to criminal penalties, regarding compliance with securities laws. Unlike section 302, section 906 was effective upon passage of the Act.

b. Forfeiture of Certain Bonuses and Profits

Section 304¹⁵⁶ of Sarbanes-Oxley provides that, if a public company is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirement under the securities laws, as a result of misconduct, then the principal executive officer and the principal financial officer(s) must reimburse the corporation for (i) any bonus or other incentive-based or equity-based compensation received by such person during the twelve-month period following the first public issuance of the defective report and (ii) any profits realized from the sale of securities of the corporation during that twelve-month period. Section 304 was self-executing upon effectiveness of the Sarbanes-Oxley Act.¹⁵⁷ The intent of this section seems

15d-15). The statutory section and rules related to internal financial controls are found in the Securities Exchange Act of 1934, § 13(b)(2), and Exchange Act Rules 13b2-1 and 12b2-2 promulgated under Section 13(b)(2).

153. Section 302 Release, *supra* note 146.

154. *Id.*

155. Pub. L. No. 170-204, 116 Stat. 745, 806 (2002) (to be codified at 18 U.S.C. § 1350).

156. *Id.* 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243).

157. *See* S. REP. NO. 107-205 (2002).

Recent events have raised concern about management benefiting from unsound financial statements, many of which ultimately result in corporate restatements. The President has recommended that “CEOs or other officers should not be allowed to profit from erroneous financial statements,” and that “CEO bonuses and other incentive-based forms of compensation [sh]ould be disgorged in cases of accounting restatement and misconduct.”

Id. at 26.

straightforward enough—forcing the principal officers of the company to pay more attention to the company's financial reporting and to dissuade management from focusing on short-term gain.¹⁵⁸

c. Management Assessment of Internal Controls

Section 404 of Sarbanes-Oxley requires corporations to include an internal control report in each annual report. The internal control report shall:

- (1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and
- (2) Contain an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.¹⁵⁹

In addition, section 404 requires each registered public accounting firm of a public corporation to certify as to the management assessment contained in paragraph 2 above.¹⁶⁰

The SEC promulgated rules under section 404 on August 14, 2003, as directed by the Act.¹⁶¹ These rules sought to not only incorporate the required provisions of section 404, but to expand on those provisions and provide additional guidance to public companies.¹⁶² The SEC amended Item 307 of Regulation S-K (as well as other similar regulations) to require a company's annual report to include an internal control report of management

158. See Cynthia A. Glassman, Address at the Conference on Bank Structure and Competition (May 9, 2003), at <http://www.sec.gov/news/speech/spch050903cag.htm> (last visited Apr. 20, 2004). "[I]t should be clear from the recent scandals that there is a risk that some executives will manage to short-term performance goals to maximize their compensation. For its part, Sarbanes-Oxley provides an incentive against this type of conduct." *Id.*

159. Sarbanes-Oxley Act, § 404(a), 116 Stat. at 789 (to be codified at 15 U.S.C. § 7262).

160. *Id.* § 404(b) (stating also that the accounting firm's attestation could not be pursuant to a separate engagement of the accounting firm). See also Public Company Accounting Oversight Board Auditing Standard No. 2 providing additional standards for the auditor's certification. (The authors are indebted to Professor Larry Cunningham for this point.)

161. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274 (2003), available at <http://www.sec.gov/rules/final/33-8238.htm> [hereinafter Section 404 Release].

162. See generally *id.* § II(B).

containing:¹⁶³

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;

(2) A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;

(3) Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and

(4) A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.¹⁶⁴

Finally, the SEC required public companies to include in their quarterly reports whether any change in the company's internal controls has occurred "that has materially affected, or is reasonably likely to materially affect, the [company's] internal control over financial reporting."¹⁶⁵

An important contribution of the new rules was to define the term "internal control over financial reporting" for purposes of section 404 compliance. The rules define the term as follows:

A process designed by, or under the supervision of, the

163. *Id.*

164. Paragraph 4 is contained in Item 308 of Regulation S-K. 17 C.F.R. § 229.308 (2003), available at <http://www.sec.gov/divisions/corpfin/forms/regsk.htm> (last modified Nov. 19, 2003) (last visited Apr. 20, 2004).

165. *Id.* The Section 404 Release also effected certain technical amendments to the Exchange Act Rules in connection with the certifications required by sections 302 and 906. See *supra* Section II.B.2.a.

registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.¹⁶⁶

The Section 404 Release spends a good deal of time on this definition, as it has been the subject of much writing in the accounting literature over the years.¹⁶⁷

Section 404's requirements, particularly the auditor certification requirement, have been and will continue to be very challenging for public companies. In discussing section 404 and the SEC's rulemaking pursuant to section 404, SEC Chairman William Donaldson stated:

For many companies, the new rules on internal control reports will represent the most significant single requirement associated with the Sarbanes-Oxley Act. The establishment and maintenance of internal control over financial reporting has always been an important responsibility of management

166. See Securities Exchange Act of 1934 §§ 13a-14(d) and 15d-14(d), 17 C.F.R. §§ 240.13a-15(f) (2003).

167. See generally Section 404 Release, *supra* note 161, § II(A).

.... By requiring a report stating management's responsibility for internal control over financial reporting and management's assessment regarding the effectiveness of such control, investors will be better able to evaluate management's stewardship responsibilities and the reliability of a company's disclosure.¹⁶⁸

d. Code of Ethics for Senior Financial Officers

Section 406 of Sarbanes-Oxley requires a public company to disclose whether it has adopted a code of ethics for senior financial officers and to disclose in public filings if its code of ethics changes or if any waivers from the code are granted by the company.¹⁶⁹

Section 406(c) defines the term "code of ethics" to mean:

such standards as are reasonably necessary to promote—

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with applicable governmental rules and regulations.¹⁷⁰

On March 3, 2003, the SEC promulgated rules implementing section 406, along with its rules implementing section 407.¹⁷¹ In the Section 407 Release, the SEC extended the requirements of section 406 to also include disclosure of whether a public company has adopted a code of ethics that applies to its principal executive officer.¹⁷² In addition, the SEC expanded on the definition of "code of ethics," defining it as follows:

[W]ritten standards that are reasonably designed to deter

168. Donaldson Testimony, *supra* note 16, at 19-20 (citation omitted).

169. Pub. L. No. 170-204, § 406, 116 Stat. 745, 789 (2002) (to be codified at 15 U.S.C. § 7264).

170. "The problems surrounding Enron Corp. and other public companies raise concerns about the ethical standards of corporations and their senior financial managers. The Committee believes that investors have a legitimate interest in knowing whether a public company holds its financial officers to certain ethical standards in their financial dealings." S. REP. NO. 107-205 at 32 (2002).

171. See Section 407 Release, *supra* note 127.

172. 17 C.F.R. § 229.406 (2003). See also Donaldson Testimony, *supra* note 16, at 17. "Given the role of the CEO in setting the 'tone at the top,' the [SEC] also included a company's principal executive officer in its final rules." *Id.*

wrongdoing and to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
3. Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
4. Compliance with applicable governmental laws, rules and regulations;
5. The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
6. Accountability for adherence to the code.¹⁷³

The NYSE enacted and extended section 406 of Sarbanes-Oxley and the SEC's rulemaking in section 303A of its Listed Company Manual.¹⁷⁴ Section 303A requires NYSE companies to "adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers."¹⁷⁵ The NYSE

173. Section 407 Release, *supra* note 127, § II(B)(2). The SEC resisted commenters' suggestions to set forth additional ethical principles: "We continue to believe that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company. Such an approach is consistent with our disclosure-based regulatory scheme." *Id.*

174. *See generally id.*

175. New York Stock Exchange, Final NYSE Corporate Governance Rules, § 303A(10) (Nov. 4, 2003), *available at* <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> (last modified No. 15, 2003) (last visited Apr. 20, 2004) [hereinafter NYSE Final Rules].

No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the

stated that each company “may determine its own policies”¹⁷⁶ but nevertheless provided a fairly extensive listing of important matters that the code of business conduct “should”¹⁷⁷ address. That list includes the following:¹⁷⁸ conflicts of interest;¹⁷⁹ corporate opportunities;¹⁸⁰ confidentiality;¹⁸¹ fair dealing;¹⁸² protection and

company Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company’s website must include its code of business conduct and ethics.

Id. § 303A(10) cmt.

176. *Id.*

177. NYSE Governance Release, *supra* note 48, § 303A(10) cmt.

The NYSE advises readers that the words “must” and “should” have been chosen with care when used. The use of the word “must” indicates a standard or practice with which companies would be required to comply. The use of the word “should” indicates a standard or practice that the Exchange believes is appropriate for most if not all companies, but failure to employ or comply with such standard or practice will not constitute a violation of NYSE standards.

Id. at n.5. *See also* New York Stock Exchange, Corporate Governance Rule Proposals, Amend. No. 2, File No. SR-NYSE-2002-33 (Oct. 8, 2003), *available at* <http://www.NYSE.com/pdfs/amend2-10-08-03.pdf> (last modified Oct. 9, 2003) (last visited Apr. 20, 2004).

178. *See supra* note 48 § 303A(10) cmt.

179. *Id.*

A “conflict of interest” occurs when an individual’s private interest interferes in any way—or even appears to interfere—with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

Id.

180. *Id.*

Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

Id.

181. *Id.* “Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if

proper use of company assets;¹⁸³ compliance with laws, rules, and regulations (including insider trading laws);¹⁸⁴ and encouraging the reporting of any illegal or unethical behavior.¹⁸⁵

Stating that “[e]thical behavior is required and expected of every corporate director, officer and employee,”¹⁸⁶ the Nasdaq proposed in October 2002, as amended by a filing published by the SEC on July 10, 2003,¹⁸⁷ a new subsection (m) to NASD Rule 4350, as follows:

Each Issuer shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available. A code of conduct satisfying this rule must comply with the definition of a “code of ethics” set out in Section 406(c) of [Sarbanes-Oxley] and any regulations promulgated thereunder by the [SEC]. In addition, the code must provide for an enforcement mechanism. Any

disclosed.” *Id.*

182. *Id.*

Each employee, officer and director should endeavor to deal fairly with the company’s customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as “at will” employment arrangements.

Id.

183. *Id.* “All employees, officers and directors should protect the company’s assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company’s profitability. All company assets should be used for legitimate business purposes.” *Id.*

184. *Id.* “Insider trading is both unethical and illegal, and should be dealt with decisively.” *Id.*

185. *Id.*

The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

Id.

186. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. to Amend NASD Rule 4350 To Require Listed Companies To Adopt a Code of Conduct for All Directors, Officers, and Employees, Release No. 34-48125, 68 Fed. Reg. 41,194, 41,194 (July 10, 2003).

