

American Bar Association Task Force on Corporate Responsibility

Testimony of Michael J. Halloran

Recommendations for Further Actions to Enhance Investor Confidence

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I. Introduction

I have been practicing as a corporate attorney for 37 years. In that time, I have been a general outside corporate advisor to many companies, both large and small, public and private. I have overseen numerous forms of corporate finance and structuring transactions, including all forms of corporate and partnership public offerings, many acquisitions, friendly and un-negotiated, investment company and investment advisory firms and funds (including formation of many venture funds), project financings and secured debt financings. From 1990 to 1996, I was also the Group Executive Vice President and General Counsel of the third-largest bank holding company in the country, BancAmerica Corporation (NYSE: BAC). In addition, as some of you know, I have served as Chairman of committees of the Business Law Section of the American Bar Association, and as a member of its Section Council.

I speak to you today not as a partner of my law firm, Pillsbury Winthrop LLP, for which I am the Senior Partner of its Corporate Securities Section, or as a member of the American Bar Association's Committee on Corporate Laws, but as an investor, a student of the business world and a concerned citizen.

I am pro-business at a fundamental level. I believe that the American capital markets are the greatest system in the world for formation and efficient allocation of capital to valuable enterprises, which in turn create jobs and more prosperity. They have created the most powerful economy in the world by doing so.

However, like many people, I am deeply troubled by the state of the American capital markets. In the past two years, we've seen major corporations like Enron, Global Crossing, WorldCom and Adelphia collapse. We've seen CEOs go from being glorified to vilified and the reputations of board members tarnished. Accounting firms that were once revered for their integrity are now seen as pawns of management, if not complicit in financial manipulation. Analysts associated with investment banks are now seen as little more than hucksters. The investment banks that employ them are tainted by their use of the analysts and IPO allocations to reap profits at the expense of the average investor. Even the Securities and Exchange Commission is not immune from alleged scandal, as last week's resignation of Chairman Pitt shows. The public questions whether we, as lawyers, have done enough in many of these cases.

Meanwhile, the savings of millions of Americans have been devastated. The New York Stock Exchange and NASDAQ National Market languish near their lowest levels in years and prospects for recovery seem vague and distant. In my opinion and the opinion of executives I

have talked to, one of the reasons the markets are behaving this way is because investors are no longer confident that they can trust what they see. They don't feel that they can rely on analysts, because they believe that the recommendations analysts provide are generally skewed toward "buy" ratings and compromised by their firms' relationships with the companies that they follow. Furthermore, investors don't trust the timeliness, accuracy or transparency of the financial information that they receive—over the last two years, it seems like we have constantly read about a senior executive who cashed out on options while announcing good news only to restate that good news later. After announcements like that, shareholder confidence is eroded further and the corporation's share price drops, along with the share prices of many innocent corporations having management with great integrity.

Through the Sarbanes-Oxley Act, Congress has implemented the most sweeping reforms of our nation's securities laws since the New Deal. The New York Stock Exchange has greatly expanded its listing standards, as NASDAQ will probably do soon. Nonetheless, investor confidence remains low. The public perceives that many of the executives who have become poster boys for fraud and abuse seem to be getting off scot-free—they committed "financial murder" and got away with it. Congress will come back into session in mid-January, and if the public remains unhappy, it may well decide to enact further legislation.

II. Overview of Comments

I believe that the Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (the "Report") is an important step for the legal profession in responding to the present crisis, but I'd like to offer some constructive criticism. Most of the comments that have been offered to the Task Force at the two previous hearings in New York and Chicago have focused on the Report's proposed revisions to the Model Rules of Professional Conduct. I'd like to comment on that as well, but I'd like to focus on the other half of the Report, the proposed reforms to corporate governance.

A number of the reforms suggested by the Report are excellent and are likely to help restore and secure investor confidence. For example, requiring that each board be composed of a substantial majority of independent directors, possess a Corporate Governance Committee and have access to some form of continuing education. I also agree with the Report's emphasis on promoting active and informed stewardship by the boards of public companies; this was the subject of a speech that I gave to the CEO Summit in April, which I have attached. In some respects, however, I feel that the Report's proposals fall short of the mark. Many of the suggestions have already been superseded by the passage of the Sarbanes-Oxley Act and the stock exchange proposed rules. Other suggestions don't go far enough. My fear is that if we fail to take the initiative by enacting rules in corporate law at the state level and amending our Model Rules of Professional Conduct, Congress will do it for us.

III. The Case for Revising the Model Business Corporation Act

In the Report, the Task Force suggests implementing proposals through expansion of the stock exchange listing standards. The Report advances two good reasons for doing so—first, a desire for uniformity among jurisdictions nationwide, and second, a belief that the reforms it proposes should only be applicable to public companies. These are legitimate concerns—any

proposal the Task Force adopts should be geared to uniformity across borders, but should still recognize the fundamental differences between public and private companies.

