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The YIN & YANG Of Corporate Governance

In the post-Enron era, companies search for the right balance.

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BEING IN FAVOR of corporate governance is somewhat akin to being in favor of Mom, apple pie and the flag. Either everyone is for it, or those few who are not are demonstrably subject to being characterized as misfits, traitors or worse. But what does the elastic, amorphous phrase "corporate governance" mean? And has in fact this concept been a shifting target, with its meaning and application in the post-Enron era being fixed only with hindsight judgments and justifications?

This article will focus on three recent developments in corporate governance and attempt to delineate whether the trend lines bode well or ill for the investing public, directors, corporate managers and (our primary concern) lawyers.

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Hidden and not so Hidden Costs

Whether we like it or not, Sarbanes-Oxley has been the law of the land for three years now, and we can start to reflect on whether the requirements of more independent directors, CEOs and CFOs certifying financials, etc. have prevented and are preventing future Enrons. Many critics of the law have focused upon Section 404 as the "poster child" of over-regulation. That provision requires public companies to demonstrate on an ongoing basis that they have sufficient internal controls to prevent fraud.

What's wrong with this? As a basic premise, nothing. (After all, who is "pro" fraud?) But there are downsides. The first is the up-front costs to date, which have been conservatively estimated at $35 billion (and that number does not reflect outlays of time and lost opportunity costs). The second is the burden on smaller public companies, as well as the impact upon those private companies that are thinking of going public; related to that is the effect (real and imagined) on foreign companies, which either are thinking of delisting or, for those not currently listed, are rethinking coming to the U.S. capital markets.[1]

The third is whether this is truly the best (or first) line of defense against fraud. In 2004, the Association of Certified Fraud Examiners reported the following: 43 percent of business frauds in excess of $1 million were exposed by tips; 41 percent were exposed by external or internal audits; and, 8 percent were uncovered as a result of

rooting out and detecting fraud. Fourth, because of Sarbanes-Oxley's compliance hurdles (mainly imposed by Section 404), a record number of companies have this year missed filing deadlines for annual reports. One consequence of this failure is that the NASDAQ gives such companies a "Scarlett Letter" (an "E"); that letter accompanies the stock symbol, can have an obvious and serious drag on the stock's price, and (if not resolved satisfactorily) can ultimately lead to delisting.[2] Last, but not least, comes the news that a number of companies are outsourcing Sarbanes-Oxley related work offshore, to low wage countries such as India—query whether that consequence was intended by the legislative draftsmen in 2002.

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Another set of costs comes from the rise of the Audit Committee and the independent directors—a change from advisers and counselors to the CEO and senior management, to that of a sort of shadow corporate government. Audit committees and independent directors have been given immense power in this new era; commensurate with that power, however, has come hair-trigger liability (more on this later). As a result, these individuals have decided both as offensive and defensive measures to have independent staff, independent auditors and independent counsel advise them. While rational behavior, whether this is also good for the company for decision-making purposes, not to mention whether these additional and substantial costs will be helpful to a company's profitability, seem to be rhetorical questions. One thing is clear, however: With everyone needing separate counsel (including members of senior management), this trend is surely good for the legal profession![3]

The Shrinking Director Pool

The corporate train wreck involving WorldCom presents a paradigm of issues/problems facing corporate directors. Besides the fact that massive fraud happened on their (and Mr. Ebbers') watch, the board had also approved more than $400 million in loans to Mr. Ebbers, the goal of which was to help him meet margin calls on his WorldCom stock.[4] In the securities class action that followed, the directors were named as party defendants based upon their roles. That much is/was pretty standard; what came next was not. The directors settled their participation in the civil litigation, but did so by paying $24.75 million out of their own individual pockets (on top of an additional $36 million that came from WorldCom's director and officer (D&O) insurance policy).[5]