187. *Id.*

waivers of the code for directors or executive officers must be approved by the Board and must be disclosed in the issuer's public filings, not later than the next periodic report.¹⁸⁸

The Nasdaq also promulgated an interpretation under Rule 4350(m), IM-4350-7, providing guidance for Rule 4350(m).¹⁸⁹ In IM 4350-7, the Nasdaq states:

The requirement of a publicly available code of conduct applicable to all directors, officers and employees of an issuer is intended to demonstrate to investors that the board and management of Nasdaq issuers have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior.¹⁹⁰

Given the concern that employees of public companies feel protected in enforcing ethical standards, the interpretation states that “[f]or company personnel, a code of conduct with enforcement provisions provides assurance that reporting of questionable behavior is protected and encouraged, and fosters an atmosphere of self-awareness and prudent conduct.”¹⁹¹

Rule 4350(m) requires that Nasdaq companies comply with section 406(c) of Sarbanes-Oxley and, thus, “must include such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure, and compliance with laws, rules and regulations.”¹⁹² However, Rule 4350(m) also goes beyond the requirements of section 406(c), applying to all directors, officers, and employees. Companies can either address each requirement with one comprehensive code or two or more separate codes.¹⁹³

Finally, to give the code the necessary teeth, the interpretation states that “[e]ach code of conduct must also contain an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

compliance, and a fair process by which to determine violations.”¹⁹⁴

e. NYSE and Nasdaq Rules on Shareholder Approval of Equity Compensation Plans.

The SEC approved new rules proposed by the NYSE and the Nasdaq requiring shareholder approval of Equity Compensation Plans of listed companies.¹⁹⁵ The Equity Plan Release approved an amended new section 303A(8) of the NYSE’s listed Company Manual and an amended NASD Rule 4350(i).¹⁹⁶ Although not required by Sarbanes-Oxley, these SRO provisions were clearly adopted as additional corporate governance rules evincing the spirit of Sarbanes-Oxley.

The new NYSE rule provides that “[s]hareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions”¹⁹⁷ The rule defines an “equity-compensation plan” as one that “provides for the delivery of equity securities (either newly issued or treasury

194. *Id.* at 41,195. Part of the enforcement mechanism is contained in the requirement that companies disclose waivers of the code promptly. *Id.*

195. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, Exchange Act Release No. 34-48108 (proposed June 20, 2003), 68 Fed. Reg. 39,995, (July 3, 2003) [hereinafter Self-Regulatory Organizations Release]:

The [SEC] has long encouraged exchanges to adopt and strengthen their corporate governance listing standards in order to, among other things, restore investor confidence in the national marketplace. The [SEC] believes that the NYSE proposal and the Nasdaq proposal, which require shareholder approval of equity compensation plans, are the first step under this directive because they should have the effect of safeguarding the interests of shareholders, while placing certain restrictions on their listed companies.

Id. at 40,005.

196. *Id.* at 39,996, 39,999.

197. *Id.* at 39,997. See also NYSE Listed Company Manual, *supra* note 49, § 303A(8):

Equity-compensation plans can help align shareholder and management interests, and equity-based awards are often very important components of employee compensation. To provide checks and balances on the potential dilution resulting from the process of earmarking shares to be used for equity-based awards, the [NYSE] requires that all equity-compensation plans, and any material revisions to the terms of such plans, be subject to shareholder approval

Id.

shares) of the listed company to any employee, director or other service provider as compensation for services, including a compensatory grant of options or other equity securities that is not made under a plan.”¹⁹⁸ The rule provides for certain exclusions from the definition of “equity-compensation plans” including “[p]lans that are made available to shareholders generally, such as a typical dividend reinvestment plan”¹⁹⁹ and “[p]lans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value.”²⁰⁰

Section 303A(8) defines “material revision” to include, for example, a material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff, or similar transaction);²⁰¹ an expansion of the types of awards available under the plan;²⁰² a material expansion of the class of employees, directors, or other service providers eligible to participate in the plan;²⁰³ a material expansion of the term of the plan;²⁰⁴ a material change to the method of determining the strike price of options under the plan;²⁰⁵ and the deletion or limitation of any provision prohibiting repricing of options.²⁰⁶ The rule exempts certain actions from the shareholder vote requirement, including “employment inducement awards,”²⁰⁷ certain grants, plans and

198. Self-Regulatory Organizations Release, *supra* note 195, at 39,996.

199. *Id.* at 39,997.

200. *Id.*

201. *Id.*

If a plan contains a formula for automatic increases in the shares available . . . or for automatic grants pursuant to a formula, each such increase or grant will be considered a revision requiring shareholder approval unless the plan has a term of not more than ten years If a plan contains no limit on the number of shares available and is not a formula plan, then each grant under the plan will require separate shareholder approval regardless of whether the plan has a term of not more than ten years.

Id.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.* at 39,997.

206. *Id.* at 39,998.

207. *Id.* “An employment inducement award is a grant of options or other equity-based compensation as a material inducement to a person or persons being hired by the listed company Inducement awards include grants to new employees in connection with a merger or acquisition.” *Id.*

amendments in the context of mergers and acquisitions,²⁰⁸ and certain specific types of plans²⁰⁹” The new Nasdaq rule requires shareholder approval in the same instances, and exempt the same types of transactions, as those set forth in NYSE section 303A(8).²¹⁰

III. CORPORATE FIDUCIARY DUTIES

States, not the federal government, traditionally have regulated corporate governance.²¹¹ In contrast to the statutory and regulatory mandate of Sarbanes-Oxley, state corporation statutes largely are enabling, not regulatory, in thrust.²¹² These statutes establish the basic architecture of corporate governance, but they have relatively little to say about the standards that directors and officers must adhere to or practices they must follow. In the latter part of the twentieth century, many states (but not Delaware) codified a director standard of care,²¹³ and many states (including

208. There are two exemptions in the context of mergers and acquisitions: (i) converting, replacing, or adjusting outstanding options to reflect the transaction and (ii) shares existing under certain pre-existing plans that were acquired. *See id.*

209. Certain tax-qualified plans are exempt under this provision, including plans intended to meet the requirements of section 401 under the Internal Revenue Code (ESOPs), plans intended to meet the requirements of section 423 under the Internal Revenue Code (employee stock purchase plans), and “parallel excess plans.” *Id.*

210. *See generally id.* at 39,999. The Nasdaq also promulgated IM-4350-5, providing for interpretations under amended Rule 4350(i). *See also id.* at 40,008 (which contains the SEC’s discussion of the proposals of both the NYSE and Nasdaq and “notes that the NYSE and Nasdaq proposals, while not identical, set a consistent, minimum standard for shareholder approval of equity compensation plans.”).

211. *CTS Corp. v Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) (“No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations”); *Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977) (holding there is no federal Rule 10b-5 cause of action for breach of corporate fiduciary duty without deception or manipulation). *See also Bus. Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990) (vacating SEC rule prohibiting national securities exchanges and associations from listing the stock of companies violating a one-share, one-vote policy).

212. To be sure, corporate statutes contain mandatory provisions, but they are not strong constraints and often can be avoided by planning. *See e.g.*, Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 *Nw. U. L. REV.* 542 (1990); Elvin R. Latty, *Why Are Business Corporation Laws Largely “Enabling”?*, 50 *CORNELL L.Q.* 599 (1965).

213. Forty states have enacted a statutory standard of care for directors. MODEL BUS. CORP. ACT ANN. § 8.30 at 8-177 (3d ed. 1996) (2000/01/02 Supp.). Delaware does have a statute permitting directors to rely on other persons in specified situations. DEL. CODE ANN. tit. 8, § 141(e) (2003). This statute, as to director reliance on professionals or experts, requires that such persons must have been

Delaware)²¹⁴ enacted statutes partially addressing director conflict of interest transactions,²¹⁵ but not addressing other aspects of the director duty of loyalty. This statutory “silence” meant that, historically, standards for the proper discharge of corporate governance responsibilities come from non-legislative sources. These may be non-binding and aspirational in nature, as with the notion of corporate “best practices,”²¹⁶ or legally binding, as with NYSE and Nasdaq listing standards²¹⁷ and judge-made law.

Courts have long recognized that corporate officers and directors are fiduciaries and that equity, not law, is the source of their fiduciary obligations. As stated by former Delaware Chancellor William Allen:

The duties [corporate officers and directors] owe to shareholders with respect to the exercise of their legal power over corporate property supervene their legal

selected “with reasonable care . . .” If directors select these persons, therefore, directors must act with “reasonable care” in doing so, if they desire the right to rely on the professional or expert.

214. DEL. CODE ANN. tit. 8, § 144 (2003).

215. These statutes address only “transactions” and, accordingly, they do not deal with usurpation of corporate opportunities, wrongful competition with a corporation, or appropriating confidential information—all matters implicating a director’s duty of loyalty. Moreover, these statutes were designed to overcome the common law rule that such transactions were voidable; most such statutes do not affirmatively validate such transactions or immunize them from judicial review. *Compare* Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976), *with* Fisher v. State Mutual Ins. Co., 290 F.3d 1256 (11th Cir. 2002) (holding that Georgia’s version of the Model Business Corporation Act’s conflict-of-interest transaction statute provides a “safe harbor” for upholding such transactions without judicial review for fairness).

216. Chief Justice Veasey has stated:

Aspirational ideals of good corporate governance practices for boards of directors that go beyond minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.

Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

217. The NYSE and NASDAQ have a limited range of sanctions for noncompliance with listing standards. They may suspend trading in a security or delist a company. These are very rarely used, however, as they penalize investors and raise difficult practical problems. *See* John F. Olson, *How to Really Make Audit Committees More Effective*, 54 BUS. LAW. 1097, 1100 (1999). *See* NYSE Governance Release, *supra* note 48, § 303A(13) discussed at *supra* note 89 and accompanying text. *See also* SEC Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 2638-01 (proposed January 17, 2003), 17 C.F.R. pts 228, 229, 240, 249, and 274 (2003) (proposing adoption of Rule 10A-3, which would prohibit the listing of securities of issuers not following the audit committee mandates of Sarbanes-Oxley) discussed *supra* notes 39 through 45 and accompanying text.

rights, are imposed by equity and are recognized and enforced exclusively by a court of equity. Chancery takes jurisdiction over “fiduciary” relationships because equity, not law, is the source of the right asserted.²¹⁸

The vocabulary of equity is not legal rules; indeed, from the outset the function of equity has been to correct the unfairness caused by too rigidly adhering to a universal, rules-based approach to justice.²¹⁹ Consequently, equity—although still susceptible to the lure of precision offered by rules²²⁰—largely approaches the obligations of directors and officers through the use of duties and standards. Duties and standards often are more cogent than rules while also being more open-textured, fluid, and context-sensitive. This is evident in corporate law, where the duties are broad and usefully ill-defined—decision-makers must act with “loyalty” and “care” and in “good faith,” but are accorded wide latitude in discharging their governance responsibilities in conformance with these standards. This is highly functional in corporate law given the strong “process” dimension to fiduciary analysis.²²¹ A “process” approach to judicial review avoids both overly strict substantive review and specification of rules of behavior, focusing instead on assessing whether the *manner* in which directors acted in a particular setting conforms to evolving understandings of broad standards.²²²

At the same time, such imprecision necessarily accords both

218. *McMahon v. New Castle Assocs.*, 532 A. 2d 601, 604 (Del. Ch. 1987) (citations omitted).

