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Corporate Laws Committee of the Business Law Section
of the
American Bar Association

WHITE PAPER

**UNIFORMITY IN CORPORATE REFORM THROUGH
CHANGES TO THE MODEL BUSINESS CORPORATIONS ACT**

DECEMBER __, 2002

ADDRESSED TO:

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CORPORATE LAWS COMMITTEE OF THE BUSINESS LAW SECTION
OF THE AMERICAN BAR ASSOCIATION

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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.

However, the current state of the American capital markets is deeply troubling. In the past two years, major corporations like Enron, Global Crossing, WorldCom and Adelphia have collapsed. Corporate executives have gone from being glorified to vilified and the reputations of board members tarnished. Accounting firms 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 government is susceptible to alleged scandal, as demonstrated by the recent resignation of Chairman Harvey Pitt from the SEC and William Webster from the Public Company Accounting Oversight Board. The public questions whether 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, partly because investors no longer trust what they see.¹ Investors do not feel they can rely on analysts, because they believe the recommendations analysts provide are generally skewed toward “buy” ratings and compromised by their firms’ relationships with the companies they follow.² Furthermore, investors do not trust the timeliness, accuracy or transparency of the financial information they receive.³ Over the last two years, there have been numerous stories about senior executives who cashed out on options while announcing good news only to restate that good news later. After such announcements, shareholder confidence is eroded further and the corporation’s share price drops, along with the share prices of the many innocent corporations having management with great integrity.

¹ Testimony by Alan Greenspan, Chairman, Board of Governors of Federal Reserve System, before the Joint Economic Committee, United States Congress, November 13, 2002 (<http://jec.senate.gov/hearings.htm>).

² See “Citicorp Investigation Now Leads To Door of Elite Nursery School,” Wall Street Journal, November 14, 2002, regarding Salomon Smith Barney’s former star research analyst, Jack Grubman, and his possible conflict-of-interest tainted stock research.

³ On October 23, 2002, the United States General Accounting Office released a report finding that approximately 10% of publicly traded companies restated their financials between 1997 and 2001 due to accounting irregularities, a number that increased every year during that period (<http://www.gao.gov/new.items/d03138.pdf>).

Through the Sarbanes-Oxley Act, Congress implemented the most sweeping reforms of our nation's securities laws and, of great importance to this Corporate Law Committee, since the New Deal. In addition, the New York Stock Exchange and NASDAQ have proposed greatly expanding their listing standards, which also effect corporate structural changes. 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, that 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.

I. Task Force on Corporate Responsibility

On March 28, 2002, the American Bar Association Task Force on Corporate Responsibility (the "Task Force") was appointed by Robert Hirshon, former President of the American Bar Association (the "ABA"), with the following charge:

The Task Force on Corporate Responsibility shall examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility. The Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.

On July 16, 2002, the Task Force published the Preliminary Report of The American Bar Association Task Force on Corporate Responsibility (the "Preliminary Report"), advocating general reform in the area of internal corporate governance, particularly the composition and processes of the board of directors and its core committees. In the fall of 2002, the Task Force convened three public hearings to elicit comments on the Preliminary Report from interested observers.

This White Paper, a product of deliberations of the Corporate Laws Committee of the Business Law Section of the ABA (the "Committee"), and also a product in part of testimony at the foregoing Task Force hearings which Committee members have received, is intended to serve as a general recommendation to the Section Council of the ABA Section of Business Law, the Task Force and the President of the ABA, as to (a) how certain corporate governance reform measures discussed in the Preliminary Report may be effectively implemented, and (b) additional corporate governance reform measures deemed appropriate by the Committee to ensure good corporate governance and help restore investor confidence. Not all members of the Committee endorse each recommendation and views expressed in this White Paper, but the White Paper taken as a whole reflects a consensus of the members of the Committee.

II. Revising the Model Business Corporation Act

In the wake of the Enron collapse, corporate governance reform in the United States has been attempted by a variety of players -- the federal government, individual state governments, the Nasdaq National Market, the New York Stock Exchange, public pension funds like CalPERS and TIAA-CREF, etc. -- potentially resulting in inconsistent and complex layers of regulation. Inarguably, immediate reform is necessary, but not at the cost of disparate rules, regulatory gaps and varying penalties.⁴

The Model Business Corporation Act (the “MBCA”), designed as a free standing general corporation statute that can be enacted substantially in its entirety by a state legislature, is currently the law in 44 states and is followed in varying degrees in the other states. When the Committee adopts revisions to the MBCA, states typically enact the revisions, as they have consistently done in the past. For this reason, the MBCA is an ideal vehicle to effect broad and uniform corporate governance reform applicable to public corporations.

Ordinarily, the Committee itself has authority to and would adopt the amendments to the MBCA envisioned herein. However, in light of the importance and effect of these measures, the Committee desires the Section Council of the Section of Business Law to first approve these recommendations. In addition, the Committee desires the President of the ABA following upon the Final Report of his Task Force, to approve the proposals as well. Once the MBCA amendments are adopted, the Committee is unanimously of the view that (a) no further federal legislative action to preempt state corporate laws should be necessary, (b) investors will be given enforceable rights to corporate reforms which will greatly help restore investor confidence, and (c) these reforms should be adopted by all states of the United States. The Committee feels the reforms it proposes in corporate law should be adopted after such approvals, and will do so then with the precise technical drafting and commentary typical of the Committee. The provisions drafted below are exemplars of what may be done to effectuate the proposals made below and do not purport to be the precisely drafted provisions containing the required technical commentary.

* * * * *

To ensure uniformity at the state level and avoid disparate standards among federal governments, state governments and self-regulatory organizations, the Committee recommends that broad corporate governance reform be adopted through amendments to the MBCA. Our recommendation is that the MBCA should be amended to include new corporate governance rules applicable only to “public corporations,” a newly defined term under the MBCA. The definition would only include corporations with market capitalizations in excess of \$100 million, thus exempting smaller corporations from the higher costs to them associated with the additional corporate governance requirement we have proposed. These corporate governance rules are set forth below, with the actual text of the proposed MBCA amendments following a short discussion of the changes proposed by the Committee. The current text of the MBCA is indicated in regular text, with proposed additions to the MBCA indicated with double-underlined text and proposed deletions from the MBCA indicated with strike-through text.

⁴ For example, as the Preliminary Report recognizes, some stock exchanges might adopt inconsistent rules, while others might adopt none at all. *See* Preliminary Report, page 14.

1. Independent Directors and Board Committees

The Committee believes most executive officers, directors and professional advisers act honestly and in good faith. Direct operational control of American public companies is and must remain primarily in the hands of their executive officers. It has always been recognized, however, that executive officers and other employees of public companies may succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being. To check such temptation, and to focus the corporation on the interests of the shareholders, our system of corporate governance has long relied upon the active oversight and advice of independent participants in the corporate governance process, such as the outside directors, outside auditors and outside counsel. Corporate responsibility and sound corporate governance thus depend upon the active and informed participation of independent directors and advisers who act vigorously in the best interests of the corporation and are empowered effectively to exercise their responsibilities.

