

Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle

By Leo E. Strine, Jr.*

It is far too early to understand the long-term implications of the collapse of Enron Corporation. The intriguing story of exactly how that company came to catastrophe is still unfolding, and has all the necessary elements to capture the attention of the public—it is a tale of greed, political influence, conflicts of interests, and even romantic love involving the rich and powerful. Titans of capitalism who had reveled in their status as the genius inventors of a new engine for wealth creation have been rendered mute and dazed before some of the same elected officials who had previously lauded them. A corporate board advertised as having an independent majority finds itself explaining why multifarious economic, personal, and political ties among the directors and management did not cloud the board's ability to monitor management's performance and integrity impartially and effectively. Supposedly gimlet-eyed institutions like bond rating agencies, mutual funds, and investment banks end up looking like giddy adherents to the teachings of pop psychologists, fervently placing blind faith ahead of a skeptical and close reading of financial statements.¹

Political officials have reacted to the Enron debacle with outrage. Separating the part of the reaction that is sincere and that which is defensive may be difficult for the public, given the huge contributions Enron had made to politicians across the ideological spectrum.² Likewise, the reality that the political branches had stalled in implementing and proposing reforms addressed to areas of concern that Enron raises—such as former Securities and Exchange Commission Chairman Ar-

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1. I thankfully acknowledge the assistance of Andrew H. Lippstone, Esq., Adam M. McLain, Esq., and Karlis P. Johnson for their diligent and thoughtful work on this Article, which was presented at the University of Pennsylvania Law School Corporate Law Roundtable on April 26, 2002. I also benefited from valuable comments and information received from Jack B. Jacobs, William B. Chandler III, Stuart M. Grant, Charles M. Elson, Jeffrey N. Gordon, Robert Friedman, and Marcel Kahan, as well as from the other participants in a seminar on Enron at Harvard Law School put together by Professor Mark J. Roe. No attempt was made to incorporate materials or events that emerged after the Penn seminar, such as the report of the New York Stock Exchange Corporate Accountability and Listings Standards Committee issued June 6, 2002, the revelations regarding WorldCom's accounting failures, or the recently enacted Sarbanes-Oxley Act of 2002.

2. See, e.g., Dan Morgan, *Rivals Battled Enron in Energy Lobbying; Firm Thwarted in Key Business Moves*, WASH. POST, Feb. 19, 2002, at A4 (while Enron and CEO Kenneth Lay were among the largest contributors to President George W. Bush's campaign, Enron and Lay also donated \$532,000 to the Democratic Party in 2000).

thur Levitt's proposals to improve the integrity of the accounting of public companies—poses the danger that the political branches will seek to avoid responsibility for previous torpor by means of a too-aggressive response.

Hanging in the balance are important issues, among them the appropriate method by which to set accounting standards and to regulate the integrity, independence, and compliance of the accounting profession. Starkly posed is the question of whether existing disclosure requirements are adequate to ensure that the investing public receives sufficient information. Congress may even be tempted to consider federalizing key elements of corporate law that have traditionally been the province of state law by, for example, attempting to define a federal standard of performance for corporate directors and officers. In this vein, some will have the impulse to write bright-line rules to govern the independence of directors, and particularly audit committees, to strengthen the perception that there was a firm congressional and presidential response to the demise of Enron.

The debate is potentially productive. If it results in a corporate governance system that, on balance, operates with more integrity and increases the confidence investors place in financial disclosures, then it will be useful to long-term wealth creation. But the debate also poses the risk of leading to the creation of policies that are too rigid and punitive, and that cannot respond flexibly to future developments. There is also a danger that policies will be adopted that diminish the responsibility of investors to act carefully and to bear the risk of their own imprudent decisions—thereby undermining the strongest form of monitoring, the market system.

In this Article, I will not attempt to venture into the policy debate raging on Capitol Hill, nor will I give a blow-by-blow of the underlying facts of the debacle, which are still being uncovered and which I will assume the reader has digested elsewhere.³ Instead, I will focus solely on the possible implications Enron has for the state law of corporations.⁴ In addressing these implications, my assumption is that, when all the hearings are done and all the bills are passed or shelved, state corporation law will continue to be the primary regulator of the duties that corporate directors and officers owe to their equity investors. But I also assume that the Enron debate will create pressure on the current standards of state corporation law, and that participants in the policymaking process will identify what they perceive as inadequacies in that law, which they will cite as justifying a stronger role for federal regulation.

State policymakers will not block their ears to these arguments. They can be expected to be responsive to legitimate concerns. These policymakers include those who forge the common law of corporations—state judges—who play the

3. The reader interested in the events leading to Enron's bankruptcy must, of course, consult WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), available at 2002 WL 198018 [hereinafter POWERS REPORT].

4. I do not claim that the state corporation law issues are as important as other issues raised by Enron and situations like it. The issues of accounting and disclosure standards, and auditor and corporate compliance with those standards strike me as more critical, but are not my focus here.

leading role in formulating and enforcing the fiduciary duties of corporate directors and officers. Judges, in particular, can expect that Enron will lead our friends in the corporate plaintiffs' bar to step up their efforts to change legal doctrines that they see as too trusting of corporate management. They will cite to Enron, and similar situations, such as Sunbeam, Cendant, and Global Crossing, in support of closer judicial review of director actions, including directors' performance of their duty to monitor the corporation's compliance with legal standards.⁵

This Article concentrates on some of the most important ways in which the Enron experience is likely to strain existing doctrines of state corporation law.⁶ As a general matter, I focus on the types of arguments I foresee being made by stockholder plaintiffs in Enron's wake. Because some of these same arguments may also lie in the mouths of policymakers arguing for a stronger federal role in the regulation of director conduct, the Article is obliquely responsive to the debate on Capitol Hill.

In particular, I believe that Enron will ignite a fiery debate centered upon the so-called "independent director." Exactly what and who is an independent director? And once we define what and who they are, how effective can they be in overseeing the corporation and cleansing situations involving managerial conflicts of interest? In Part I of this Article, I touch on some of the ways Enron might influence the legal arguments made to courts about these questions.

Relatedly, in Part II of this Article, I explore how Enron might exert pressure on courts to look more carefully at whether directors have made a good faith effort to accomplish their duties. That the Enron Audit Committee process did not quell poorly thought-out financial practices raises questions about whether corporate committees all too often comprised of persons who are overly busy, have strong ties to management, and meet infrequently, are in an effective position to carry out their challenging responsibilities.

I then consider briefly in Part III the concerns that have arisen about whether the corporate governance system has become too imbalanced in favor of incentives

5. Enron is an Oregon corporation; thus, any state law fiduciary duty claims brought against its directors would be brought under Oregon and not Delaware law. I have purposely avoided consulting Oregon law and the complaints in pending lawsuits in preparing this Article. I also have purposely avoided any indication of how the Enron directors' conduct might be evaluated under Delaware law, and making any comments on the merits of any claims brought against them. Instead, I have focused on the types of arguments likely to arise in future cases in the wake of Enron, and have used some Enron "facts" reported in the mainstream financial and news press to illustrate the form these arguments might take. From experience, I am aware that the full story rarely emerges before trial, and that much remains to be learned about the actual facts leading to the company's bankruptcy. Therefore, nothing in this Article should be construed as an opinion about the adequacy of the performance of Enron's board.

6. As I was in the early stages of my thinking about these issues, I benefited from access to the incisive thoughts of Professor Jeffrey N. Gordon, whose work on the implications of Enron I had a chance to preview at a corporate law conference at the University of Chicago in February 2002. That conference gave me the opportunity to articulate my own preliminary thoughts, which, as it turned out, were similar to some of Professor Gordon's. See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002). I also benefited from another early academic commentary on Enron, a provocative piece by Professor William W. Bratton. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. (forthcoming 2002).

for short-term stock value maximization. For the last two decades, much thought has been devoted to finding ways to direct the attention of boards and directors away from a safe managerialist perspective focusing on entity preservation, and toward a more entrepreneurial, risk-taking, and competitive-enhancing attitude. One method to induce this change has been the implementation of compensation policies for managers and directors that reward short-term stock price gains. This more entrepreneurial mind set has also affected the behavior of stereotypically staid and cautious corporate advisors, such as accountants and lawyers. I identify some of the ramifications these practices might have for state corporation principles.

In Part IV of this Article, I address the indirect but traceable effects Enron might have on the subject of corporate takeover law. In that regard, Enron has dealt a body blow to both those who advocate that directors are better positioned than stockholders to know about intrinsic corporate value, as well as those who believe in the efficient market theory. The Enron experience again poses the recurring question of whether directors are in fact materially more likely than stockholders to make better decisions about the value of the corporation. If the empirical evidence suggests only a draw or merely a slight advantage for directors in making value determinations, I note the normative reasons why that outcome could be thought to weigh in favor of those who argue that stockholders should ultimately have the right to decide for themselves whether to accept all-shares, premium offers. For similar reasons, I observe that a tie could influence the legal debate about the effect to give approval of a conflict transaction by a board majority or special committee comprised of independent directors, and whether independent directors can safeguard fairness as well as majority-of-the-minority votes of the disinterested stockholders.

I finish with a plea for a firm but balanced reaction to Enron and situations like it. Risk-free capitalism is an oxymoron, and we endanger much by tampering with a system of corporate governance that, while imperfect, continues to serve our nation well.

PART I

The Enron debacle must inspire anyone deeply interested in corporation law to think anew about the role of independent directors in our system of governance.⁷ The challenges Enron presents for the independent director concept are perhaps too numerous to identify fully yet, but some surface immediately.

Preliminarily, long-standing questions about the proper definition of an independent director have returned to the fore. Skepticism has always existed about

7. See E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2181-82 (2001). "Under Delaware fiduciary duty law, the independence of directors becomes critical in some discrete areas. For example, two areas are interested director or controlling stockholder transactions and derivative litigation Generally speaking, the more the board is dominated by purely independent directors, the more likely it is that board action will find a safe harbor from liability in many settings. Thus, the relevant inquiries are: Independent for what purpose? Independence from whom?" *Id.*

whether there is in fact such a thing as an independent director, given the heavy role management has traditionally played in selecting directors, the reality that independent directors tend to be managers of other corporations, the social affinities that often exist between independent directors and managers, and the acculturating power of the board room.⁸

For many reasons, the law of corporations has proceeded, however, on the contrary premise that truly independent directors can have a meaningfully beneficial influence in ensuring that corporate decisions are made impartially and with integrity. While this method of proceeding is at least partially based on an intuitive judgment that independent directors can serve important cleansing and protective purposes, we must not forget that the law also proceeds in this manner for a more fundamental reason: it is the directors whom stockholders elect to make corporate decisions, not the judiciary.⁹ When corporate decisions are made by attentive directors acting rationally and without any conflicting self-interest, the stockholders have arguably received the benefit of their bargain and an unelected judiciary has no strong claim of entitlement to overturn the directors' judgment.¹⁰ While courts have historically been vigilant about policing self-

8. The body of literature touching on these subjects is rich. Some of the more interesting examples include: Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 160-61 (1996); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055 (1990); Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455 (1984); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982).