219. See MARGARET HALLIWELL, *EQUITY AND GOOD CONSCIENCE IN A CONTEMPORARY CONTEXT* 6 (1997) (“Fundamental misconceptions of equity abound . . . because of a persistent refusal to acknowledge that equity is, by its very nature, subversive of the law.”).

220. For example, corporate law has developed a business judgment “rule” and conflict of interest “rules.” These “rules” are an attempt to give more specific content to fiduciary duties and to give *ex ante* guidance to corporate planners. They do not fully capture the reach of more open-ended and pervasive fiduciary duties, however. See Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 *UCLA L. REV.* 738, 760 & nn.65, 68 (1978).

221. Although a process focus is especially important in the duty-of-care area, see *infra* notes 230-31 and accompanying text, it is also important in the loyalty and good faith areas. See *supra* notes 249-57 and accompanying text.

222. Recently, two scholars have argued that good corporate governance practices require moving beyond a focus on “structural” considerations—e.g., whether directors are independent, the number of directors, etc.—to a greater focus on the “process” attributes of greater board effectiveness. Sydney Finkelstein and Ann C. Mooney, *Not the Usual Suspects: How to Use Board Process to Make Boards Better*, 17 *ACAD. OF MGMT. EXECUTIVE* 101 (2003).

directors and judges more interpretive discretion than do rules, a feature some applaud and others decry.²²³ For example, a traffic safety rule might specify in clear detail what conduct is required in operating a motor vehicle, while a traffic standard might simply mandate that one drive “safely” under all circumstances, leaving it to drivers and judges to construe that standard over time. Likewise, in corporate law, the notions of “care” and “loyalty” and “fairness” have been given meaning in a wide variety of contexts through decades of case-by-case adjudication. This allows a more probing and “tailored” legal response to a particular claim while also leading, over time, to a rich body of incremental changes in corporate law as a whole.

The legal regulation of corporate governance practices, therefore, traditionally has been the work of judges using the tools of equity—duties and standards—and not the work of legislatures and administrative agencies enacting detailed statutes, rules, and regulations. The latter have been predominant in federal securities regulation, but not in corporate governance. As seen in Part II of this article, Sarbanes-Oxley—housed in the federal securities law—not only represents a new federal *presence* in corporate governance,²²⁴ it adopts a wholly novel, rules-based *approach* to corporate governance. Moreover, the federal intervention is not pervasive but is partial and selective, and it provides no built-in interpretive, adjudicative, or enforcement mechanisms accessible to shareholders. Growth in the law, through interpretation, largely will come at the urging of the SEC rather than shareholders.

223. If one goal of judicial review is to encourage a dynamic approach to board practice, such that change and new thinking are encouraged, standards are superior to rules, the latter running the risk of “freezing” current practice. *But see* Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989) (arguing that rules are better than standards in constraining judges).

224. Sarbanes-Oxley represents a federal presence in corporate law quite different in the particulars, but similar overall in aim, to Professor William Cary’s proposal thirty years ago for a Federal Corporate Uniformity Act. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701-03 (1974). For two insightful treatments of federal law, state law, and listing standards—taken together—as forming a new, collaborative “tri-partite” approach to corporate governance, see William B. Chandler III and Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003) (cited in Letter from the State of Wisconsin Investment Board to SEC Secretary Jonathan Katz, (June 12, 2003)), *available at* <http://www.swib.state.wi.us/rule.pdf> (last visited Apr. 20, 2004); Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003).

Overall, Sarbanes-Oxley simply is not a comprehensive, systematic approach to corporate governance, as is the case with state corporate law. This contrast in federal and state approaches to corporate regulation can easily be seen by reviewing Delaware's judicial treatment of director and officer fiduciary duties.

We first briefly describe the traditional duties of corporate directors,²²⁵ highlighting recent renewed emphasis on the obligation of good faith. Next, we describe the neglected status of corporate officers as agents owing robust fiduciary duties.

A. *Director Fiduciary Duties*

On several occasions, the Delaware Supreme Court has stated that corporate directors owe "fiduciary duties of care, loyalty and good faith."²²⁶ However, Vice Chancellor Leo Strine, upon closely examining supreme court language, concluded that the obligation of good faith, although a fiduciary requirement, is, in fact, an aspect of the duty of loyalty.²²⁷ Recently, Chief Justice Veasey, citing both corporate statutes and decisional law, reiterated the distinctive place of good faith in fiduciary analysis: "[I]t seems that there is a separate duty of good faith, not only arising out of our case law, but also as a matter of statutory construction."²²⁸ Later in the same article, he softened this observation a bit, stating: "Because the jurisprudence on good faith is unresolved, I express no opinion whether or when a separate duty of good faith that is not subsumed in the duty of loyalty should apply upon court review."²²⁹ As will be seen later, the effort to more sharply differentiate good faith, or at least give it greater prominence in

225. See Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003) (providing a recent and more complete treatment of director fiduciary duties under Delaware law) [hereinafter *After Enron*]; Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787 (1999) [hereinafter *Rethinking Care*].

226. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995).

227. *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 475-76 n.41 (Del. Ch. 2000).

228. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 447 (2003) [hereinafter *State-Federal Tension*]. See also Charles Elson, *What's Wrong with Executive Compensation?*, 81 HARV. BUS. REV. 1, Jan. 2003, at 68, 76; E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 850 (2003).

229. *State-Federal Tension*, *supra* note 228, at 448.

fiduciary analysis, may pave the way in translating the mandates of Sarbanes-Oxley into state fiduciary analysis. For now, whether the obligation of good faith is subsumed within the duty of loyalty is less important than the fact that there is a director obligation of good faith, and that it has several facets.

1. *Duty of Due Care*

The duty of due care specifies the manner in which directors must discharge their legal responsibilities. These responsibilities include electing, evaluating, and compensating corporate officers; reviewing and approving corporate strategy, budgets, and capital expenditures; monitoring internal financial information systems and financial reporting obligations, and complying with legal requirements; making distributions to shareholders; approving transactions not in the ordinary course of business; appointing members to committees and discharging committee assignments, including the important audit, compensation and nominating committees; and initiating changes to the certificate of incorporation and bylaws.

The duty of due care arises in both the discrete decision-making context and in the oversight and monitoring areas. In the decision-making setting—whether it involves directors making a routine business decision or responding to a high-stakes unsolicited bid for corporate control—the duty of care inquiry clearly focuses on a board’s “decision-making process.”²³⁰ Directors in that setting are under an obligation to obtain and act with due care on all material information reasonably available.²³¹ The most famous case involving breach of the duty of care in the decision-making context is *Smith v. Van Gorkom*,²³² where directors were held to have been grossly negligent in discharging that facet of the duty of due care requiring them to be fully informed before making a business decision.²³³ After the *Van Gorkom* decision, however, Delaware amended its corporation statute to permit an amendment to a company’s certificate of incorporation either to limit or eliminate

230. See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989); *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“Due care in the decisionmaking context is *process* due care only.”).

231. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994).

232. 488 A.2d 858 (Del. 1985).

233. *Id.* at 893.

director liability for breaches of the duty of due care.²³⁴ The vast majority of public companies in Delaware have adopted an exculpation provision eliminating director liability in this way.²³⁵

Directors also may be liable for breach of the duty of care if they fail to properly monitor and oversee the business affairs of a corporation. The Delaware Supreme Court has not yet addressed whether negligence or gross negligence is the proper standard of conduct in the oversight context, as opposed to the business judgment context.²³⁶ As famously noted by Chancellor Allen, this monitoring and oversight obligation “includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may . . . render a director liable.”²³⁷ Importantly, however, noted Chancellor Allen’s dictum, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”²³⁸

If one focuses on certain language—“sustained or systematic failure” or “utter failure”—the *Caremark* standard of care for directors in the oversight context seems very low. The difficulties associated with this view can be seen in Chancellor Chandler’s illustration, discussed in an extended footnote, of what he called “the problem of assessing claims, based on accounting regularities, under the *Caremark* standard.”²³⁹ Often overlooked, however, in reading *Caremark* are repeated references to a director’s “obligation to be reasonably informed”²⁴⁰ and the duty “to exercise reasonable oversight,”²⁴¹ as well as the statement that directors must act to “assure a reasonable information and reporting system.”²⁴² Thus, director failure to act reasonably in the oversight area may allow an

234. DEL. CODE ANN. tit. 8, §102 (b) (7) (2003).

235. See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209-10 (1988).

236. See *Rethinking Care*, *supra* note 225, at 815-16 & nn.162-64.

237. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

238. *Id.* at 971.

239. *Ash v. McCall*, No. 17132, 2000 WL 1370341, at *15 n.57 (Del. Ch. Sept. 15, 2000). See also *Salsitz v. Nasser*, 208 F.R.D. 589, 599 (E.D. Mich. 2002) (rejecting shareholder claim under *Caremark* standard).

240. *Caremark*, 698 A.2d at 970.

241. *Id.* at 971.

242. *Id.*

inference of bad faith or, more likely, such inaction may constitute a breach of that facet of due care requiring directors to be “reasonably informed.”²⁴³ What it means to be “reasonably informed” is different in corporate law today—after Sarbanes-Oxley—than in 1996, before Congress mandated adoption of certain governance reforms, including internal processes aimed at providing “reasonable assurance” regarding the reliability of corporate information.²⁴⁴ In *Caremark*, Chancellor Allen noted the relevance of federal law—in that case, federal organizational sentencing guidelines²⁴⁵—to understanding director governance responsibilities under state law. Likewise, Sarbanes-Oxley may infuse new meaning into our notions of “reasonable” oversight in a way that leads courts to demand greater director vigilance under the “reasonableness” standard of *Caremark*.²⁴⁶

Other director oversight responsibilities with a due care dimension include the duty to monitor a corporation’s compliance with various regulatory regimes governing its activities.²⁴⁷ Perceived breakdowns in director monitoring of corporate accounting systems and company compliance with various regulatory regimes and internal control practices led to many of the corporate scandals such as Enron, Tyco, WorldCom, and others. Consequently, as noted in Part II, Sarbanes-Oxley includes several provisions aimed at bolstering director discharge of oversight responsibilities.²⁴⁸

243. *Id.* at 970.

244. *See supra* notes 166-67 and accompanying text. Corporate law, of course, is influenced by wider social norms: “[C]orporation law exists, not as an isolated body of rules and principles, but rather in a historical setting and as part of a larger body of law premised upon shared values.” *City Capitol Assocs. Ltd. P’ship v. Interco, Inc.*, 551 A.2d 787, 799 (Del. Ch. 1988) *appeal dismissed without opinion*, 556 A.2d 1070 (Del. 1988). It is fair to say that today it is a “shared value” that corporate directors must be more zealous in discharging their oversight responsibilities. Corporation law should reflect this value through its handling of fiduciary duties.

245. *Caremark*, 698 A.2d at 970.

246. Chief Justice Veasey tersely conveys the same idea—that federal law may alter state fiduciary standards—through his phrase “evolving standards of director conduct, [and] the minimum expectations of Sarbanes-Oxley” *State-Federal Tension*, *supra* note 228, at 446.

