Wyoming Law Review

Volume 6 | Number 1 Article 5

January 2006

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WYOMING LAW REVIEW

VOLUME 6 2006 NUMBER 1

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INTRODUCTION

It is both ironic and sad that federal and state attempts to deal with corporate governance problems and deception in the securities field use mechanisms based on the utilization of so-called independent persons to protect investors. The irony results from the deceptive characterization of such persons as "independent." Sadness comes from disappointment in lawmakers who blatantly misuse such terminology, from the fecklessness of laws based on it, from any waste of resources created by compliance with or administration of such laws, from any sense of security they may falsely contribute to, and for the diminution in respect for law that may result.

This article deals with the erosion of state law principles designed to protect corporations and investors, and with disappointing federal efforts, principally under Sarbanes-Oxley (SOX),[1] to mandate better corporate gov-

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ernance and safeguard corporations and investors, with principal focus on the recurring and misguided reliance upon so-called "independent" persons to achieve legal goals.

PART I: STATE LEGAL PRINCIPLES – THE EROSION OF INVESTOR PROTECTION

Significant legal principles, which seemingly protected the corporation and its shareholders from fiduciary misbehavior such as breaches of the duty of loyalty or care, have been rendered almost impotent through the deft use of sophistic formulas in state legislation and case law. The history of the legal treatment of self-dealing transactions involving corporate contracts with one or more of its directors is illustrative. That history has been recounted by commentators as follows.

Once upon a time such transactions were automatically voidable at the election of the corporation.[2] Later most courts held that support for the transaction by a disinterested majority of directors (if the interested director was not necessary for a quorum), plus a fairness determination by courts that the transaction was neither fraudulent nor unfair to the corporation, could save such transactions from voidability.[3] The importance of shareholder ratification of voidable transactions has been pointed out:

> [u]nder both of these earlier approaches, however, the rule was that voidable transactions could be validated by full disclosure to and ratification by a majority of the shareholders – at least in the absence of fraud or unfairness. Further, it was held that shareholders who had an interest adverse to the corporation in the voidable transaction with directors were not disqualified from voting on the shareholder ratification.[4]

The general rule by the mid-twentieth century would uphold the validity of a transaction even in the absence of a disinterested director majority

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grateful for the generous support of his research by Charles and Ursula Kepler and the Paul Stock Foundation. To his excellent student research assistants, Paul K. Bachman, Teresa E. Buelow, Erin M. Freeman, Lyndsay S. Martin, Stacey L. Obrecht, Catherine M. Rogers, Angie M. Stewart, and J. Mark Stewart, the author expresses his deep appreciation. The author is especially happy to thank his son, Attorney James M. Gelb, for his cogent editing contribution.

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

2. JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 114 (Erwin Chemerinsky et al. eds., Aspen Publishers 6th ed. 2004).

3. *Id.* at 114-15. The burden of proving fairness was usually placed on the party seeking to uphold the transaction. *Id.*

4. *Id.* at 115.

vote unless it was found by the court to be unfair to the corporation.[5] A number of states passed statutes confirming the end of the automatic voidability rule if certain conditions were met.[6] These state statutes are not identical, but it suffices for purposes of this article to illustrate the erosion of fiduciary duty in self-dealing transactions by examining two influential statutory approaches - that of the Model Business Corporation Act and that of Delaware.

A. The Model Business Corporation Act

Model Business Corporation Act (MBCA) provisions (which have been adopted in whole or in similar form in a number of states) allow a court to protect the corporation or shareholders in director conflict of interest transactions by applying a fairness test to them only if certain technical corporate procedures have not been followed.[7] Such procedures often require easy to obtain director or shareholder approvals of the transaction, sometimes referred to as "sanitizing votes."[8]

The required directors' action to preclude a judicial fairness review is "the affirmative vote of a majority (but no fewer than two) of those qualified directors on the board of directors or on a duly empowered committee of the board who voted on the transaction" after appropriate disclosure to them.[9] It is noteworthy (and at least linguistically praiseworthy) that the sanitizing votes are not described as coming from "independent" directors but rather from "qualified" directors. The term "qualified director" is defined as follows:

> with respect to a director's conflicting interest transaction, any director who does not have either (1) a conflicting inter-

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5. *Id.*

6. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 cmt. a (American Law Institute Publishers 1994); ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 763 (9th ed. 2005).

7. *See* MODEL BUS. CORP. ACT ANN. § 8.61 (2002). The MBCA provisions referred to in this section were revised as indicated in the footnotes by the Committee on Corporate Laws of the American Bar Association in 2005. It should be noted that the unrevised sections reflect to a considerable degree current statutes in a number of jurisdictions (e.g. Alabama, Arizona, Connecticut, Hawaii, Idaho, Maine, Mississippi, Montana, Nebraska, Vermont, and Washington), making it useful to continue to use such sections as a basis of discussion here. Citations to the revised MBCA provisions are provided for the reader's convenience.

8. *See* MODEL BUS. CORP. ACT ANN. §§ 8.62, 8.63 (2002). *See* MODEL BUS. CORP. ACT §§ 1.43, 8.62, 8.63 (2005) for recent revisions to these provisions.

9. MODEL BUS. CORP. ACT ANN. § 8.62 (2002). This section also provides that committee action is "effective only if: (1) all its members are qualified directors, and (2) its members are either all the qualified directors on the board or are appointed by the affirmative vote of a majority of the qualified directors on the board." *Id.* *See* MODEL BUS. CORP. ACT § 8.62 (2005) for recent revisions to this provision.

> est respecting the transaction, or (2) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest respecting the transaction, which relationship would, in the circumstances, reasonably be expected to exert an influence on the first director's judgment when voting on the transaction.[10]
>
> A "conflicting interest" exists if:
>
> the director knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or related person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction.[11]

If the transaction is of such character and significance as to normally be brought to the board of directors of the corporation for action, the MBCA would then enlarge somewhat the relationships considered as involving "conflicting interest."[12]

Shareholder action with appropriate disclosure to them would preclude judicial review regarding conflict of interest transactions under section 8.63 of the MBCA.[13] This section would require that a majority of votes of qualified shares be cast in favor of the transactions.[14] "Qualified shares" do not include those beneficially owned, or the voting of which is controlled, by a director who has a conflicting interest or by a related person of the director.[15]

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10. MODEL BUS. CORP. ACT ANN. § 8.62 (2002). *See* MODEL BUS. CORP. ACT § 1.43 (2005) for recent revisions to this definition.
11. MODEL BUS. CORP. ACT ANN. § 8.60(1)(i) (2002). Under the Model Business Corporation Act (MBCA) a

> "[r]elated person" of a director means (i) the spouse (or a parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director, or an individual having the same home as the director, or a trust or estate of which an individual specified in this clause (i) is a substantial beneficiary; or (ii) a trust, estate, incompetent, conservatee, or minor of which the director is a fiduciary.