9. See E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 402 (1997) ("Whether or not the assumed value of independent directors is empirically supported, institutional investors prefer independent directors. So do courts, but for different reasons. At the end of the day, corporate governance depends on the board of directors as an independent corporate decision-maker operating with due care and in good faith."); Veasey, *supra* note 7, at 2180 ("[P]erhaps the most effective stockholder protection device is the independence of directors. Stockholders vote for directors and expect proper governance from them. The expectation is a strong bond of trust vested in the directors. Courts enforce that trust. At the same time, courts should be reluctant to interfere with business decisions and should not create surprises or wild doctrinal swings in their expectations of directorial behavior.").

10. With the help of Learned Hand, former Chancellor Allen stated this viewpoint articulately in his *Caremark* decision:

[O]ne wonders on what moral basis might shareholders attack a good faith business decision of a director as "unreasonable" or "irrational". Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors. Judge Learned Hand made the point rather better than can I. In speaking of the passive director defendant Mr. Andrews in *Barnes v. Andrews*, Judge Hand said:

True, he was not very suited by experience for the job he had undertaken, but I cannot hold him on that account. After all it is the same corporation that chose him that now seeks to

dealing transactions,¹¹ they have at the same time been hesitant to second-guess business decisions made by impartial directors.¹²

In particular, courts prefer to resolve cases on a basis that does not require a judicial re-examination of the substance of a business decision. Therefore, the common law of corporations has developed procedural tests focusing on whether corporate decisions have been made in a manner sufficiently trustworthy to obviate the need for substantive judicial review. These tests often focus on the presence of one of two integrity-ensuring devices. Was the decision made by disinterested, independent directors with the power to act on behalf of the corporation?¹³ Was the decision approved by a majority of the disinterested stockholders?¹⁴

As a matter of social policy, these factors are important and legitimate. Their recognition reflects a sound deference to decisions made by impartial directors elected by stockholders, and to decisions approved by the stockholders themselves. In either instance, the stockholders have a weak claim that they should be protected by judicially intrusive action to override the results generated by the internal processes of organizations whose shares they voluntarily purchased. Equally important, corporate boards will not function well (it is reasonably feared) if their every decision is subject to relatively unconstrained judicial review. Such easy second-guessing is likely to have a paralyzing effect, and diminish risk-taking, to the larger detriment of stockholders.

The social policy of deference to decisions made by impartial directors or stockholders is, of course, easier to state than to put into practice. Human nature being the wonderfully complex and maddening thing that it is, the judicial task of determining when one of the two cleansing factors exists—and, if one of them does, how much deference to give that fact—has never been simple. Indeed, it has been an obsession of the American corporate law.¹⁵

charge him Directors are not specialists like lawyers or doctors They are the general advisors of the business and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable. Must a director guarantee that his judgment is good? Can a shareholder call him to account for deficiencies that their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such role.

In re Caremark Int'l Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996) (quoting *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924)) (italics omitted).

11. See, e.g., *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

12. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000).

13. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (when majority of board asked to consider whether demand is independent, demand is not excused unless the complaint states a claim for breach of fiduciary duty with particularity).

14. See *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 620-21 (Del. Ch. 1999); *Solomon v. Armstrong*, 747 A.2d 1098, 1129 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000) (both holding that disinterested shareholder ratification of merger transactions after adequate disclosure invokes the business judgment standard of review).

15. Some of the nuances of that focus are discussed in William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001).

I concentrate now solely on Enron's effect on the difficulties courts encounter in determining when to defer to decisions made by the directors without stockholder approval. In this narrower regard, corporation law has long wrestled with fundamental issues such as: what is an independent director? In what factual circumstances do we trust decisions made by independent directors? Do they need to constitute a board majority? If they are constituted as a special committee with their own advisors and empowered to take or stop corporate action, does that validate an otherwise interested transaction?

All of these questions have consumed a great deal of judicial and scholarly energy. The Enron example highlights the most preliminary of these questions: exactly what characteristics must a director possess to qualify as disinterested and independent?¹⁶

Certain judgments about director bias are easy. When a director sells an asset to the corporation, the corporate law easily identifies him as interested.¹⁷ When a corporate manager resists a hostile takeover that might result in the loss of her prestigious position, the corporate law recognizes that the manager's judgment could be clouded by self-interest.¹⁸ What becomes complicated in these situations is determining whether the remaining directors can impartially direct corporate action, and thereby ensure that the interested director's personal interests do not create harm to the stockholders. That is the point when matters often become convoluted.

Because of the structural realities of the corporation, it is unsurprising that courts have struggled with these issues. Courts are aware that corporate boards are not elected in a process that would be considered fair if replicated by the political processes of our nation. In reality, boards are most powerfully shaped by nominating committees, rather than by stockholders. The proxy mechanism is tilted heavily in favor of the management slate, and contested elections rarely occur outside the takeover context.¹⁹ That puts the independence concept under stress from the start, because outside directors are usually identified and selected in the first instance by the incumbent board members. Traditionally, chief exec-

16. As case law makes clear, the concepts of "interestedness" and "independence" are distinct, but related. A director is interested if he receives something from the transaction that is different than that received by the corporation or its other stockholders. A director is not independent if his relationship to a director interested in the decision at hand makes him unable to fulfill his duties to the corporation impartially. For a lucid description of these concepts, see *Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002); see also *Aronson*, 473 A.2d at 816.

Allow me one important disclaimer. The question of whether a director can act independently is inherently situational. For example, outside director Jones could have no consulting arrangements with the company, no personal friendships with management, and no other ties, but could be the close personal friend of another outside director, Johnson. If Johnson were to sell an asset to the corporation, a question would arise about Jones's ability to consider that transaction impartially (i.e., independently), even though in most other circumstances Jones's independence would be unassailable. I elide complexities like these for purposes of the Article, to better concentrate on more general issues relating to independence.

17. See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001).

18. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

19. See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1094 (2002) (citing authorities).

utive officers (CEOs) have played an important role in board selection, a practice that has often resulted in the selection of directors with pre-existing relationships with management.²⁰

As a general matter, the judiciary has been reluctant to conclude that non-economic relationships—such as close personal friendships—among outside directors and management compromise independence.²¹ Underscoring this approach is a judicial intuition that boards must act collegially and cohesively, and not as adversaries or strangers.²² Lest they disrupt board harmony and effectiveness, courts have hesitated to impose rules that lightly label persons of accomplishment and distinction as non-independent, simply because those persons have social and professional ties to corporate management that go beyond service on the same board. This judicial reticence is reinforced by a concern that labeling a director as non-independent disables the effectiveness of a person chosen by the corporate electorate to make decisions (albeit in a management-biased election process). Put bluntly, if the stockholders thought that this individual could make good decisions irrespective of his disclosed ties to the CEO, shouldn't the court be cautious about concluding otherwise?²³

Management's strong role in shaping boards has also complicated the judicial role in another way. Because directors are paid and often derive indirect benefits from service on a prestigious board, the question arises whether a director's desire to continue to serve on the board compromises his ability to make a decision that displeases management. If the outside director's conduct as a board member angers or upsets the insiders, will the outsider be left off next year's management slate?

This question takes on added significance when directors' fees and emoluments are substantial. Enron's outside directors, for example, each earned over \$300,000 in one year from options alone,²⁴ and outside director Wendy Gramm is reported to have made between \$900,000 and \$1.8 million during her first eight years on

20. See, e.g., Gilson & Kraakman, *supra* note 8, at 884 ("Although outside directors are financially independent, they are traditionally selected by management and remain socially and ideologically tied to management . . ."); see also Aronson, 473 A.2d at 816 ("[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director.").

21. See, e.g., *Crescent/Mach I Partners L.P. v. Turner*, No. 17455, 2000 WL 1481002, at *11 (Del. Ch. Sept. 29, 2000).

22. See Veasey, *supra* note 9, at 395.

23. See Veasey, *supra* note 7, at 2183 ("The inquiry in the Disney case was not whether we 'liked' the composition, behavior, and decisions of Disney's board as alleged in the Complaint. That determination is not for the courts. It is a decision for the stockholders to make in voting for directors, in urging other stockholders to reform or oust the board, or in making individual buy-sell decisions involving Disney securities.").

24. See Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, § 3, at 4. Indeed, some estimates have indicated that the outside directors of Enron received stock and option packages worth more than \$800,000 in the year 2000. Theo Francis, *Questioning the Books: Waiver Approved for Enron Director May Cut Her Losses*, WALL ST. J., Feb. 11, 2002, at A8. Even though much of this value may have eroded with Enron's bankruptcy, the fact that such a value could have been placed on the directors' compensation at any time is obviously at odds with the traditional common law assumptions about the level of director pay.

the Enron board.²⁵ The Enron outside directors also had a variety of arrangements with the corporation that went well beyond mere service on the board.²⁶

This legitimate concern creates a quandary for the judiciary. If a director's desire to continue serving in that capacity renders him unable to act independently of management, the independent director concept loses virtually all of its utility. Why? Because in any scenario in which the role of independent directors has been declared most useful—such as the approval of an interested transaction or a take-over fight—the independent directors simply do not exist.

For these and other reasons, the corporation law's resolutions of these subsurface policy contradictions has been to cloak outside directors with a "presumption" of independence that is not easily overcome.²⁷ It has been noted, for instance, that demand is not excused in a derivative case "just because directors would have to sue 'their friends, family, and business associates.'"²⁸ Courts have also held that the "[r]eceipt of director's fees does not suggest a conflict of interest . . . [because if] [i]t did, every director who receives a director's fee would [be] biased."²⁹ Likewise, the judiciary has been chary about finding that relatively modest contractual relationships between an outside director and the corporation—such as a consulting contract paying a well-heeled outside director \$50,000 or so annually on top of his directors' fees—compromises independence.³⁰ A similar approach has characterized certain judicial decisions addressing challenges to the independence of outside directors affiliated with institutions that have been the object of the corporation's charitable beneficence.³¹

Decisions of this nature have not gone uncriticized. And in some cases, the "presumption" of independence has been pierced. The cases, however, evidence a see-saw pattern. Judicial confidence in the ability of directors to put aside troubling personal, professional, and financial circumstances has wavered. For every two decisions that display a more optimistic belief in human nature and its implications for director independence, at least one involves a more searching examination of relationships and economic arrangements that could arguably gen-

25. See Jay Root & Jennifer Autrey, *Power Couple; Sen. Phil Gramm and His Wife, Wendy, Have Deep Ties to Enron*, FT. WORTH STAR-TELEGRAM, Jan. 18, 2002, at 23A; Nancy Benac, *Gramms Entangled in Enron Collapse*, THE ASSOCIATED PRESS, Jan. 23, 2002.