247. *See* Lyman Johnson, *Misunderstanding Director Duties: The Strange Case of Virginia*, 56 WASH. & LEE L. REV. 1127, 1138-40 & nn.51-58 (1999) (enumerating various regulatory regimes). *See also* John J. Fons, *The Case for Compliance: Now It’s a Necessity, not an Option*, 13 BUS. LAW TODAY 1, Sept./Oct. 2003, at 27.

248. *See supra* Part II(B)(1).

2. *Duty of Loyalty*

The duty of loyalty requires directors to act in the best interest of the corporation. The duty of loyalty has a well-recognized dimension prohibiting a director from preferring his or her own interests over the interests of the corporation. Accordingly, a director may not engage in an unfair self-dealing (“conflict of interest”) transaction, wrongly usurp a corporate opportunity, improperly compete with the corporation, or use corporate assets or confidential company information for personal gain. Mere absence of a personal, conflicting interest by a director, however, is insufficient, by itself, to fulfill the affirmative aspect of the duty of loyalty.²⁴⁹ The Delaware Chancery Court has observed that a breach of loyalty can be unintended and can occur even when board action is taken in good faith, and even where self-interest is absent.²⁵⁰ As the chancery court has noted, “a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and . . . regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.”²⁵¹

3. *Good faith*

The obligation of good faith has long been important to fiduciary analysis in corporate law, but its meaning has been somewhat nebulous. A recent statement by Chief Justice Veasey helps in understanding the breadth of this concept:

It is all about process, and process is all about due care and good faith, as well as loyalty. In my opinion, good faith requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the well-being of the constituents of the fiduciary. Although the concept of

249. For an elaboration of the dual aspects of the duty of loyalty, see *After Enron*, *supra* note 225, at 37-42.

250. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988); *accord* *State of Wisconsin Inv. Bd. v. Peerless Sys. Corp.*, No. 17637, 2000 WL 1805376 (Del. Ch. Dec. 4, 2000), *reargument denied*, 2001 WL 32639 (Del. Ch. Jan. 5, 2001).

251. *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000). *See also* *Hoover Indus., Inc. v. Chase*, 1988 WL 73758, at *2 (Del. Ch. July 13, 1988) (“A director does breach his duty of loyalty if he knows that the company has been defrauded and does not report what he knows to the board . . .”).

good faith is not fully developed in the case law, and factual scenarios are difficult to formulate, an argument could be made that reckless, disingenuous, irresponsible, or irrational conduct—but not necessarily self-dealing or larcenous conduct—could implicate concepts of good faith. If the board’s decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.²⁵²

Vice Chancellor Leo Strine also has commented on how the notion of good faith may play a more prominent role in fiduciary analysis: “Enron might exert pressure on courts to look more carefully at whether directors have made a good faith effort to accomplish their duties.”²⁵³ Asserting that good faith goes to director “state of mind,”²⁵⁴ Strine identifies certain kinds of director conduct that may call good faith into question. These include “a failure to monitor if their [directors’] laxity in oversight was so persistent and substantial that it evidences bad faith.”²⁵⁵ It can also arise in situations where “committee members *knew* that their inadequate knowledge disabled them from discharging their responsibilities with fidelity . . . [Here,] the court will be called on to conclude that a director who is *conscious* that he is not devoting sufficient attention to his duties is not acting in good faith”²⁵⁶ Finally, where

an overly busy person on the board of five public companies . . . takes on challenging duties on each of these boards, and then finds himself in a situation where one of his companies is accused of serious wrongdoing that the board arguably should have prevented, he should not be surprised if his good faith comes under severe attack in the financial press and in the courts.²⁵⁷

These publicly expressed judicial views on the importance of good faith serve an important “signaling” function in corporate law. The signal is aimed, first, at the SEC, which has been engaged

252. *State-Federal Tension*, *supra* note 228, at 447. For a more extensive treatment of good faith, see Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456 (2004).

253. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1373 (2002).

254. *Id.* at 1386.

255. *Id.*

256. *Id.* at 1393 (emphasis in original).

257. *Id.* at 1395.

in monumental rule-making under the auspices of Sarbanes-Oxley. These highly respected judges sought to convey the message that Delaware judges are fully aware of corporate misconduct and its pernicious effects on our corporate law system, and that Delaware judges intend to creatively deploy their arsenal of doctrinal concepts to reinvigorate their assessment of corporate decision-makers. This amounts to a “pledge” of action, designed, in part, to reassure the SEC that the traditional makers of corporate law are attending to the problem.²⁵⁸ No doubt, they hope to preserve Delaware’s central role in corporate jurisprudence by forestalling further congressional action and possibly curbing the most expansive reading of the SEC’s mandate to regulate under Sarbanes-Oxley. The judicial signal also is aimed at the corporate bar, both practicing and academic, who have been critical members in the interpretive community of corporate law. By speaking and writing to practitioners, Delaware’s judges can upgrade boardroom conduct by announcing that judicial eyebrows are raised, and that they intend to vigilantly examine director conduct. The audience—corporate lawyers—will, in turn, assimilate and re-broadcast these judicial views, along with commentary, to other lawyers through print media²⁵⁹ and seminars. These lawyers in turn will distill and convey these sentiments to clients, through letters, memoranda, and advice. The result of this exhortation—obvious across corporate America in the past year or two—is heightened attention to reform of corporate governance practices.

To be credible, these judicial admonitions must find expression in case law. This has recently occurred, in both the decision-making and oversight contexts. In denying a motion to dismiss a shareholder complaint, Chancellor Chandler shed new light on the meaning of the director good faith obligation.²⁶⁰ The chancellor noted that the complaint did much more than portray directors who were grossly negligent; rather, it suggested that “the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a ‘we don’t care about the risks’ attitude

258. Chief Justice Veasey clearly has undertaken this task. He states that “one can foresee a major role for state courts . . . in continuing to set a positive tone for best practices in Corporate America . . .” *State-Federal Tension*, *supra* note 228, at 444. He then goes on to discuss “good faith” as a promising doctrinal notion, describing it as an “area where the common law approach of the Delaware law of fiduciary duty is progressing.” *Id.*

259. *See, e.g.*, the articles collected *supra* note 8.

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

concerning a material corporate decision.”²⁶¹ He stated that such “deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interest of the company.”²⁶² In other words, deliberate indifference to the director duties of care and loyalty, or consciously disregarding those duties, is conduct sufficiently faulty to indicate a lack of the required motive—i.e. good faith—of advancing the best interest of the company. The court, in assessing director behavior, is not substantively evaluating conduct, but is drawing an inference about the propriety of director motive from the nature of the conduct. This allows the court an indirect way to do what the business judgment rule precludes—consider the substance of director conduct; not to assess it outright, but to draw an inference of bad motive if it is sufficiently egregious.²⁶³

A recent Seventh Circuit Court of Appeals decision applying Illinois law found a lack of director good faith in the oversight context where directors had made a conscious decision.²⁶⁴ Plaintiffs did not allege, as in *Caremark*, that the corporation’s reporting system was inadequate.²⁶⁵ Rather, plaintiffs alleged that directors knew of the company’s ongoing violations of federal law and yet consciously decided to take no steps in an effort to prevent or remedy the situation, with the result that the corporation incurred substantial losses.²⁶⁶ Relying both on *Caremark*²⁶⁷ and a Sixth Circuit decision for guidance as to what sort of director failings indicate lack of good faith in the oversight context,²⁶⁸ the court ruled that reckless disregard of a known risk is not conduct undertaken in good faith, for purposes of demand futility in shareholder

261. *Id.* at 289.

262. *Id.*

263. *See* *Parnes v. Bally Entm’t Corp.*, 722 A.2d 1243, 1246 (Del. 1999) (noting that a business decision may be “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith” (quoting *In re J.P. Stevens & Co. Inc. S’holders Litig.*, 542 A.2d 770, 780-81 (Del. Ch. 1988))). Judge Friendly appears to be the first proponent of the view that the rationality of a decision is pertinent to the issue of good faith. *Sam Wong & Son, Inc. v. N.Y. Mercantile Exch.*, 735 F.2d 653, 671, 678 & n.32 (2d Cir. 1984).

264. *In re Abbott Labs. Derivative S’holders Litig.*, 325 F.3d 795 (7th Cir. 2003).

265. *Id.* at 806.

266. *Id.* at 809.

267. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

268. *McCall v. Scott*, 239 F.3d. 808 (6th Cir. 2001).

derivative litigation.²⁶⁹ Consequently, given that claims against the directors implicated good faith and not just due care, directors were not exculpated from personal liability under the company's articles of incorporation.²⁷⁰

These authorities reveal a marked change in judicial attitude toward the analysis of fiduciary duty claims against directors. Given the widespread exculpation from liability for breaching the duty of due care, renewed emphasis on good faith serves to reintroduce the specter of director liability through a new doctrinal vessel. Judicial exhortation of the kind provided by Chief Justice Veasey and Vice Chancellor Strine, coupled with decisions denying motions to dismiss and a recent decision awarding damages against directors,²⁷¹ can remind directors that personal liability remains a distinct possibility for faulty performance, with the expectation that such reminders will induce better performance. These authorities also suggest that the key issue with respect to analyzing good faith is whether the directors' motivation and purpose was to advance the corporation's interest. The absence of proper motivation can be inferred in a variety of ways. These include, to recapitulate: approval of a substantively irrational course of conduct; acting with deliberate indifference to known risks; reckless failure to disclose;²⁷² seeking entrenchment of director positions; acting with an awareness that as directors they are not fully discharging their fiduciary responsibilities, as by deliberately acting without sufficient knowledge, hastily, or in a manner that fails to devote sufficient attention to those responsibilities; and egregious process failures that suggest lack of concern for advancing corporate interests.

Another indicator of director bad faith, often forgotten, is conduct known to constitute a violation of applicable positive law. For example, in a well-known case where directors failed to collect a \$1.5 million debt owed to a company by the Democratic National Committee that shareholders alleged constituted an illegal campaign contribution, such director conduct, being itself a violation of a federal statute, was held to breach the obligation of

269. *Abbot Labs.*, 325 F.3d at 809.

270. *Id.* at 810-11. *See also* *Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003) (holding directors of closely held Delaware corporation liable for breaching duties of loyalty and due care because they failed to halt self-dealing conduct by the CEO).

271. *Pereira*, 294 B.R. at 449.

272. *See* *Johnson v. Shapiro*, No. 17,651 (Del. Ch. Oct. 18, 2002), *reprinted in* 28 DEL. J. CORP. L. 237, 361 (2003).

good faith.²⁷³

Delaware's exculpation statute contains an exception for acts or omissions that involve a knowing violation of law as well as an exception for acts or omissions not in good faith.²⁷⁴ Consequently, a director who knowingly violates the law or who allows the corporation to violate the law—such as applicable provisions of Sarbanes-Oxley—is not entitled to exculpation, whether or not such conduct also constitutes a breach of the obligation of good faith. Nonetheless, for two reasons, it is significant that knowing violations of a statute such as Sarbanes-Oxley may independently constitute breach of good faith. First, Delaware's statute allowing director reliance on corporate officers, committees of other directors, and professional advisers requires that the director act in good faith.²⁷⁵ A director who has knowledge of illegality as to a particular matter will not be acting in good faith in relying on another person as to that matter. Second, Delaware's indemnification statute requires that a director or officer must have acted in good faith.²⁷⁶ Knowledge of illegality precludes good faith. Thus, a director who acts while knowing the conduct is unlawful falls outside the coverage of these two important statutes.