Id. at § 8.60(3). *See* MODEL BUS. CORP. ACT § 8.60 (2005) for recent revisions to this provision.
12. MODEL BUS. CORP. ACT ANN. § 8.60(1)(ii) (2002).
13. *Id.* at § 8.63.
14. *Id.*
15. *Id.*

Judicial relief in what some may consider conflict of interest situations is also excluded under MBCA section 8.61(a) which provides:

> A transaction effected or proposed to be effected by a corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest) that is not a director's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages, or other sanctions, in a proceeding by a shareholder or by or in the right of the corporation, because a director of the corporation, or any person with whom or which he has a personal, economic, or other association, has an interest in the transaction.[16]

The strict limits imposed by section 8.61(a), coupled with the definitions contained in section 8.60, are discussed under the comment to section 8.61(a) which states:

> [Section 8.61(a)] draws a bright-line circle, declaring that the definitions of section 8.60 wholly occupy and preempt the field of directors' conflicting interest transactions. *Of course, outside this circle there is a penumbra of director interests, desires, goals, loyalties, and prejudices that may, in a particular context, run at odds with the best interests of the corporation, but section 8.61(a) forbids a court to ground remedial action on any of them.* If a plaintiff charges that a director had a conflict of interest with respect to a transaction of the corporation because the other party was his cousin, the answer of the court should be: "No. A cousin, as such and without more, is not included in section 8.60(3) as a related person – and under section 8.61(a), I have no authority to reach out farther." If a plaintiff contends that the director had a conflict of interest in a corporate transaction because the other party is president of the golf club the director wants desperately to join, the court should respond: "No. *The only director's conflicting interest on the basis of which I can set aside a corporate transaction or impose other sanctions is a financial interest as defined in section 8.60.*"[17]

16. *Id.* at § 8.61. *See* MODEL BUS. CORP. ACT § 8.61 (2005) for recent revisions to this provision.

17. MODEL BUS. CORP. ACT ANN. § 8.61(a) official cmt. (2002) (emphasis added); *see* MODEL BUS. CORP. ACT § 8.61(a) official cmt. (2005) for recent revisions to this Official Comment. Comment to section 8.61(b) states:

B. Delaware Law

Delaware law, preeminent with respect to many large American corporations, contains statutory section 144, which addresses director or officer self-dealing in contracts or transactions.[18] While this statute provides such a contract or transaction is not voidable solely because of its interested nature, it leaves much to judicial interpretation and imagination.[19] Under the statute there is no automatic voidability if:

> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
>
> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

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> Clause (1) of subsection (b) provides that if a director has a conflicting interest respecting a transaction, neither the transaction nor the director is legally vulnerable if the procedures of section 8.62 have been properly followed. Subsection (b)(1) is, however, subject to a critically important predicate condition.
>
> The condition—an obvious one—is that the board's action must comply with the care, best interests and good faith criteria prescribed in section 8.30(a) for all directors' actions. If the directors who voted for the conflicting interest transaction were qualified directors under subchapter F, but approved the transaction merely as an accommodation to the director with the conflicting interest, going through the motions of board action without complying with the requirements of section 8.30(a), the action of the board would not be given effect for purposes of section 8.61(b)(1).

MODEL BUS. CORP. ACT ANN. § 8.61(b) official cmt. (2002). The impact of this official MBCA comment on a statutory interpretation by a court in any state which has adopted section 8.61(b) is open to question. *See* MODEL BUS. CORP. ACT § 8.61(b) official cmt. (2005) for recent revisions to this Official Comment.

18. DEL. CODE ANN. tit. 8, §144 (2004).
19. *Id.*

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.[20]

Delaware case law–while risky to predict or state–seems to say that while the normal rule in interested director cases would call for determination of the fairness of transactions and place the burden of proving fairness on the interested directors, generally approval of an interested transaction by the informed vote of disinterested directors results in the challenger having to prove that the transaction does not satisfy the far more lenient business judgment rule.[21]

Yet, even the platonic disinterested or independent director may lack the intelligence, courage, desire, time, character, communicative skill, or knowledge to carefully scrutinize, stand against, or influence others with respect to self-dealing transactions.[22] Therefore, any formulation changing the burden and the standard of review in director self-dealing transactions appears more designed to free self-dealing fiduciaries from appropriate scrutiny than to protect the corporation.

Delaware law also allows an impact in duty of loyalty cases for votes of approval of an interested transaction by disinterested shareholders. If the transaction involves a corporation and its controlling shareholder, such as a parent-subsidiary merger, approval by a majority of the minority shareholders may shift the burden of proof to the plaintiff but require an entire fairness review of the transaction.[23] If the interested transaction is between a corporation and its directors, or between the corporation and an entity in which the corporation's directors are also directors or have a financial interest, but does not involve a controlling shareholder, then the burden of proof may shift and the business judgment rule applies.[24] Once again, since it is sometimes difficult or risky to state or predict Delaware law with assurance, the above description should not be assumed to be a sure thing.[25]

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20. *Id.*

21. *See* Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987). *See also* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 311-16 (Foundation Press 2002) for discussion of Delaware law on this issue and on the impact of approval of conflicted transactions by shareholders.

22. *See* The Harvard Law Review Association, *Developments in the Law – Corporations and Society: II. And Now, The Independent Director! Have Congress, the NYSE, and NASD Finally Figured Out How to Make the Independent Director Actually Work?*, 117 HARV. L. REV. 2181, 2185-87, 2186 n.24 (2004) for a good discussion of some constraints on directors' performance [hereinafter *Developments*].

23. *In re* Wheelabrator, Technologies, Inc., 663 A.2d 1194, 1205 (Del. Ch. 1995).

24. *Id.*; BAINBRIDGE, *supra* note 21, at 314.

25. There are other examples of the use of sanitizing votes to insulate directors from meaningful judicial review of their fiduciary behavior in the duty of loyalty area. *See, e.g.*, the American Law Institute (ALI) § 5.05 approach to corporate opportunity doctrine cases.

Another example of the deterioration of fiduciary responsibility is that Delaware and many other states permit the inclusion of provisions in corporate charters that protect directors from liability in damage suits alleging breaches of the fiduciary duty of care. For example, section 102(b)(7) of the Delaware Corporation Code permits the inclusion of:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit . . . .[26]

As is well known, the actual role of directors is much less than their statutory empowerment would suggest. In considering the fiduciary responsibilities of directors under state law and under SOX, it is useful to examine their roles in corporate governance. Although they are given broad power to manage or direct the business and affairs of the corporation, in fact the lion's share of power is really exercised by the Chief Executive Officer (CEO) and managerial employees.[27] Director's roles *qua* directors are very limited.[28] Still, a board of directors does have potentially important roles. For example the board's role in hiring, evaluating, setting the compensation of and replacing senior executives is significant.[29] A leading institutional investor, TIAA-CREF (TIAA), states that:

> The development, selection and evaluation of executive leadership are among the most important decisions the board will make. Continuity of strong executive leadership with proper values is critical to corporate success. Under such leadership, companies have the best opportunity to succeed and benefit shareholders. Indifferent or weak leadership over time allows the best of business positions to erode and a company's fortunes to decline. To ensure the long-term success of the company and its shareholders, it is imperative

AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.05 (American Law Institute Publishers 1994).

26. DEL. CODE ANN. tit. 8, §102 (2004). *See also* MODEL BUS. CORP. ACT ANN. § 2.02 statutory comparison 6 (2002) for reference to, and discussion of provisions such as that of Delaware in various states limiting or eliminating personal liability of directors.

27. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 198 (Robert C. Clark et al. eds., Foundation Press 9th ed. 2005) (1940).

28. *Id.*

29. *Id.* at 199; *see also Developments, supra* note 22, at 2183-84.