What does this (previously) unprecedented outcome tell us?[6] Well, first, that being a director is not without significant downsides. The WorldCom directors, for example, had already lost more than $250 million in the WorldCom stock they held, while having received just a teensy fraction of that in directors' fees.[7] More importantly, the loss of the prophylactic protection from D&O coverage constitutes a huge sea change, with an impact not only on the subjection of directors to money damages liability, but also on insurance companies changing D&O policies to make coverage for directors more limited. And these two "reforms" have more than just legal liability and insurance policy ramifications; they also are likely to have a significant impact upon the already shrinking pool of qualified individuals who wish to serve on corporate boards. In the words of one CEO: "The compensation hasn't gone up that much, the hours have gone up a lot and the liabilities have increased."[8] As to those directors who are currently in place, it is easy to understand why in this environment they have reflexively moved to have their own independent staff, independent auditors and independent counsel.[9]

The Judiciary Weighs In

Recent developments in the areas of due diligence and fiduciary obligations have an impact on corporate governance as well. The first such development is Judge Denise Cote's Dec. 15, 2004, decision, denying summary judgment to the WorldCom underwriter defendants.[10] In that case, the underwriters had argued that they had met their due diligence obligations (in satisfaction of Section 11 of the Securities Act of 1933) by: (i) their extensive reviews of WorldCom's registration statements; (ii) their reliance on WorldCom's audited financial statements; and (iii) their reliance on Arthur Andersen's "comfort letters" in conjunction with WorldCom's unaudited financial statements.

Judge Cote rejected these arguments, principally because she determined that the underwriters had seen numerous "red flags" and still went forward. Among the "red flags" noted were: (a) the simultaneous credit downgrade of WorldCom by the underwriters; (b) the simultaneous hedging of exposure to WorldCom undertaken by certain of the underwriters; and (c) the underwriters' then-current knowledge of the weakening position of WorldCom and the telecommunications sector generally.[11] As a result, Judge Cote ruled that there were issues of material fact for a jury to decide as to whether the underwriters should be held accountable for WorldCom's collapse.[12]

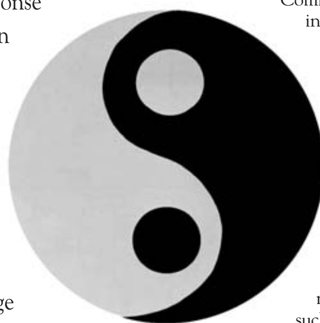
The second development comes from the New York Court of Appeals' ruling in *EBC I Inc. v. Goldman Sachs & Co.*[13] That litigation stemmed from Goldman's role in taking eToys public. Although the newly public company did well for a time, like many dot.com IPOs it eventually tanked. Angry investors sought to blame the lead managing underwriter, arguing that Goldman had a fiduciary obligation to eToys arising out of Goldman's expertise and advice regarding the pricing of the IPO, and breached that duty by allegedly concealing from eToys a purported conflict by dint of a "profit-sharing" arrangement Goldman had with its clients in the secondary market.

Goldman moved to dismiss (by which, of course, the alleged arrangement was presumed), contending that "the relationship between an issuer and underwriter is an arms-length commercial relation from which fiduciary duties may not arise." While the Court of Appeals agreed with that argument, it did so only as to the underwriting agreement itself, holding that the allegation of an "advisory relationship…independent of the underwriting agreement" (i.e., Goldman's pricing advice) could give rise to fiduciary duties. As such, the Court refused to dismiss the case.

The last development arises from the Morgan Stanley/Ronald Perelman nuclear war in the Florida state court system. At trial, Mr. Perelman received a huge financial recovery (with a very significant punitive damages component) on a jury determination that Morgan Stanley, which had represented Sunbeam in a transaction in which Mr. Perelman swapped his 82 percent stake in another company for Sunbeam stock, had failed in its due diligence vis-à-vis Sunbeam's true financial position (the company ultimately failed, to Mr. Perelman's significant detriment). Mr. Perelman's due diligence of Sunbeam was not at issue, only Morgan Stanley's, with the further issue of whether that firm had duties of disclosure to Mr. Perelman and his advisors. All of these matters were resolved against Morgan Stanley, and the case is now up on appeal.