B. Officer Fiduciary Duties

Although often overlooked, corporate officers, including senior officers such as the Chief Executive Officer, the Chief Financial Officer, Chief Technology Officer, General Counsel, Executive Vice Presidents, the Treasurer, the Secretary, and others²⁷⁷ are "agents" of the corporation. Agency is a fiduciary

273. *Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759 (3rd Cir. 1974) (holding business judgment rule inapplicable where directors' decision was itself illegal); *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). See S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 129-30 (1979) ("Bad faith may preclude the application of the business judgment defense where directors knowingly [sic] violate a statute or comparable expression of public policy, even if such a violation is undertaken in the corporation's best interests.").

274. DEL. CODE ANN. tit. 8, § 102(b)(7) (2003).

275. DEL. CODE ANN. tit. 8, § 141(e) (2003); *Brehm v. Eisner*, 746 A.2d 244, 261-62 (Del. 2000).

276. DEL. CODE ANN. tit. 8, § 145(a) (2003).

277. SEC Rule 3b-7 defines "executive officer" to include, among others, any person or officer who performs a policymaking function.

relationship.²⁷⁸ Even though senior officers of corporations typically have employment agreements, they still occupy a fiduciary status in relation to the corporate principal. As fiduciaries, officers owe several duties to the corporation that exist independently of contract—although they may, to a degree, be altered by agreement. Breach of these duties affords the corporate principal a host of remedies, including a tort action against the agent for losses caused by the breach.²⁷⁹

One cornerstone fiduciary duty owed by officers is a duty of loyalty, which requires the agent to act solely for the benefit of the corporate principal.²⁸⁰ There are many aspects to the agent's duty of loyalty. These include: not acting adversely to the principal without consent²⁸¹ or on behalf of one with interests adverse to the principal without consent,²⁸² not competing with the principal,²⁸³ providing an accounting to the principal for profits,²⁸⁴ and not using or wrongly communicating confidential information.²⁸⁵ Besides owing a duty of loyalty, officers owe a duty of ordinary care²⁸⁶ and, consequently, simple negligence is a breach of this duty. Additional important duties include a duty of good conduct,²⁸⁷ a duty to provide information,²⁸⁸ and a duty to obey the principal,²⁸⁹ among others.²⁹⁰

The agency status of officers seems to have been more significant to the issue of whether, in a particular case, officers had the power to affect the corporation's relationship with third parties than to the issue of the fiduciary duties owed by officers, as agents,

278. RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

279. *Id.* § 399.

280. *Id.* § 387.

281. *Id.* §§ 389-90.

282. *Id.* §§ 391-92, 394.

283. *Id.* § 393.

284. *Id.* § 388.

285. *Id.* §§ 395-96.

286. *Id.* § 379.

287. *Id.* § 380.

288. *Id.* § 381. In a recent case, a de facto CFO and the corporation's general counsel were held liable for not informing the board of directors that the CEO was taking unauthorized loans at favorable interest rates. *Pereira v. Cogan*, 294 B.R. 449, 523-24 (S.D.N.Y. 2003). It is unclear from the opinion whether the general counsel was held liable in his capacity as an officer or as a lawyer.

289. RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

290. For a good, recent explanation of an agent's fiduciary duties, see DANIEL S. KLEINBERGER, AGENCY, PARTNERSHIPS, AND LLCs, EXAMPLES AND EXPLANATIONS 117-28 (2002).

to the corporate principal. Relatively little litigation asserting breach of fiduciary duty claims against officers has been brought either by boards of directors or, derivatively, by shareholders. As stated by a leading Delaware corporate law treatise: “Few authorities deal with the nature of the obligation owed by officers to the corporation and its stockholders.”²⁹¹ The foundational duty of loyalty case in Delaware,²⁹² for example, groups officers and directors together when discussing fiduciary obligations,²⁹³ instead of distinguishing the differing conceptual bases for imposing fiduciary duties on officers and directors.²⁹⁴

There may be several reasons for this dearth of attention to the distinctive status of corporate officers as fiduciaries.²⁹⁵ First, boards of directors may deal with officer misconduct by contractual means. That is, boards may negotiate settlements with officers as part of an infracorporate sanction, whether that sanction be discharge,

291. R. FRANKLIN BALOTTI AND JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.17 (3d ed. Supp. 2003). See A. GILCHRIST SPARKS AND LAWRENCE A. HAMERMESH, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 215 (1992) (stating “The precise nature of the duties and liabilities of corporate officers who are not directors is a topic that has received little attention from courts and commentators.”). See also Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN’S L. REV. 767, 770 (2002) (“I conclude that courts and attorneys should distinguish analysis of the duty of care owed by corporate executives or managers from the duty of care owed by directors.”).

292. *Guth v. Loft*, 5 A.2d 503 (Del. 1939).

293. *Id.* (stating “[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.”).

294. The Delaware Supreme Court has, however, properly applied agency principles as the legal basis for imposing duties on non-officer employees. See *Sci. Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980).

295. This is not to say that there are no decisions holding officers liable for breach of fiduciary duty. There are several, though fewer than one might expect. See SPARKS & HAMERMESH, *supra* note 291, at 216-20 (collecting cases); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries* (2003) (unpublished manuscript, on file with the authors). What is puzzling is the dearth of decisional law squarely grounding liability on agency law or acknowledging that it is the officer’s status as an agent that carries with it—for sound economic and policy reasons—strong fiduciary duties. The lack of conceptual clarity as to the rationale for officer liability was true in Justice Holmes’ famous 1919 opinion holding a bank president liable for mismanagement, *Bates v. Dresser*, 251 U.S. 524 (1920), and remains true in 2003, as seen by a recent federal court decision holding a chief executive officer personally liable for losses associated with putting his daughter on the corporate payroll and allowing her to use corporate property. *Pereira v. Cogan*, 294 B.R. 449, 539 (Bankr. S.D.N.Y. 2003). These cases are rightly decided and the *Bates* case is rich in facts supporting liability, but both lack a clearly articulated theoretical and doctrinal underpinning.

reprimand, compensation adjustment, demotion, or delayed promotion. This resolution probably entails the release of all claims, whatever the underlying legal theory. Second, until January 1, 2004, the Delaware Chancery Court did not have personal jurisdiction over officers as such.²⁹⁶ Accordingly, legal action against officers who were not also directors could not—absent other jurisdictional means—be brought in the Chancery Court. Third, lawyers for shareholders, and perhaps lawyers for boards of directors, simply may not appreciate the distinctive fiduciary obligations owed by officers to the corporation as agents, obligations existing in addition to those created expressly by contract. Fourth, the overly “cozy” relationship between boards of directors and senior officers that has been the subject of much recent criticism may result in a corporate culture where directors do not regard officers as persons owing high fiduciary duties to the corporation. Instead, they may feel indebted to the officer or believe it is their responsibility to support senior officers. Indeed, they may still regard those officers, especially a Chief Executive Officer, as “the boss,”²⁹⁷ rather than, as is the case legally, an agent owing fiduciary responsibility to the corporation, whose institutional interests the directors are under their own distinct fiduciary duty to protect.²⁹⁸

296. DEL. CODE ANN. tit. 10, § 3114 (2003).

297. As Daniel Kleinberger puts it, “the agent may be the ‘star’ and the principal merely the supporting context. Consider, for example, Itzhak Perlman serving for a season as first violinist of a metropolitan orchestra or Barry Bonds playing baseball for the San Francisco Giants.” KLEINBERGER, *supra* note 290, at 17 n.2. To those names could be added the names of many high-profile, assertive corporate CEOs.

298. Vice Chancellor Strine, addressing a different legal issue, recently described more generally how the social dynamic for corporate directors may inhibit them from fully discharging their responsibilities:

Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are “just not done,” or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume—absent some proof of the point—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.

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

IV. THE INTERPLAY OF SARBANES-OXLEY AND STATE FIDUCIARY DUTY LAW

Sarbanes-Oxley's mandates do not represent a systematic approach to corporate governance. Rather, they operate in a piecemeal fashion on a wide variety of subjects, sometimes aiming at the board of director level and sometimes centering on senior officers. The new federal rules largely accept as given state law's structural allocation of decision-making responsibility within corporations. That is to say, Sarbanes-Oxley does not dramatically revise the traditional spheres of responsibility as between shareholders, directors, and officers. In certain areas, however, as described in Part II, Sarbanes-Oxley specifies both structural change within these spheres and alters the way boards and officers must operate. We begin by identifying how those particular federal mandates described in Part II bear specifically on director fiduciary duties. We then turn to how officer fiduciary duties might be altered by the new federal rules. Before doing so, however, we offer a few observations on the key constitutional issue raised by Sarbanes-Oxley in relation to state corporate law, the issue of preemption.

Congress, of course, has the power to preempt state law.²⁹⁹ Even without express preemption, state law must yield where Congress intends federal law to "occupy the field" and where state law conflicts with federal law.³⁰⁰ Such conflict will be found where it is impossible to comply with both state and federal law,³⁰¹ and where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."³⁰²

There is no constitutional reason why state corporate law, including judge-made law pertaining to fiduciary duties, as well as corporate statutes,³⁰³ could not be preempted. Congress did not do so expressly in Sarbanes-Oxley. Commentators, however, have raised the issue of whether Sarbanes-Oxley impliedly preempts

299. *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372 (2000).

300. *Id.*

301. *Id.* See *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963).

302. *Crosby*, 530 U.S. at 373. See also *Hines v. Davidowitz*, 312 U.S. 52, 66-67 (1941).

303. See Lyman Johnson & David Millon, *Does the Williams Act Preempt State Common Law in Hostile Takeovers?*, 16 SEC. REG. L.J. 339, 349-52 (1989) (arguing that the issue of federal law preemption of state corporate law must address state judge-made law as well as state corporate statutes).

certain aspects of state corporate law.³⁰⁴ Professors Thompson and Sale argue that Sarbanes-Oxley imposes a new *federal* fiduciary duty of care,³⁰⁵ while Chief Justice Veasey worries that Sarbanes-Oxley and SEC rules “may trump Delaware fiduciary law.”³⁰⁶

We do not address the preemptive effect of all of Sarbanes-Oxley’s provisions, only certain of those identified in Part II as having special significance for the state law of fiduciary duties. In general, we see Sarbanes-Oxley as having only limited preemptive effect, though it will have considerable influence on state law fiduciary analysis. The Supreme Court has set a high standard for preemption of a common law principle, such as judge-made fiduciary duty standards: “In order to abrogate a common-law principle, the [federal] statute must ‘speak directly’ to the question addressed by the common law.”³⁰⁷ We see no congressional intent to “occupy the field” and only a few instances where it is impossible to comply with both federal and state law or where state law stands as an obstacle to federal law purposes. As to the governance mandates of the NYSE and Nasdaq listing standards, courts view listing standards as a private contract between the listed company and the exchange, and hold that shareholders have no rights under them.³⁰⁸ As such, the rules do not displace state fiduciary standards. Consequently, fiduciary duty will largely remain a state law and not a federal law matter.