> that the board develop, select and support strong corporate leadership.[30]

TIAA considers the board role regarding executive compensation to be important:

> Executive compensation practices provide a window into the effectiveness of the board. Through the compensation committee, the board should implement rational compensation practices that respond to the company's equity policy, including conditional forms of compensation that motivate managers to achieve performance that is better than that of a peer group. They should not be driven by accounting treatment or the pursuit of short-term share price results. Compensation should reward only the creation of genuine and sustainable value.[31]

TIAA calls for the compensation committee to develop with the shareholders' interest and fairness in mind, "policies and practices regarding cash pay, the role of equity-based compensation, fringe benefits and senior management employment contracts, severance and payments after change of control."[32]

The board has an oversight role which involves monitoring of management performance and integrity.[33] Of this monitoring role TIAA calls for the board to exercise its fiduciary responsibility in the best interests of the corporation and its shareholders; to ensure that corporate resources are used only for appropriate business purposes; and for the board itself be a model of integrity and inspire a culture of high ethical standards. TIAA further states:

> The board should mandate strong internal controls, avoid board member conflicts of interest, and promote fiscal accountability and compliance with all applicable laws and regulations. The board should develop a clear and meaningful set of governance principles and disclose them to shareholders on the company's website, as well as in the annual report or proxy statement. The board also should develop procedures that require that it be informed of violations of corporate standards. Finally, through the audit committee,

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30. TEACHERS INSURANCE AND ANNUITY ASSOCIATION - COLLEGE RETIREMENT EQUITIES FUND, POLICY STATEMENT ON CORPORATE GOVERNANCE (2005), http://www.tiaa-cref.org/pubs/html/governance_policy/board_directors.html (last visited Oct. 17, 2005) [hereinafter TIAA].
31. *Id.*
32. *Id.*
33. *Developments*, *supra* note 22, at 2184; *see also* EISENBERG, *supra* note 27, at 199.

> the board should be directly engaged in the selection and oversight of the corporation's external audit firm.[34]

According to TIAA the board may help in the making of strategic decisions and should review the company's strategic plan.[35] TIAA states:

> The board should review the company's strategic plan at least annually. The strategic allocation of corporate resources to each of the company's businesses is critical to its future success. Strategic plan reviews should include assessments of a) markets, products and customers for each major business segment; b) competitive strengths and weaknesses of the company; c) opportunities and threats confronting the company; d) key success factors and other elements necessary to maintain a competitive advantage; e) human resource management issues; and f) a projection of the firm's financial resources, which ensures flexibility and includes sufficient availability of capital needed to achieve its strategic objectives.[36]

While all of these TIAA objectives regarding board participation in corporate governance appear laudable, it is unrealistic to assume that directors generally have sufficient independence, time, or energy, or that their position in corporate governance is so strategically structured that they can play a meaningful role in protecting the corporation and its investors from management mistakes or wrongdoing.

The board too, may have a role to negotiate with management and protect the corporation when the latter is involved in self-dealing transactions.[37] To elaborate:

> [w]hile this process might not be pure negotiation, the point is that boards can in such reviews adopt a role resembling negotiation more than monitoring or oversight. They can do so by openly acknowledging management's conflicting interests and actively debating the potential risks and rewards of alternative approaches, rather than taking a monitoring or "policing" stance that at least implicitly frames disagreements with management as resulting from suspicions of dis-

34. TIAA, *supra* note 30.
35. *Id.*
36. *Id.*
37. *Developments*, *supra* note 22, at 2185.

honesty or breach of duty (instead of as being a natural consequence of the board's less conflicted perspective).[38]

Again, however, this role may naively rely on a degree of director independence and effectiveness that will generally be non-existent.

As discussed earlier, so-called disinterested and independent directors may even immunize transactions from judicial scrutiny regarding fairness through sanitizing votes.[39] In addition, directors may have a significant impact in other ways on litigation against corporate officials who have allegedly violated their fiduciary duties. Delaware law illustrates how, in the first instance, it is for the board to decide what litigation a corporation should engage in, but how, under certain conditions, shareholders can bypass the board and bring derivative actions which may be thwarted by a requirement that shareholders first demand board action unless demand is excused by futility.[40] The demand requirement as applied in Delaware is a big hurdle to shareholder derivative suits and seems at times to be characterized by sophistic formalism.[41] In addition, the board of directors can appoint from its membership a special litigation committee consisting of so-called independent directors to decide if a court should be asked to dismiss a shareholder derivative action.[42]

1. The *Stewart* Case

As already indicated, Delaware courts have wrestled with director independence issues in various contexts. Two recent cases illustrate why realistic independence determinations must extend beyond those expressly articulated in SOX, New York Stock Exchange, Inc. (NYSE), and National Association of Securities Dealers, Inc. (NASD) listing standards which are discussed later in this article.

Beam v. Stewart, 845 A.2d 1040 (Del. 2004), (*Stewart*) was a shareholder derivative suit against Martha Stewart (founder of the corporate nominal defendant, Martha Stewart Living Omnimedia, Inc.) and officers and directors of the nominal defendant.[43] The suit arrived at the Delaware

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38. *Developments*, *supra* note 22, at 2185 n.23.

39. Recall also the impact of "qualified" directors under the MBCA, *supra* notes 9-11 and accompanying text.

40. *See infra* discussion of Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004) in Part I(B)(1) of this article. *See also Developments*, *supra* note 22, for further discussion.

41. *See infra* discussion of Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004) in Part I(B)(1) of this article.

42. *See infra* discussion of the special litigation committee in the Oracle case in Part I(B)(2) of this article.

43. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1043 (Del. 2004).

Supreme Court after the Chancery Court dismissed claims of Martha Stewart's alleged insider trading and the handling of resulting media attention as constituting a breach of fiduciary duties of loyalty and care.[44] Delaware requires that demand be made on the Board of Directors before proceeding with a derivative suit unless the plaintiff can show that demand would be futile.[45]

A two-step test used to determine if demand is required is: "whether (1) 'the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.'"[46] The *Stewart* case involved only the first step of the test. To show demand futility, plaintiff had to allege particularized facts creating a "reasonable doubt that a majority of the [B]oard could have acted independently in responding to the demand."[47] Since the lack of independence of two directors[48] and the independence of one were not at issue,[49] plaintiff needed only to plead adequately with respect to any one of the three remaining directors.[50]

The court asserted the general principle that "[a] director will be considered unable to act objectively with respect to a presuit demand if he or she is interested in the outcome of the litigation or is otherwise not independent."[51] If a director has potential personal benefit or detriment as a result of the decision, the director "cannot be expected to exercise his or her independent business judgment without being influenced by the . . . personal consequences resulting from the decision."[52]

The court said the primary basis for measuring a director's independence is "whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or in-

44. *Id.*; Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961 (Del. Ch. 2003), *aff'd,* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1043 (Del. 2004).

45. *Beam*, 845 A.2d at 1048.

46. *Id.* at 1048 n.14 (quoting Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).

47. *Beam*, 845 A.2d at 1049.

48. *Id.* at 1044-45. The Court of Chancery determined that the complaint alleged sufficient facts to find directors Martha Stewart and Sharon L. Patrick not disinterested or independent. *Id.* at 1044. Martha Stewart's potential civil and criminal liability for the acts underlying Beam's claim rendered her an interested party. *Id.* Patrick's position and the substantial compensation she received from Martha Stewart Living gave reasonable doubt to her independence. *Id.* at 1044-45.

49. *Id.* at 1045 n.6. The parties did not argue and the Court of Chancery did not address the issue of the independence of one director, and it was assumed for purposes of the appeal that the presumption of that director's independence was unrebutted. *Id.*

50. *Id.* at 1049.

51. *Id.*

52. *Id.* (citations omitted).

fluences."[53] There must be a two-pronged analysis of "whether the director is disinterested in the underlying transaction and, even if disinterested, whether the director is otherwise independent."[54] In conducting the independence inquiry in *Stewart* the court felt obligated "to determine whether there is a reasonable doubt that any one of these three directors is capable of objectively making a business decision to assert or not assert a corporate claim against Stewart."[55]

The court noted that normally a claim for demand excusal would rest on a material financial or familial interest or inability to act independently for some other reason such as domination or control.[56] Recognizing however that personal friendship may influence the demand futility inquiry, the court adopted this lower court analysis:

> [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. This is particularly true when the allegations raise serious questions of either civil or criminal liability of such a close friend.[57]

Thus unlike the silent SOX, and NYSE and NASD listing standards to be discussed below, the Delaware Supreme Court expressly acknowledged the potential impact of friendship. However, the court asserted that the plaintiffs' allegations regarding the relationships between Stewart and certain other directors largely boiled down to a "structural bias" argument, which presupposes that professional and social relationships that naturally develop among board members impede independent decision making.[58] It is likely that if the Court accepted the structural bias argument, that would be a cataclysmic event. The alleged independence and lack of interest on the part of certain directors, which rest on shaky assumptions, have spawned the entire highly questionable jurisprudence insulating interested director behavior from meaningful inquiry.