26. See, e.g., Root & Autrey, *supra* note 25.

27. See, e.g., Aronson, 473 A.2d at 805; *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 354, 355 n.19 (Del. Ch. 1998), *aff'd in part, rev'd in part*, Brehm, 746 A.2d at 244.

28. *Disney*, 731 A.2d at 355 n.18 (quoting *Abrams v. Koether*, 766 F. Supp. 237, 256 (D. N.J. 1991)).

29. *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986). In *Grobov v. Perot*, 526 A.2d 914, 923 n.12 (Del. Ch. 1987), *aff'd*, 539 A.2d 180 (Del. 1988), the Delaware Court of Chancery indicated that this view was "sound and correctly states Delaware law . . ." On appeal, the Delaware Supreme Court agreed. 539 A.2d at 188.

30. See *Disney*, 731 A.2d at 360 (\$50,000 consulting fee paid by Disney to former Sen. George Mitchell, who was special counsel to a law firm engaged by the company, did not raise reasonable doubt as to Sen. Mitchell's independence); *White v. Panic*, 2000 WL 85046, at *7 (Del. Ch. 2000), *aff'd*, 783 A.2d 543 (Del. 2001) (taking a similar approach to directors with relatively modest consulting arrangements).

31. See, e.g., *Disney*, 731 A.2d at 359 (gifts by Michael Eisner of more than \$1 million to Georgetown University did not create reasonable doubt as to independence of Georgetown's President, Father Leo J. O'Donovan).

erate bias.³² A deep skepticism pervades much thinking about the independent director concept. Many commentators believe that courts should refuse to give significant weight to independent director approval of conflict transactions, and refuse to credit the idea that independent directors will cause the corporation to sue management.³³ Even when outside directors have no other contractual arrangements with the company and no social ties to management, they remain (many commentators believe) ill-positioned to act as adequate monitors of management.³⁴

32. For a recent example of a searching and sophisticated inquiry into director independence that resulted in the denial of a motion to dismiss, see *Orman*, 794 A.2d at 5-42. For other examples of close scrutiny of independence resulting in findings that directors could not, at least as of the procedural stage at issue in the opinion, be considered independent, see *Rales v. Blasband*, 634 A.2d 927, 937 (Del. 1993) (director whose compensation was subject to influence by controlling stockholder was not independent for pleading purposes); *Mizel v. Connelly*, 1999 WL 550369, at *4-*5 (Del. Ch. 1999) (directors who were respectively the grandson and subordinate of CEO could not objectively consider demand to sue him); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) (CEO's brother-in law could not impartially consider demand to sue him); *Friedman v. Beningson*, 1995 WL 716762, at *5 (Del. Ch. 1995) (finding that a litigable question of independence was raised when a director received "consulting fees, which have been on the magnitude of \$48,000 a year, [which] when considered in the context of the other facts alleged, represents a substantial interest subject to possible corporate retribution had [the director] exercised judgment in a way displeasing to the financially interested thirty-six percent Shareholder/CEO"); *Steiner v. Meyerson*, 1995 WL 441999, at *2 (Del. Ch. 1995) (where a director, an attorney for a small law firm providing counsel to company, could potentially be hired or fired by CEO, and that director's law firm had received almost \$1 million in counsel fees in one year, that director could not be considered independent at pleading stage for demand purposes); cf. William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1088 (1999) ("Courts should not rely reflexively only on the status of a director as an 'inside director' or an 'independent director' to inform their determination of whether that director's actions were right or wrong, proper or improper, informed or uninformed.").

33. An articulate and consistent proponent of this view has been Professor Victor Brudney. See, e.g., Victor Brudney, *Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations*, 25 J. CORP. L. 209 (2000). Suspicions about the effectiveness of independent directors as an effective brake on abusive conflict transactions are also reflected in existing Delaware precedent. For example, even when a judge concludes that a special committee of independent directors bargained at arms length with the controlling stockholder over the price of a going private merger, had the power to say no, and made a well-advised decision to accept the price they did, our law does not give their decision the protection of the business judgment standard of review. Instead, the transaction remains subject to entire fairness review, with special committee negotiation and approval resulting only in a shift of the burden of persuasion under a preponderance standard from the defendants to the plaintiffs. *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1117 (Del. 1994).

34. Learned observers have noted the obstacles that make it difficult for independent directors to act as effective monitors. In the words of Professors Gilson & Kraakman:

Good character and financial independence from management may be necessary conditions for effective monitoring, but they are hardly sufficient. First, even financially independent outside directors depend on management for their tenure as directors, since management typically selects its own outside directors. Thus, directors who wish to retain their positions are not independent of management. Second, most outside directors share management's ideological disposition toward the single issue most central to their monitoring responsibilities: how intensely outside directors *should* monitor management. Some 63 percent of the outside directors of public companies are chief executive officers of other public companies. These directors are unlikely to monitor more energetically than they believe they should be monitored by their own boards. Third, outside directors are not socially independent. As Victor Brudney put it, "[n]o definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose [perfor-

The well-publicized connections between Enron and its outside directors are, of course, similar in kind to those that courts address regularly in corporation law cases. Are high-ranking officers at a medical center that has received over a million dollars from Enron and its top management "independent" Enron directors?³⁵ Is an outside director independent of Enron management when her husband's campaign coffers have been filled with contributions from Enron officers?³⁶ Can outside directors whose own companies received millions of dollars in consulting and services work from Enron monitor the behavior of Enron management?³⁷

mance] he is asked to assess." Finally, in addition to these dependency, ideological, and social obstacles to monitoring, outside directors typically lack an affirmative incentive to monitor effectively. The corporation cannot simply pay outside directors a large sum to induce careful monitoring because the prospect of a large payment would itself undercut their financial independence. Yet any serious effort to monitor inevitably imposes large personal costs on outside directors. As many commentators have pointed out, outside directors lack the time, expertise, staff, and information to challenge management, while management controls not only these resources but also has a direct and powerful incentive to direct corporate policy without interference.

Gilson & Kraakman, *supra* note 8, at 874-75. See also the views of Professor Elson:

There are three problems with a management-appointed board that lead to ineffective oversight. First, personal and psychic ties to the individuals who are responsible for one's appointment to a board make it difficult to engage in necessary confrontation. It is always tough to challenge a friend, particularly when the challenging party may one day, as an officer of another enterprise, end up in the same position. Second, conflict with a manager who is also a member of one's own board may lead to future retribution on one's own turf, thus reducing the incentive to act. Third, and most important, when one owes one's own board position to the largesse of management, any action taken that is inimical to management may result in a failure to be renominated to the board, which—given the large fees paid to directors (and the great reputational advantage of board membership)—may function as an effective club to stifle dissension. This is why the development of substantial director compensation, a consequence of management control, has acted to stifle board oversight of management and has, in fact, enhanced management domination.

Elson, *supra* note 8, at 161-62.

35. Enron directors John Mendelsohn, Charles LaMaistre, and John H. Duncan all had close ties to such a medical center. See Christopher H. Schmitt et al., *One Cozy Bunch*, U.S. NEWS & WORLD REPT., Feb. 11, 2002, at 28. Compare *Disney*, 731 A.2d at 359 (considering whether university president whose institution received \$1 million in contributions from the corporation was independent of the CEO), with *Lewis v. Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985) (fact that dominant board member, Fuqua, had made contributions totaling \$10 million to Duke University, coupled with numerous prior political and financial dealings between Fuqua and special committee member and Duke President Terry Sanford, "raised a question of fact" as to Sanford's independence).

36. Enron director Wendy Gramm's husband, Senator Phil Gramm, had received nearly \$100,000 in campaign contributions from Enron-affiliated sources. Maria Recio, *Gramm Lauds His Wife's Role in Enron*, FT. WORTH STAR-TELEGRAM, Jan. 24, 2002 (Sen. Gramm received contributions of \$97,350 from Enron officials from 1989 to 2001, citing Public Citizen as a source). In addition, Wendy Gramm is also the director of a regulatory studies center at George Mason University. During the last three years that center received more than \$50,000 from Enron and the family of former Enron Chairman and CEO Kenneth Lay. Mark Jaffe, *Enron Woes: The Board Directors' Financial Ties*, NAT'L POST, Nov. 30, 2001, available at 2001 WL 31020336.

37. This was apparently true of Enron director Herbert S. Winokur, Jr. See Schmitt et al., *supra* note 35; cf. *Orman*, 794 A.2d at 5 (Del. Ch. 2002) (considering whether a director who had a consulting contract with his corporation could be considered independent).

In the wake of Enron, the judiciary will come under increasing pressure from stockholder-plaintiffs to approach these questions in a more cold-eyed manner. Why should the law *presume* that an outside director can impartially decide to sue his long-standing personal friend, the CEO? Why should the law *presume* that rational, outside directors enter into economic contracts with the corporation—such as consulting arrangements—that are immaterial to themselves? Why should the law *presume* that a director who is also the head of a charity receiving charitable contributions directed largely by corporate management, will not fear that such contributions would be reduced if he acts contrary to management's wishes? What, they will ask, is the empirical basis for the inference that such factors do not weigh on the minds of outside directors asked to challenge or even sue management?

In other words, stockholder plaintiffs might be expected to press Delaware courts even more to develop firmer, bright-line rules about independence. They will seek to obliterate and perhaps reverse existing presumptions, and ask our courts to presume, at the pleading stage, that directors who have questionable ties to management are *not* independent for purposes of dismissal motions.³⁸ In

38. In the *Disney* case, the Council on Institutional Investors filed an amicus brief with the Delaware Supreme Court asking that Court to do just that. Because the Supreme Court did not reach the key independence issues adjudicated below, it did not have occasion to address the Council's position. The brief is nonetheless significant, if only because it represents the view of a group of powerful investors who hold significant equity portions in America's largest public corporations. In its brief, the Council argued for the following rule of law:

In conjunction with its policy requiring a substantial majority of independent directors, the Council and its members unanimously adopted a detailed definition of the term "independent director" which, in their view, recognizes the realities of how corporations are managed today. Specifically, the Council defines an "independent director" as someone whose "only non-trivial professional, familial or financial connection to the corporation or its CEO is his or her directorship." To clarify what types of relationships are "nontrivial," the Council has gone on to specify the following circumstances as ones which create a presumption of non-independence:

- where the director has been employed by the corporation or an affiliate in an executive capacity;
- where the director is, or in the past two years has been, an employee or owner of a firm that is one of the corporations' or its affiliate's or the CEO's paid advisers or consultants;
- where the director is employed by, or has a five percent or greater ownership interest in, a debtor or creditor of the corporation if the amount owed exceeds 1% of the corporation's or the third party's assets;
- where the director has, or in the past two years has had, a personal services contract with the CEO, the corporation or one of its affiliates;
- where the director is employed by, or serves as an officer or director of, a non-profit corporation, foundation, university or other organization that receives significant grants or endowments from the corporation or one of its affiliates;
- where the director is a relative of an executive of the corporation or one of its affiliates;
- where the director is part of an interlocking directorate in which the CEO or other executive officer of the corporation serves on the board of another corporation that employs the director.