A. *Sarbanes-Oxley and Director Duties*

1. *Duty of Loyalty*

Section 402 of Sarbanes-Oxley wholly preempts portions of state law governing loans to directors and senior officers of

304. See, e.g., Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer and Accountant Behavior*, 76 ST. JOHN’S L. REV. 897, 938 (2002); Bainbridge, *supra* note 8.

305. Thompson & Sale, *supra* note 8, at 877-78. Professors Thompson and Sale do not address the preemptive effect, if any, of this new federal duty on existing state law duties. As will be seen, we reject the position of Professors Thompson and Sale. See *infra* note 369 and accompanying text.

306. *State-Federal Tension*, *supra* note 228, at 443.

307. *United States v. Texas*, 507 U.S. 529, 534 (1993) (citations omitted); *United States v. Bestfoods*, 524 U.S. 51, 63 (1998) (citing *id.*). See *Burks v. Lasker*, 441 U.S. 471, 478 (1979).

308. See John F. Olson, *How to Really Make Audit Committees More Effective*, 54 BUS. LAW. 1097, 1100 n.15 (1999) (collecting cases).

reporting companies, and partially preempts state law dealing with compensation of the chief executive officer and the chief financial officer. Sarbanes-Oxley also is likely to be highly influential in causing a rethinking of state law's definition of an "independent" director, an issue that pervades state fiduciary duty law.

Delaware's statute, like many corporate statutes, permits a corporation to loan money to officers and employees, including those who are directors of the corporation.³⁰⁹ Loans to officers, or to officer-directors, raise a conflict of interest issue and, accordingly, courts insist that such transactions be handled in a way that complies with the borrower's duty of loyalty.³¹⁰ This may be done by the borrower proving, if the transaction later is challenged, that the loan is "fair" to the company. Alternatively, the borrower may make full disclosure of the material facts and seek approval of the transaction by disinterested and independent directors or shareholders.³¹¹ Directors approving the loan are required to act in good faith and with due care. Section 402 of Sarbanes-Oxley, by flatly forbidding loans to directors and executive officers, supplants this aspect of the state law duty of loyalty with respect to directors and executive officers.³¹² Because state law conflicts with the federal law prohibition, it is preempted. State law, however, remains applicable for loans to non-executive officers and employees.

As to setting the amount and terms of officer compensation, state law confers this responsibility on directors. State law also regulates this—albeit loosely—under fiduciary duty law. For the officer, whether or not she also is a director, compensation raises a loyalty issue inasmuch as corporate funds are being transferred to a fiduciary. Directors making the compensation decision are required to act in good faith, with due care, and to avoid corporate waste,³¹³ a standard thought hard to fail until Chancellor Chandler's recent Disney decision reinvigorated the good faith

309. DEL. CODE ANN. tit. 8, § 143. Until the 1970s, most corporate statutes restricted or prohibited such loans. See Jayne W. Bernard, *Corporate Loans to Directors and Officers: Every Business Now a Bank*, 1988 WIS. L. REV. 237 (1988).

310. DEL. CODE ANN. tit. 8, § 144; AM. LAW INST., 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 5.02 at 212 (1992).

311. *Id.* See also *Cooke v. Oolie*, No. Civ. A. 11134, 2000 WL710199, at *11 (Del. Ch. 2000) (implying that where self-dealing transactions are approved by independent, disinterested directors, the business judgment rule is the proper standard of review).

312. See *supra* notes 140-41 and accompanying text.

313. See *Supnick v. Goizueta*, 698 A.2d 384 (Del. Ch. 1997).

component in the compensation setting.³¹⁴ Section 304 of Sarbanes-Oxley partially preempts both the directors' role in compensation and the applicability of state law fiduciary standards for specified compensation of the chief executive officer and the chief financial officer, in the event a reporting company prepares an accounting restatement as a result of material noncompliance with financial reporting requirements due to misconduct.³¹⁵ Under section 304, the officers must reimburse certain compensation. The misconduct need not be that of the incumbent officer(s), but could be that of a predecessor. The enforcement mechanism is unclear. The Supreme Court clearly disfavors implied causes of action,³¹⁶ but the statute, by imposing an obligation on these officers, may contemplate a correlative right in the corporation to sue and collect. Arguably, state law may include the reimbursement obligation within an expanded duty of loyalty embracing the gist of section 304, thereby granting the corporation a cause of action to collect the money owed. The problem with this conceptual approach is that either or both of the two officers may have done nothing wrong. Consequently, only where an incumbent officer has engaged in some misconduct can he or she be said to have violated a fiduciary duty. As to innocent officers, section 304 imposes strict liability.

Sarbanes-Oxley does not regulate or prohibit compensation of other officers. Nor does it regulate or prohibit any compensation of the CEO and CFO other than that specified. Partial preemption of state law as to director responsibility for officer compensation and as to the remunerative consequences of an accounting misstatement is the result.

In regulating "independent" directors, Sarbanes-Oxley, the NYSE and the Nasdaq, consistent with their rules-based approach, provide more detailed definitions of "independence" than does the state law standard. State law essentially defines an independent director as one who is not under the domination or control of an interested party,³¹⁷ or is not financially or personally " beholden " to

314. See *supra* notes 260-62 and accompanying text.

315. See *supra* notes 161-63 and accompanying text. The new NYSE and Nasdaq listing standards requiring a stockholder vote on equity compensation plans also displace directors as sole decisionmakers on compensation. See *supra* notes 195-210 and accompanying text.

316. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

317. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 & n.19 (Del. Ch.

an interested party.³¹⁸ The independence inquiry arises in numerous settings, including, for example, in the judicial review of a special litigation committee's handling of derivative litigation,³¹⁹ and in the review of a board's or committee's approval of a transaction with another director.³²⁰ A court will more deferentially review director decisions in those settings if the majority of acting directors are disinterested and "independent."³²¹

The more detailed, rules-based definitions adopted by the NYSE and Nasdaq certainly govern as to the *composition* of the board itself and the audit, compensation, and nominating/governance committees, about which state law says little. They do not, however, preempt state *fiduciary* standards of independence. Section 301 of Sarbanes-Oxley only addresses independence of the audit committee, not the board itself or any board committees. The NYSE rules, moreover, specifically state that they tighten the definition of "independent director" for purposes of these standards.³²² There is no expressed aim to displace state fiduciary standards.

Moreover, the focus of NYSE and Nasdaq definitions is to assure that there is no improper relationship of directors to the company. Senior management greatly influences financial relationships with the company and, consequently, any director with such a material relationship may be influenced by senior management. Delaware's inquiry pointedly focuses on whether a director is independent of the "interested party" who has a conflict. One way a director might not be independent is through a direct or indirect (such as familial) relationship with the company, but it may happen in other ways as well. For example, a director of a company about to engage in a transaction with the director's best friend—whether or not the best friend also is a director—does not automatically disqualify the director from being considered "independent" under NYSE and Nasdaq rules, because he has no

1998).

318. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938-39 (Del. Ch. 2003).

319. *Id.* See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

320. See, e.g., *Cooke v. Oolie*, No. Civ. A. 11134, 2000 WL710199 (Del. Ch. May 24, 2000).

321. *Id.* See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917.

322. See also ROBERT TODD LANG et al., SPECIAL STUDY ON MARKET STRUCTURE, LISTING STANDARDS AND CORPORATE GOVERNANCE, 57 BUS. LAW. 1487, 1514 (stating that governance standards "do not impact the overall preeminence of state corporation law").

improper relationship to the company. The director may not be independent under Delaware law, however, which looks at “beholdenness” growing out of not only financial but also “personal or other relationships” with the interested party.³²³ State law standards that are more fluid on the issue of independence should not be considered to be preempted in the fiduciary duty context. There simply is no expressed intention for federal law or self-regulatory organization rules to “occupy the field” in this area, nor is it the case that it is impossible to comply with both federal and state law on this subject or that state law stands as an obstacle to the accomplishment of federal purposes. There now is, to be sure, dual regulation of directors, but that does not mean, for fiduciary duty purposes, that states are foreclosed from applying their own standards of independence.

Nonetheless, to the extent federal, NYSE, and Nasdaq definitions are stricter than, or at least as strict as, state law standards, directors who satisfy them will satisfy state law requirements. Moreover, those definitions may lead state court judges to regard them as highly influential for state fiduciary analysis, perhaps even incorporating them—possibly as nonexclusive “safe harbors”—into state law understandings of “independence.”³²⁴ State law is not required to do so, however, and state law may consider a director to lack independence even if he or she fulfills NYSE and Nasdaq requirements. Consequently, though lacking preemptive force, the new definitions may be highly influential for state fiduciary analysis.

Finally, the Nasdaq proposal that a company’s audit committee or other independent board committee must approve all related-party transactions technically does not preempt the state law duty of loyalty governing such transactions³²⁵—because a state may

323. *In re Oracle Corp. Derivative Litig.*, 824 A.2d at 938-39. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 984 (Del. Ch. 2003) (“[W]ith a bit more detail about the ‘relationships,’ ‘friendships,’ and ‘interconnections’ among Stewart and the other defendants . . . there may have been a reasonable doubt as to one or all of the outside directors’ disinterestedness, independence, or ability to consider and respond to demand free from improper extraneous influences.”).

324. Chancellor Chandler and Vice Chancellor Strine also have suggested that investors might argue that “Delaware’s common law ought to embrace the substance of a feature of the Reforms (e.g., the Reforms’ definition of independent director . . .).” Chandler and Strine, *supra* note 224, at 986.

325. *See supra* text accompanying notes 211-15, 250. *See also supra* text accompanying note 124 (discussing Nasdaq Rule 4350(h)).

adhere to its own standards for fiduciary duty purposes—but it will likely have that practical effect in substantial part. Currently, under Delaware law,³²⁶ a director conflict-of-interest transaction may be substantially immunized from attack on loyalty grounds either by taking, usually in advance, certain procedural safeguards—such as making full disclosure of all material facts and obtaining independent and disinterested director approval³²⁷ or stockholder ratification—or by the interested party later proving the entire fairness of the transaction to the corporation. Under the Nasdaq rule, pre-approval is mandatory. If done properly, this procedure also will lead to more deferential judicial review for state law fiduciary duty purposes. Specifically, such pre-approved transactions with directors will be reviewed under the business judgment rule, not the stricter “entire fairness” standard.³²⁸ Nonetheless, if for some reason the mandatory Nasdaq procedures were not followed, state fiduciary duty law would still allow the director to prove the “fairness” of the transaction to the company for purposes of determining compliance with state fiduciary standards. Moreover, the Nasdaq rule only governs “transactions.” Consequently, director or officer actions such as usurping a corporate opportunity, competing with the company, or improperly using corporate assets and information—all of which also implicate the duty of loyalty—will continue to be governed, in law and practice, only by state law fiduciary standards.