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53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.* at 1049 n.20 (quoting Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996), *overruled by* Brehm v. Eisner, 746 A.2d 1080 (Del. 2000)).
57. *Beam*, 845 A.2d at 1050 (quoting Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003), *aff'd,* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1043 (Del. 2004)) ("Not all friendships, or even most of them, rise to this level and the Court cannot make a *reasonable* inference that a particular friendship does so without specific factual allegations to support such a conclusion.") (alteration in original).
58. *Beam*, 845 A.2d at 1050-51.

While rejecting the general notion of structural bias as determinative of demand futility, the court left it to the court of chancery to decide if "complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility."[59]

Furthermore, the court indicated that allegations that Stewart and other directors moved in the same social circles, attended the same weddings, had business relationships preceding the directors' memberships on the board, and described each other as friends, even with Stewart's ninety-four percent voting power were insufficient of themselves to rebut the presumption of independence.[60]

Although expressly willing to consider personal friendship in the independence calculus, the court set forth a difficult test for the plaintiff to meet:

> That a much stronger relationship is necessary to overcome the presumption of independence at the demand futility stage becomes especially compelling when one considers the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct. To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.[61]

It is ironic to cite a Delaware decision as instructive, more realistic, and more explicit than the much ballyhooed federal requirements of SOX and the new NYSE and NASD listing standards to be discussed later or the RMBCA in dealing with director independence. There is so much in Delaware law to undermine litigants' efforts to deal with perceived managerial improprieties. There are the rigors of the demand futility requirement discussed in *Stewart* that can easily stop shareholder derivative suits in their tracks. There are the shareholder litigation committees, such as that in a case to be discussed, that can move to dismiss lawsuits even where demand is excused.[62] There is the likely use of so called disinterested director votes

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59. *Beam*, 845 A.2d at 1051 (quoting Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).
60. *Id.* at 1051.
61. *Id.* at 1052.
62. *See In re* Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003), *appeal denied*, Oracle Corp. v. Barone, 829 A.2d 141 (Del. 2003). The *Stewart* Court refers to *In re*

to turn conflict of interest transactions from a fairness review by the court to evaluation under the very "benign to directors" business judgment rule.[63] There is section 102(b)(7) of the Delaware Corporation Code used by corporations to establish charter provisions precluding duty of care claims against directors.[64]

And notice how shrewdly the *Stewart* opinion is written to minimize the possibility of declaring a lack of independence based on friendship. The court even appears willing to conclude that most friendships do not rise to the level of familial loyalty and closeness.[65] Since the word "friendship" is tricky to define, and may be used loosely to signify acquaintances or occasional companions, it is premature to decipher the court's meaning here, let alone reasonably comment on the accuracy of its speculation. How is a court to say that the intensity of a voluntary friendship deserves less weight than the intensity of an involuntary family relationship? Furthermore, on what basis does a court assume that a so-called non-interested director would even feel some risk to reputation by reaching a decision to vote against the maintenance of a particular suit—a feeling of risk great enough to overcome risking a relationship with an interested director. Such an assumption is questionable in light of the reasons or pretexts which can be cited to vote to avoid litigation.

Moreover, as might be expected, the Delaware court makes it clear that the plaintiff will face a significant hurdle in attempting to determine the depth and scope of friendship because of the significant limits the court places on pretrial discovery.[66] The court notes:

> [t]he general unavailability of discovery to assist plaintiffs with pleading demand futility does not leave plaintiffs without means of gathering information to support their allegations of demand futility, however. Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the

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Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003), *appeal denied,* Oracle Corp. v. Barone, 829 A.2d 141 (Del. 2003), in which the independence of the Special Litigation Committee (SLC) is discussed. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1054-55 (Del. 2004)). SLC members are "vested with enormous power to seek dismissal of a derivative suit brought against their director-colleagues in a setting where presuit demand is already excused." *Id.* at 1055.

63. *See supra* note 21 and accompanying text.

64. DEL. CODE ANN. tit. 8, §102 (2004). *See supra* note 26 and accompanying text.

65. *Beam*, 845 A.2d at 1050 (quoting Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003), *aff'd* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004)). *See supra* note 57 and accompanying text.

66. *Beam*, 845 A.2d at 1056.

> plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts.[67]

The court is referring to Section 220,[68] which provides for the inspection of a corporation's stock ledger, list of stockholders, and other books and records, but not other discovery techniques. It is unfair to expect plaintiffs to plead particularized facts about director independence and interest without allowing sufficient information gathering on those issues. The Council of Institutional Investors (CII) has pointed to the lack of perfection of Section 220 as follows:

> First, although Section 220 contemplates a summary proceeding, it frequently takes several months for a stockholder to enforce its inspection rights under the statute. In cases involving imminent corporate transactions, such delays make Section 220 an impractical means of gathering pre-suit information. Second, even in cases where timing is not an issue, Section 220 only provides plaintiffs with access to information within the corporation's possession. Such information constitutes only a small portion of the universe of facts regarding potential conflicts of interest on the part of corporate directors.[69]

If Delaware really wanted the plaintiff to have a fair opportunity to determine the truth about a director's relationship to a defendant, it would allow at least discovery limited to that issue.

A recent Securities Exchange Commission (SEC) proceeding involving undisclosed relationships bearing on objectivity and independence of directors demonstrates dramatically the need for plaintiffs to have additional discovery opportunities in Delaware demand futility cases. On December 20, 2004, the SEC instituted settled enforcement proceedings against the Walt Disney Company for failing to disclose certain related party transactions in certain proxy statements and annual reports between 1999 and 2001.[70] Failures to disclose involved company employment of three directors' children with annual compensation of $60,000 to $150,000, employment of the spouse of another director by a Disney subsidiary at more than $1,000,000 annually, certain payments to a corporation owned by a Disney director, and the provision of office space and certain services to another

67. *Id.*
68. DEL. CODE ANN. tit. 8, §220 (2004).
69. Amicus Curiae Brief of the Council of Institutional Investors at 19 n.8, Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (No. 469, 1998).
70. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors (Dec. 20, 2004), http://www.sec.gov/news/press/2004-176.htm (last visited Oct. 17, 2005).

director valued by the company at over $200,000 annually.[71] Linda Chatman Thomsen, Deputy Director of the SEC's Division of Enforcement said, "Failure to comply with the SEC's disclosure rules in this area impedes shareholders' ability to evaluate the objectivity and independence of directors."[72] How then can the Delaware Court in demand futility cases deliberately prevent the truth about director independence and interest from being obtained?

So without being able to rely on the degree of independence of a director, the independence presumed from superficial examination can be used to block litigation. Still, the Delaware Supreme Court's willingness in *Stewart* to give consideration to non-financial matters as potentially impacting on director independence offers hope, however slim, that it may evolve in a more meaningful way as a matter of state law and perhaps more so as an influence on federal requirements.

2. The *Oracle* Case

Prior to the *Stewart* case, *Living Omnimedia, Inc. v. Stewart*, the Delaware Court of Chancery focused on the question of independence of directors in *In re Oracle Corp. Derivative Litigation* (*Oracle*).[73] The court dealt with the impact of non-financial and non-familial pressures on director independence.

This case involved a shareholder derivative claim of disloyalty against four members of the Oracle Board based on alleged misappropriation of inside information used as a basis for decisions to trade shares. Claims were also made against non-trading directors.