* * *

The Council respectfully submits that its definition of "independent director" as someone whose only "non-trivial" connection to the corporation or its CEO is that person's directorship, and the criteria that have been developed to accompany that definition, are consistent with corporate reality and should be adopted by this Court as the operative standards for evaluating director independence. . . .

this respect, the plaintiffs will argue that they cannot reasonably be expected to show, at the pleading stage, that a particular director is, *in fact*, unable to consider impartially whether to sue the CEO, without taking cognizance of the fact that the CEO is his long-time friend and that their families have vacationed together.³⁹ Instead, they will argue, the law should presume that such a relationship would be on the minds of a typical director forced to make such a decision, thereby making it inferable that any particular director possessing such ties could have found it difficult to act impartially.⁴⁰ Although these factors may not be liability-producing, the plaintiffs will say that at the least, the law should preclude interested directors from hiding behind so-called "independent" directors who possess such ties to obtain the dismissal of derivative claims at the pleading stage. Put differently, in these cases the law should at minimum be supple enough to permit the plaintiffs to proceed to discovery and a trial so that they can prove that the board in fact did not fulfill its fiduciary duties impartially.⁴¹

Those who believe otherwise have their position undercut every time a court, rather than being able to determine what weight to give action by independent directors, is instead required first to engage in a painstaking and complicated analysis of which directors are entitled to be considered independent. Even if well-reasoned, judicial decisions spending twenty pages concluding that fifteen different ties between outside directors and management are not disqualifying, do little to promote public confidence in corporate boards.⁴²

Plaintiffs may also challenge the common law nostrum that a director is unlikely to be partial towards management simply so as to maintain a place on the man-

39. Shareholder activists have pointed out the difficulty of identifying all potentially disabling conflicts through public filings and books and records actions, and have argued that limited discovery about director bias should be permitted before a motion to dismiss a derivative suit is considered. *Id.* at 18 n.8.

40. It is worth observing that such ties could generate bias in either direction. The traditional worry is that the friend of the CEO will go too easy on him. The other possibility is that the friend will be tougher on his CEO-friend, precisely because of the appearance problem their relationship creates.

41. In comments on this Article, Professor Marcel Kahan noted the importance of after-the-fact judicial review of director conduct. As he noted, directors with ties that could be seen as compromising their independence might *in fact* have acted independently. By contrast, a director whose independence could not be questioned at the pleading stage might be found, after a full trial, to have acted out of bias towards an interested colleague rather than for appropriate reasons. For this reason, Chancellor Chandler has rightly urged caution in using labels like "interested" or "independent" as a critical factor in resolving cases. See Chandler, *supra* note 32, at 1083. The pleading-stage definitional test remains important, however, because that test plays a key role in determining which cases proceed to full factual investigation. There are social costs to any definitional approach that must be weighed carefully. That is, the costs of stopping potentially meritorious cases at the pleading stage that flow from a rule that makes it difficult to challenge director independence must be weighed against the costs of permitting more non-meritorious cases to go to discovery that would accompany a more plaintiff-friendly standard.

42. These factors will undoubtedly influence the debate over the effect to give disinterested director approval and negotiation of "conflict" transactions. Those who contend that the fact that an effective special committee blessed a deal should be given greater liability-insulating effect might have to be willing to live with a stricter, more pristine definition of "independence." Cf. Allen, Jacobs & Strine, *supra* note 15, at 1306-09 (suggesting that the business judgment rule apply *once* a court has closely reviewed a special committee's independence and effectiveness, and determined that the committee served as an effective proxy for genuine arm's-length bargaining).

agement slate. Although the large sums Enron paid to its directors might appear anomalous, in fact director compensation packages are increasing in many public companies. A recent survey of the top two hundred companies resulted in an average board compensation package of \$138,747 annually.⁴³

To the extent directors in such companies are nominated in a manner heavily influenced by management—rather than by a nominating committee of independent directors—the presumption that directors' compensation is not a bias-producing factor can be viewed as less sustainable. Many outside directors have made a lucrative career out of serving on three or four boards concurrently, producing an aggregate yearly salary that would have pleased top executives in decades still within memory. Plaintiffs' lawyers can be expected to begin to press the point that six-figure receipts are not lunch money.

Equally as important, do not be surprised if plaintiffs' lawyers demand that courts weighing the independence of a director consider the overall level of benefit the outside director derives from service. For example, expect plaintiffs to suggest that a court evaluating the independence of a director selected with management input consider the director's \$50,000 consulting fee, and his law firm's \$75,000 a year in fees, in addition to that director's receipt of \$175,000 in annual directors' compensation. Plaintiffs who do so will be able to cite to case law admonitions that

the rule that receipt of customary directors' fees does not create a disqualifying interest is one involving the application of a presumption (*i.e.*, the presumption of director disinterest). It is not an unvarying principle that mechanically applies irrespective of the circumstances. Conceivably a situation might arise where directors' compensation, in the form of "directors' fees," becomes so lavish that a mechanical application of the presumption would be totally at variance with reality.⁴⁴

Corporate America has an interest in addressing these pressures through its own processes, before the judiciary is called upon to do so.⁴⁵ As I have described, the institution of the independent director carries much water in American corporation law. That institution helps to reduce the extent to which the judiciary

43. PEARL MEYER & PARTNERS, 2000 DIRECTOR COMPENSATION: MEETING THE EQUITY CHALLENGE, TOP 200 CORPORATIONS AND DOT.COM 100, at 3 (2000) (annual director survey of top 200 U.S. industrial and service companies) [hereinafter PEARL MEYER 2000 REPORT]; *see also* SPENCER STUART BOARD INDEX: NOW MORE THAN EVER, DIRECTORS ARE A VITAL RESOURCE 10-12 (2001) (indicating that directors' annual compensation of excess of \$100,000 is common) [hereinafter SPENCER STUART 2000 SURVEY].

44. *See Grobow*, 526 A.2d at 923 n.12; *see also Orman*, 794 A.2d at 29 n.62 ("It is worth noting that these cases were based on circumstances in which the fees paid to directors were customary and usual in amount. This court's view of the disqualifying effect of [directors'] fees might be different if the fees were shown to exceed materially what is commonly understood and accepted to be a usual and customary director's fee.").

45. *See Veasey*, *supra* note 7, at 2189 ("Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, might be a 'safe harbor' in some cases, sometimes reduce litigation, and can usually help directors avoid liability [C]ompanies are well advised to adopt best corporate practices to stay out of court.").

intrudes on boards' substantive decisions. As Chief Justice Veasey said recently, the judiciary's resolution of corporate cases often turns primarily on whether the court feels that it can trust the directors.⁴⁶

When that trust breaks down, boards may find themselves in difficult and unenviable positions. Enron's board, at a time when its effectiveness is under challenge, must also overcome intense public cynicism regarding its real independence. That is, just when the board would most want its own integrity to be beyond question, its integrity comes instead under the closest public scrutiny. What makes this even more strange is that the Enron board was advertised as having an independent majority. For the common law of corporations, the difficulty is that this advertisement, on the basis of case precedent, was arguably truthful.⁴⁷ This fact threatens to expand public cynicism from the composition of particular corporate boards to the substance of state corporation law itself.

PART II

Apart from its influence on the independent director debate, Enron will also generate increased pressure on courts to examine carefully the plausibility of directors' claims that they were able to devote sufficient time to their duties to have carried them out in good faith. It has, of course, become common for courts to examine board processes carefully in the high-profile context of fast-moving takeover contests.⁴⁸ But Enron and situations like it suggest to me that skillful plaintiffs' lawyers will begin making common-sense arguments about the disconnect between the *routine* tasks directors undertook to perform and the effort they put in to accomplish them.

These arguments might sharpen the importance of "state of mind" determinations in the adjudication of corporate cases. There are several reasons why this is likely to be so. Most important is the prevalence of exculpatory charter provisions that exonerate directors for due care breaches.⁴⁹ Because accounting fraud cases like Enron—and high-profile matters such as Cendant, Sunbeam, and Global Crossing⁵⁰—usually arise after it is too late for prospective injunctive relief to be

46. E. Norman Veasey, Remarks at ALI-ABA Advanced Course of Study on "United States Domestic and International Litigation and Dispute Resolution" (Apr. 11, 2002) (on file with the author).

47. "The real scandal here," commented Senator Fred Thompson generally during the Governmental Affairs Committee's investigation into the Enron bankruptcy, "may not be what's illegal, but what's permissible." Quoted in *Perspectives*, NEWSWEEK, Feb. 4, 2002, at 17.

48. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

49. These provisions are authorized by state corporate codes. Delaware's statute is codified at DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Many of these provisions were approved by the stockholders of existing corporations after § 102(b)(7)'s enactment. As Congress considers reform, it should be careful to ponder the implications of the fact that sophisticated shareholder activists support such provisions in order to attract good directors and encourage useful risk-taking. If stockholders have freely chosen to give their directors such protection, modesty (and deference to the equity stakeholders with money at risk) counsels caution before that decision is overridden by positive law. For the same reason, state policymakers—including courts—must be cautious about innovations that would erode these protections and make it more difficult for corporations to find quality directors.

50. With respect to Global Crossing, see Richard A. Oppel, Jr., *Chief Acknowledges 'Debate' On Global Crossing Deal*, N.Y. TIMES, Mar. 22, 2002, at C4.

of much use, these provisions are important to litigators, because in the absence of evidence that the outside directors had a financial interest in the underlying misconduct, they force plaintiffs' counsel to challenge the state of mind (i.e., the good faith) of the outside directors.

Chancellor Allen's famous opinion in *In re Caremark International Inc. Derivative Litigation*⁵¹ emphasizes the importance of good faith. That opinion is most often cited to emphasize the duty of directors to exercise due care in monitoring the corporation's compliance with legal standards—including standards of fair disclosure of the corporation's financial health. But *Caremark* also suggests that directors should only be held personally liable for a failure to monitor if their laxity in oversight was so persistent and substantial that it evidences bad faith.⁵² Whether or not the legal standard of liability is in fact bad faith or the somewhat lower threshold of gross negligence, as some other law would suggest, is a question that is not of much practical consequence.⁵³ Because most corporations have exculpatory charter provisions, both those provisions and the *Caremark* decision will impel litigators to focus upon the directors' good faith.

After Enron and recent cases like it, one can envision plaintiffs' lawyers who will try to take apart a board of directors based on the simple argument that the board simply could not have carried out its duties in the time it devoted to them. Consider, for example, the arguments that an eloquent advocate might make based on some of the putative "facts" regarding the Enron Audit Committee.

Let us start with the new Audit Committee Charter ("Charter") that Enron adopted at its 2001 annual meeting. Key aspects of that Charter stated as follows:

COMPOSITION

The Committee shall be comprised of three or more directors who, in the opinion of the Board of Directors, as evidenced by its election of such Committee members, have no relationship to the company that may interfere with the exercise of independent judgement as a Committee member. All members of the Committee shall be financially literate or become financially literate within a reasonable period of time after appointment to the Committee, and at least one member of the Committee shall have accounting or related financial management expertise, in each case as interpreted by the Board of Directors.