Where the Task Force proposals fail is enforceability. If a rule is implemented as a listing standard by an exchange, there is presently only one remedy that can be imposed for a violation of the rule, however big or small—delisting of a company. This one size fits all approach is clumsy, but, more importantly, it hurts shareholders. When a company is delisted, shareholders lose access to a ready market for their shares.

Instead, I propose that the Task Force recommend to the American Bar Association (the “ABA”) that most of the Task Force’s corporate governance recommendations be implemented through the Model Business Corporation Act (the “MBCA”), which is drafted and published by the ABA. Furthermore, I think the ABA should implement significant provisions of the proposed stock exchange listing standards (NYSE and NASDAQ) as part of the MBCA, applicable to public companies, because it is the best way of ensuring that the law is both uniform and enforceable by shareholders as to corporations. The MBCA is currently the law in 44 states and is often followed in other jurisdictions. If the ABA were to adopt revisions to the MBCA, states would likely enact them, as they have consistently done in the past. I note that even without adoption of the MBCA by all 50 states, there is currently remarkable consistency as a result of states following the MBCA as a standard. Moreover, if we leave implementation to the stock exchanges, as the Report proposes, it is still no guarantee of uniformity. As the Report recognizes, some stock exchanges might adopt inconsistent rules, while others might adopt none at all.¹

How do you protect public investors without ensnaring private companies in the new rules? I propose adding a new definition to Section 1.40 of the MBCA to distinguish between private companies and public companies. Then I propose incorporating good governance standards into the Act for public companies. We are talking here about requiring independent audit, nominating (corporate governance) and compensation committees, having biannual meetings with auditors and counsel without inside management present, requiring audit committee selection and retention of auditors, etc. Public companies must be held to a higher standard because their shareholders apparently are no match for the frauds that have taken place within the corporations. If they can’t comply, maybe they shouldn’t be public. The playing field needs to be leveled.

IV. Suggested Substantive Modifications to the MBCA

I would also like to highlight some substantive areas where further investor protections are necessary, and which I encourage the Task Force to include in its Report.

1. Refunds Following Restatements

Perhaps the most demoralizing phenomenon for investors has been how insiders enriched themselves while ordinary investors got substantially poorer. *Fortune* magazine recently published an article (October 2, 2002) entitled “You Bought. They Sold,” which names the “25

¹ See Preliminary Report of the American Bar Association Task Force on Corporate Responsibility 14 (2002).

companies with the greediest executives”—companies where executives made as much as two and a quarter billion dollars selling company shares, while those shares dropped more than 75% from their boom-time peak. Stories like this that document the enrichment of a few executives at the expense of tens of thousands of shareholders have undermined investor confidence in the basic fairness of the system.

Currently, securities laws protect against insiders enriching themselves at the expense of the company in two ways. Under the short-swing rules of Section 16(b), an insider who buys and sells, or sells and buys securities of the company in the same six-month window, is presumed to be trading on non-public information and can be required to disgorge any profit to the company in a suit by a shareholder or the corporation. Under the fraud rules of Section 10(b)(5), a plaintiff may sue to recover from an insider who bought or sold securities with the requisite scienter (knowledge) regarding undisclosed material, non-public information.

These rules are currently proving inadequate to protect investors from mismanagement and manipulation. The short-swing rules do not protect investors against the “long swing” that occurs when executives acquire stock in their company, run up the stock price over a period longer than six months and bail out before the crash. For example, Gary Winnick, the former head of Global Crossing, sold over \$700 million worth of company shares between 1999 and the announcement of the company’s bankruptcy and numerous restatements earlier this year. These sales did not violate the short-swing rules, so they are immune on that score. If a shareholder wants to prove fraud and recover damages, he or she is required to allege with particularity facts that show that the insider (Mr. Winnick) traded on the basis of material, non-public information and had scienter. These are frequently difficult showings and thus it’s unlikely that the corporation will recover even if the results seem blatantly unfair. Going further, many have come to believe it is simply unfair for a senior executive to make money on false financial statements of his company, whether or not he knew they were false—leaving the public shareholder to suffer his loss.

I propose a simple rule to correct this problem: When a corporation issues a restatement that requires a substantial downward adjustment of the corporation’s financial results, the senior executive officers and directors of the corporation should be required to refund to the company all bonuses and all profits on stock transactions received within the two years prior to the restatement (or the period covered by the restatement, if less). What better incentive could senior executive officers and directors have to make sure the numbers are right the first time? This rule would of course be subject to some exceptions, as for restatements as a result of a change in applicable accounting principles that are beyond the company’s control. My proposal goes beyond Sarbanes-Oxley because there would be no need to prove misconduct and the disgorgement would reach back two years, rather than one year. Furthermore, unlike the Sarbanes-Oxley provision,² the remedy would not be limited to CEOs and CFOs but would apply to all senior executive officers and directors. Yes, it is a new “crude-rule-of-thumb” like Section

² Section 304 of the Sarbanes-Oxley Act provides for the disgorgement by the chief executive officer and chief financial officer of their bonuses, incentive- or equity-based compensation and “any profits realized from the sale of securities” of the company if the company restates its financials “due to the material noncompliance” of the company “as a result of misconduct.” The disgorgement under Sarbanes-Oxley relates to the compensation given the CEO and CFO for the 12-month period following the public issuance of the flawed financial statements.