In response to the derivative suit Oracle named two directors to a Special Litigation Committee (SLC) to determine if Oracle should press the claims of the plaintiff, settle or terminate the case.[74] The SLC was given full authority to decide those matters without the approval of other directors.[75]

Two tenured Stanford faculty members constituted the SLC.[76] One of the four defendant directors was also a Stanford faculty member, another a Stanford alumnus who had donated millions of dollars to Stanford in recent years, and another director, Oracle's CEO, had donated millions of dollars to Stanford through a personal foundation and was considering further

71. *Id.*
72. *Id.*
73. *In re* Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch., 2003), *appeal denied*, Oracle Corp. v. Barone, 829 A.2d 141 (Del. 2003).
74. *Id.* at 923.
75. *Id.*
76. *Id.* at 923-24.

large donations around the same time period the SLC members were added to the Oracle Board.[77]

The SLC prepared a report and moved to terminate the litigation.[78] The court explained that Delaware Law required it to determine, based on the "undisputed factual record" if the "SLC was independent, acted in good faith, and had a reasonable basis for its recommendation" and "[i]f there is a material factual question about these issues causing doubt" about any of the committee members, the motion to terminate must be denied.[79] The court was able to reject the motion to dismiss based solely on the issue of independence without ruling on the other matters.[80]

The court referred to the SLC Report, which took the position that the committee members were independent.[81] It found "[n]oticeably absent from the SLC Report was any disclosure of several significant ties between Oracle or the Trading Defendants and Stanford University," the employer of both SLC members.[82] During discovery, however, other ties emerged, ties that had to be evaluated to determine the issues of SLC member independence.[83]

The court thought it important to point out that it was "not faced with the relatively easier call of considering whether [the] ties would call into question the impartiality of an SLC member who was a key fundraiser at Stanford or . . . an untenured faculty member subject to removal without cause."[84] Faced with the argument that members are independent unless essentially subservient to the Trading Defendants—that is, under their domination and control—and the absence of anything in the record suggesting such domination and control, the court declared its independence from such a narrow approach: "But, in my view, an emphasis on 'domination and control' would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity."[85]

Moving away from economic factors as the only basis for human behavior, the court eloquently stated the rationale for considering other human motivations:

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines

77. *Id.* at 920-21.
78. *Id.* at 925-28.
79. *Id.* at 928-29.
80. *Id.* at 929.
81. *Id.*
82. *Id.*
83. *Id.* at 929-30.
84. *Id.* at 930.
85. *Id.* at 937.

> of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus.* We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.[86]

The court continued with a refreshing discussion of the social nature of humans:

> 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.[87]

Furthermore, the court tried to fit its position into Delaware Supreme Court teachings on independence: "At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity."[88]

Admitting that the result he reaches is in "tension with the specific outcomes of certain other decisions" Vice Chancellor Strine did not believe

86. *Id.* at 938.
87. *Id.* (footnote omitted).
88. *Id.* (emphasis in original). *See* Orman v. Cullman, 794 A.2d 5, 24 n.47 (Del. Ch. 2002) (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)). *See also* Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 n.55 (Del. Ch. 2001), *rev'd on other grounds,* Parfi Holding AB v. Mirror Image Internet, Inc., 817 A.2d 149 (Del. 2002), *cert. denied,* Mirror Image Internet, Inc. v. Parfi Holding AB, 538 U.S. 1032 (2003) (citing definitions of beholden as meaning "'[o]wing something . . . to another' and 'under obligation'"). Being beholden reflects, of course, on the ability of the obligor to be impartial and objective to the obligee.

it applied "a new definition of independence."[89] "[R]ather, it recognizes the importance (*i.e.*, the materiality) of other bias-creating factors other than fear that acting a certain way will invite economic retribution by the interested directors."[90]

The court furnished a number of persuasive reasons for its conclusion that the SLC had failed to meet its burden on the independence question. As an example consider the following passage from the court's opinion:

> Nor has the SLC convinced me that tenured faculty are indifferent to large contributors to their institutions, such that a tenured faculty member would not be worried about writing a report finding that a suit by the corporation should proceed against a large contributor and that there was credible evidence that he had engaged in illegal insider trading. The idea that faculty members would not be concerned that action of that kind might offend a large contributor who a university administrator or fellow faculty colleague . . . had taken the time to cultivate strikes me as implausible and as resting on an [sic] narrow-minded understanding of the way that collegiality works in institutional settings.[91]

3. *Oracle*'s Bearing on *Stewart*

In *Stewart* the court took pains to distinguish *Oracle* from the case before it. The court emphasized the procedural distinctions regarding burdens of proof and availability of discovery into independence without deciding whether the substantive standard of independence in an SLC case differs from that in a presuit demand case.[92] The court emphasized the need for careful oversight of the bona fides of the SLC and its process and stated that the Stanford connections in *Oracle* were factually different from those in *Stewart*.[93] Still, it would be foolish to try to predict the extent to which the Delaware Supreme Court may ultimately approve of the *Oracle* analysis.

89. *In re* Oracle Corp. Derivative Litigation, 824 A.2d 917, 939 n.55 (Del. Ch., 2003), *appeal denied*, Oracle Corp. v. Barone, 829 A.2d 141 (Del. 2003).
90. *Id.*
91. *Id.* at 945.
92. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004).
93. *Id.*

4. The Goldberg Issue

As discussed earlier, the effectiveness of the board of directors within the scheme of corporate governance is subject to inherent limits on the role of the board.

No slow learner or thinker, Arthur J. Goldberg, former Supreme Court Justice and United States Ambassador to the United Nations, resigned as a director of Trans World Airlines and explained director informational problems as follows:

> At the very best, outside directors of almost all large corporate enterprises under the present system cannot acquire more than a smattering of knowledge about any large and far-flung company of which they are directors. As a result, outside directors often are even unable to ask discerning questions when presented with a complex management decision for approval at the board meetings.

This can result in the outside director not fulfilling his fiduciary responsibility to the shareholders.[94]

Goldberg thought that one possible solution to assure that the board would perform its duties by using its best and independent judgment would be for the board to establish a committee of overseers or outside directors to be generally responsible for supervising company operations on a broad scale and making periodic reports to the board.[95] He suggested the committee should be authorized to hire a small staff of experts independent of management control.[96] Interestingly, Goldberg cited as among possible experts an independent auditor to assure the soundness of the accounting techniques used by the corporation.[97]

As will be seen, a recent federal statute, SOX, like the Goldberg suggestions, places a value on independent auditing and calls for an independent board audit committee with the possibility of their engaging consultants to help the committee. Additionally, independent directors are called for in listing standards of the NYSE and NASD discussed later. Pension fund investors have also called for director independence and certain committee independence. For example, TIAA states:

> The [b]oard should be comprised of a substantial majority of independent directors . . . . Going forward, TIAA-CREF will

94. Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, at F1.
95. *Id.*
96. *Id.*
97. *Id.*

> focus on how company boards interpret and implement the new exchange listing requirements as reflected by their actions and corporate governance positions and will encourage board practices that promote a spirit and culture of true independence and vitality.[98]

In addition TIAA, referring to the audit committee, the compensation committee, and the corporate governance/nominating committee, states: "The credibility of the corporation will depend in part on the vigorous demonstration of independence by the committees and their chairs. Committees should have the right to retain and evaluate outside consultants and to communicate directly with staff below the senior level."[99] Yet committee members are directors and subject to the same limits on their independence and ability to play very significant roles in corporate governance vis-à-vis management.

PART II: SARBANES-OXLEY

In view of pusillanimous state law protection of corporations and shareholders from management misbehavior and in light of the extreme unlikelihood of states beefing up such protection and losing some of the business of incorporating businesses to states that refuse to do so, one turns with at least a little hope to federal regulation to improve the situation.[100] Enter SOX onto the stage of federal regulation, an Act passed in the heat of reaction to major corporate scandals. That regulation revolves partially around alleged independent audits, independent directors, and independent audit committee members.