The core conclusion of the Committee, however (which is shared in the Preliminary Report of the Task Force), is that, as evidenced by recent failures of corporate responsibility, the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short. Unless the governance system is changed in ways designed to encourage such active and informed stewardship, the Committee (and the Task Force) believes that public trust and investor confidence in the corporate governance system will not be restored.

An independent director is a person whose directorship constitutes his or her only material connection to the corporation. An independent director is able to exercise objective judgment in carrying out his or her responsibilities so as to avoid damaging conflicts of interest. Board committees (such as the audit committee and compensation committee) composed entirely of independent directors better ensure corporate accountability and increase investor confidence.

The Committee recommends the MBCA be amended to require the boards of directors of all public companies, other than majority controlled public corporations, be composed of a majority of independent directors. To encourage corporate accountability, the MBCA should require public corporations to have an audit committee, compensation committee and a nominating/corporate governance committee, each composed entirely of independent directors and obligated to meet at least twice each fiscal year outside the presence of management. Finally, the MBCA should require all public corporations to adopt a code of conduct addressing conflict of interest issues and legal compliance matters.

The language for following proposals was generally derived from (a) the corporate governance rule proposals adopted by the New York Stock Exchange and submitted to the Securities and Exchange Commission on August 1, 2002 (the “NYSE Governance Proposals”)⁵, (b) Amendments to Rule 4200 and 4350 regarding board independence and independent committees adopted by the National Association of Securities Dealers, Inc. (the “NASD”) and submitted to the Securities and Exchange Commission on October 9, 2002 (the “Nasdaq

⁵ See http://www.nyse.com/pdfs/corp_gov_pro_b.pdf.

Governance Proposals”)⁶, (c) the code of conduct rule adopted by the NASD and submitted to the Securities and Exchange Commission on October 9, 2002 (the “Nasdaq Code of Conduct Rule”)⁷, (d) Sections 301, 401 and 406 of the Sarbanes-Oxley Act of 2002, (e) TIAA-CREF’s Policy Statement on Corporate Governance (“TIAA-CREF’s Governance Statement”)⁸, and (f) CalPERS U.S. Corporate Governance Principles (“CalPERS’ Governance Principles”)⁹.

In terms of drafting the following proposed definition of the term “independent director,” the Committee generally used the organization set forth in the NYSE Governance Proposals, i.e., a general statement that an independent director can have no “material relationship” with the corporation as determined by the board of directors, followed by a list of specific relationships that are deemed material. Thereafter and with the goal of legislating a broad definition of independence, additional relationships deemed “material” were taken from the Nasdaq Governance Proposals, TIAA-CREF’s Governance Statement and CalPERS’ Governance Principles. These additional relationships are (a) affiliation with a corporation’s customer or supplier (derived from the Nasdaq Governance Proposals and CalPERS’ Governance Principles), (b) affiliation with a non-profit entity that has received contributions from the public corporation (derived from CalPERS’ Governance Principles, with the addition of a \$10,000 minimum threshold for contributions), and (c) affiliation with a consultant or adviser to the corporation (derived from CalPERS’ Governance Principles).

The NYSE Governance Proposals exempts majority controlled public corporations from the requirement that the board of directors have a majority of independent directors and the requirement that the public corporation have a compensation committee and nominating/corporate governance committee.¹⁰ Under the NYSE Governance Proposals, majority controlled public corporations must have a minimum three person audit committee composed entirely of independent directors. The Committee’s proposals follow the NYSE Governance Proposal with respect to excluding a majority controlled public corporation from the requirement that its board be composed of a majority of independent directors. However, the Committee feels controlled public corporations should not be exempt from the requirements regarding nominating/corporate governance committees or compensation committees, as the minority independent directors need to be nominated in an objective process and the proliferation of exorbitant officer compensation at the expense of public shareholders remains unchecked and needs to be within the purview of objective directors, and this is all the more important in a majority controlled corporation.

The Committee’s proposed definition of “public corporation” was generally derived from Section 2(a)(7) of the Sarbanes-Oxley Act, which defines the term “issuer” for purposes of regulation under the Sarbanes-Oxley Acts as a corporation (a) registered under section 12 of the Securities and Exchange Act of 1934, as amended (the “1934 Act”), (b) required to file reports under section 15(d) of the 1934 Act, or (c) that files or has filed a registration statement that has

⁶ See http://www.nasdaq.com/about/2002_141.pdf.

⁷ See http://www.nasdaq.com/about/2002_139.pdf.

⁸ See <http://www.tiaa-cref.org/libra/governance/index.html#policy>.

⁹ See <http://www.calpers-governance.org/principles/domestic/us/page01.asp>.

¹⁰ Under the NYSE Governance Proposals, a controlled company that chooses to take advantage of this exemption must disclose in its annual proxy that it is a controlled company and the basis for that determination.

not become effective under the Securities Act of 1933, as amended (the “1933 Act”). The Committee’s proposed definition of “public corporation” includes the first two aspects of the foregoing definition. However, the Committee understands that many issuers initially file registration statements to “test the waters” of the capital markets with respect to a proposed debt or equity issuance, only to later withdraw such registration statements after low interest in the offering. In light of this, the Committee feels the proposed corporate governance rules should only apply to corporations that avail themselves of the public markets in a transaction that is consummated. Moreover, the Committee acknowledges that the proposed legislation will be costly and time consuming to public corporation in terms of implementation and ongoing monitoring. The Committee submits that the benefits associated with these corporate governance proposals are likely disproportionate to the costs that would be borne by the management and boards of smaller public corporations. As such, the Committee’s proposed definition of “public corporation” applies only to corporations with a market capitalization in excess of \$100 million.

The Committee’s proposals regarding the composition and responsibilities of the compensation committee, the nominating/corporate governance committee and the audit committee were derived from the NYSE Governance Proposals, with no substantive changes.

The Committee’s proposal regarding a public corporation’s obligation to adopt a code of conduct was derived substantially from the Nasdaq Code of Conduct Rule, with the only difference being that waivers of the code of conduct require board approval and subsequent disclosure to the extent they involve amounts in excess of \$50,000. The Nasdaq Code of Conduct Rule has no monetary threshold regarding such waivers.

§ 1.40. ACT DEFINITIONS

(9C) “Executive officer” means the five most highly compensated officers of a public corporation, as set forth in the public corporation’s filings with the Securities and Exchange Commission.