MISSION STATEMENT AND PRINCIPAL FUNCTIONS

The Committee shall serve as the overseer of the Company's financial reporting process and internal control The Committee's principal functions shall include:

51. 698 A.2d 959 (Del. Ch. 1996).

52. *Id.* at 971.

53. I note that there may be some discontent expressed with this standard in Congress, and proposals to trigger liability on a lesser showing. Any initiative in this direction arguably threatens more harm to stockholders than good. Obtaining high-quality directors will become more difficult. And on a practical level, just which institution will enforce the federal standard? The federal courts or the SEC, both of which claim to be overburdened already? Or will state courts be asked to apply federal standards overriding a subject area traditionally a concern of state law?

Ensure Audit Function Independence

- Recommend to the Board of Directors, for subsequent submission to the shareholders of the Company, the firm to engage as the Company's independent auditor; and, if warranted in the discretion of the Committee, recommend to the Board of Directors the termination of that engagement. *Furthermore, ensure that the independent auditor is ultimately responsible and accountable to the Committee and the Board of Directors as representatives of the Company's shareholders.*
- Review the independent auditor's compensation, the terms of its engagement, and its independence
- Serve as a channel of communication between the independent auditor and the Board of Directors and
- *Review the Company's annual financial statements and any significant disputes between management and the independent auditor that arose in connection with the preparation of those financial statements, including any restrictions on the scope of work or access to required information.*

Assess Internal Controls and Quality of Financial Reporting

- Discuss with the independent auditor information relating to the auditor's judgments about the quality of the Company's accounting principles, including such matters as the consistency of application of the Company's accounting policies, as well as the clarity and completeness of the Company's accounting information contained in the financial statements and related disclosures filed with the Securities and Exchange Commission and distributed to the Company's shareholders.
- Review, in consultation with the independent auditor and the executive having responsibility for the internal and contract audit functions, the adequacy of the Company's internal financial controls. *Among other things, determine whether these controls provide reasonable assurance that the Company's publicly reported financial statements are presented fairly in conformity with generally accepted accounting principles*
- Approve major changes and other major questions of choice regarding the appropriate accounting principles and practices to be followed when preparing the Company's financial statements for the purpose of making recommendations to the Board of Directors as necessary.

Review Financial Statements

- Review financial statements included in the Annual Report to Shareholders, footnotes, and management commentaries, [and] Form 10-K filings made with the Securities and Exchange Commission prior to release of such statements and filings. In addition, review findings of any examinations by regulatory agencies, such as the Securities and Exchange Commission.
- Publish a written report in the annual proxy statement indicating that (a) the Committee has reviewed and discussed the financial statements with management, (b) the Committee has discussed the quality of the Company's accounting principles as applied in its financial reporting,

(c) the Committee has received the written report from the independent auditors delineating all relationships between the auditor and the Company, (d) the Committee has discussed with the independent auditors their independence and taken or recommended action, if necessary, related to independence concerns and (e) *nothing has come to the Committee's attention that would cause them to believe that the financial statements included in the Annual Report on Form 10-K contain an untrue statement or omit a material fact*, and thus recommend to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K. Furthermore, the Committee will take action where necessary to be in compliance with all applicable rules and regulations

- Review with management the Company's policies and practices for communications with analysts.

Other

- Approve for recommendation to the Board of Directors the Company's policies and procedures regarding compliance with the law and with significant Company policies, including but not limited to, codes of conduct expressing principles of business ethics, legal compliance, the Foreign Corrupt Practices Act, and other matters relating to business conduct, and programs of legal compliance designed to prevent and detect violations of law.
- Review with the general counsel any legal and regulatory matters that may have a material effect on the Company's financial statements, compliance policies, and programs

MEETINGS

The Committee shall meet at least four times annually, or more frequently as circumstances dictate

While the Audit and Compliance Committee has the responsibility and power set forth in this charter, it is not the duty of the Audit and Compliance Committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. This is the responsibility of management and/or the independent auditors.⁵⁴

That Charter gives the Audit Committee rather daunting responsibilities. One would imagine that the members of the Committee would have to devote considerable sustained attention if they intend to fulfill the Charter's goals. This would require that the members not be too burdened by other responsibilities or obstacles that would detract from their ability to spend significant time on Enron matters. The duties of the Audit Committee also require that the members be capable of acting in a manner that is genuinely independent—indeed actively

54. ENRON CORP., AUDIT AND COMPLIANCE COMMITTEE CHARTER (as amended Feb. 12, 2001) (emphasis added) in ENRON CORP. PROXY STATEMENT PURSUANT TO SECTION 14(A) OF THE SECURITIES AND EXCHANGE ACT OF 1934, at 44-47 (2001) [hereinafter ENRON 2001 PROXY].

challenging—of management. The Committee must probe regularly about the corporation's practices and integrity, pushing management to come clean and stay clear of ethical gray areas.⁵⁵

55. The Chief Accountant of the SEC, Robert Herdman, recently commented on the challenging task confronted by audit committees at a speech at the Tulane Corporate Law Institute. During his remarks, Mr. Herdman suggested a three-point "short list" of tasks required of an effective audit committee: "(1) control the agenda, (2) be diligent, and (3) take the time." Some of his more specific recommendations are as follows:

- "Audit committee members simply must ask the tough questions of management and of internal and external auditors. And, they have to understand the sometimes highly complex information and results put before them."
- The "audit committee members need to probe to find out the nature and extent of issues that management and the auditors gave considerable attention to. It's not enough to merely be told there were no reportable disagreements."
- "[A]udit committees need to engage in proactive discussions with company management and outside auditors regarding key accounting judgments. It is essential that the audit committee be actively, not passively, engaged."
- "Audit committee members cannot walk away if they don't understand a material transaction, the economics, or the accounting behind that transaction, no matter how complex. And here it's the overall presentation and economic effect that absolutely must be understood, with as much supporting details as necessary and appropriate."
- "[I]n understanding critical accounting policies, it is important to be able to explain the range of results that would be followed, if alternate accounting methods had been used, and why the particular method was chosen."
- Borrowing from Warren Buffett, the audit committee should discuss and document in the minutes these three questions to the auditor:
 - "If the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way different than the manner selected by management? The audit committee should inquire as to both material and nonmaterial differences. If the auditor would have done anything differently than management, an explanation should be made of management's argument and the auditor's response."
 - "If the auditor were an investor, would he have received the information essential to a proper understanding of the company's financial performance during the reporting period?"
 - "Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?"
- "Audit committee members must make the time, and take the time, to achieve an adequate understanding of what the company's financials represent, to have enough time to consult with outside counsel and experts if necessary, to ask the tough and incisive questions, and to obtain answers that make sense. As such, an effective audit committee requires a commitment of quality and quantity time: quality time in that they will give the critical corporate governance and accounting and disclosure issues their full attention, and quantity of time to allow thorough deliberations and discussion. This means that proper upfront planning, conduct of meetings and follow[-]up are essential.

"It also means that spending an hour together three and four times a year probably is not sufficient. The critical accounting policy exercise . . . outlined above undoubtedly requires more time than that alone. Reading the financial statements and MD&A for clarity and understandability, for purposes of making a recommendation to the full Board, requires more time than that alone."

Robert K. Herdman, Remarks at the Tulane Corporate Law Institute (Mar. 7, 2002) (transcript on file with author).

With the litany of administrative directives and legislative proposals which have followed in the wake of the Enron debacle, more probing and activist audit committees may well become the normative standard. Recently, Martin Lipton of Wachtell, Lipton, Rosen & Katz wrote a memorandum reflecting his "current thinking" on the challenges now facing directors and, in particular, audit com-

The full story about Enron's Audit Committee still remains to be told, and therefore fairness and reason dictate that observers reserve judgment on just how well or poorly the Audit Committee in fact performed its duties. In this regard, we must also be cognizant of the dangers of hindsight bias; what looks so obvious to some after the fact might not have been so apparent to even a diligent independent director in advance.⁵⁶ Not only that, commentators should heed the parts of the Powers Report that suggest that the Enron Audit Committee was given less-than-candid answers by management and company advisors about key issues, cutting off the in-depth Committee deliberations that might have followed forthright responses. Indeed, some sophisticated commentators have opined that the Committee carried out its duties in literal compliance with the urgings of corporate governance advocates.⁵⁷

What is less debatable, however, is that the Committee left itself open to criticism by displaying several characteristics that cut against what distinguished commentators have advocated as best board practices.⁵⁸ For example, plaintiffs' lawyers and corporate governance activists will likely question whether the Enron Audit Committee was well-situated to fulfill its charter. Was it possible for them to devote the necessary time? Was it possible for them to act independently of management?

Take the time commitment issue. Without denigrating the important contribution non-U.S. members can bring to American corporate boards, a reasonable question can be posed whether it makes sense, as Enron did, to have an Audit Committee with three members who live abroad—one from Hong Kong, one from Brazil, and one from England.⁵⁹ As a purely logistical matter, their residences simply make it much harder for them to attend meetings in person on a regular basis, especially for the two of them who appear to be top executives of large companies. While it is true that directors can attend meetings by phone, in reality the tough slogging required of an effective Audit Committee will likely be done less than optimally if certain members regularly participate only by videoconference.

mittee members. Among other things, Mr. Lipton advised that "[t]he charter and procedures of the audit committee should be reviewed to bring them up to the state of the art"; "[t]he audit committee should meet with the outside audit firm and review that firm's quality control procedures to determine if they are satisfactory"; and that "[t]he audit committee . . . review the company's 'critical accounting principles' with management and the audit firm as is being urged by the SEC and as would be required by proposed rules and legislation." Mr. Lipton concluded that "[w]hat has changed is the amount of time that audit committees will need to spend to meet the procedures referred to above, and companies will have to reexamine the scheduling of audit committee meetings." Memorandum of Martin Lipton (Mar. 20, 2002) (on file with author).

56. See Bratton, *supra* note 6, at 48, 53 (warning of the dangers of hindsight bias in analyzing the behavior of Enron's management and board).

57. See, e.g., *id.* at 53-55.

58. See, e.g., E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 700 (1998) (enumerating seven aspirational norms for good corporate practice with respect to boards of directors); Martin A. Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992) (identifying best practices).

59. Messrs. Chan, Ferraz Pereira, and Wakeham, respectively. See ENRON 2001 PROXY, *supra* note 54, at 4-7; *Enron's Board of Directors: Full List of Enron's Key Decision Makers*, THE GUARDIAN (U.K.), Mar. 5, 2002.

