CORPORATE GOVERNANCE ISSUES: UNITED STATES AND THE EUROPEAN UNION

*Florence Shu-Acquaye**

I. INTRODUCTION

While the exact definition of corporate governance should be specifically tailored to the requirements of each jurisdiction in which it is maintained, one concept utilized by both the United

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* Florence Shu-Acquaye is a Professor of Law at the Shepard Broad Law Center of Nova Southeastern University. She would like to thank Ms. Heather Last for her excellent research assistance.

States and Europe is consistent: Corporate governance relates to some form of company "control."[1]

The European Union has very recently increased its list of member states from fifteen to twentyseven with the recent accession of Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Malta, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia; and, with a total population in excess of 450 million, it is certainly a force in corporate governance to reckon with.[2] It is in the interest of other powerful industrialized

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1. The definition of corporate governance per some European members' states is worth noting. *See* COMM. ON FIN. ASPECTS OF CORP. GOVERNANCE, REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE 14 (1992) ("Corporate governance is the system by which companies are directed and controlled."); BERLIN INITIATIVE GROUP, GERMAN CODE OF CORPORATE GOVERNANCE 4 (2000) ("Corporate governance describes the legal and factual regulatory framework for managing and supervising a company."); WEIL, GOTSHAL & MANGES LLP, EUR. COMM'N, COMPARATIVE STUDY OF CORPORATE GOVERNANCE CODES RELEVANT TO THE EUROPEAN UNION AND ITS MEMBER STATES, FINAL REPORT & ANNEXES I–III 28 tbl.1 (2002), *available at* http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf [hereinafter COMPARATIVE STUDY] ("Corporate Governance is the goals, according to which a company is managed, and the major principles and frameworks . . . ." (quoting NORBY COMM., CORP. GOVERNANCE IN DENMARK - RECOMMENDATIONS FOR GOOD CORPORATE GOVERNANCE IN DENMARK 1 (2001), *available at* http://www.ecgi.org/codes/documents/haa_kap05-01uk.pdf)); COMM'N OF THE EUR. CMTYS., COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT: MODERNISING COMPANY LAW AND ENHANCING CORPORATE GOVERNANCE IN THE EUROPEAN UNION—A PLAN TO MOVE FORWARD 10 n.10 (2003), *available at* http://eur-lex.europa.eu/LexUriServ/site/en/com/2003/com2003_0284en01.pdf [hereinafter COMM'N OF THE EUR. CMTYS] (Principles issued by the Organization for Economic Co-operation and Development Governance (OECD) of 1999, (an ad-hoc task force on corporate governance), also known as the OECD Principles, describe corporate governance as: "involv[ing] a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.").

2. George L. Bustin et al., *2003 Annual Review of European Union Legal Developments*, 38 INT'L LAW. 639, 639 (2004); *Romania and Bulgaria join the European Union*, INT'L HERALD TRIB. (EUR.), Dec. 31, 2006, *available at* http://www.iht.com/articles/ap/2006/12/31/europe/EU_GEN_Romania_Bulgaria_EU.php (listing Romania and Bulgaria as the two most recent states to join the European Union, pushing the total to twentyseven). There have always been fundamental differences between Europe and the United States over the conduct of international affairs that are not likely to diminish anytime soon, but "the clashes reflect inevitable tensions between a United States that

nations, such as the United States, to monitor trends set by the European Union and for the country's corporate practitioners and academicians to monitor the trends in corporate governance and their implication for the United States. Not surprisingly, the European Union has been doing just that with respect to corporate governance trends in the United States. For example, the European Commission (the Commission) in May 2003, responding to recent corporate governance crises depicted by Enron and its progeny and the enactment of the Sarbanes-Oxley Act of 2002 in the United States (SOX or the Act), "presented a proposed 'Action Plan for Moderni[z]ing Company law and Enhancing Corporate Governance in the EU'."[3] This plan refers to some of the same corporate governance challenges faced in the United States, relating to such things as management responsibilities, composition, and operation of the board and its committees, shareholders' rights and how they can be exercised, derivative suits, takeovers and mergers, public auditing and public confidence in the audit profession, a reference to a code on corporate governance designated for use at national level, and so forth.[4] The European Union and the United States have

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feels its sole-superpower status gives it a broad entitlement to get its way in world affairs and a uniting Europe that is struggling to become a more influential political and economic actor on the global scene." Reginald Dale, *European Union, Properly Construed*, POL'Y REV., Dec. 2003–Jan. 2004, at 39. Perhaps this is why the Europeans think they are on the ascent in world affairs, that is, the European Union will "restore Europe to its rightful place as a continental-scale economic and political grouping more or less on a par with the United States." *Id.* at 41.