(13C) “Independent director” means a director that the board of directors affirmatively determines has no material relationship with the public corporation (either directly or indirectly), other than his or her status as director of the public corporation. In no event shall a director be deemed an “independent director” if he or she:

(a) has been employed by the public corporation or any parent, subsidiary or affiliate of the public corporation at any point during the previous five years;

(b) has been affiliated with or employed by a present or former auditor of the public corporation (or a parent, subsidiary or affiliate of the public corporation) during the previous five years;

(c) has been employed during the previous five years by another entity in which an executive officer of the public corporation serves on the compensation committee;

(d) has been affiliated with a not-for-profit entity that has received contributions in excess of \$10,000 during any calendar year in the last five years from the public

corporation;

(e) is or has been affiliated with an entity that is an advisor or consultant to the public corporation, or a customer or supplier of the public corporation involving (in the case of a customer) revenues to the corporation in excess of ½ of 1% of total revenues in any fiscal year, or (in the case of a supplier) more than ½ of 1% of the total expenditures of the public corporation in any fiscal year; or

(f) has an immediate family member (i.e., related by blood, marriage or adoption or who has the same residence) described in paragraphs (a), (b), (c), (d) or (e) above during the previous five years, who in connection therewith received, directly or indirectly through an affiliate, compensation or payments in excess of \$60,000 during any of the previous five years.

The definition set forth in this Section 13C shall not apply for purposes of the application of section 7.44.¹¹

(14D) “Majority-owned public corporation” means a public corporation of which more than 50% of the voting power is held by an individual, group or another entity.

(17C) “Public corporation” means a corporation with a total market capitalization at the end of the fiscal year preceding the year in which a provision of this Code applicable to public corporations is being applied, in excess of \$100,000,000, and (a) with securities registered under section 12 of the Securities Exchange Act of 1934, as amended, or (b) required to file reports under section 15(d) of the Securities Exchange Act of 1934, as amended.

§ 8.01. REQUIREMENT FOR AND DUTIES OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) The board of directors of all public corporations, other than majority-owned public corporations, must be composed of a majority of independent directors. The chairman of the board of directors of all public corporations must be an independent director and shall oversee and administer the operation of the board of directors, which shall include (i) planning and finalizing the agenda for all meetings of the board of directors, (ii) presiding over all

¹¹ Section 7.44 of the MBCA, dealing with a corporation’s good faith dismissal of derivative proceedings, sets forth special standards for determining whether directors are “interested” for purposes of such decision. The Committee feels the new definition of “independent director” should not affect the determination of independence for purposes of section 7.44 of the MBCA.

meetings of the board of directors, (iii) the nomination and selection of new directors, and (iv) the nomination and selection of directors to serve on committees of the board of directors.¹²

§ 8.20. MEETINGS

(a) The board of directors may hold regular or special meetings in or out of this state.

(b) Unless the articles of incorporation or bylaws provide otherwise, the board of directors may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting. A director participating in a meeting by this means is deemed to be present in person at the meeting.

(c) The independent directors of all public corporations must meet at regularly scheduled executive sessions without the presence of the officers of the public corporation or the presence of the directors who are not independent directors.

§ 8.26. MANDATORY COMMITTEES FOR PUBLIC CORPORATIONS

(a) The board of directors of a public corporation must have a nominating/corporate governance committee composed entirely of independent directors. The nominating/corporate governance committee must meet at least twice each fiscal year outside the presence of the public corporation's officers. The nominating/corporate governance committee must have a written charter addressing each of the following:

(1) the nominating/corporate governance committee's purpose, which must include the following: (i) identification of individuals qualified to become directors of the public corporation, (ii) selecting, or recommending that the board of directors select, the director nominees for the next annual meeting of shareholders (or special meetings if directors are to be elected therein), and (iii) developing and recommending to the board of directors a set of corporate governance principles applicable to the public corporation;

(2) the nominating/corporate governance committee's goals and responsibilities, which must set forth the public corporation's criteria for selecting new directors, and oversight of the evaluation of the board of directors and management; and

(3) an annual performance evaluation of the nominating/corporate governance committee.

(b) The board of directors of a public corporation must have a compensation committee composed entirely of independent directors, a majority of whom are not themselves executive officers of a public corporation. The compensation committee must meet at least twice each fiscal year outside the presence of the public corporation's officers. The compensation committee must have a written charter addressing each of the following:

¹² See Item 6 below, regarding this new provision relating to the chairman of the board of directors of public corporations.

(1) the compensation committee's purpose, which must include the following: (i) discharging the board's responsibilities relating to compensation of the public corporation's officers, and (ii) production of an annual report on executive officer compensation for inclusion in the public corporation's proxy statement, in accordance with applicable rules and regulations;

(2) the compensation committee's duties and responsibilities, which must include the following: (i) reviewing and approving corporate goals and objectives relevant to compensation of the public corporation's chief executive officer, (ii) evaluating the chief executive officer's performance in light of those goals and objectives, (iii) establishing the chief executive officer's compensation level based on this evaluation, (iv) establishing all other executive officers' compensation levels (unless such compensation is otherwise approved by a majority of the independent directors), and (v) making recommendations to the board of directors with respect to incentive-compensation plans and equity-based plans; and

(3) an annual performance evaluation of the compensation committee.

(c) The board of directors of a public corporation must have an audit committee composed of at least three directors, all of whom must be independent directors and a majority of whom must not be executive officers of other public corporations. The audit committee must meet at least twice each fiscal year outside the presence of the public corporation's officers. Each member of the audit committee shall be financially literate as determined by the board of directors in its judgment, as such qualification is defined by the public corporation's board of directors but which definition must include the ability to read and understand balance sheets, income statements and cash flow statements, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. The audit committee must have a written charter addressing each of the following:

(1) the audit committee's purposes, which must include the following: (i) assisting the board of directors with the oversight of (A) the integrity of the public corporation's financial statements, (B) the public corporation's compliance with legal and regulatory requirements, (C) the independent auditor's qualifications and independence, and (D) the performance of the public corporation's internal audit function and independent auditors; and (ii) preparing reports required by Securities and Exchange Commission rules to be included in the public corporation's annual proxy statement;

(2) the duties and responsibilities of the audit committee, which must include the following: (i) retention and termination of the public corporation's independent auditors (subject, if applicable, to shareholder ratification), (ii) at least annually, obtaining and reviewing a report by the independent auditor describing: (A) the public corporation's internal quality-control procedures; (B) any material issues raised by the most recent internal quality-control review, or peer review, of the public corporation, or by any material inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (C) to assess the auditor's independence, all material relationships between the independent auditor and the public corporation, (iii) discussing the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the public corporation's disclosures under "Management's Discussion and Analysis of Financial

Condition and Results of Operations” in its reports, (iv) discussing earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies, (v) as appropriate in the judgment of the audit committee, obtaining advice and assistance from outside legal, accounting or other advisors, (vi) discussing policies with respect to risk assessment and risk management, (vii) meeting separately and periodically with representatives of management and with internal auditors (or representatives of other personnel responsible for the internal audit function) and with representatives of independent auditors, (viii) reviewing with the independent auditor any audit problems or difficulties and management’s response, (ix) setting hiring policies for employees or former employees of the independent auditors, and (x) reporting regularly to the board of directors; and

(3) an annual performance evaluation of the audit committee.

§ 8.27. CODE OF CONDUCT

A public corporation shall adopt a code of conduct applicable to all directors, officers and employees, addressing the issues of conflicts of interest and compliance with law and regulation, and providing for an enforcement mechanism. Any waivers of the code for directors or officers involving amounts in excess of \$50,000 must be approved by the board of directors and promptly and publicly disclosed.