Furthermore, the other professional duties required of the Enron Audit Committee members may raise some eyebrows. Put aside the common and unavoidable issue that certain Committee members have full-time executive positions⁶⁰ that might have limited their capacity to devote time to audit committee duties at Enron.⁶¹ Even so, several members of the Enron Audit Committee also served on the boards of other publicly traded companies. Some of these members served on at least three other boards while serving on the Enron Audit Committee.⁶² One of these members, Robert Jaedicke, was the Chairman of Enron's Audit Committee.⁶³

The intuitions a skeptical mind might draw from a close examination of the Audit Committee members' active lives will, regrettably, not be quelled by the frequency with which the Enron Audit Committee met. In the year 2000, the Enron Audit Committee met five times.⁶⁴ And when it did gather, the Committee apparently met for one to two hours before the full Enron board meeting.⁶⁵ An Enron stockholder is assured by the proxy statement that the members attended at least seventy-five percent of the meetings, except for Mr. Chan from Hong Kong.⁶⁶ The Enron Audit Committee Charter only called for the Committee to meet a minimum of four times a year.⁶⁷

An aggressive plaintiffs' lawyer might question whether it is sufficient for the audit committee of any major public company to meet only four times a year. But persons besides plaintiffs' lawyers have wondered how the Enron Audit Committee could fathom what the company was doing when it met as infrequently as it did.⁶⁸ It has been said that Enron had one of the least understandable business structures going. Its finances were dauntingly complex. This might lead some to

60. It is undoubtedly useful to have active, top executives serve as independent directors. The time of such executives, however, is at a premium and must be rationed carefully.

61. Directors Chan, Mendelsohn, and Ferraz Pereira fall into this category. See ENRON 2001 PROXY, *supra* note 54, at 4-6.

62. This was true of directors Gramm, Jaedicke, and Wakeham. *Id.* at 4-7. Directors Chan and Mendelsohn served on at least one other board. *Id.*; see Veasey, *supra* note 7, at 2190 ("[T]he directors should limit to a reasonable number the major boards on which they serve. What is a reasonable number depends on the extent to which each director is able to carry out his or her responsibilities to each board in a professional manner, leaving room for crisis management when necessary.")

63. Although age is a delicate subject, completeness requires acknowledgment that some commentators have called on boards to set a mandatory retirement age for directors. Mr. Jaedicke is seventy-three years old. See Lipton & Lorsch, *supra* note 58, at 68. For a relatively balanced article on Jaedicke's role, see Kathleen Pender, *Stanford Dean's Role In Enron; Ex-Dean of Stanford Business School Led Enron Audit Panel*, S.F. CHRON., Feb. 7, 2002, at B1.

64. ENRON 2001 PROXY, *supra* note 54, at 13.

65. POWERS REPORT, *supra* note 3, at 158 n.73.

66. ENRON 2001 PROXY, *supra* note 54, at 14.

67. ENRON AUDIT COMM. CHARTER, in ENRON 2001 PROXY, *supra* note 54, at 46.

68. In his thoughtful article with Professor Lorsch, Martin Lipton has noted:

Boards should meet at least bimonthly and each meeting should take a full day, including committee sessions and other related activities. One meeting each year should be a two or three day strategy session. Directors should also spend the equivalent of another day preparing for each meeting by reviewing reports and other materials sent to them in advance. This would mean that directors would be expected to spend more than 100 hours annually on each board, not counting special meetings and not counting travel time. We believe this much time is essential to allow

suggest that Enron's Audit Committee should have been devoting more, rather than less, time to its job than that of a typical audit committee.⁶⁹

Turning to the question of independence, some might also argue that there is another gap between aspiration and appearances. Enron's new Audit Committee Charter states that the Committee was to be comprised of members who "have no relationship to the company that may interfere with the exercise of independent judgment as a committee member."⁷⁰ Chairing the Committee was Mr. Jaedicke, who had been an "outside director" since 1985, or sixteen years. Some commentators would question whether one can in fact function as an Audit Committee Chairman after such a long affiliation with a corporate board.⁷¹ After that period of time, it is only human for feelings of collegiality and kinship between the director and management to run rather deep. But under the Enron Audit Committee Charter, the Committee was to function as a kind of active corporate conscience, pushing and prodding management toward strict adherence to normative and positive standards of good corporate behavior.⁷² Intrinsic to this role is a certain amount of distance, and perhaps freshness. This is not to say that a director of long standing should not serve as a director, only that forceful advocates will contend that such directors are not well-suited to independently chair the committee.

directors properly to carry out their monitoring function It may be desirable for the boards of major corporations to meet more often, perhaps 8 to 12 times per year.

Lipton & Lorsch, *supra* note 58, at 69 n.35; see also Veasey, *supra* note 7, at 2190 ("[T]he directors should meet face-to-face frequently throughout the year and spend substantial time on their homework. A minimum of at least one hundred hours per year on routine matters on each board has been suggested and seems reasonable, in my view. Of course more may be required in time of crisis, and directors should not become so overcommitted that they cannot deal adequately with crises.").

69. According to Professor Allen, who spoke on this subject in a recent address,

In the short Board meetings we have read about[,] it does not appear that the [Enron] board members were skeptical, probing and alert, as we would want them to be. They failed to ask the difficult questions. They accepted all that they were told and they don't seem to have been told all that much. They seem to fit the self-description of T.S. Eliot's Prufrock, who was "a lesser lord, deferential, glad to be of use."

Clearly in this instance the relevant board committees have no reason to be proud of their service. Whether liability is a high risk or low I will leave to others, but the shareholders would have wished for more than a board that avoided liability for breach of its duty of care. They would have wished for insight premised on knowledge and informed action based upon character and courage. What they and the workers and the creditors got instead[,] it seems, was standard, compliant advisors of senior management.

William T. Allen, Corporate Governance Post-Enron, Address at the Bar Ass'n of the City of New York 11-12 (Apr. 1, 2002) (transcript on file with author).

70. ENRON 2001 PROXY, *supra* note 54, at 44.

71. The difficulty of retaining an independent mind set after too long a tenure has been noted by many commentators. See, e.g., Lipton & Lorsch, *supra* note 58, at 68 ("We approve and adopt the proposal . . . that each board should establish a term limit for the independent directors."); see also Bhagat & Black, *supra* note 8, at 953 ("It is . . . possible that directors who have been on the board for a long time, though nominally independent, may simply be less energetic than newer directors."). These arguments have been made about independent directors in general, and arguably apply more forcefully to audit committee members.

72. ENRON AUDIT COMM. CHARTER, in ENRON 2001 PROXY, *supra* note 54, at 41.

Nor are the other members' affiliations likely to escape the attention of plaintiffs' lawyers and corporate governance activists. Directors Gramm, Mendelsohn, and Wakeham all had direct or indirect financial ties to Enron that raise questions about their ability to act independently from Enron management. Indeed, director Gramm's ability to impartially select and oversee Enron's auditors, Arthur Andersen, has come under fire given her husband's receipt of more Andersen-directed contributions than any other member of Congress.⁷³ That Ms. Gramm's husband was also publicly quoted as calling Enron CEO Kenneth Lay a "longtime friend," has not helped her in the court of public opinion.⁷⁴ Some of these ties might be explicable, but the mere fact that they must be explained can be viewed as inconsistent with the Committee's new Charter, and does little to promote public confidence.

Returning from Enron to the more general issue of good faith, one can see how plaintiffs' lawyers might approach "duty to monitor" cases somewhat differently in the near future. They might well ask courts to infer not only that audit committee members did not know enough about their company's financial and accounting practices, but also that the committee members *knew* that their inadequate knowledge disabled them from discharging their responsibilities with fidelity. Stated crudely, the court will be called on to conclude that a director who is *conscious* that he is not devoting sufficient attention to his duties is not acting in good faith, and is therefore not entitled to exculpation from damages liability.

We should anticipate that courts will deal sensitively with arguments of this kind, and err on the side of the directors when close questions arise. This is necessary because it is possible that even directors who make a good faith effort and ask penetrating and thoughtful questions might miss a key problem area or be deceived by management. Courts want to protect directors who try their best, so that they will continue to serve. *Courts must therefore proceed with great caution when confronted with arguments of the type anticipated here, and recognize that directors can only be expected to fulfill certain core oversight responsibilities.*⁷⁵ Directors cannot guarantee corporate compliance; they can only be expected to undertake and execute good faith efforts to ensure that it occurs.

At the same time, the integrity of the corporation law demands that directors be held accountable if they are clearly proceeding with conscious knowledge of their own inadequacy in performance. A decision to become the director of a public corporation should not be undertaken lightly. As Enron exemplifies, the

73. See Root & Autrey, *supra* note 25, at 1A (Sen. Gramm received \$76,850 in contributions from Arthur Andersen interests since 1989, more than any other senator, citing the Center for Responsive Politics).

74. See *id.* at 23A.

75. A large issue worthy of more consideration than this Article gives it is whether boards are becoming involved in too many issues to be effective. Any triage will have risks, but so will a failure to set priorities for board focus. Core areas of board responsibility would seem to include: the approval, evolution, and execution of the company's business strategy; the selection, retention, and oversight of top management; oversight designed to assure the corporation's financial integrity, disclosure, and controls; and monitoring of the corporation's adherence to positive law and its management of key business risks. Before involving itself in other areas, a board might usefully ask itself whether it can do so and still do justice to more fundamental tasks.

lives of thousands of investors and employees are often influenced by the solvency of public corporations. These corporations often engage in far-flung activities of a complex nature, which a mature person recognizes cannot be understood, let alone overseen, without substantial effort.

The types of people who become directors are too savvy, and the warnings to them have been too widespread,⁷⁶ for public company directors to claim that their acceptance of the position did not carry with it a burden of making a good faith effort. If directors accept so many variegated responsibilities that they cannot discharge any of them adequately, they have put themselves—and the corporations on whose boards they serve—at risk.

In this regard, there is a simple test many of us apply when asked to undertake a new assignment: can I do it justice? This is an important question for a public company director who is considering whether to remain on a board or accept a new board assignment. Even if the director is only receiving a mere \$138,000 or so a year in total compensation,⁷⁷ he owes the stockholders a good faith effort to carry out the duties he has taken on. Part of that effort should occur up front, in a candid self-examination of whether he has the time and will to perform those responsibilities.⁷⁸

76. See, e.g., these widely noted words of former Chancellor Allen:

The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency or an MBO proposal, for example.

This view of the responsibilities of membership on the board of directors of a public company is, in my opinion, badly deficient. It ignores a most basic responsibility: the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.

William T. Allen, *Redefining the Role of the Outside Directors in an Age of Global Competition*, Address at Ray Garrett Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (Apr. 1992) (quoted in Lipton & Lorsch, *supra* note 58, at 62 n.14); see also Veasey, *supra* note 7, at 2190 ("[T]he board should be engaged in actual governance, and not merely act as advisors to the CEO. This does not mean that the board runs the operations of the company (normally it should not). It means directors are in control of the policy of the firm, and the managers work for them.").