Taken together, these three developments seem to be part of the ever-changing mosaic of post-

Enron corporate responsibilities and liabilities. Deconstructed separately, they can be picked apart, at least a bit. The Morgan Stanley case (hopefully) is sui generis, because the judge's pretrial and trial rulings made liability pretty much a foregone conclusion; at the same time, however, shifting Mr. Perelman's due diligence obligations to the other side of the deal's investment bank (and then imposing disclosure duties on that firm) seem just wrong. As to the WorldCom ruling, given the evidentiary record before Judge Cote (and WorldCom's legacy), it is easier perhaps to understand the difficulty she faced at the summary judgment stage.[14] Going forward, the underwriting world may need to develop more detailed due diligence protocols in response to this decision, so as to be in a stronger position at the dispositive stages of complex civil litigation.



With respect to the eToys decision, it just seems impossible to square the circle; notwithstanding the Court of Appeals majority's attempt (per Judge Carmen Beauchamp Ciparick) to limit its scope or impact, the ruling has the potential to have opened Pandora's Box.[15] Underwriting agreements epitomize arms-length agreements between sophisticated businessmen advised by high-priced legal talent. Putting to one side whether the allegation of Goldman's "conflict" makes sense,[16] the law of New York state appears now to be that the mere allegation of such a conflict (and/or "advisory" relationship) pushes this commercial transaction into the legal stratosphere of a fiduciary relationship—query as to what other areas this notion will be extended (real estate sales?). And with respect only to the financial services field, who can foresee what this will mean for underwriters as they attempt to delineate their obligations going forward under the federal securities laws. Although the eToys majority was sanguine on that score, I side with Judge Susan Phillips Read in her dissent, where she wrote that the majority's ruling has "introduced uncertainty into a complex subject of enormous importance to investors. [A] subject…better dealt with by specialized regulation than by the evolving common law."

Conclusion

There are many other corporate governance related issues to be addressed at some future point.[17] In the meantime, the basic question of how to motivate business people to do the right thing remains unresolved. In the last few years, Congress, prosecutors/regulators and the judiciary have all attempted to scare the heck out of corporate boards, corporate managers and (not to be left out) the lawyers who represent public companies.[18] Will those efforts achieve the promised land? This participant/observer remains skeptical.

1. Interestingly, the Securities and Exchange Commission has recently "delayed" implementing the application of Section 404 to smaller U.S. companies, as well as to foreign private issuers. While rational in one sense, such action(s) underscore the notion that headline-grabbing fraud by huge companies (like Enron) is the principal focus of the regulators. Economic fraud (and investor harm), however, come from (and in) all sizes.

2. While the New York Stock Exchange (which also has had a record number of late filers this year) does not require a "Scarlett Letter" as such upon such late filers' stock symbols, an "lf" (late filer) designation does appear in newspaper listings.

3. I have previously written about the growing tension between regulators and companies on the interrelated issues of indemnification and advancement. See, e.g., "When the Government Comes Knocking," GC New York (March 14, 2005). These issues do not appear to be going away. Just before he left his post as head of the SEC's enforcement division, Stephen Cutler spoke of companies advancing employees/officers' fees as insulating individuals from their own bad acts: "If an individual can look to his/her employer to pay the freight, what good have we done?" See J. Emshwiller & K. Scannell, "Merrill Faces Issue of Enron Legal Fees: To Pay or Not to Pay?" The Wall Street Journal, C1 (May 11, 2005). More recently, a securities regulator advanced the notion of having a federal court, as part of an enforcement division settlement, order a public company to be directed either to revoke its indemnification obligations and/or to seek reimbursement of attorney's fees advanced. Regardless of the fact that this notion would be in conflict with corporate bylaws and Delaware State Law (and would purport to have jurisdiction over a non-party to the proceeding), it shows the antipathy the government has to allowing individuals to have adequate resources to defend themselves.

4. This directorial boo-boo is perhaps only exceeded (of late) by the Enron board twice waiving corporate protocols for off-the-books partnerships, without the benefit of counsel.