2. *Duties of Care and Good Faith*

As noted in Part II of this article, Sarbanes-Oxley and SRO rules impose certain direct responsibilities on those directors who are members of a company’s audit committee³²⁹ and mandate identification of any financial expert on the audit committee.³³⁰ SEC rules under section 404 of Sarbanes-Oxley define “internal control over financial reporting” as a process for providing “reasonable assurance regarding the reliability of financial reporting,” requiring such a process to be “effected by the registrant’s board of directors” after being designed by the CEO

326. DEL. CODE ANN. tit. 8, § 144 (2003).

327. *Cooke v. Oolie*, No. Civ. A. 11134, 2000 WL 710199, at *13 (Del. Ch. May 24, 2000).

328. *Id.*

329. *See supra* notes 31-46, 60-76, 114-24 and accompanying text.

330. *See supra* notes 129-37 and accompanying text.

and CFO.³³¹ These new federal responsibilities, and others, may influence analysis of the fiduciary duties of care and good faith. They may be included within those substantive director functions that must be discharged with due care and good faith, under state fiduciary duty law. For example, the new NYSE rules require the nominating/governance committee to have a charter that addresses that committee's responsibility, among other matters, to "develop and recommend to the board a set of corporate governance principles to the corporation; oversee the evaluation of the board and management."³³² Those are significant committee functions and must be discharged in accordance with state fiduciary standards.

More specifically, the "reasonableness" standard for internal controls is a higher standard than that adopted in the common reading of *Caremark*,³³³ although that opinion is replete with references to "reasonableness."³³⁴ The fact that public company directors must, as a matter of federal law, adopt "reasonable" controls does not necessarily displace the due care fiduciary standard of state law. Nonetheless, faced with a claim that a Delaware company failed to comply with the mandates of Sarbanes-Oxley on internal controls, Delaware courts, especially when reminded of the several references to "reasonableness" in *Caremark* itself,³³⁵ may be hard-pressed, in the right case, not to draw on federal mandates as the applicable state law fiduciary standard in the monitoring context. Essentially, depending on the reading given the term "reasonable," this would amount to a negligence standard, though state courts could require greater culpability. Moreover, recent case law indicates that deliberate or reckless failure in, or indifference toward, discharging director functions in this area may be construed as a breach of good faith,³³⁶ as would any significant deviations from oversight conduct thought essential if directors truly were motivated to advance corporate interests, the hallmark of good faith.³³⁷ As noted in Part III, recent judicial

331. See *supra* notes 168-72 and accompanying text.

332. See *supra* note 58 and accompanying text.

333. See *supra* notes 237-40 and accompanying text.

334. See *supra* notes 244-46 and accompanying text.

335. See *supra* notes 244-46 and accompanying text.

336. See *supra* notes 262-73 and accompanying text.

337. This is the key point made by Chief Justice Veasey and Vice Chancellor Strine in their discussions of good faith. See *supra* text and accompanying notes 252-57.

developments and judicial commentary indicate a growing sympathy for shareholders' assertions that director misconduct implicates the duty of good faith.³³⁸ Consequently, even if courts do not modify their due care analysis under the influence of federal law, they may regard more egregious director deviations from federal and SRO mandates as breaching the duty of good faith. Recall too that any knowing director failure to comply with the requirements of Sarbanes-Oxley may violate the duty of good faith.³³⁹ In this way, state fiduciary analysis would be influenced by federal initiatives, but not controlled by them. This is significant from a liability perspective as well, because breach of good faith, unlike breach of due care, allows a judgment for money damages against directors.

One question that will arise in the monitoring area will be whether all directors or only members of the audit committee face liability for oversight lapses associated with faulty internal controls. Section 301 of Sarbanes-Oxley places direct statutory responsibilities on the audit committee, thereby appearing to override statutes such as § 8.25(d) of the Model Business Corporation Act,³⁴⁰ which makes the empowerment of committees a board function. That federal section also states, however, that the specified responsibilities are reposed in the audit committee "as a committee of the board of directors"³⁴¹ and section 205 defines the audit committee as a committee "established by and amongst the board of directors."³⁴² This language appears to be designed to honor the state law-ordained board and committee structure. Although Delaware does not have such a statute, § 8.25(f) of the Model Business Corporation Act makes clear that delegation of authority to, or action by, a committee of the board does not alone constitute compliance with a director's duty of care.³⁴³ Thus,

338. See *supra* notes 252-57, 263-73 and accompanying text.

339. See *supra* notes 273-76 and accompanying text.

340. Model Bus. Corp. Act § 8.25(d) (1998). "To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01." *Id.*

341. Securities Exchange Act of 1934 § 10(m). See *supra* text accompanying note 33. See also *supra* text accompanying note 125 (discussing the SEC adoption of rules under section 407 in connection with the financial expert on the audit committee).

342. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 205, 116 Stat. 745 (2002).

343. Model Bus. Corp. Act § 8.25(f) (1998). "The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a

directors not on the audit committee—or any of the other committees mandated by NYSE and Nasdaq rules—do not satisfy their fiduciary duties simply by delegation to that committee. They continue to have state law monitoring and oversight responsibilities. This will continue to be the case even though Sarbanes-Oxley, NYSE, and Nasdaq rules impose certain duties on the audit, compensation, and nominating/governance committees, specifically. At the same time, both the Model Act and Delaware's statute allow a director to rely on committees of the board of directors.³⁴⁴ Thus, provided the good faith and reasonableness conditions of those director reliance statutes are met,³⁴⁵ directors not on a mandated committee should not face liability for misconduct by the mandated committee, as opposed to liability for their own misconduct in relation to the activities of the audit and other mandated committees.

As to the liability standard for the audit committee financial expert, the SEC adopting release states that it does not contemplate greater liability under federal or state law for that person.³⁴⁶ Nonetheless, a director having a specialized background, qualifications, and responsibilities may find those relevant in any judicial assessment of his or her compliance with the duty of care.³⁴⁷ Moreover, alleged failures by such an expert to act in conformance with accepted standards and practices—as these continue to develop—may be open to proof by expert witness evidence on evolving customs and practices in corporate governance. Extreme departures from such standards of practice (as these develop) may also raise a good faith issue. For the non-experts on the committee, as to specialized financial matters they may be able to rely on the financial expert under director reliance statutes,³⁴⁸ although those state law provisions are in some tension with section 301, which confers responsibility on the committee itself. Still, the language describing the audit committee as a “committee . . . [of]

director with the standards of conduct described in section 8.30.” *Id.*

344. See Model Business Corporation Act § 8.30(e); DEL. CODE ANN. tit. 8 § 141(e) (2003).

345. See *supra* note 275 and accompanying text.

346. See *supra* note 132.

347. Model Bus. Corp. Act § 8.30 cmt. 2 (2002) (stating “the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director’s compliance with the standard of care”). This language may apply to members of the audit committee and other mandated committees as well.

348. See *supra* note 275 and accompanying text.

the board . . .” suggests a federal intention to honor state law governing the committee/board relationship.³⁴⁹

Other provisions of Sarbanes-Oxley and related rulemaking—for example, the NYSE and Nasdaq requirements that independent directors meet in regularly scheduled sessions³⁵⁰ and that boards determine whether a particular director is truly “independent,”³⁵¹ and the provision requiring specific codes of ethics and charters—³⁵² require a great deal of interpretation and judgment by the board. Although disclosure may discharge some of the board’s duties in connection with these provisions, generally the board’s determinations with respect to such provisions must be done in accordance with the requirements of state fiduciary duty law.

B. *Sarbanes-Oxley and Officer Duties*

Renewed legal and social attention is being focused on senior corporate officers. The Sarbanes-Oxley mandate for more “independent” directors, coupled with far-reaching SRO rules on independence, will mean fewer corporate officers on corporate boards. Misconduct by such officers will not lend itself to redress by invoking director duties. Only duties attaching to a person in his or her distinct capacity as an officer will support a claim. Much of the recent corporate wrongdoing involves senior officers,³⁵³ many of whom—Andrew Fastow at Enron being a notable example—were not members of the board. The Securities and Exchange Commission has brought several administrative proceedings against corporate officers,³⁵⁴ and federal and state prosecutors have brought criminal charges as well.³⁵⁵ As noted in Part II, Sarbanes-Oxley places significant new responsibilities directly on senior officers. Two responsibilities are especially

349. See Sarbanes-Oxley Act of 2002, Pub. L. No. 170-204, § 205, 116 Stat. 745 (2002) (adding Securities Exchange Act of 1934, *supra* note 3, at § 3(a)(58)) (to be codified at 15 U.S.C. § 78c) (defining the audit committee as a committee “established by and amongst the board” and providing that if no committee is designated, then the entire board serves as the committee).

350. See *supra* text accompanying notes 55-56, 105-106.

351. See *supra* text accompanying notes 47-48, 95-97.

352. See *supra* note 178 and accompanying text.

353. *Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1 (detailing criminal charges and investigations against various corporate officers). See also Robert W. Hamilton, *The Crisis in Corporate Governance 2002 Style*, 40 HOUSTON L. REV. 3, 19-34 (2003) (recounting wrongdoing at several companies).

354. *Id.*

355. *Id.*

important for fiduciary duty analysis. First, under SEC rules adopted pursuant to section 302 of Sarbanes-Oxley, the CEO and CFO must certify quarterly and annual reports.³⁵⁶ The responsible officers must certify, among other matters, that internal controls have been designed to ensure that material information is made known to such officers and that they have evaluated the effectiveness of the company's internal controls. Second, the CEO and CFO, under SEC rules adopted pursuant to section 404, must make annual certifications as to their responsibility for establishing, maintaining, and evaluating the effectiveness of internal controls over financial reporting.³⁵⁷ The controls must provide "reasonable assurance regarding the reliability of the company's financial reporting and the preparation of financial statements."³⁵⁸ These two provisions, in effect, require the chief executive officer and chief financial officer to set up an extensive "reporting up" information chain within the company. Because the CEO and CFO cannot possibly review every transaction made by a company, the requirements force the chief executive officer and chief financial officer to develop a reliable information system and trust that the system's policies and procedures are carried out effectively by their subordinates. This focus on internal affairs was clearly the intent of Congress and the SEC.³⁵⁹

The responsibilities assigned by Sarbanes-Oxley might be regarded as building on the state law-ordained governance arrangement whereby senior officers are expressly or impliedly authorized by boards of directors, via delegation, to manage significant aspects of a corporation's business and affairs, including the design and maintenance of its financial reporting and internal controls systems. In this understanding of Sarbanes-Oxley, federal law defers to the decisionmaking *structure* of state corporate law in maintaining the central place of the board, while enhancing the *responsibilities* of officers. Alternatively, Sarbanes-Oxley may be thought to remove traditional board responsibility for those matters under state law and impose direct federal responsibility on senior officers. The new definition of "internal controls over financial reporting" adopted by SEC Rule makes this latter interpretation—which would represent a dramatic change in the

356. See *supra* notes 149-58 and accompanying text.

357. See *supra* notes 163-72 and accompanying text.

358. See *supra* notes 170-71 and accompanying text.

359. See *supra* notes 147-50 and accompanying text.

basic architecture of corporate governance—less likely by stating that responsible officer actions are to be “effected” by the board of directors, as well as by management.³⁶⁰

These new, federally mandated responsibilities are legally significant, especially as they emphasize the important role and functions of senior officers in corporate governance. Although Sarbanes-Oxley mandates new responsibilities, there is no evidence of an intention to “federalize” fiduciary duty law. Moreover, as noted earlier, the Supreme Court is extremely unwilling to preempt state common law principles or to imply private causes of action,³⁶¹ especially in the corporate law area.³⁶² Consequently, the new officer functions mandated by Sarbanes-Oxley have, in effect, statutorily increased the *scope* of managerial responsibilities owed by senior officers, but their fiduciary status as agents still exists by virtue of *state law*.³⁶³ These enhanced responsibilities must be properly discharged by officers as part of the fiduciary obligations owed to the corporate principal itself. Breach of these duties creates exposure to the grant of equitable relief and liability for resulting monetary losses incurred by the corporation.³⁶⁴ In this way, unlike the case under Sarbanes-Oxley, which conferred few private causes of action,³⁶⁵ the corporation and stockholders may have redress against officers who engage in wrongdoing.