77. See PEARL MEYER 2000 REPORT, *supra* note 43, at 3.

78. The lack of time many directors have to carry out the complex duties they have undertaken has been noted as a major problem by many observers, including the leading lawyerly voice in favor of a director-centered corporate law:

Based on our experience, the most widely shared problem directors have is a lack of time to carry out their duties. The typical board meets less than eight times annually. Even with committee meetings and informal gatherings before or after the formal board meeting, directors rarely spend as much as a working day together in and around each meeting . . . In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors . . . A related difficulty is the complexity of the matters directors must understand, discuss, and decide upon in their limited time. The concern

If an overly busy person serves on the boards of five public companies (thereby reaping annual returns of over a half million dollars from board service alone), takes on challenging duties on each of those boards, and then finds himself in a situation where one of his companies is accused of serious wrongdoing that the board arguably should have prevented, he should not be surprised if his good faith comes under severe attack in the financial press and in the courts. If he has complicated things further by, for example, having a side consulting arrangement with the company, he should expect it.

To the extent that access to persons without sufficient time to serve as directors has a real economic value to corporations, mechanisms—such as advisory committees—can be created to give the corporation access to their counsel and their ability to make certain phone calls and introductions, in exchange for fair compensation to them. But a directorship simply is not the appropriate place for a specialized consultant of that kind.

PART III

A larger issue raised by Enron is what attitude our society wants managers and directors to bring to the boardroom. For the last few decades, there has been a marked movement towards an ethos centered on the maximization of the value of corporate stock. The fear was that old-time boards and management were too worried about self-perpetuation to the detriment of business combinations and strategies that might be better for shareholders, but would be tumultuous to employees and other corporate constituencies. Therefore, techniques were developed to overcome this bias. The prevalence of option-based compensation for both top management and directors is an example of one of the most important of these.⁷⁹

Less noticed is that these trends also extend to key advisors to boards, such as accountants and lawyers. The traditional image of accountants and lawyers as school marms, scolds and foot-draggers, whose cautious attention to rule compliance acts as a brake on risky (and sometimes unethical) practices, has faded fast.⁸⁰

most independent directors have is not with a lack of information, but with the amount and complexity of the data they receive.

Lipton & Lorsch, *supra* note 58, at 64-65; see also Lin, *supra* note 8, at 914-15 (“[E]ven if outside directors receive all relevant information, they may not have the expertise to understand the often complex corporate decisions. Also, even if they have the expertise, these directors’ busy schedules may preclude them from devoting sufficient amounts of time to thoroughly review management’s proposals.”); Gilson & Kraakman, *supra* note 8, at 884 (“[O]utside directors presently lack the time to monitor, except during corporate crises, because they are either CEOs themselves or hold equally demanding full-time positions.”) (citations omitted).

79. Compensation consultants have noted the sharply increased level of equity compensation received by directors, including grants of stock options. See PEARL MEYER 2000 REPORT, *supra* note 43, at 4; SPENCER STUART 2001 SURVEY, *supra* note 43, at 11. The reader interested in Enron’s advisors should consult Professor William T. Allen’s recent speech. Allen, *supra* note 69.

80. The Powers Report creates the impression that (at least in the Special Committee’s view) the auditors and outside counsel of Enron took the less conservative position whenever they faced a key choice. See, e.g., POWERS REPORT, *supra* note 3, at 190 (discussing a close disclosure resolved by taking the more aggressive, less conservative approach). The Report also indicates that the outside advisors yielded to inside pressure not to disclose certain facts, on at least one occasion. *Id.* at 200 n.89.

Accounting firms have increasingly devoted their attention to providing advice akin to that of investment bankers. And some law firms have pitched themselves more as joint venturers than as traditional providers of legal advice by freely giving out business counsel and accepting large equity positions in the very firms they counsel.⁸¹

Enron and cases like it obviously raise the question whether our system of corporate governance has swung too far from a primary concern about whether the entity will be around to meet payroll in ten years to an obsessional focus on short-term balance sheet reports that keep stock prices up. Is there a better balance? As thoughtful commentators from both the business and the academy have noted, option-based compensation does not perfectly align directors' interests with those of common stockholders.⁸² The public does not have access to grants of cost- and (arguably) risk-free "at the money" options, with the possibility of replacement option grants if events do not make the initial options profitable. The public must put the full cost of a share at risk, and bear real losses if a catastrophe occurs. Option recipients can also obtain windfalls off of volatility, rather than from consistent, long-term growth in share value. One wonders how many outside directors who have reaped large gains on options have thought to themselves, "I'm working with the best damn management in America. I don't know how they do it, but these guys are just flat-out geniuses!"

81. A corporate lawyer of some eminence told me some time ago of his concern about how compensation levels were affecting the behavior of law partners towards the admission of new partners. While happy to receive the extraordinary level of compensation he was getting, he noted the profound change in corporate lawyers' economic status with some concern. He observed that lawyers and accountants used to live reasonably affluent lives, acting as advisors to the wealthy, but not being among their ranks. He feared that investment banker-like salary expectations—and in some cases, realities—would change professional and collegial attitudes for the worse. In particular, he worried about whether the desire for lucre would subordinate lawyers' desire to maintain the appearance—and more important—the reality of ethical practice.

82. Warren E. Buffett has recently expressed this concern. See Floyd Norris, *Stock Options Are Faulted By Buffett*, N.Y. TIMES, Mar. 11, 2002, at C1. Professor Charles M. Elson has also articulated this position:

But New Economy directors tend to be compensated in the company's stock options. And this is a big mistake. They should receive the stock itself. The reason is simple: When the stock you own declines in price, you feel a real loss; with an option, the loss is just a loss of an expectancy. The key is compensating directors with something that gives them a real sense of equity in the business.

Charles M. Elson, *The Bad Board Booby Trap*, CORP. COUNSEL, Mar. 2001. Professor Allen also pithily articulated this position in a recent speech to the Bar Association of the City of New York:

[S]tock ownership by management would be a good thing[,] all other things to one side, and options instead of shares might be a useful substitute for stock for tax reasons. But we have not paid enough attention to the serious agency problems that options can create. An option holder—especially one that might get a replacement grant if the stock drops below his strike price—has a much greater appetite for risk than has a shareholder with an investment basis in that stock. Wholly apart from the accounting problems that options have under today's politically mandated system, this incentive inconsistency is a serious problem [] in my opinion with some CEO grants of options[,] and may be a problem on some boards as well.

Allen, *supra* note 69, at 10-11.

The subject of executive and director compensation is a complex one, which I do not attempt to address in any substantial way in this Article.⁸³ I do venture that Enron will bring these issues to the fore, and generate renewed attempts to have courts review compensation arrangements more carefully, both as part of any inquiry into board independence and as a direct object of substantive challenge in derivative suits.

Enron will create cross-cutting pressures that courts and other policy-makers must balance carefully. A realistic assessment of what audit committees are required to do may well dictate the conclusion that audit committee members should receive much more substantial compensation than other board members, in exchange for a greater commitment of time. It may also be (as Professor Gordon has advocated) that audit committee members should ideally be compensated largely in cold, hard cash, perhaps supplemented with grants of restricted, common stock.⁸⁴ By this method, audit committee members would have little personal incentive to revel in short-term spikes in stock prices caused by marginal financial practices.

But the cross-cutting problem is that the level of compensation to be fairly granted to the chairman of an audit committee of a company like Enron—or other less controversial, but highly complex companies, like General Electric—might be, to some, untraditionally high. For example, if the chairman was paid \$250,000 a year, could the chairman be said to be independent? Would that level of compensation not be material to most people?⁸⁵ There is a rather nice doctrinal dilemma here, because our desire for effectiveness might require a more supple application of legal principles of independence.

Judges must be prepared to open their minds to innovative methods that might overcome this problem. For example, it is possible to imagine a company where audit committee members are paid substantial sums in annual compensation in exchange for great effort, but genuinely derive their status on the management slate from a selection process that involves only other independent directors and that affirmatively excludes all management input.⁸⁶ In this regard, the long-standing questions about a corporate election process that is so heavily biased towards incumbents and their self-chosen successors will yet again be asked,

83. The reader interested in this subject might usefully consult these recent works: Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. (forthcoming 2002); Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L. Q. 569 (2001); Lucian Arye Bebchuk et al., *Executive Compensation in America: Optimal Contracting or Extraction of Rents?* U. CHI. L. REV. (forthcoming).

84. Gordon, *supra* note 6. Professor Gordon aptly suggests that these directors might be called "trustee directors," reflecting their special focus on corporate integrity and sound financial practices. *Id.* at 9.

85. Professors Gilson & Kraakman have noted this dilemma. See Gilson & Kraakman, *supra* note 8, at 874-75 ("The corporation cannot simply pay outside directors a large sum to induce careful monitoring because the prospect of a large payment would itself undercut their financial independence.")

86. Professor Gordon has also noted this possibility and its potential utility. See Gordon, *supra* note 6.

perhaps with more effect. For now, suffice it to say that there is much room for creative debate here, some of which might find its way into the courtroom.

The compensation incentives of corporate advisors also have state law implications. State law enables directors to rely in good faith on reports from such advisors.⁸⁷ But the law gives less deference to advisors if the advisors themselves are seen as suffering from disabling conflicts.⁸⁸ Imagine if Enron's outside counsel had owned a sizable block of Enron stock and had been actively engaged in a selling program. To what extent would that have affected its ability to render unconflicted advice about subjects affecting the value of the company's securities? Likewise, to the extent that a board's accountants are deriving huge fees from helping management craft innovative financial strategies, how does that largesse affect their ability to advise the audit committee about the integrity of management's activities? While the concerns about the tainting influence of all consulting activities by audit firms might be somewhat overstated,⁸⁹ corporate advisors must be careful not to put themselves in the position of acting as the monitor of their

87. DEL CODE ANN. tit. 8, § 141(e) (2001). See also Veasey, *supra* note 9, at 395:

A significant element of corporate governance in Delaware, and in many other jurisdictions, is the expectation that directors, in carrying out their duty to direct the management of the business and affairs of the corporation, will delegate many responsibilities to management, board committees, and others. Moreover, directors may rely in good faith on corporate records, management reports, board committees, and outside experts, *provided that due care is exercised in selecting those upon whom reliance is placed.*

(emphasis added). Cf. Allen, *supra* note 8, at 2061:

[I] come to the role of the committee's advisors—the lawyers and investment bankers who guide the committee through the process of the sale of a public company. I regard the role of the advisors in establishing the integrity of this process as absolutely crucial. Indeed, the motives and performance of the lawyers and bankers who specialize in the field of mergers and acquisitions is to my mind the great, largely unexamined variable in the process. In all events, it is plain that quite often the special committee relies upon the advisors almost totally. It is understandable why. Frequently, the outside directors who find themselves in control of a corporate sale process have had little or no experience in the sale of a public company. They are in *terra incognita*. Naturally, they turn for guidance to their specialist advisors who will typically have had a great deal of relevant experience.

Thus in my opinion, if the special committee process is to have integrity, it falls in the first instance to the lawyers to unwrap the bindings that have joined the directors into a single board; to instill in the committee a clear understanding of the radically altered state in which it finds itself and to lead the committee to a full understanding of its new duty.