2. Refunds Following Restatements

Perhaps the most demoralizing phenomenon for investors has been the enrichment of insiders at the expense of ordinary investors. *Fortune* magazine published an article on October 2, 2002 entitled “You Bought. They Sold,” naming the “25 companies with the greediest executives” who made as much as \$2,250,000,000 selling company shares, while those shares dropped more than 75% from their boom-time peak. The enrichment of a few executives at the expense of tens of thousands of shareholders undermines investors’ confidence in the basic fairness of the system.

Currently, federal securities laws protect against insiders enriching themselves at the expense of the company in three 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 knowledge regarding undisclosed material, non-public information. 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 Section 304 of the Sarbanes-Oxley Act relates to the compensation given the chief executive officer and chief financial officer for the 12-month period following the public issuance of the flawed financial statements.

Section 16(b) and Section 10(b)(5) are currently proving inadequate to protect investors from mismanagement and manipulation. The short-swing Section 16(b) 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.¹³ These sales do 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 traded on the basis of material, non-public information and had knowledge. These are frequently difficult showings and thus it is unlikely the corporation will recover even if the results seem blatantly unfair.

The Committee recommends that the MBCA be amended to provide that when a public corporation issues a restatement requiring a substantial downward adjustment of previously reported financial results (i.e., 20% or greater reduction in revenues, operating income or net income), the senior executive officers and directors of the public corporation must 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 [which a court determines would not have been received had the financial statements been as restated throughout the period]. This rule would constitute a strong incentive for the senior executive officers and directors to make sure the numbers are materially right the first time. This rule would of course be subject to some exceptions, as for restatements resulting from a change in applicable accounting principles beyond the company’s control. The Committee is asking public companies to do what they should do for themselves – require the disgorgement of bonuses and stock profits received as a result of falsified financial statements. The proposal goes beyond Section 304 of the Sarbanes-Oxley Act because there would be no need to prove misconduct and the disgorgement would reach back two years (or for the period of the restatement, if less), rather than one year. Furthermore, unlike Section 304 of the Sarbanes-Oxley Act, the remedy would not be limited to chief executive officers and chief financial officers, but would apply to directors and the five most highly compensated executive officers and directors (see the new definition of “executive officer” at Section 1 above).

¹³ 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.

The Committee's proposal regarding refunds following restatements was conceptually based on Section 304 of the Sarbanes-Oxley Act, with the material differences discussed above. The Committee proposes creating a new Subchapter H to Chapter 8 of the MBCA, which otherwise pertains to a corporations directors and officers, to implement the new proposal.¹⁴

Chapter 8

DIRECTORS AND OFFICERS

Subchapter H.

REFUNDS FOLLOWING RESTATEMENTS

§ 8.70. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) "Material restatement" means a restatement in which the restated or revised financial information reported by the public corporation results in a 20% or greater reduction in the public corporation's revenues, operating income or net income, as compared against the financial information originally reported by the public corporation.

(2) "Restatement" means a public corporation's restatement or revision, either voluntarily or involuntary, of financial information previously reported to the public, other than restatements made in connection with (i) a recapitalization of the public corporation, or (ii) changes in generally accepted accounting principles.

§ 8.71. FORFEITURE OF CERTAIN BONUSES AND PROFITS

If a public corporation issues a material restatement, each executive officer and director of the public corporation at the time of the material restatement shall be required to promptly refund to the public corporation in cash the full amount of all bonuses, and all profits on share transactions, received by such executive officer or director within the two year period prior to the material restatement, or the period covered by the material restatement, if less [which a court determines would not have been received had the financial statements been as restated throughout the period].

3. Conflict of Interest Transactions

Another recurring theme in the corporate scandals of the past year has been conflict of interest transactions, where a member of a board of directors has a financial or other material interest in the outcome of a transaction involving the corporation on whose board he or she serves. At Enron and Adelphia, two particularly flagrant examples, insiders engineered complicated transactions that grossly enriched themselves at the expense of the corporation and its shareholders.

¹⁴ The Committee is presently working on a new Subchapter G to the MBCA, which relates to corporate opportunity issues applicable to directors.

Under Subchapter F of Chapter 8 of the MBCA as currently in effect, a conflict of interest transaction is not voidable as to the corporation if the facts of the transaction were disclosed to and approved by the board of directors or shareholders, or even if such disclosure and approval was not obtained, if the transaction was fair to the corporation. Currently, Subchapter F of Chapter 8 of the MBCA applies only to conflict of interest transactions involving directors of a corporation, and does not govern transactions involving officers of a corporation. The Committee recommends the MBCA be amended (a) to have Subchapter F of Chapter 8 apply to both director and officer conflict of interest transactions, and (b) to require all conflict of transactions involving directors or officers of public corporations over \$500,000 be submitted to shareholders, whether “fair” or not. Conflict of interest transactions should be voidable or enjoined unless so approved. The argument will be made that shareholder approval is slow. However, given that 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.

Public companies should not become involved in a substantial conflict of interest business transaction unless the transaction presents a unique and crucial opportunity not otherwise available to the corporation. Placing a hurdle as significant as shareholder approval would ensure that public companies only go forward with the most necessary and desirable conflict of interest 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.

The Committee recently organized a task force to update and improve Subchapter F of Article 8. The updates and improvements currently being proposed by and circulated among the members of the task force, which the Committee feels will soon be adopted, are generally unrelated to the Committee’s proposals set forth below. For purposes of drafting the following proposals, the Committee has assumed that the task force’s changes will be implemented. Accordingly, the proposals set forth below are marked against the task force’s latest draft of Subchapter F, rather than the current Subchapter F under the MBCA.

Specifically, in addition to the changes currently being circulated by and among the task force, the Committee proposes the following changes to the conflict of interest provisions of the MBCA: (a) adding a definition of “executive officer’s conflict of interest transaction,” which substantially parallels the language proposed by the task force with respect to director’s conflict of interest transactions; (b) provide for specific carve-outs from the definition of each of officer’s and director’s conflict of interest transactions for (i) matters relating to the compensation of the director or officer otherwise approved by the compensation committee of the public corporation, and (ii) matters with approval procedures already specifically set forth in the MBCA (e.g., section 8.51 relating to indemnification and section 7.44 relating to dismissal of derivative proceedings); (c) adding to the definition of “control” an equity ownership test;¹⁵ and (d)

¹⁵ The task force currently defines “control” for purposes of Subchapter F as the ability to elect a majority of directors or other members of a governing body of an entity. In the Committee’s opinion and based on reports generated by the board of directors of Enron, under this test certain of the special purpose entities created by Enron would not have been deemed “controlled” by Enron. Such is the case notwithstanding the fact that Enron owned in some cases 97% of the limited partnership interests of these entities. The Committee’s addition of an

mandating shareholder approval with respect to any director or officer conflict of interest transaction involving the payment or receipt of amounts in excess of \$500,000 over the life of such transaction. Finally, the Committee notes that section 8.61 of the MBCA (both in its current form and as currently proposed by the task force) allows a corporation to seek shareholder or board approval “at any time,” thereby allowing transactions to be ratified after the fact. The Committee feels that \$500,000 director’s and officer’s conflict of interest transactions of public corporation subject to mandatory shareholder approval must be so approved prior to the consummation of such transaction, and post-closing ratification should not be permissible.