360. See *supra* notes 170-73 and accompanying text. The text of the SEC’s new definition includes a footnote reference also making clear the central role of the board of directors. See the Section 404 Release, *supra* note 161.

361. See *supra* notes 307, 316 and accompanying text. See also *supra* note 14 and accompanying text (describing the Fair Funds provision of section 308(a)).

362. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987).

363. We reject the thesis recently advanced by Professors Robert Thompson and Hillary Sale, *supra* note 8, that state law says little about the fiduciary duties of officers and that Sarbanes-Oxley—not state law—imposes a duty of care on officers. We agree that state law has been surprisingly unclear as to the conceptual footing for the officers’ fiduciary duties, see *supra* notes 291-95 and accompanying text, but we disagree that state law does not address officer fiduciary duties because, in fact, it does so through well-established agency principles. See Johnson & Millon, *supra* note 295. Consequently, state law, not federal law, creates the fiduciary status of officers. Federal law, through Sarbanes-Oxley, increases officer responsibilities, which enrich the range of conduct for which officers serve as state law fiduciaries for the corporation. We also disagree with Professor Larry Cata Backer’s assertion that federal law “overrides” state law on the duty of care, including the exculpation provisions of state statutes like Delaware’s section 102(b)(7). These provisions govern directors, not officers. Backer, *supra* note 304, at 938.

364. See *supra* note 279 and accompanying text.

365. See *supra* note 14 and accompanying text.

Again, although these provisions codify certain obligations and activities of the officers, the provisions leave the details—the “how”—to the officers. The manner in which the officers conduct the required activities, and the standard by which they will be judged as fiduciaries, will largely be supplied by state law.

As argued in Part III, we believe the whole area of officer fiduciary duties lacks a conceptual or doctrinal foundation. We believe that agency law, sensibly applied,³⁶⁶ can provide that foundation.³⁶⁷ Also, agency law serves as a coherent way to translate Sarbanes-Oxley’s mandates for corporate officers into fiduciary duty nomenclature. The heightened responsibilities imposed on senior officers by Sarbanes-Oxley may best be characterized, in traditional terms, as forming part of the agent’s duty of due care. The officer certifications required under SEC rules adopted pursuant to sections 302 and 404 of Sarbanes-Oxley involve “care-like” monitoring responsibilities. For example, under section 302, certifying officers must state that they are responsible for establishing and maintaining internal controls,³⁶⁸ and that the controls will “ensure” that material information is made known to such officers, among other qualitative matters.³⁶⁹ Evaluation of compliance with these standards invites a care-like inquiry.

The fiduciary duty of care includes a wide range of functions. For example, as stated in comment b to § 379 of the Restatement (2d) of Agency, in describing an agent’s duty of care: “The negligence for which an agent is subject to liability to the principal may consist of misconduct in negotiations with third persons, of conduct causing harm to the principal’s tangible things in his custody, or of conduct causing the principal to be subject to liability for a tort, crime, or breach of contract.”³⁷⁰ Clearly, Sarbanes-Oxley deliberately broadened the governance functions associated with senior officers. As a result, the range of inquiry for determining compliance of these officers with their fiduciary duty of care under state law has correspondingly broadened as well.

Alternatively, the new Sarbanes-Oxley obligations might be

366. For an argument that agency law principles should be applied to internal corporate governance only with discernment and justification, see Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 72 *CIN. L. REV.* 1187 (2003).

367. See Johnson & Millon, *supra* note 295.

368. See *supra* note 153 and accompanying text.

369. *Id.*

370. RESTATEMENT (SECOND) OF AGENCY § 379 cmt. b (1958).

regarded as part of the agent's duty to act within authority and to obey instructions, particularly given that boards now will likely consider officer compliance with Sarbanes-Oxley to be part of an officer's express or implicit management responsibilities.³⁷¹ Deliberate or reckless disregard of these responsibilities may also constitute a breach of good faith.³⁷² These federal obligations might even be considered a component of the agent's duty of loyalty, which demands that officers act for the benefit of their principal.³⁷³ It benefits a corporation if its senior officers fully and properly discharge the obligations mandated by a federal statute such as Sarbanes-Oxley. In short, courts serious about bringing fiduciary duty "bite" to the new focus on corporate officers have an array of state law theories for doing so.

Significantly, the standard of care for an agent is usually a standard of ordinary care.³⁷⁴ Thus, simple negligence is a breach of duty. This stands in contrast to the looser standard of gross negligence for directors, at least in the decisionmaking context.³⁷⁵ Moreover, the exculpation provisions of Delaware's section 102(b)(7) do not apply to officers, but only to directors.³⁷⁶ Thus, unlike the case with claims against directors, a due care claim against officers may still result in an award of money damages for simple negligence. This, coupled with a 2003 change in Delaware's law to provide for personal jurisdiction over corporate officers³⁷⁷ and heightened officer responsibilities under Sarbanes-Oxley, may lead to renewed attention to the liability of corporate officers in their capacity as agents owing fiduciary duties to the corporation. Heightened exposure to potential *state* law liability for officers

371. Moreover, directors likely have, as part of their expanded duty of care, a responsibility to monitor officers' discharge of officer responsibilities under Sarbanes-Oxley.

372. See *In re The Walt Disney Co Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

373. RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

374. RESTATEMENT (SECOND) OF AGENCY § 379 (1958).

375. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

376. DEL. CODE ANN. tit. 8, § 102(b)(7). See also *Pereira v. Cogan*, 294 B.R. 449, 534 (S.D.N.Y. 2003) ("The Exculpatory clause in any case would not provide protection for officers for any breach of fiduciary duty.") Some states, however, do include officers within the coverage of their corporate exculpation statutes. See SPARKS & HAMERMESH, *supra* note 291, at 229 n.90. In those states not providing officer exculpation by statute, officer employment agreements must cover the subject, as constrained by agency law's proscriptions on negating fiduciary duty altogether.

377. DEL. CODE ANN. tit. 10, § 3114.

seems consistent with Sarbanes-Oxley's effort to increase officer responsibilities in corporate governance as a matter of *federal law*. It also seems fitting given the central role in corporate affairs played by senior officers and given that corporate officers engaged in much of the corporate misconduct inspiring Sarbanes-Oxley.³⁷⁸ Thus, although federal rules now partially regulate officer conduct, it will remain the province of state fiduciary duty law to provide to the corporation and its stockholders a remedy for officer wrongdoing.

Characterizing the wrongdoing of an officer (or director) as a breach of the agent's state law fiduciary duty also carries implications for indemnification. Indemnification for federal securities law wrongdoing is thought to violate public policy,³⁷⁹ under both the Securities Act of 1933,³⁸⁰ and the Securities Exchange Act of 1934.³⁸¹ If officer or director wrongdoing in the fiduciary duty context is considered a violation of state law—albeit state law enriched by federal responsibilities—rather than federal securities law, the federal prohibition on indemnification falls away.

Characterizing officer misconduct as a breach of an agent's fiduciary duty carries consequences for lawyers under Sarbanes-Oxley as well. Section 307 directs the SEC to promulgate "rules . . . setting forth minimum standards of professional conduct for attorneys . . . 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 . . ." ³⁸² The rules adopted by the SEC on January 29, 2003 elaborate on this attorney obligation.³⁸³ The rules create a duty to report evidence of an officer's, director's, or agent's "material violation,"³⁸⁴ which is defined to include a material "breach of fiduciary duty."³⁸⁵ This latter term is defined to refer to any breach of fiduciary duty recognized under federal or state statute or common law.³⁸⁶ In short, lawyers must report "up the corporate

378. See *Executives at Trial: Scandal Scorecard*, WALL ST. J., Oct. 3, 2003, at B1.

379. See Item 510 of Regulation S-K.

380. *Globus v. Law Research Serv., Inc.*, 418 F. 2d 1276, 1288 (2d Cir. 1969).

381. *King v. Gibbs*, 876 F. 2d 1275, 1282-83 (7th Cir. 1989).

382. 15 U.S.C. § 7245.

383. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8185, (January 29, 2003).

384. *Id.*

385. *Id.*

386. *Id.*

ladder” evidence of fiduciary duty breaches by corporate directors and officers. State law understanding of officer fiduciary duty is somewhat amorphous and undeveloped, as seen in Part III,³⁸⁷ unless conceptualized as implicating the several fiduciary duties associated with agency status. Understanding senior corporate officers as agents means a lawyer—to fulfill his or her responsibilities under Sarbanes-Oxley—must “report up” officer misconduct amounting to breach of any of the agent’s several fiduciary duties.³⁸⁸ Moreover, recalling that lawyers themselves are agents—whether serving as employees of the company, such as general counsel, or as outside counsel—means they too have fiduciary duties, the breach of which, apparently, creates a (self) “reporting up” obligation under the new rules.

V. CONCLUSION

Undoubtedly, Sarbanes-Oxley will have a profound impact on officers and directors. As federal law, where Sarbanes-Oxley speaks affirmatively, officers and directors, and more importantly federal and state courts, must give effect to its provisions. However, as we have argued, Sarbanes-Oxley does not explicitly preempt all state-imposed fiduciary duty concepts, nor are its provisions so far-reaching as to implicitly preempt such concepts. Rather, Sarbanes-Oxley contains very targeted provisions that are aimed at certain actions of officers and directors and which, in selected areas, preempt state fiduciary duty law. Beyond that, compliance with many of the provisions of Sarbanes-Oxley must be interpreted in the light of some standard. In those many cases in which Sarbanes-Oxley does not itself provide the standard, then existing state law concepts will almost certainly provide the conceptual framework. In other words, state fiduciary duty concepts will need to incorporate Sarbanes-Oxley, but will not be preempted by Sarbanes-Oxley.

387. See *supra* notes 291-95 and accompanying text.

388. See *supra* notes 281-92 and accompanying text.