16. The rule is that the senior executives and directors cannot profit on substantially false public company financial statements. The argument will be made that this will discourage restatements; my belief is that once the outside auditors (and even some inside ones) discover substantially incorrect historical financial statements that would have a materially adverse effect on the company's stock, they will not want to incur the enormous liability to public investors and the SEC that could stem from keeping that knowledge to themselves.

2. Conflict of Interest Transactions

Another recurring theme in the corporate scandals of the past year has been conflict of interest transactions. At Enron and Adelphia, to name two particularly flagrant examples, insiders engineered transactions that enriched themselves at the expense of the corporation and its shareholders. The ABA Task Force Report proposes the adoption of procedures for the review and approval by directors of any material transaction between the corporation and any director and executive officer of the corporation. The Report suggests that the review include an explanation of why the transaction is in the best interests of the corporation, a documented rationale for engaging in the transaction with a related party rather than a third party, a specific determination of fairness to the corporation and a review of the public disclosure that may be appropriate for the transaction. These procedures are good insofar as they would force directors to examine interested transactions very closely, but they may be too little to restore the confidence of the investor. After all, the investor still would only learn of an interested transaction after the corporation went ahead with it and then disclosed the transaction. It looks like business as usual.

Under Section 8.31 of the current MBCA, a conflict of interest transaction is not voidable as to the corporation if the facts of the transaction were disclosed to the board of directors or shareholders, or even if such disclosure was not made, if the transaction was fair to the corporation. While management at Enron and Adelphia may not have complied with even these basic rules, I think more protection is necessary. The rules should be expanded to require that all interested transactions over a certain size be submitted to shareholders, whether they are fair or not. Conflict of interest transactions should be invalid and rescindable unless so approved. The argument will be made that shareholder approval is slow; in my experience, SEC proxy statement clearance and shareholder solicitation can take place in a minimum of 45 days and a maximum of 90 days—most transactions can be held under temporary contract subject to shareholder approval for that period.

While this may seem extreme, I think it's warranted. Public companies should not become involved in business transactions with their directors and officers unless a transaction presents a unique and crucial opportunity that would not be available to the corporation otherwise. Placing a hurdle as significant as shareholder approval would ensure that companies only go forward with the most necessary and desirable transactions. If the transaction is important to the conflicted director or officer, and yet shareholder approval is not going to be sought, he or she can resign from one side or the other, or dispose of the conflicting interest.

3. Duty of Candor as Among Directors

Another persistent theme in each of the corporate fiascos has been claims by outside directors that they were kept in the dark by management and their fellow directors. For example, the outside directors at Enron have claimed that material information about the purpose and crucial terms of off-balance sheet transactions was withheld from them. As a result, they claim that they had no meaningful opportunity to exercise review or oversight. In WorldCom, it is apparent that the outside directors had no knowledge of the improper accounting that was going on.

In recent years, courts have developed the duty of candor to protect shareholders. When the directors present the shareholders with an investment or a voting decision, directors are required to furnish shareholders with all material relevant information known to the directors.

I believe the Task Force should recommend that the MBCA be amended to create a specific duty of candor that applies to voting decisions by the board of directors and its committees, too. When a member of the board has material information that is relevant to a voting decision by the board (for example, the approval of financial statements), the director should be required to provide such information to his or her fellow directors. Those who fail to do so would be subject to suits just as directors who breach their duties of care or loyalty currently are. This is not a radical idea; it has been implicitly recognized in the Delaware decision of *Weinberger v. UOP*, in which the court stated that directors who failed to disclose material information to their fellow directors about the pricing in the acquisition of a corporation breached their fiduciary duties to the corporation.