§ 8.60. SUBCHAPTER DEFINITIONS

In this subchapter:

(1) “Director’s conflicting interest transaction” means a transaction (other than matters relating to the compensation of the director in his or her capacity as such approved by the compensation committee of the public corporation and other than matters, the approval procedures for which are otherwise specifically set forth in this Act) effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)

- (i) to which, at the relevant time, the director is a party; or
- (ii) respecting which, at the relevant time, the director had knowledge and a known material financial interest; or
- (iii) respecting which, at the relevant time, the director knew that a related person was a party or had a material financial interest.

(2) “Control” (including the term “controlled by”) means (a) having the power, directly or indirectly, to elect a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares, by contract, or otherwise, or (b) ownership, whether directly or indirectly, of at least 50% of the voting power or equity securities of an entity.

(3) “Relevant time” means (i) the time at which directors’ or executive officer’s action respecting the transaction is taken in compliance with section 8.62 or section 8.63, or (ii) if the transaction is not brought before the board of directors of the corporation (or its committee) for action under section 8.62, at the time the corporation (or an entity controlled by the corporation) becomes legally obligated to consummate the transaction.

(4) “Material financial interest” means a financial interest in a transaction that would reasonably be expected to influence the director’s or executive officer’s judgment in any vote by the directors taken on the authorization of the transaction.

(5) “Related person” means:

equity ownership test to the definition of control should address these situations where entities are not controlled from a management perspective but are otherwise controlled from an ownership perspective.

- (i) the director's or executive officer's spouse;
- (ii) a child, stepchild, grandchild, parent, step parent, grandparent, sibling, step sibling, half sibling, aunt, uncle, niece or nephew (or spouse of any thereof) of the director or executive officer or of the director's or executive officer's spouse;
- (iii) an individual living in the same home as the director or executive officer;
- (iv) an entity (other than the corporation or an entity controlled by the corporation) controlled by the director or executive officer or any person specified above in this subdivision (5);
- (v) a domestic or foreign (A) business or nonprofit corporation (other than the corporation or an entity controlled by the corporation) of which the director or executive officer is a director, (B) unincorporated entity of which the director or executive officer is a general partner or a member of the governing body, or (C) individual, trust or estate for whom or of which the director or executive officer is a trustee, guardian, personal representative or like fiduciary; or
- (vi) a person that is, or an entity that is controlled by, an employer of the director or executive officer.

(6) "Fair to the corporation" means, for purposes of section 8.61(b)(3), that the transaction as a whole was beneficial to the corporation, taking into appropriate account whether it was (i) fair in terms of the director's dealings with the corporation, and (ii) comparable to what might have been obtainable in an arm's length transaction, given the consideration paid or received by the corporation.

(7) "Required disclosure" means disclosure of (i) the existence and nature of the director's or executive officer's conflicting interest, and (ii) all facts known to the director or executive officer respecting the subject matter of the transaction that a director or executive officer free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction.

(8) "Executive officer's conflicting interest transaction" means a transaction (other than matters relating to the compensation of the executive officer in his or her capacity as such approved by the compensation committee of the public corporation and other than matters, the approval procedures for which are otherwise specifically set forth in this Act), effected or proposed to be effected by the corporation (or by an entity controlled by the corporation)

- (i) to which, at the relevant time, the executive officer is a party; or
- (ii) respecting which, at the relevant time, the executive officer had knowledge and a known material financial interest; or
- (iii) respecting which, at the relevant time, the executive officer knew that a

related person was a party or had a material financial interest.

§ 8.61. JUDICIAL ACTION

(a) A transaction effected or proposed to be effected by the corporation (or by an entity controlled by the corporation) may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if it is not a director's conflicting interest transaction.

(b) A director's conflicting interest transaction may not be the subject of equitable relief or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if:

(1) directors' action respecting the transaction was taken in compliance with section 8.62 at any time; or

(2) shareholders' action respecting the transaction was taken in compliance with section 8.63 at any time; or

(3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.

(c) Notwithstanding paragraph (a) and (b) hereof, with respect to a public corporation, a director's conflicting interest transaction or an executive officer's conflicting interest transaction involving the payment or receipt of amounts in excess of \$500,000 over the life of such transaction may not be the subject of equitable relief or give rise to an award of damages or other sanctions against a director or officers of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director or executive officer has an interest respecting the transaction, only if shareholders' action respecting the transaction was taken in compliance with section 8.63 prior to such transaction.

§ 8.63. SHAREHOLDERS' ACTION

(a) Shareholders' action respecting a director's conflicting interest transaction is effective for purposes of section 8.61(b)(2) (or an executive officer's conflicting interest transaction for purposes of section 8.61(c)) if a majority of the votes cast by the holders of all qualified shares are in favor of the transaction after (1) notice to shareholders describing the action to be taken respecting the transaction, (2) provision to the corporation of the information referred to in subsection (b), and (3) required disclosure to the shareholders who vote on the transaction, to the extent the information is not known by them.

(b) A director (or an executive officer for purposes of section 8.61(c)) who has a conflicting interest respecting the transaction shall, before the shareholders' vote, inform the secretary or other officer or agent of the corporation authorized to tabulate votes, in writing, of the number of shares that the director (or executive officer) knows are not qualified shares under

subsection (c), and the identity of the holders of those shares.

(c) For purposes of this section: (1) “holder” means and “held by” refers to shares held by both a record shareholder (as defined in section 13.01(7)) and a beneficial shareholder (as defined in section 13.01(2)); and (2) “qualified shares” means all shares entitled to vote with respect to the transaction except for shares that the secretary or other officer or agent of the corporation authorized to tabulate votes either knows, or under subsection (b) is notified, are held by (A) a director or executive officer who has a conflicting interest respecting the transaction or (B) a related person of the director or executive officer (excluding a person described in clause (vi) of Section 8.60(5)).

(d) A majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes of compliance with this section. Subject to the provisions of subsection (e), shareholders’ action that otherwise complies with this section is not affected by the presence of holders, or by the voting, of shares that are not qualified shares.

(e) If a shareholders’ vote does not comply with subsection (a) solely because of a director’s or an executive officer’s failure to comply with subsection (b), and if the director or executive officer establishes that the failure was not intended to influence and did not in fact determine the outcome of the vote, the court may take such action respecting the transaction and the director or executive officer, and may give such effect, if any, to the shareholders’ vote, as the court considers appropriate in the circumstances.

(f) If shareholders’ action is legally required to authorize the transaction, the requirement should be considered separately for purposes of determining whether the shareholders’ action under this section constitutes effective authorization of the transaction.