5. At about the same time Enron's directors did likewise, paying $13 million out of their own pockets to settle the Enron securities class action (on top of an additional $155 million that came from Enron's D&O insurance policy).

6. There appears to have been only one prior such director out-of-pocket settlement. See M. Klausner, et al., "Outside Directors' Liability: Have WorldCom and Enron Changed the Rules?" (www.law.Stanford.edu/ publications/lawyer/issues/71/klausner.html).

7. In 1999, WorldCom directors received $35,000 annually, $1,000 per meeting and expenses.

8. A. Raghavan, "More CEOs Say 'No Thanks' to Board Seats," The Wall Street Journal, B1 (Jan. 28, 2005) (quoting comments of John Thain). See also S. McGee, "The Great American Corporate Director Hunt," Institutional Investor 32 (April 2005). Counterintuitively, a prominent securities plaintiffs' lawyer has opined that this trend "will enhance the deterrent effect of the securities laws with respect to directors' obligations." J. Glater, "A Big New Worry for Corporate Directors," The New York Times, C1 (Jan. 6, 2005) (comments of Thomas A. Dubbs). How the securities laws will be enhanced by having qualified people opt out of serving on boards for fear of personal liability is unclear.

9. And all this comes in the midst of another reform — the S.E.C.'s controversial (and currently litigated) proposal to have three-fourths of directors of mutual funds be "independent." See R. Cass and H. Manne, "SEC à la Donaldson," The Wall Street Journal, A18 (July 1, 2005). Regardless of whether this initiative makes sense (and will be upheld by the courts), where are these independent people going to come from (and who would want to be one)?

10. *In re WorldCom, Inc. Securities Litigation*, 346 F.Supp.2d 628 (S.D.N.Y. 2004).

11. Even as to audited financials, Judge Cote refused to adopt the notion that underwriters could rest assured that the auditors had gotten it right, ruling that there "is no category of information which can always be ignored by an underwriter on the grounds that it constitutes an ordinary business event. What is ordinary in one context may be sufficiently unusual in another to create a duty of investigation by a 'prudent man.'" 346 F.Supp.2d at 680. In the words of one plaintiffs' lawyer, Judge Cote's decision on this point "rejects the notion that an audit opinion is a 'get out of jail free' card for investment bankers." G. Morgenson, "Judge in WorldCom Lawsuit Sides With Plaintiffs on Issue of Due Diligence by Banks," The New York Times C1 (Dec. 16, 2004) (comments of Sean Coffey).

12. That ruling, not surprisingly, pushed those underwriters to write big checks rather than face a jury's verdict. The last settling underwriters, JPMorgan Chase, had to write the biggest check.

13. 2005 N.Y. Slip Op. 04478 (June 7, 2005).

14. At the same time, however, in hindsight after a corporate train wreck, it is a heck of a lot easier to spot red flags than it is while the corporate train is still moving down the track.

15. The Court contended that "we intend no damage" to the "general rule" that fiduciary duties do not exist between commercial parties operating at arms-length. Not surprisingly, the dissent noted the problem with such an assertion: "How may a buyer ever owe a duty of the highest trust and confidence to a seller regarding a negotiated purchase price? The interests of a buyer and seller are inevitably not the same."

16. As Judge Read's dissent makes clear, it does not.

17. For example, there is the very disturbing trend of effecting regulation by prosecution. See J. Macey, "Wall Street in Turmoil: Who Is Protecting the Investor?" 70 Brooklyn L. Rev. 117 (2004).

18. See, e.g., C.E. Stewart, "A Walk on the Wild Side: Law Enforcement and Law Practice in the Post-Enron Era," Compliance Reporter (June 21, 2004); C.E. Stewart, "Sarbanes-Oxley: Panacea or Quagmire for Securities Lawyers?" New York Law Journal (March 21, 2003); C.E. Stewart, "Liability for Securities Lawyers in the Post-Enron Era," Rev. Sec. & Comm. Reg. (Sept. 11, 2002).

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