88. For example, Delaware law has long encouraged independent directors to retain counsel who do not ordinarily work for management. See, e.g., *Kahn v. Tremont*, 694 A.2d 422, 428-30 (Del. 1997) (fact that special committee chose counsel suggested and previously retained by parent company was factor in conclusion that special committee was not independent); *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 2000 WL 1476663, at *19 (Del. Ch. 2000) (in partnership context, attorney representing both sides in self-dealing transaction "could not give objective, independent advice"); see also Veasey, *supra* note 7, at 2190-91 ("Committees should consist 'solely of independent directors, independently advised.'").

89. As virtually everything in this debate has been, at one time or another. But see Richard M. Frankel et al., *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality* 26 (Jan. 2002) (unpublished manuscript), available at http://papers.ssrn.com/abstract_id=296557 (concluding that firms whose auditors also receive non-audit fees are "more likely to engage in earnings management").

own creativity and ingenuity. When a board permits its advisors to get in such a position, it puts arguments in the mouths of talented adversaries.

PART IV

Of course, no Article touching on state corporation law would be complete without some mention of hostile takeovers and conflict transactions. How does Enron relate to them? The answer is this: in an arguably contradictory way.

For those who advocate a director-centered approach to corporate law, in which directors are given a strong hand to block all-shares, high-premium cash tender offers, the Enron situation is problematic. There is case law adored by this school that credits the proposition that directors know more than stockholders about the value of the corporation and must be permitted to protect stockholders from their own ignorant views of value.⁹⁰

Enron obviously creates further fissures in that concept. The parade of Enron executives and directors who went before the Congress to plead guilty to ignorance about key financial issues is arguably difficult to reconcile with the ideal of paternalistic and all-knowing directors acting as the faithful market intermediaries for the stockholders. Some have contended that the Enron board failed to ask the probing, but not complex, questions necessary to expose the risky and (perhaps) unethical initiatives that supposedly led the company into the abyss. If these contentions are true, that reality will embolden those who already believe that American corporation law vests too much power in directors.⁹¹

This will also be the case if lawsuits proceed and the Enron outside directors argue that they really did not grasp the company's operations—and more impor-

90. See *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1384-85 (Del. 1995); *Moore Corp. Ltd. v. Wallace Computer Servs.*, 907 F. Supp. 1545, 1557-58 (D. Del. 1995); Lucian Bebchuk, *The Case for Shareholder Voting and Against Board Control in Corporate Takeovers*, 69 U. CHI. L. REV. (forthcoming 2002) (assessing, and ultimately rejecting, argument of proponents of "board veto" who contend that "[b]ecause managers have superior information about the target . . . managers would be in a better position to estimate the target's fundamental long-term value."). In a new work, Professors Black and Kraakman argue that Delaware takeover cases reflect "an often implicit 'hidden value' model of the stock market, in which a firm's true economic value is visible to well-informed corporate directors but not to the company's shareholders or potential acquirors." Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 521-22 (2002). Professors Black and Kraakman contend that the available empirical evidence does not justify placing confidence in the judgment of directors who claim that their corporation's prospects are markedly better than the stock market anticipates. *Id.* at 559.

91. The Powers Report indicates that Enron's off-balance-sheet transactions were extremely important contributors to Enron's corporate earnings. In May 2000, the Enron Finance Committee was apparently told that these transactions had contributed over \$229 million in profits to Enron in 1999. The following year, these transactions generated some \$500 million in profits. POWERS REPORT, *supra* note 3, at 163 n.76.

Readers of that Report should ponder for themselves how challenging it would have been to understand the basic elements of these transactions, and whether they effectively transferred risk from Enron to a third party. Although the Report found that Enron management did not come clean with the Audit Committee, it also found that the Audit Committee spent only ten to fifteen minutes a meeting discussing the transactions. POWERS REPORT, *supra* note 3, at 162; see also Mark Babineck, *Enron's Overseers Did Nothing as Creative Financing Wrecked Company*, THE ASSOCIATED PRESS, Feb. 18, 2002.

tant—that they could not be expected to fully do so. Because of concerns about conflicts of interest, takeover law usually accords less respect to inside directors resisting a bid or advocating a particular deal.⁹² It, by contrast, pays great deference to the views of independent directors.⁹³ The question that will again be raised is whether independent directors are really more expert than stockholders about the right value or time at which to sell.⁹⁴

Cutting in the other direction is the body-blow Enron has inflicted on the efficient market theory. Even considering the information that was not disclosed, what had been disclosed about Enron should, as others have noted, have been sufficient to send a cold-eyed investor running with fear.⁹⁵ Some have said that only someone applying the psychologically based “greater fool” theory of investing could have been confident that Enron was operating on a sound basis justifying its market price. The overall picture is of a marketplace dominated by speculators, caught up in a frenzied desire to Boogie Board on the big wave, rather than by careful investors whose investments follow a careful examination of fundamental drivers of long-term corporate performance.⁹⁶

That the market as a whole also failed to catch on to Enron until it was too late does not, however, necessarily mean that the director-centered view of optimal takeover policy achieved a draw here. An important normative factor intrudes to arguably tilt the balance the other way. To the extent that it appears that directors are, on average, no more likely to know better than stockholders about the value questions at the bottom of takeover fights, the question of who bears the risk of a wrong decision becomes more central. Without a credible basis to believe that the directors generally know best, articulators of the corporate law will not be as well positioned to permit directors to, in essence, make such fundamental investment decisions for owners of securities.

92. See, e.g., *Unocal Corp.*, 493 A.2d at 955; *Unitrin*, 651 A.2d at 1375; see also *Panther v. Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

93. *Id.*

94. Professors Bebchuk and Gilson have each written eloquently about the reasons to doubt that they can, and why, even if they are marginally better at this task, the agency-cost dangers of permitting directors to block premium bids indefinitely outweigh any benefits of their greater knowledge. See Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002); see also Ronald J. Gilson, *Lipton and Rowe's Apologia for Delaware: A Short Reply*, 27 DEL. J. CORP. L. (forthcoming 2002).

95. See Gordon, *supra* note 6, at 3-4.

96. One savvy money manager continued to buy large blocks of Enron stock deep into the company's slide into the mire. See Leslie Wayne, *At 11th Hour, He Bought Enron. But Why?* N.Y. TIMES, Mar. 3, 2002, § 3, at 1. Apparently, analysts at respected investment banks continued to recommend Enron as a buy into the autumn of 2001. Richard W. Stevenson & Jeff Gerth, *Web of Safeguards Failed as Enron Fell*, N.Y. TIMES, Jan. 20, 2002, § 1, at 1. The major bond rating agencies have been reported to have waited until a couple of months before Enron's bankruptcy filing to threaten to downgrade Enron's debt rating. *Id.*

For a thought-provoking, scholarly look at the possible policy implications of cognitive psychology's finding regarding investor behavior, which differ from those hypothesized by the adherents of the efficient market hypothesis, see Donald C. Langevoort, *Taming the Animal Spirits of Stock Markets: A Behavioral Approach to Securities Regulation*, NW. U. L. REV. (forthcoming 2002).

Likewise, this normative concern potentially extends to the approval of conflict transactions. The vigorous debate over the extent to which independent directors can be trusted to cleanse interested transactions turns importantly on the idea that independent directors have the expertise and access to information to negotiate effectively with interested managers. Indeed, some distinguished practitioners argue that well-motivated and well-advised independent directors are better positioned to protect stockholders than stockholders themselves, and that the special committee device is therefore a preferable protection to a majority of the minority vote.⁹⁷

The empirical question of which protective device is best will probably never be definitively settled.⁹⁸ What can be said more confidently is that a stockholder vote, based on full information, creates a greater appearance of fairness, because the stockholders have had the opportunity to protect themselves, and have not been forced to rely solely on the skills and integrity of the directors. With the increasing activism of institutional investors and of easy information flows, the stockholder franchise is also growing in genuine potency and efficacy. Its normative appeal to jurists has always been undeniable, and may be increased by Enron, if only in an oblique way.

PART V

The stockholders' role in the system of corporate governance brings me around to some final thoughts. Enron and corporations like it are dangerous not only for the obvious harm they cause to their own constituencies and confidence in the capital markets in general, but also because they generate the potential for over-reaction by policymakers, to the overall detriment of our economic well-being.

There are many useful reforms that can be undertaken. Improved federal oversight and enforcement of corporate and auditor compliance with accounting standards, and enhanced requirements for the disclosure of close judgment calls about financial practices and potential conflicts of interest, is in everyone's interest.⁹⁹ More timely and independent methods of setting fair accounting standards in the first instance would be helpful. An overhaul of federal tax policies and generally accepted accounting principles standards that tilt incentives for corporate compensation and pension policies may also be overdue.

But at the same time, I confess that part of me sees the Enron situation as a healthy, if very painful, lesson about the need for investors and other market

97. Robert E. Spatt and A. Gilchrist Sparks, III have expressed this view to me, for example.

98. See, e.g., Lin, *supra* note 8, at 962 ("[T]here is some support for the proposition that outside directors make a difference in specific transactions involving potential conflicts of interest between management and shareholders—for example, turnover due to poor firm performance, the level and structure of executive compensation, corporate acquisitions, adoption of poison pills, and management buy-outs.") (emphasis added).

99. Professor Joseph Grundfest has made promising proposals about how increased disclosure requirements can generate greater responsibility and financial prudence. See Joseph A. Grundfest, Addressing Enron: Can We Craft an Efficient Disclosure-Based Policy Response?, Address to the Silicon Valley Chapter of The Federalist Society (Jan. 29, 2002), available at <http://www.fed-soc.org/Publications/White%20Papers/enrondraft.htm>.

players to be attentive to their own self-interest. *Caveat emptor! Caveat emptor! Caveat emptor!*

The after-the-fact threat of federal and state law liability can never be an efficient or adequate method by which to ensure corporate integrity. And quite bluntly, it is questionable whether costly government policies ought be directed at placing crutches under well-heeled investors who can walk for themselves. The most vigorous enforcement of director fiduciary duties cannot hope to substitute for careful monitoring performed by rational and active investors, who demand transparency in the financial statements of companies in which they invest.

This is not to say that the corporate governance policymakers at all levels, including the level of state corporation law, must not ponder the implications of Enron and examples like it. It is only to emphasize that we must act with care, and consider the costs of unwise and extreme reform. As always, state courts and legislatures will face one of the most difficult tasks in this respect. They must set and monitor the standards of fiduciary conduct expected of corporate directors, balancing the public interest in holding directors accountable for injurious actions not taken in good faith, with the equally important public interest in attracting and retaining high-quality directors.

The basic bargain that stockholders have with directors is that the directors will give them a good faith and impartial effort. Courts must enforce that bargain, but much rides on their firm resistance to going beyond it. As it informs our thinking, the Enron debacle should not obscure that reality.