4. Duty of Candor as Among Directors; Limitations on Personal Liability

Another persistent theme in each of the recent corporate collapses has been claims by outside directors that they were “kept in the dark” by management and their fellow directors. For example, outside directors at Enron claimed that material information about the purpose and crucial terms of off-balance sheet transactions was withheld from them. As a result, they claim they had no meaningful opportunity to exercise review or oversight. In WorldCom, the outside directors clearly had no knowledge of the company’s pervasive, improper accounting practices. There are many other examples.

In recent years, some courts have articulated a duty of candor to shareholders and the corporation. For instance, numerous Delaware decisions state that 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.¹⁶ Other courts have suggested that, under certain circumstances, directors have a duty to disclose material facts to

¹⁶ See, e.g., *In re Anderson, Clayton Shareholders Litigation*, 519 A.2d 680 (Del. Ch. 1986) (holding that directors owe shareholders a duty to provide full and honest disclosure of material facts relating to any transaction that requires shareholder approval).

their fellow directors.¹⁷ However, it appears that Delaware is the only state to consistently adopt and articulate a duty of candor, and decisions requiring a duty of candor as among directors remain relatively few. As such, the Committee feels there is a pressing need for a uniform standard applicable to directors of corporations organized under all jurisdictions.

The Committee recommends the MBCA be amended to create a specific duty of candor applicable to voting decisions by the board of directors and board committees. This statutory duty of candor would be applicable to all corporations under the MBCA, both public and private. When a member of the board has knowledge of material information 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.¹⁸

Furthermore, the Committee feels sections 2.02(b)(4)-(5) of the MBCA, which generally prohibit a corporation from limiting a director's personal liability in specific instances, should be amended in two regards. First, corporations (both public and private) should not be able to limit a director's personal liability for breaches of a duty of candor. Second, corporations (both public and private) should not be able to limit a director's personal liability for breaches of such director's duty of loyalty to the corporation and its shareholders or for such director's failure to act in good faith. Currently and with respect to the latter limitation, sections 2.02(b)(4)-(5) of the MBCA only prohibit the elimination of liability of directors for "an intentional infliction of harm of the corporation or the shareholders."¹⁹ This limitation is not consistent with other jurisdictions, most notably Delaware, where section 102(b)(7) of the Delaware General Corporation Law prohibits limitations on personal liability in cases (a) where a director breaches a duty of loyalty, (b) involving acts or omissions to act not in good faith, and (c) involving acts which involve intentional misconduct or a knowing violation of the law.²⁰ The Committee feels

¹⁷ See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (stating that directors who failed to disclose material information to fellow directors about pricing in an acquisition transaction breached fiduciary duties to the corporation); *In re Illinois Valley Acceptance Corp.*, 531 F.Supp. 737 (C.D. Ill. 1982) (finding that a director breached his fiduciary duty to the corporation by failing to disclose another director's conflict of interest); *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W.2d 166 (Ky. Ct. App. 1974) (holding that whenever a fiduciary possesses information and the withholding of that information will damage the corporation, it is the duty of the fiduciary to fully disclose those facts to the corporation).

¹⁸ The Committee has given consideration to amending the standards of care for directors in section 8.30 of the MBCA in light of recent corporate failures and issues regarding director performance. The Committee believes that the only amendment necessary is to add a duty of candor and the present duty of care set forth in the MBCA suffices so long as a duty of candor is added. The Committee is confident that the courts will properly and diligently apply the general director duty of care standard and that, with the other amendments being proposed here, there will be an overall upgrading of director and corporate performance. Thus, truly independent directors together with truly independent committees, taken together with the duty of candor, and the exceptions to the limitations on director monetary liability as well as the other changes proposed herein, in the Committee's view, can be expected to substantially upgrade corporate responsibility and governance at the director level.

¹⁹ According to the General Comment applicable to Section 2.02(b)(4), the use of the word "intentional" is meant to refer to the specific intent to perform, or fail to perform, the acts with actual knowledge that the director's action, or failure to act, will cause harm, rather than the general intent to perform.

²⁰ See also section 204(a)(10) of the California Corporations Code, which prohibits the limitation of personal liability for, *inter alia*, acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders or that involve the absence of good faith on the part of the director.

sections 2.02(b)(4)-(5) should be amended to make it consistent with current law in most state jurisdictions.

To implement the foregoing changes, the Committee proposes amending section 2.02(b)(4) and section 2.02(b)(5) of the MBCA to carve-out (a) violations of the duty of candor, (b) violations of the duty of loyalty, (c) failures to act in good faith from the permissive personal liability limitation section of a corporation's (both public and private) articles of incorporation. Furthermore, section 8.30 of the MBCA, which sets forth the standards of conduct applicable to directors, would be amended to add a duty of candor as to matters and information within a director's knowledge relevant to a decision by the board of directors.

§ 2.02. ARTICLES OF INCORPORATION

- (a) The articles of incorporation must set forth:
- (1) a corporate name for the corporation that satisfies the requirements of section 4.01;
 - (2) the number of shares the corporation is authorized to issue;
 - (3) the street address of the corporation's initial registered office and the name of its initial registered agent at that office; and
 - (4) the name of address of each incorporator.
- (b) The articles of incorporation may set forth:
- (1) the names and addressed of the individuals who are to serve as the initial directors;
 - (2) provisions not inconsistent with law regarding:
 - (i) the purpose for which the corporation is organized;
 - (ii) managing the business and regulating the affairs of the corporation;
 - (iii) defining, limiting and regulating the powers of the corporation, its board of directors, and shareholders;
 - (iv) a par value for authorized shares or classes of shares;
 - (v) the imposition of personal liability on shareholders for debts of the corporation to a specified extent and on specified conditions;
 - (3) any provision that under this Act is required or permitted to be set forth in the bylaws;
 - (4) a provision eliminating or limiting the liability of a director to the

corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled, (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; ~~(D)~~ (D) an intentional violation of criminal law; (E) a violation of such director's duty of candor under section 8.30; (F) any breach of the director's duty of loyalty to the corporation or its stockholders; or (G) for acts or omissions not in good faith; and

(5) a provision permitting or making obligatory indemnification of a director for liability (as defined in section 8.50(5)) to any person for any action taken, or any failure to take action, as a director, except liability for (A) receipt of a financial benefit to which he is not entitled, (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; ~~(D)~~ (D) an intentional violation of criminal law; (E) a violation of such director's duty of candor under section 8.30; (F) any breach of the director's duty of loyalty to the corporation or its stockholders; or (G) for acts or omissions not in good faith.

(c) The articles of incorporation need not set forth any of the corporate powers enumerated in this Act.

(d) Provisions of the articles of incorporation may be made dependent upon facts objectively ascertainable outside the articles of incorporation in accordance with section 1.20(k).