Furthermore, like directors who are found to violate the duty of loyalty, directors who breach this duty of candor should not be protected by exemptions contained in the charter from liability for money damages to the shareholders and corporation, and I believe the MBCA should be amended in that regard. I should tell you I have been giving consideration to suggesting the outright repeal of the limitation on monetary liability provisions for directors of public companies on the grounds that they were simply a 1990 reaction to Delaware's *Smith v. Van Gorkom* decision. I have the eerie feeling that if one of the Enron, WorldCom, Global Crossing or Adelphia directors defeats a lawsuit on the basis of a statutorily authorized elimination of monetary liability for directors, the public outcry for repeal will be difficult to ignore. I don't go as far as that today, but we are already seeing an erosion of exculpatory provisions. For example, in the Seventh Circuit's recent *Abbott Labs* decision,³ the court held that the directors were not exempt from liability for money damages because their failure to inform themselves and to act was so egregious as to not be in good faith. Although the decision has been withdrawn for reconsideration by the Seventh Circuit, it signals a new willingness to interpret the exceptions to exemption provisions broadly. Directors should get insurance, and if the company can't get it or can't afford it, then maybe the company should not be public. Directors also have indemnity against the corporation under corporate law and under indemnity contracts.

³ See *In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002).

4. Reining in Incentive-Based Compensation

Throughout the 1990s, the conventional wisdom was that by granting management incentive-based compensation, typically in the form of large stock option grants, a corporation would align the interests of management with those of the ordinary shareholder. If an executive's compensation were tied to the share price of the company, the theory went, the executive would maximize shareholder value by working harder to make the corporation more successful. As a result, the share price would go up, and executives and investors would both prosper. Recently, we've seen how wrong this theory can be when executives pump the stock price up by engaging in transactions that inflate short-term revenues or earnings and then cash in before the business collapses. Unfortunately, courts have largely avoided questioning executive compensation.

While some suggest that we can control options by requiring corporations to record them as an expense, I am against doing so. In part, this is because treating options as an expense results in double-dipping—options granted are treated as outstanding stock, which dilutes earnings, and when they are expensed on top of that, earnings are reduced further. In addition, for many companies it is extremely difficult to measure the true cost of options—where share price is very volatile, it is impossible to assign an accurate value to options; the net result is potentially large charges to earnings that are not comparable from company to company. The Black-Scholes formula, which is frequently used to value options, produces numbers that are way out of line with reason and judgment. Tell me why it makes sense to cut Cisco's June 27, 2002 year-end earnings from \$1.9 billion to \$373 million by application of this formula, as would happen if the company were to record stock options as an expense,⁴ when (1) most of the options are "underwater" at Cisco's current price; (2) no cash has been taken out of Cisco's drawer to pay anybody; and (3) what is going on is a splitting of the Cisco equity pie among a greater number of holders, the existing shareholders and option holders, which is reflected in the fully-diluted earnings per share published by the company. The abuse presented by excessive stock option grants is better addressed in other ways. I respectfully submit the following.

I think there are three reforms that are preferable and that the Task Force should recommend be incorporated in the MBCA for public companies. First, corporations should not be allowed to grant executives options with exercise prices less than fair market value. No venture capitalist would allow options at below fair market value, yet public shareholders (including the institutional investors who have the clout to do something about it) routinely allow directors to do so. For example, the Gap just granted its new CEO \$24 million worth of options at half of fair market value.⁵ Second, the law should require that options only vest if an executive satisfies meaningful objective criteria that indicate success, other than stock market price. I leave the specific metrics to the business judgment of a company's board or compensation committee. Executives and directors should benefit only if they improve operating earnings, net income or whatever measure of internal financial performance the board

⁴ See David R. Baker, *Silicon Valley Fights Fiercely for Options: Stock Carrot Vital Incentive, Firms Argue*, SAN FRANCISCO CHRONICLE, November 10, 2002 at G4 (describing what the effect of recording stock options as an expense would be on Cisco's reported earnings).

⁵ See Employment Agreement by and between Paul S. Pressler and the Gap, Inc. dated as of September 25, 2002 (filed as an exhibit to the Current Report on Form 8-K filed with the SEC on September 26, 2002).

approves. If that measurement of internal performance is later restated, the benefit would have to be paid back, as described above. Finally, executive stock option grants should be vetted by independent directors and approved by disinterested shareholders. We cannot and should not expect institutional investors to continue to act as sole corporate watchdogs for management compensation.

5. Separating the Chairman and CEO

The Task Force Report suggests that companies might consider the appointment of a lead independent director. I believe that this proposal is too weak. While I believe that operational control of a corporation must remain with the Chief Executive Officer, I also think that the time has come to separate the Chairman of the Board function from the office of Chief Executive Officer. The Chairman of the Board should be truly independent and should have the authority to coordinate the selection of new directors, to appoint directors to committees and to plan the agendas. This separation of powers is a necessary step to discourage CEO dominance of the board—another recurring theme in the recent corporate scandals—and encourage boards of directors to be more active, informed and objective.

Some major companies are moving in this direction. For example, on Thursday, General Electric named what it termed a “presiding director,” a director who will lead at least three meetings each year for the board without management present and will advise on the selection of committee chairs and on the agenda for board meetings.⁶ On a related note, I applaud GE for requiring that their directors limit the number of public company boards that they sit on to two for CEOs and four for everyone else.