Although SOX[101] provides more federal regulation of public company audits, the extent to which it will enhance the quality and reliability of audits is doubtful. It relies upon the so-called independence of directors and auditors to achieve its goals. SOX defines "audit" as an "examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission . . . for the purpose of expressing an opinion on such statements."[102] The Commission re-

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98. TIAA, *supra* note 30.
99. *Id.*
100. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974). In a classic article written more than thirty years ago the late Professor and former SEC Chairman William L. Cary referred to the problem of state corporate governance law contributing to the deterioration of corporate standards and recommended establishing federal standards of corporate responsibility. *Id.*
101. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.) (2002).
102. *Id.* at § 2(a)(2) (codified at 15 U.S.C. § 7201(2)). (removing from sentence "or, for the period preceding the adoption of applicable rules of the Board under section 103, in ac-

ferred to is the SEC[103] and the Board is the "Public Company Accounting Oversight Board" established under SOX.[104] A "public accounting firm . . . is engaged in the practice of public accounting or preparing or issuing audit reports."[105] The Board is established

> to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.[106]

The statute limits membership on the Board of five to only two who have been certified public accountants and indicates that each member of the Board must serve on a full-time basis and may not be employed during Board service by any other person or engage in any other professional business activities or share in any of the profits of, or receive payments from, a public accounting firm or any other person as determined by rule of the Commission with certain exceptions.[107] It is evident that the design of the statute is to preserve a degree of independence of these Board members. Express provision is made for the Board to establish auditing, quality control and independence standards and rules to be used by registered public accounting firms in the preparation and issuance of audit reports.[108] The inspection of registered public accounting firms by the Board is also provided for.[109] In addition, the Board is to establish procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.[110]

The SEC has general oversight responsibility with respect to the Board and the statute is not to be construed as impairing or limiting SEC authority to establish accounting principles or standards for purposes of enforcement of securities laws.[111]

Hopefully the items referred to thus far will somehow contribute to the quality and reliability of the audit performed by the public accounting

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cordance with then-applicable generally accepted auditing and related standards for such purposes").

103. *Id.* at § 2(a)(6) (codified at 15 U.S.C. § 7201(6)).

104. *Id.* at § 2(a)(5) (codified at 15 U.S.C. § 7201(5)).

105. *Id.* at § 2(a)(11) (codified at 15 U.S.C. § 7201(11)). It may under Board rules also include an associated person of an entity described in the statute. *Id.*

106. *Id.* at § 101(a) (codified at 15 U.S.C. § 7211(a)).

107. *Id.* at § 101(e) (codified at 15 U.S.C. § 7211(e)).

108. *Id.* at § 101(c)(2) (codified at 15 U.S.C. § 7211(c)(2)).

109. *Id.* at § 101(c)(3) (codified at 15 U.S.C. § 7211(c)(3)).

110. *Id.* at § 101(c)(4) (codified at 15 U.S.C. § 7211(c)(4)).

111. *Id.* at § 107(a) (codified at 15 U.S.C. § 7217(a)).

firm. But the law itself—part of a securities regulation scheme to prevent deception—is itself deceptive. It refers to the public accounting firm as "independent." Is it any wonder that people lose confidence in laws purportedly designed for their protection? If the legislature enacts a statute that says "for purposes of this law an apple shall be defined as a grapefruit" at least the conflict between reality and definition is apparent. But to define or characterize the public accounting firm as "independent" may lead the naïve to believe in such a thing. A dictionary definition of "independent" states: "free from the influence, control, or determination of another or others . . . ."[112]

How can it be seriously said that a public accounting firm, paid for its audit services by its client and allowed to perform other services for the client, could be classified as "independent" within any justifiable meaning of the term? All would be forgiven if the issue were merely one of nice semantics—but if the accounting firm is not really independent of management, how can it be trusted to protect the public against the financial improprieties of management?

If management engages in manipulation of financial statements, can public accounting firms be realistically relied upon to act against management? Will audit firms overcome economic pressures to keep clients and preserve audit fees?

It is no wonder that a persuasive commentator has said that "auditors are prone to bias their conclusions to best preserve the client relationship that pays their bills, hardly a ringing endorsement of the cherished 'independence' concept."[113]

SOX statutory provisions do not come to grips with the fundamental problem of the lack of auditor independence just referred to and are even quite weak in reducing existing auditor dependence. First, an audit is not to be performed by a firm or by an associated person doing certain other work contemporaneously with the audit for the issuer.[114] A number of such services are set forth specifically in the statute and include: bookkeeping, financial information systems design and implementation, actuarial services and other services that the Board determines by regulation not to be permissible.[115] Tax services, however, are not excluded. In fact, such services are permitted by the statute.[116] What an odd way to encourage or achieve auditor independence or even reduce dependence—to allow the auditor to make

112. Webster's New World College Dictionary 725 (4th ed. 1999).
113. Richard L. Kaplan, *The Mother of All Conflicts: Auditors and Their Clients*, 29 J. CORP. L. 363, 368 (2004).
114. Sarbanes-Oxley Act § 201(a) (codified at 15 U.S.C. § 78j-1(g)).
115. *Id.*
116. *Id.* at § 201(a) (codified at 15 U.S.C. § 78j-1(h)).

money from providing tax services to the issuer. SEC regulations also deal with auditor independence. One of them states:

> An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.[117]

Second, SOX and the SEC provide rotation requirements within a firm performing an audit.[118] The registered public accounting firm is not allowed "to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."[119] The SEC requires lead and concurring partners on the audit to change after five years and not become involved with that audit for at least five years.[120] The

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117. 17 C.F.R. § 210.2-01 (2004). "Covered persons in the firm" means

> the following partners, principals, shareholders, and employees of an accounting firm:
>
> (i) The "audit engagement team";
>
> (ii) The "chain of command";
>
> (iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those service are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and
>
> (iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

Id.

118. Sarbanes-Oxley Act § 203 (codified at 15 U.S.C. § 78j-1(j)).

119. *Id.*

120. 17 C.F.R. § 210.2-01(c)(6) (2005).

Commission also requires any partner with significant involvement with the client to rotate off after seven years and stay away for at least two.[121] The efficacy of such rotation requirements would appear to be limited at best. How much will the cause of audit quality and reliability be advanced by the same auditing firm continuing to audit after the rotation of a few key persons? Will firm personnel be zealous in questioning or impugning the prior work of other firm personnel?[122]

Audit firms need to be sufficiently insulated from the temptation to please the management of a company in order to retain or in the hope of obtaining other business from the company such as lucrative tax service. Furthermore, the fact that SOX comes up so short in its provisions for attaining auditor independence or reducing auditor dependence, even in the face of the need for firmer rules demonstrated by Enron and other scandals, is very disappointing.

CII Corporate Governance Policies are more stringent than SOX requirements regarding auditor independence, calling for only very limited non-audit services to be performed by the outside auditor and competitive bidding for the external audit engagement no less frequently than every five years:

> As prescribed by law, the audit committee has the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.
>
> The audit committee should seek competitive bids for the external audit engagement no less frequently than every five years.
>
> The company's external auditor should not perform any non-audit services for the company, except those required by statute or regulation to be performed by a company's external auditor, such as attest services.
>
> The proxy statement should also include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.[123]

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121. *Id.*

122. Kaplan, *supra* note 113, at 369-70 for a detailed and excellent critique of the partner rotation provision and its inadequacies.

123. Council of Institutional Investors, The Council of Institutional Investors Corporate Governance Policies, II. "Auditor independence" (2004), http://www.cii.org/policies/boardofdirectors.htm (last visited Oct. 17, 2005) [hereinafter CII].