§ 8.30. STANDARDS OF CONDUCT FOR DIRECTORS

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances and each shall be subject to duty of candor owing to the other members of the board of directors as to matters and information within such director's knowledge relevant to a decision by the board of directors (except to the extent provided in section 8.62(b)).²¹

(c) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on the performance by any of the persons specified in subsection (e)(1) or subsection (e)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law.

²¹ Section 8.62(b) of the MBCA allows directors to withhold certain information from other directors in the context of a director's conflict of interest transaction if such director is otherwise subject to a duty of confidentiality, so long as *inter alia* the director discloses the limits imposed on him or her by virtue of the duty of confidentiality. This exception would not become a factor in the context of a \$500,000 director or executive officer conflict of interest transaction, as section 8.62 would not be available as a means to approve such transaction.

(d) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (e).

(e) A director is entitled to rely, in accordance with subsection (c) or (d), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

5. 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 have 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.

Some shareholder activists suggest controlling executive compensation abuse by requiring corporations to record stock options as an expense. The Committee disagrees with this approach, as it feels the expensing of stock options results in "double-dipping," i.e., options granted are treated as outstanding stock, thereby diluting earnings, and options are additionally expensed, reducing earnings even further. In addition, for many companies it is extremely difficult to measure the true cost of options. Share price is very volatile, and it is therefore impossible to assign an accurate value to options. The net result is potentially large charges to earnings that are not comparable company to company. The Black-Scholes formula, which is frequently used to value options, produces numbers that seem out of line with reason and judgment. For instance, it makes little sense to cut Cisco's June 27, 2002 year-end earnings from \$1.9 billion to \$373 million by application of the Black-Scholes formula, as would happen if the

company were to record stock options as an expense.²² Such is the case even though (a) most of Cisco's options are "underwater" at Cisco's current share price, (a) no cash has been used by Cisco's when issuing options, and (c) Cisco is simply distributing equity among a greater number of holders, the existing shareholders and option holders, which is already reflected in the fully diluted earnings per share published by the company.

The Committee feels the abuse presented by excessive stock option grants is better addressed in other ways. Accordingly, the Committee recommends the MBCA be amended in the following four respects: (a) public corporations should not be allowed to grant executives options with exercise prices less than fair market value,²³ (b) stock options of public corporations should have vesting requirements and should only vest if an executive satisfies meaningful objective criteria that indicate success, other than solely longevity of the employment and the stock market price, as determined by the compensation committee using its business judgment,²⁴ (c) all stock option plans and material amendments thereto should be approved by independent directors and approved by shareholders, and (d) all non-stock, incentive based compensation awards granted to executive officers must be approved by the shareholders of the public corporation, unless such relates to the attainment of predetermined and objective criteria relating to the public corporation's critical financial performance, as determined by the compensation committee of the board of directors using its business judgment.

§ 8.45. STOCK OPTION PLAN; INCENTIVE COMPENSATION PLAN

(a) "Stock option plan" shall mean any employee benefit plan providing for the award to officers, directors, employees or consultants of options, warrants or other rights to purchase shares of a public corporation or shares of an affiliate of a public corporation, other than (i) warrants or rights issued generally to all shareholders of the public corporation, (ii) tax qualified, non-discriminatory employee benefit plans or parallel nonqualified plans approved by the public corporation's compensation committee or a majority of the public corporation's independent directors, and (iii) plans assumed from a corporation that is not a public corporation relating to the acquisition or merger of such corporation and relating solely to the directors, officers and employees of such corporation.

(b) "Incentive compensation plan" shall mean any employee benefit plan providing

²² 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).

²³ For example, Gap, Inc. recently granted its new CEO \$24 million worth of stock options at half of fair market value. 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). The Committee submits that the "business-as-usual" approach to executive compensation as evidenced by this action should change.

²⁴ The Committee understands that, under APB Opinion No. 25 (Accounting for Stock Issued to Employees), performance based vesting under stock option awards are generally subject to "variable" accounting treatment (options are "expensed"). In light of this fact, the Committee's proposal (see proposed section 8.45(f)) would permit time-based combined with performance based vesting (e.g., in order to avoid variable accounting treatment under APB Opinion No. 25, mandatory vesting after a period of 5-7 years regardless of attainment of performance criteria) so as to avoid variable accounting treatment, so long as the performance criteria were also included in the vesting criteria.

for the award to officers, directors, employee or consultants of incentive compensation or bonuses.

(c) No awards may be granted to an executive officer or director of a public corporation under any stock option plan until (i) the shareholders of the public corporation have approved the stock option plan and any subsequent, material amendment thereto, and (ii) all of the independent directors of the public corporation have approved the stock option plan and any subsequent, material amendment thereto.

(d) No awards may be granted to an executive officer of a public corporation under any incentive compensation plan until the shareholders of the public corporation have approved such award and all material amendments thereto, provided that no such shareholder approval shall be required to the extent such award relates to the attainment of predetermined and objective criteria relating to the public corporation's critical financial performance, as determined by the compensation committee of the board of directors using its business judgment.

(e) The exercise price per share under any award granted to an executive officer or director under a stock option plan shall not be less than the fair market value per share as of the date of the grant of the award, as determined in good faith by the compensation committee of the board of directors.

(f) Any award granted to an executive officer under a stock option plan shall be subject to vesting requirements, which shall in part be dependent on the attainment of predetermined and objective criteria relating to the public corporation's critical financial performance, as determined by the compensation committee of the board of directors using its business judgment.

6. Separating the Chairman and CEO

While operational control of a corporation must remain with the chief executive officer, the Committee believes the time has come to separate the chairman of the board function from the office of chief executive officer. The chairman should be truly independent and should have the authority to coordinate the selection of new directors, to nominate directors to committees and to plan the agendas. This separation of powers is a necessary step to discourage dominance of the board by a member of management, another recurring theme in the recent corporate scandals, and encourage boards of directors to be more active, informed and objective.

The Committee proposes adding a new section 8.01(c) to the MBCA to explicitly provide that the chairman of all public corporations shall (a) be an independent director, (b) be responsible for planning and finalizing the agenda for all board meetings (with the assistance of management), (c) preside over meetings of the board of directors, and (d) nominate directors to serve on the board and committees of the board, as recommended by the nominating/corporate governance committee. It should be noted that the chairman of the board of directors is not given authority to run the day-to-day business of the corporation.

The Committee understands that certain public corporations might desire to provide executive officers the dual title of chairman and chief executive officer. In light of this, the Committee is considering revising the following proposal to require an independent director to perform the functions articulate below, thus allowing an executive officer to have the dual title while also accomplishing the corporate governance objectives.

§ 8.01. REQUIREMENT FOR AND DUTIES OF BOARD OF DIRECTORS

(a) Except as provided in section 7.32, each corporation must have a board of directors.

(b) All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.

(c) The board of directors of all public corporations, other than majority-owned public corporations, must be composed of a majority of independent directors. The chairman of the board of directors of all public corporations must be an independent director and shall oversee and administer the operation of the board of directors, which shall include (i) planning and finalizing the agenda for all meetings of the board of directors (which may be done with the assistance of representatives of the public corporation's management), (ii) presiding over all meetings of the board of directors, (iii) the nomination of new directors recommended by the nominating/corporate governance committee, and (iv) the nomination of directors to serve on committees of the board of directors recommended by the nominating/corporate governance committee.