6. Advances Against Indemnity

If all of this sounds a bit harsh to officers and directors, I think we should also do some things that are helpful to officers and directors, like placing a provision in the MBCA stating that advances against indemnity are not considered loans for any purpose. I believe that the Sarbanes-Oxley Act goes way too far if it outlaws advances for indemnity as a result of its outlawing personal loans, and is likely to dissuade good people from wanting to serve as directors.

V. Professional Responsibility

In addition to the foregoing corporate governance reforms, I believe that we should take some additional steps to address our professional responsibility as lawyers for dealing with situations where our clients are engaged in fraudulent transactions. Through the Sarbanes-Oxley Act, Congress has already begun to legislate the professional duties of attorneys, a task that has traditionally been reserved to attorneys themselves. We must consider what we can do to address our role in corporate reform before Congress legislates or the SEC regulates further. The public perception of lawyers is undermined tremendously when lawyers appear before Congress testifying, as the inside and outside counsel for Enron did, that they were merely following

⁶ See Rachel Emma Silverman, *GE Makes Changes on Board Policy*, WALL ST. J., November 8, 2002 at A5.

ethical rules. They were right—they were following the rules. The public expects better of our profession, and as I talk to corporate executives, they agree it is time to do something.

1. Section 10A for Attorneys

Currently, Section 10A of the 1934 Act requires that where an independent public accountant discovers evidence of an illegal act, the accountant must report such evidence to the appropriate level of management and assure that the audit committee is adequately informed. Where the illegal act has a material effect on the financial statements of the corporation and an accountant is unsatisfied with the corporation's response, the accountant is required to report to the board of directors, which, in turn, is required to report to the SEC. If the board fails to do so, the accountant must report to the SEC and may resign from the engagement. Section 10A exempts accountants from civil liability for complying with the reporting obligations of the statute. Accountants who fail to comply with the requirements of Section 10A are themselves subject to civil penalties.

I think that inside and outside lawyers who represent a corporation should be made subject to a similar whistleblower duty to prevent current, ongoing or prospective fraud. Some may say that this suggestion goes too far. After all, there are basic differences between the role of an accountant, whose services are provided to the corporation for reliance by third parties, and that of the lawyer, whose services are provided to the corporate client alone. Some have suggested to me that this proposal would undermine the relationship of trust and confidence between lawyer and client and that it will discourage clients from confiding in lawyers. I believe that there is some merit to these concerns, but I think they confuse management with the true owners of the corporation, the shareholders. Management is not the client, the corporation is, and the owners of the corporation, the shareholders, expect counsel to represent their interests.

Furthermore, the Model Rules of Professional Conduct currently contain an exception to the prohibition on revealing client confidences when a lawyer believes it necessary “to prevent reasonably certain death or substantial bodily harm.”⁷ Why is it that when a client is about to commit murder, we go to the authorities, but when a client is about to commit “financial murder,” either we commit malpractice if we go to the authorities or we do nothing? The public expects more from us, and it is time that our professional rules recognize that we have a duty to prevent financial, and not just physical, harm. If we fail to rise to their expectations by regulating ourselves, Congress or the SEC may do so for us. As the Report observes, four states currently require lawyers to make disclosure to prevent a client from perpetrating a fraud that constitutes a crime and 41 more states allow a lawyer to do so.⁸ I think requiring disclosure is the trend, and the ABA should get in front of it.

Finally, I think the rule is necessary to protect lawyers from liability for the malfeasance of their clients. For example, the SEC has enforcement powers that it can use to sanction those who fail to report serious misconduct by the SEC. For example, in a 1992 release stemming from false bidding on U.S. Treasury securities at Salomon Brothers, the SEC described at length

⁷ See Model Rules of Professional Conduct, Rule 1.6 (2002).

⁸ See Preliminary Report of the American Bar Association Task Force on Corporate Responsibility 32 n. 28 (2002).

the responsibility of the firm's chief legal officer upon discovery of misconduct.⁹ The SEC stated that a person in the legal officer's position has an obligation to ensure that appropriate steps are taken, and if management fails to act, the person should consider disclosure to the board, resignation and even disclosure to regulatory authorities. Although the SEC did not make the chief legal officer subject to sanctions, it strongly implied that a general counsel could be liable under Section 15 for failure to supervise where the legal officer fails to ensure that the corporation resolves the matter appropriately. Seen in this light, a lawyer needs the ability to report financial misdoings in order to protect himself.