Yet, even CII's stricter policies are insufficient to reduce auditor dependence on the corporation being audited.

Third, SOX attempts to address the issue of employees migrating from auditor to client by making it unlawful for the firm to perform an audit service for an issuer "if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position" had been employed by the audit firm and participated in an audit of the issuer during the year preceding the date of audit initiation.[124] That the client may be a potentially attractive source of a plum position for an audit firm employee and that this may affect that employee's independence or increase her dependence is obvious. That the firm employee would need to delay for a short time after participating in an audit before moving over to accept certain positions with the issuer would not seem to prevent problems of auditor dependence. Furthermore, the employee desiring to migrate may be interested in positions other than those specified. One simple way to deal with the auditing employee movement to its client is to prohibit it. "Corporations would still have an enormous pool of financial talent that they could tap—namely, employees of *other* accounting firms, both large and small. But at the very minimum, people who worked on a company's audit should not be employable by that company in any capacity, ever!"[125]

SOX does contain some other provisions aimed at strengthening the independence or reducing the dependence of the auditor versus the issuer or its management through the role of the issuer corporation's audit committee, which is defined 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.[126]

The audit committee is given important responsibilities relating to registered public accounting firms. The committee is "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work," and the accounting firm is to "report directly to the audit commit-

124. Sarbanes-Oxley Act § 206 (codified at 15 U.S.C. § 78j-1(l)).
125. Kaplan, *supra* note 113, at 372.
126. Sarbanes-Oxley Act § 205(a) (codified at 15 U.S.C. § 78c(a)(58)).

tee."[127] This provision could, in theory at least, insulate the auditing firm from some managerial pressures but that would depend on the existence of a truly independent and capable audit committee willing and able to provide the basis for genuine independent audits, an existence unlikely to be born.

SOX expressly provides for the independence of audit committee members as follows: "Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent."[128] Criteria for independence are set forth in the statute:

> 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.[129]

Can an individual collecting fees from the company as director and/or committee member be relied upon to take on management? Can such an individual be generally perceived as independent?

The national drive to ensure director independence or to reduce director dependence is further illustrated by new listing standards of the NYSE and NASD.[130] Corporate governance rules of the NYSE call for listed companies to have a majority of independent directors[131] and require that the board "affirmatively determines that the [independent] director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."[132] The standards state that a director who is an employee, or whose immediate family member is an executive officer, of the company would not

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127. *Id.* at § 301 (codified at 15 U.S.C. § 78j-1(m)(2)).
128. *Id.* (codified at 15 U.S.C. § 78j-1(m)(3)(A)).
129. *Id.* (codified at 15 U.S.C. § 78j-1(m)(3)(B)).
130. Order Approving Proposed Rule Changes Relating to Corporate Governance, Exchange Act Release No. 34-48745, 68 Fed. Reg. 64,154, at 64,154-55 (Nov. 12, 2003). For amendments to the NYSE rules see Order Granting Approval of Proposed Rule Change by the New York Stock Exchange, Inc., Exchange Act Release No. 34-50625, 69 Fed. Reg. 65,006 (Nov. 9, 2004) and Final NYSE Corporate Governance Rules, (2004), http://www.nyse.com/pdfs/finalcorpgovrules.pdf (last visited on Oct. 19, 2005) [hereinafter NYSE].
131. NYSE § 303A(1).
132. *Id.* § 303A(2)(a).

be independent until three years after the end of such employment relationship.[133] Moreover, a director who received, or whose immediate family member received, more than $100,000 during any twelve month period within the past three years in direct compensation from the listed company, other than director and committee fees and certain pension or other forms of deferred compensation for prior service, would not be independent.[134]

Independence is also excluded by standards involving relationships of the director or an immediate family member with the internal or external auditor of the company[135] or where a director or an immediate family member is within the last three years employed as an "executive officer of another company where any of the listed company's present executives serve on that company's compensation committee.[136] In addition, a director who is an executive officer or employee, or whose immediate family member is an executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or two percent of such other company's consolidated gross revenues, would not be considered independent.[137]

The NYSE standards provide that the company must have a "nominating/corporate governance committee composed entirely of independent directors"[138] and also a "compensation committee" composed entirely of such directors.[139] In addition, the listing standards provide that all auditing committee members must satisfy the requirements for independence of the listing standards requirements as well as the statutory requirements of SEC Rule 10A-3(b)(1).[140]

Several other enhancements are contained in the NYSE listing standards which are helpful in maintaining director independence and responsibility or reducing dependence and irresponsibility. Listed companies must "adopt and disclose corporate governance guidelines,"[141] which must address director qualification standards; director responsibilities; director access to management and, as necessary and appropriate, independent advisors; director compensation; director orientation and continuing education; management succession; and annual performance evaluation of the board.[142] Listed companies must also "adopt and disclose a code of business conduct and

133. *Id.* § 303A(2)(b)(i).
134. *Id.* § 303A(2)(b)(ii).
135. *Id.* § 303A(2)(b)(iii).
136. *Id.* § 303A(2)(b)(iv).
137. *Id.* § 303A(2)(b)(v).
138. *Id.* § 303A(4)(a).
139. *Id.* § 303A(5).
140. *Id.* § 303A(7)(b).
141. *Id.* § 303A(9).
142. *Id.*

ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers."[143] The standards indicate that listed companies should address topics including: conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of company assets; compliance with laws, rules and regulations (including insider trading laws); and encouraging the reporting of any illegal or unethical behavior.[144] Furthermore, the standards call for empowering non-management directors to serve as a more effective check on management by mandating "regularly scheduled executive sessions without management."[145]

NASD listing standards also illustrate the drive for director independence or reduced director dependence. The NASD standards, however, do vary from those of the NYSE. For example, there are variations regarding the definitions of director independence; NASD sets the threshold level of director compensation for independence disqualification at $60,000 in a particular year[146] rather than the $100,000 NYSE level referred to above;[147] and the NASD and NYSE definitions of non-independence because of business relationships between the listed company and other entities with which the director is affiliated differ.[148]

SOX and the listing standards do not even on their face represent a very good effort to reduce director, committee member or auditor dependence let alone achieve independence. Despite the impetus for action triggered by Enron and other scandals, neither SOX nor the listing standards expressly cover the impact of direct management relationships with board or committee members. Suppose, for example, that an audit committee member has a contract with the corporate chief executive officer (CEO) for services to be directly furnished to the CEO and not to the corporation and that the contract will result in profit of $200,000 to the committee member. SOX does not deal expressly with this relationship, nor do the listing standards. This is so despite the obvious danger of undue influence presented by such a scenario. The commentary to NYSE listing standard 2(a) specifically recognizes the "concern is independence from management . . . ."[149] It also states that "[i]t is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on

143. *Id.* § 303A(10).
144. *Id.*
145. *Id.* § 303A(3).
146. Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64,154 at 64,161. (*See* Rule 4200(a)(15)(B), "NASD Payments Provision").
147. Order Approving Proposed Rule Changes Relating to Corporate Governance, *supra* note 130 and accompanying text.
148. For discussion of NASD rules see *Developments*, *supra* note 22, at 2189-94.
149. NYSE 303A(2)(a) (Commentary), http://www.nyse.com/pdfs/finalcorpgovrules.pdf (last visited Oct. 19, 2005).

the materiality of a director's relationship to a listed company . . . ."[150] While it is true that the standards contain broad phraseology which would allow a Board to go beyond express language to determine a lack of requisite independence, failure to deal with direct relationships involving management is puzzling and the use of bright line standards like $100,000 per year or the greater of $1 million, or two percent fails to encourage a policy of genuine strictness on independence. Who knows how much it takes in individual cases to affect or impair independence or increase dependence? The loyalties of some may be lost or impaired for less than others.