7. Advances Against Indemnity

Section 402 of the Sarbanes-Oxley Act generally prohibits public companies from providing personal loans to any director or executive officer. The Sarbanes-Oxley Act might be construed, and in fact some commentators have suggested, that advances for indemnity constitute “personal loans” for purposes of Section 402 of the Sarbanes-Oxley Act, which the Committee believes is unfair and may inhibit otherwise qualified persons from agreeing to become directors or officers. Accordingly, the Committee recommends that section 8.53(b) of the MBCA be amended to provide that advances for indemnity shall not be deemed to constitute “personal loans” for any purpose.

§ 8.53. ADVANCE FOR EXPENSES

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding because he is a director if he delivers to the corporation:

(1) a written affirmation of his good faith belief that he has met the relevant standard of conduct described in section 8.51 or that the proceeding involves conduct for which

liability has been eliminated under a provision of the articles of incorporation as authorized by section 202(b)(4); and

(2) his written undertaking to repay any fund advanced if he is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or section 8.55 that he has not met the relevant standard of conduct described in section 8.51.

(b) The undertaking required by subsection (a)(2) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment. [Funds advanced to any director pursuant to section 8.13\(a\) shall not be deemed to constitute loans for any purpose.](#)

(c) Authorizations under this section shall be made:

(1) by the board of directors:

(i) if there are two or more disinterested directors, by a majority vote of all the disinterested directors (a majority of whom shall for such purpose constitute a quorum) or by a majority of the member of a committee of two or more disinterested directors appointed by such a vote; or

(ii) if there are fewer than two disinterested directors, by the vote necessary for action by the board in accordance with section 8.24(c), in which authorization directors who do not qualify as disinterested directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time does not qualify as a disinterested director may not be voted on the authorization.

8. Mandatory Change of Auditor; Forensic Accounting

Management owes a duty to shareholders and the investing public to assure that a company's financial reports are reliable and truthfully prepared. Outside auditors are extraordinarily important in auditing and opining on the financial statements in order to promote investor confidence. It is of paramount importance that auditors remain objective and independent in their review of companies. However, objectivity and independence is necessarily undermined by familiarity. The ability to detect fraud or wrongdoing diminishes after relationships between management and the auditor solidify and an intrinsic level of trust is established. This exact situation, which is commonplace in the capital markets, resulted in longtime auditor Ernst & Young overlooking CUC International Inc.'s inflation of operating income by \$500 million.²⁵

To force auditors to put a "fresh set of eyes" on a public company's books and records, Congress enacted Section 203 of the Sarbanes-Oxley Act, thereby making it unlawful for a

²⁵ "Forensic Auditors Find What Some Companies Try to Hide," Hilzenrath, David S., The Washington Post, November 23, 2002.

registered public accounting firm to provide audit services to a public corporation if the lead audit partner, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer. On November 19, 2002, departing SEC Chairman Harvey Pitt suggested that companies should undergo periodic audits designed specifically to detect fraud and performed by someone other than their regular auditing firms.²⁶ According to Pitt, forensic audits provide the audit committees of corporate boards a way to check up on their regular auditors.

The Committee respectfully submits that Section 203 of the Sarbanes-Oxley Act does not go far enough to protect the objectivity and independence of auditors of public companies. It is the Committee's understanding that most public accounting firms already internally require primary audit partners to rotate at least once every five years or even less, and have done so for many years. Even though mandating auditing firms to switch audit partners is a step in the right direction, it only confirms what has already been the practice through all the corporate audits that now take place, and through all the corporate scandals that have taken place, and in any event (a) the ability to detect fraud and wrongdoing is most likely to occur by employees under the audit partner who are working "in the trenches," and (b) where the audit client is an important one to the audit firm's revenues, there may be less incentive to disagree with management's assertions of accuracy. Furthermore, the Committee supports Pitt's proposal regarding periodic forensic audits, as they are specialized audits focused specifically on the detection of fraud and the individuals performing them are not saddled with the dual responsibility of auditing books and maintaining an ongoing business relationship. However, the Committee acknowledges that forensic audits, especially ones that fail to uncover wrongdoing, may be costly.²⁷ Nevertheless, these additional costs are insignificant in relation to the market value that has been lost as a result of erroneous or fraudulent financial statements, and many corporate executives agree.

In light of the foregoing, the Committee proposes that public corporations be provided an option of, once every five years, either (a) switching their primary auditors, or (b) employing an additional independent auditor to perform a forensic audit specifically designed towards detecting fraud or wrongdoing. Providing public corporations this choice will allow them to determine the most efficient and cost-effective method of compliance, and simultaneously ensure that an independent examination of the public corporation's books and records is performed.

To implement the foregoing proposal, the Committee recommends the MBCA be amended to adopt a new section 3.05, entitled "Audit Firm Rotation or Forensic Accounting."

§ 3.05. AUDIT FIRM ROTATION OR FORENSIC AUDIT

(a) Unless a public corporation complies with paragraph (b) hereof, it shall be unlawful for a public corporation to employ the same accounting firm for services relating to the audit of the public corporation's periodic financial reports for more than five fiscal years in any continuous period of ten fiscal years.

²⁶ "Pitt Wants Special Audits to Find Fraud," Hilzenrath, David S., The Washington Post, November 20, 2002.

²⁷ According to the article cited in footnote 25, Harvey Pitt indicated that the SEC might consider granting public companies exemptions from section 203 of the Sarbanes-Oxley Act if they regularly submit to a forensic audit.

(b) A public corporation shall not be required to comply with paragraph (a) hereof if such public corporation, at least once in each five fiscal year period, employs an accounting firm (other than the accounting firm that provides audit services for the public corporation) to perform an audit, the primary focus of which is to uncover fraud, dishonesty or wrongdoing with respect to the procedures and internal control structure associated with a public corporation's preparation of periodic financial reports.

III. Conclusion

Few events in business history since the Great Depression have had the public impact of the stunning collapse of Enron and other major companies in the past year. Although President Hirshon's and now-president A.P. Carlton's charge to the Task Force specifically refers to Enron, that company is merely one of the most notorious in a disturbing series of recent lapses at large corporations involving false or misleading financial statements and alleged misconduct by executive officers. Investor confidence in the quality and integrity of public company corporate governance is compromised, and the pace of calls by the President, Congress, the SEC, stock markets and other interested groups for regulatory reform has quickened dramatically.

The restore investor confidence in the American capital markets, broad reform at the state corporate law level applicable to public corporations is immediately necessary in the areas of internal corporate governance. Boards of directors of public corporations must be independent of management and management must not be allowed to profit at the expense of the ordinary investor. The MBCA is an ideal vehicle to effect change, and the ABA is in a perfect position to effect broad and uniform reform and best ensure consistency in corporate regulation.