The rules proposed by the SEC last Wednesday move a good deal in this direction. Under those rules, when an attorney reasonably believes a "material violation of securities laws or breach of fiduciary duty or similar violation" has occurred, the attorney is required to report the violation "up the ladder" to the corporation's chief legal counsel or chief executive officer, and if they don't respond appropriately, to the audit committee, another committee of independent directors or the board as a whole. If the attorney does not receive an appropriate response from these parties, the SEC rule permits, and in some cases requires, a "noisy withdrawal"—the disaffirmance of a submission to the commission that the attorney believes has been tainted by a material violation. In addition, the rule provides that the attorney may reveal confidential client information to the extent necessary to prevent the commission of an illegal act that the attorney reasonably believes will result in the perpetration of a fraud on the SEC or in substantial injury to the financial or property interests of the company or of another. The rule also allows an attorney to reveal confidences to rectify illegal actions involving use of the attorney's services. I believe it would behoove the ABA not to oppose the proposed SEC rule, although I believe lawyers should only be allowed to reveal client confidences to prevent *continuing* "financial murder."

On the other hand, I think that the ABA should oppose any rule requiring a firm to resign from its representation of a client where a material violation of securities laws or breach of fiduciary duties occurs and the client fails to take appropriate action. Modern law firms frequently represent clients in many matters and in many areas—for example, labor, tax, litigation, contract review, and others. It would be extremely harmful to the client to require the entire firm to resign from its representation, prejudicing the client in numerous matters, and there would be no corresponding benefit to the public or to the shareholders. What is needed in this situation is disaffirmance of false or misleading information, not resignation.

2. Special Investigations

I believe that when a lawyer accepts an engagement to perform a special investigation for a corporation, he should not be limited by his client as to what he can inquire into, and has a duty to inquire into matters where it appears they have material relevance to the investigation. As a result, I think we should also consider a rule that a lawyer cannot issue a report on a special investigation where in the lawyer's reasonable judgment there has been a limitation placed on the lawyer's investigation that could materially affect the conclusions in the report. If there are limitations placed on the scope of a lawyer's inquiry, the lawyer should be required to state in the

⁹ See In the Matter of John H. Gutfreund, Thomas W. Strauss, and John W. Meriwether, Exchange Act Release No. 31554 (December 3, 1992).

report that such limitations in his or her reasonable judgment did not or were not likely to materially affect the conclusions in the report had they not been imposed and the lawyer had been allowed to perform the investigation in the absence of such limitations.

The logic here is that since the lawyer and client get the benefit of the privilege, they should not limit the investigation. Otherwise, special investigative reports can be used as defensive covers when in fact they are limited. Then firms could no longer be hired to do an investigation on an accounting challenge, but not be permitted to talk to the accountants, as was the case in Enron. We should not allow ourselves as professionals to be used in that manner.

VI. Policy Proposals

1. The Analyst Problem

Finally, I think the Task Force should recommend to the ABA that it endorse reforms to solve the analyst problem.¹⁰ Numerous investment banks are under fire for providing investors with recommendations that were tainted by their firms' relationships with the companies that they follow.

There are numerous proposals being circulated to address this issue, from building firewalls between bankers and analysts to enacting rules regarding the compensation of analysts and even separating analysis from investment banking entirely within the same corporate umbrella. I believe that these proposals are too unwieldy. Rather than get embroiled in these questions, I believe the best solution is to bar investment banks from providing analysis to retail customers and prohibit analysts affiliated with the investment banks (and institutions to whom they are allowed to provide reports, as discussed below) from making their analysis—including any projections of earnings, revenues or stock price—public.

I would allow investment banks to continue to provide research to institutional customers, the Qualified Institutional Buyers (as defined in Rule 144A) who can fend for themselves. In fact, I would not even bar these analysts from “coming over the wall” and participating in pitches or receiving bonuses based on investment banking business they obtain—I would leave it to investment bankers and analysts to figure out how to present themselves to the institutions and to the institutions to demand the degree of independence that they want. Since roughly 65% of the market is owned by institutional investors, this preserves the transparency created by research. Companies that beg for after-offering research will get it for 65% of their market, but it won't go to the retail part of the market. That has to come from independent research firms such as Standard & Poor's, Value Line, Sanford C. Bernstein & Co., AXA and new entities spun off by investment banks. It may come to pass that retail investors have to pay for research (as they do today with those named entities), but that is okay, and it may make investors more demanding. By adopting this law at the federal or SEC level, we could create a level playing field for all investment bankers with research arms. None could use retail research to compete with the others, nor could they use it in an inappropriate way—in fact, they couldn't use it at all.

¹⁰ In note 8 of the Report, the Task Force states its sense that meaningful reforms in this area are necessary.

I also endorse, and urge the Task Force to recommend, a proposal recently put forward by David Pottruck, the President and co-CEO of the Charles Schwab Corporation, who suggests that analysts and research firms be required to publish their “report cards”—track records of whether or not their financial advice has previously proven accurate—just as mutual funds currently are. When Schwab surveyed their customers to see what they thought of the idea, 85% of them supported it.¹¹ I believe that requiring this and other disclosure from analysts and research firms will go a long way towards restoring investor confidence in the credibility of market research.