This problem is clearly recognized in the "NYSE Listed Company Manual Section 303A Corporate Governance Listing Standards Frequently Asked Questions," which deems unsupportable a company's attempt to take the "position as a categorical matter that any director who passes the bright line tests [independence criteria set forth in Section 303A. 02 (b)] is per se independent."[151] Still, the large sums allowed by the bright line criteria send the message that director independence is not really a serious goal.

In addition, the federal statute and the listing standards fail to grapple at all with independence issues arising from friendship, romance, or other important relationships. The *Oracle* and *Stewart* cases discussed earlier are illustrative of such issues. Furthermore, whether an individual gathering compensation and prestige as a director can be generally perceived as independent is very doubtful.

The approach of the CII to the problem of director independence expressly takes into account not only connections to the corporation but also those to its chairman, CEO or any other executive officer,[152] interests unmentioned by SOX, and the NYSE and NASD listing standards. CII Corporate Governance Policies call for a board of at least two-thirds independent directors[153] and all independent auditing, nominating and compensation committees.[154] Speaking of the board the Council says:

At least two-thirds of the directors should be independent (i.e., their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is their directorship). The company should disclose information necessary for shareholders to determine whether directors qualify as independent, whether or not the disclo-

150. *Id.*
151. NYSE Listed Company Manual Section 303A Corporate Governance Listing Standards Frequently Asked Questions, section C "Questions Regarding Independence Determination" question 2, (2004) http://www.nyse.com/pdfs/section303Afaqs.pdf (last visited Oct. 19, 2005).
152. *See* CII, VI. "Independent Director Definition," *supra* note 123, at 15.
153. *Id.* at 14.
154. *Id.*

sure is required by state or federal law. This information should include all financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors.[155]

TIAA expressly calls for company boards to define independence more strictly than the listing standards of the exchanges. TIAA specifically covers non-independence arising from a substantial connection, not just of a financial but also of a personal nature and not just to the company but to its management.

> We believe independence means that a director and his or her immediate family have no present or former employment with the company, nor any substantial connection of a personal or financial nature (other than equity in the company or equivalent stake) to the company or its management that could in fact or in appearance compromise the director's objectivity and loyalty to shareholders. To be independent, the director must not provide, or be affiliated with any organization that provides goods or services for the company if a reasonable, disinterested observer could consider the relationship substantial.
>
> True independence depends upon these and other factors that may not be readily discerned by shareholders. In view of the importance of independence, non-management directors should evaluate the independence of each of their fellow directors based on all information available to them and should disclose to shareholders how they determine that directors are capable of acting independently.[156]

Obviously even sophisticated institutional investors fall into the trap of referring to "independent" directors and depending, at least ostensibly, on the dependent.

CONCLUSION

It would be naïve to believe that there are independent directors or independent auditors positioned to really do an effective job in protecting public investors from management deceptions or self-dealing. Certainly, fear of penalties and sanctions will have some deterrent effect. But various factors significantly dash hopes for the success of a marquee law like SOX,

155. *See* CII, II. "Independent Board," *supra* note 123, at 2.
156. *See* TIAA, *supra* note 30.

let alone old unreliable state law dependent on the governance activity of so-called independent or "qualified" directors.

As discussed above, state law largely protects directors from liability in damage suits alleging breaches in their duty of care simply by allowing exculpatory charter provisions, or using a lenient business judgment rule. Directors are also protected as a result of the historic erosion of the effectiveness of fiduciary duty of loyalty suits under state law. In addition, neither federal law nor the listing standards, referred to above, truly guarantee auditor or director independence from management.

In fact it is doubtful that many truly independent directors who can effectively check the misbehavior of company management exist. A recent survey of 100 of the largest United States companies shows that in the year 2005, eleven of them paid in excess of $80,000 in annual cash retainers to directors, and only twenty-nine paid such retainers in amounts of $40,000 or less.[157] Other forms of compensation such as stock options, stock or restricted stock were also paid by a significant number of the companies.[158] A substantial number of the companies paid additional retainers to board committee chairs and some paid additional retainers to all committee members.[159] While high director compensation may encourage a director to spend more fruitful time and energy on corporate matters and thereby have a better opportunity to prevent or deal with managerial misbehavior, it may also cause her to trim the sails of independence lest she lose her lucrative and prestigious directorship.

The SEC has provided for disclosure rules that will reveal sources of company director nominees by the category or categories of persons or entities that have recommended each nominee and specifically require disclosure when a nominee was recommended by the Chief Executive Officer.[160] These rules should result in some enlightenment about the potential influence on board members beholden to those who got them there. How much such rules will actually contribute to director independence or reduce director dependence is open to question.

Another important factor is the time directors and audit committee members should be able to spend on their work in order to perform respon-

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157. SHEARMAN & STERLING LLP, TRENDS IN THE CORPORATE GOVERNANCE PRACTICES OF THE 100 LARGEST U.S. PUBLIC COMPANIES, 6 (2005), *available at* http://www.shearman.com/cg_survey05/ (last visited Oct. 25, 2005). The 100 largest U.S. public companies were from a Fortune magazine Fortune 500 list. *Id.* at 4.

158. *Id.* at 6.

159. *Id.* at 40.

160. U.S. Sec. & Exch. Comm'n, Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 17 C.F.R. pts. 228, 229, 240, 249, 270 & 274 (Nov. 24, 2003), http://www.sec.gov/rules/final/33-8340.htm (last visited Oct. 19, 2005).

sibly. Of the 100 top companies a majority limited service of audit committee members to no more than three audit committees or conditioned service beyond that on Board approval or determination that such service will not impair the director's ability to serve on the audit committee.[161] In addition, eighty-six of the top 100 companies required a minimum number of audit committee meetings ranging from three to nine each year.[162]

Eighty-six of the top 100 companies addressed the issue of director service on multiple boards but only forty-two placed limits on such service.[163] At least one director of forty-five of the top 100 companies serves on five or more public company boards.[164] In addition, boards of fifty-four companies met eight or fewer times in 2004, and eighty-five met fewer than twelve times in 2004.[165] Moreover, being a director may not be regarded as a full-time job, and other time consuming responsibilities may take priority in directors' lives.

Being paid lucrative director's compensation for service on multiple boards may make directors hesitant to get a reputation for asking too many questions or offending management, and multiple board responsibilities plus other positions may reduce a director's time, energy, and effectiveness respecting any or all companies served.

Moreover, there are various limits to director vigilance and effectiveness in monitoring corporate affairs or participating effectively in other director roles amid the complex array of motives affecting director independence discussed earlier. Freedom from bias (conscious or not), intelligence, information, time required, strength of character, courage and ability to influence others are all important to the fulfillment of the director's ideal role. Directorships as presently constituted simply lack the effectiveness to reliably deal with corporate governance problems.

The myth of independence of directors, auditors, or committee members is a pernicious one if it discourages the pursuit of other creative solutions for corporate governance problems. Much of the time and energy spent on devising independent director, auditor, and committee member schemes is wasted. The naïve are exploited. Important legal rights and remedies are denied to aggrieved persons because of votes by so-called independent or qualified directors. Perhaps worst of all, brilliant minds inside and outside the academic world are diverted from pursuing or developing creative and meaningful solutions to problems of corporate governance be-

161. SHEARMAN & STERLING, *supra* note 157, at 28.
162. *Id.* at 21. In 2004, eighty companies held eight or more audit committee meetings. *Id.*
163. *Id.* at 12.
164. *Id.*
165. *Id.* at 20.

cause they work within the box of the mythology of independence. Empirical studies and law and economics scholarship may rightly question the impact of existing regulatory laws based on reality checks or cost-benefit analyses. However, the answer to corporate governance problems must be found not in a "no law" approach, which would rightly alarm investors or potential investors, but in a realistic "effective law" approach.