2. Increased Resources for the SEC

I believe that it is imperative that Congress increase the amount of funding that is given to the SEC to strengthen its enforcement capabilities with more staff and better resources. Executives I talk to say that the billions and billions of share value lost from revelations of financial fraud justify modest expenditures to restore investor confidence, and the increase in SEC budget is just that. The SEC is the chief protector of investors in the Federal government and although its recent rulemaking efforts have been impressive, the Commission seems overwhelmed in its enforcement activities.

3. Increased Pay for Independent Directors

Similarly, I think the time has come to increase independent director compensation. Recent events have made the job of being a director a scarier one and a harder one. We are asking directors to do more—to be independent, to be inquisitive, to be active and interactive—and as a result we should pay them more to compensate them for their efforts.

VII. Conclusion

I hope that these suggestions are provocative in the best sense of the word, in that they provoke the Task Force to consider how we as lawyers can help to implement an effective series of reforms. We cannot wait to see what happens. I think that if the ABA lapses into a “nothing needs to be changed, everything is fine” mode, or even adopts a “wait and see” attitude, we will not only be irrelevant, we will be viewed as simply the advocates of our corporate clients and not part of the solution. Instead, we need to claim a role of leadership.

We can’t be reactive or short-sighted. We don’t want laws that will hamper the legitimate exercise of management prerogatives. As the Report observes, “Direct operational control of American public companies is and must remain primarily in the hands of their executive officers.” However, if there’s a danger in going too far, there’s also a danger in not going far enough. We must remember who owns those public corporations that management manages and we lawyers represent—the shareholders. Whatever proposals the ABA adopts, we should be confident that we’ve done our utmost to ensure the integrity of our markets and the actors in them, so investors feel confident again.

¹¹ See David S. Pottruck, Address at the National Press Club Luncheon (Oct. 18, 2002).

The Board of Directors in the Post-Enron Era

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I've been counseling corporations for 37 years—talking with management and directors, attending Board meetings, giving them advice on how to negotiate and structure transactions and how to respond to changes in the law. I've done this both from the inside of corporations and the outside. Even so, I have never seen a time like this. We are witnessing a fundamental change in how investors view corporations and there's going to be a fundamental change in corporate governance as a result.

In the past year, we've seen major corporations like Enron and Global Crossing collapse. We've seen industry giants lose as much as two-thirds of their value overnight when investors get spooked by information in the market, as ABB and Halliburton did when they disclosed their provision for reserves against asbestos liabilities. The markets are reacting this way because investors are no longer confident that they can trust what they see. They don't feel that they can rely on analysts, because they believe that the recommendations analysts provide are generally skewed toward "buy" ratings and sometimes compromised by their firms' relationships with the companies that they follow. Furthermore, they don't trust the timeliness, accuracy or transparency of the financial information that they receive—it seems like every day you read about a senior executive who cashed out on options while announcing good news only to restate that good news later. After announcements like that, shareholder confidence is eroded further and the corporation's share price drops.

This relates to what I call the "Ted Koppel test." Briefly stated, the Ted Koppel test says that when a corporation puts out news that doesn't play well on Nightline, the market reacts and the corporation's shareholders lose value. The Ted Koppel test goes beyond legal and regulatory requirements—it says that it is bad business to do things that look bad or will look bad if anybody ever finds out about them because you can destroy billions of dollars of shareholder value that way. In other words, if it wouldn't play well on Ted Koppel, you shouldn't do it. If you know it won't play well on Ted Koppel and you can prevent it, you prevent it.

For all of these reasons, companies need to focus on restoring the confidence of investors and they need to do it now. Although the Bush Administration, Congress, the SEC, institutional investors and academics are all proposing reforms to how companies manage risk and review and report their financial information, it's crucial that companies start doing something on their own. They have to control bad news at its source by preventing the kind of decision-making that

leads to these revelations in the first place. I believe that one of the most important steps a company can take is to revitalize its Board of Directors.

The Board of Directors as an institution is designed to represent the shareholders by providing general direction for and oversight of the management of the corporation's business and affairs. It is supposed to endeavor to create and protect shareholder value by formulating with management the strategic goals of the corporation and by guiding the implementation of the policies and actions necessary to reach those goals. In doing so, directors are there to bring to bear the experience and the judgment that they possess in endeavoring to make sure the company is on track. Directors are supposed to be informed, to ask questions, to participate in the major decisions affecting the affairs of the corporation. In short, while it is the job of management to manage, it is the job of directors to direct.

Unfortunately, it does not always work this way. In my experience, there are two kinds of Boards: what I call the "Rubber-Stamp" Board of Directors and what I call the "Active and Interactive" Board of Directors.

The Rubber Stamp directors have been nominated to the Board because they're friends of the CEO. They attend meetings a few times a year, they listen to management and they vote as management suggests. They may be bright, accomplished and even attentive, but they are deferential—they don't direct. Only two situations cause Rubber Stamp directors to snap to attention and act like real directors—when the corporation is considering a change in control or when the directors are selecting a new CEO. However, once the Rubber Stamp directors have appointed a CEO, they relax—they won't interfere with the course set by the CEO they have selected.

By contrast, the members of an Active and Interactive Board are inquisitive and assertive. They prepare for meetings, they ask questions. They don't antagonize management for the sake of it, but they do bring an attitude of constructive skepticism to the process. They are a second set of eyes, one that not only brings experience and judgment, but is willing to exercise it. In short, they direct. As an aside, this isn't entirely new; those of you who lead start-ups or companies that recently were start-ups have probably seen this if you have venture capitalists on your board—if VCs have a substantial stake in a company, they will watch everything very closely. It's their money.

What we are now seeing is the VC model coming in to the boardrooms of even the largest, most established companies. The newly "Active and Interactive" Board members aren't driven by the promise of wealth—they are doing it because their reputations are on the line. When a company fails or its stock price tanks, it tarnishes the reputation of every director associated with the company—people assume the directors were asleep at the switch, that they didn't have the judgment or the capability to watch the store. Ask Frank Savage, one of the Enron directors—institutional investors like CalPERS are now opposing his reelection on other Boards and refusing to fund his new private equity fund, as reported in Wednesday's *Wall Street Journal*. Directors are realizing that they have to be active and engaged, both for the shareholders and for their own sake. This not only will happen, it has to happen.

So what is the role of the CEO in all this? The CEO has to encourage an “Active and Interactive” Board and should be doing everything possible to make sure he or she gets one. Here are seven suggestions:

1. The CEO and other members of management should rethink their process for recruiting and nominating Board members. They should be recruiting directors who are not only willing to commit the time to performing their duties as directors faithfully, but are also able to think critically and to speak up. It’s the end of the “old boy” network. Management has to place “Active and Interactive” Directors on the Board. Better, the Board should have a Nominating Committee that does this.

Again, think of the Ted Koppel test—how does it look when things go wrong at a corporation and the media later reports that one of the independent directors responsible for a decision has a consulting contract with the company or teaches at a university to which the company makes substantial contributions? Or how does it look when, despite the eminent qualifications of its members, a Board of Directors only meets three or four times a year and even then meets briefly without engaging in serious discussion of the corporation’s affairs and several members did not attend? It would look bad on Nightline and the market would punish you when it learns of it because it gets disclosed in the annual proxy statement. But you can prevent this. You do so by selecting directors who are not beholden to the corporation personally, financially or otherwise. You do so by selecting directors who have the confidence and independence to act and interact and who will take the time to attend meetings to do so.

2. CEOs need to be more resilient. The CEO must be able not only to tolerate directors who question the CEO’s agenda—the CEO must encourage them to do so. There has to be a dialogue. The corporation is not served by directors who don’t direct and it’s part of the CEO’s job to make sure they do so.
3. The Board of Directors has to have access to information, access to personnel and access to advice. The Board and Committees of the Board should be empowered to request that corporate personnel attend meetings and answer their questions when necessary. The Board and its Committees must have access to the professional advice of counsel and accountants, both from within the company and, where necessary, from outside.
4. The Board and its Committees must be able to meet in executive session, without management present. It is essential that Board members exercise independent, objective thought, and sometimes they may have to meet alone to do that. Among other things, they should evaluate the performance of senior management at these executive sessions and evaluate their own performance as a Board. The Nominating Committee should evaluate the performance of each Board member against the “Active and Interactive” standard.

5. An “Active and Interactive” Board of Directors works harder than a Rubber-Stamp Board, and you should pay them accordingly.
6. The “Active and Interactive” Board must have a plan in place for senior executive succession. CEOs should not resist this.
7. The “Active and Interactive” Board should grant compensation, cash and equity, short-term and long-term, that is tied in part to good—and lasting—corporate performance.

Of course, I am presumptuous in lecturing you like this, never having been a CEO myself. The highest I ever got was Executive Vice President and General Counsel. However, having been a personal counselor to the CEO of BancAmerica for seven years, I understand that at times it can be lonely at the top and that CEOs are subject to great and often conflicting pressures. I hope you will take my observations with that in mind and with the realization that this is an extraordinary time in corporate governance.

These suggestions are an important start, but the most important thing a CEO can do is to set the tone at the top. CEOs need to demand more from their directors. CEOs need to understand that they benefit from an “Active and Interactive” Board of Directors, even one that disagrees with the CEO sometimes. CEOs should not fear this disagreement—they should harness it. Corporations that have “Active and Interactive” Boards will function better and will outperform their competition because they are better able to recognize opportunities and manage risks. In short, CEOs must embrace and promote the new Board of Directors for the good of the corporation. Do this, and hopefully, when you’re on Nightline, it will be good news.