3. Bustin et al., *supra* note 2, at 647.

4. *See* COMM'N OF THE EUR. CMTYS., *supra* note 1, at 4, 8, 12, 16–17, 20–21; *see* Bustin et al., *supra* note 2 (discussing a recent review of corporate developments in the European Union). This group of High Level Company Law Experts was organized by the European Commission in 2001 "to make recommendations on a modern regulatory framework in the European Union for company law." EUR. COMM'N, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 1 (2002). [hereinafter EUR. COMM'N, REPORT] The group published this consultative document on the issues specified in their mandate. *Id.* at 43. Four issues were discussed concerning corporate governance in section 3.1 of the consultative document: 1) "[b]etter information for shareholders and creditors, in particular better disclosure of corporate governance structures and practices, including remuneration of board members;" 2) "[s]trengthening shareholders' rights and minority protection, in particular supplementing the right to vote by special investigation procedures;" 3) "[s]trengthening the duties of the board, in particular the accountability

identified basically the same broad problems and goals in corporate governance (the importance of good corporate governance for the investors and the economy);[5] however, unlike the Sarbanes-Oxley Act, which imposes mandatory provisions for U.S. companies (through a one-size-fits-all approach), the corporate governance initiatives proposed in the E.U. Action Plan are not intended to be mandatory.[6] The European Commission stated "it d[id] not believe that a European Corporate Governance Code would offer significant added value but would simply add an additional layer between international principles and national codes."[7] The Commission, in conceding that "a self-regulatory market approach based on non-binding recommendations" would be futile as sound corporate governance, especially "[i]n view of the growing integration of European capital markets," adopted in the Action Plan a "common approach covering only certain essential rules[.]"[8] This

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of directors where the company becomes insolvent;" and 4) "[n]eed for a European corporate governance code or coordination of national codes in order to stimulate development of best practice and convergence." *Id.*

"In a direct reaction to the Enron case, the Commission and the ECOFIN [Economic and Financial Affairs Subcouncil of the Council for the European Union] have agreed to extend the mandate of the Group to review 'issues related to best practices in corporate governance and auditing, in particular: [] the role of non-executive and supervisory directors; [] remuneration of management; [] responsibility of management for financial statements; [] and auditing practices.'" *Id.* (footnote omitted).

5. *See* Richard Y. Roberts et al., *Spilt Milk: Parmalat and Sarbanes-Oxley Internal Controls Reporting*, 1 INT'L J. DISCLOSURE & GOVERNANCE 215, 222 (2004). Europe also experienced its equivalent of America's Enron with Parmalat, a "corporate debacle comparable in size and intricacy" to Enron that was dubbed "Europe's Enron." Claudio Storelli, *Corporate Governance Failures—Is Parmalat Europe's Enron?*, 2005 COLUM. BUS. L. REV. 765, 766 (2005). While the Parmalat catastrophe may have played out with "some typically Italian or European aspects," it tended to exhibit strong "similarities to the Enron scandal and other egregious examples of 'gatekeeper' failure." *Id.* at 768. Hence, understanding the similarities and differences between the two corporate scandals could be helpful in showing how "corporate governance systems across the world could be improved." *Id. See* discussion of Parmalat *infra* note 12.

6. *See* Roberts et al., *supra* note 5, at 222.

7. *Id.*

8. *Id.* The rules covered by the European Commission's plan were:

1) The"[i]ntroduction of an Annual Corporate Governance Statement. Listed companies should be required to include in their annual documents a 'coherent and descriptive statement covering the key elements of their corporate governance structures and

is typical of the European approach to corporate governance: self-regulation through corporate governance codes, with public companies then required to disclose whether or not they are in compliance with such codes.[9]

Consequently, a comparison of some of the corporate issues in these two systems in light of recent laws and regulations may not only be beneficial in understanding how each system functions, but may also be helpful in drawing lessons from the potential strengths and weaknesses of each system, thereby fortifying global corporate governance principles. For example, although the Sarbanes-Oxley Act of 2002 was drafted primarily with the U.S. regulatory market in mind, it also "regulates non-U.S. companies doing business in the U.S. capital markets despite the fact foreign jurisdictions may already have their own corporate governance regulatory schemes in place."[10] Foreign

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practices.'" *Id.*

2) "Development of a legislative framework aimed at helping shareholders to exercise various rights (for example, asking questions, tabling resolutions, voting in absentia, participating in general meetings via electronic means). These facilities should be offered to shareholders across the EU, and specific problems relating to crossborder voting should be solved urgently." *Id.*

3) "Adoption of a Recommendation aimed at promoting the role of (independent) non-executive or supervisory directors. Minimum standards on the creation, composition and role of the nomination, remuneration and audit committees should be defined at the EU level and enforced by member states, at least on a 'comply or explain' basis." *Id.*

4) "Adoption of a Recommendation on Directors' Remuneration. Member states should be rapidly invited to put in place an appropriate regulatory regime providing shareholders with more transparency and influence, which includes detailed disclosure of individual remuneration." *Id.*

5) "Creation of a European Corporate Governance Forum to help encourage coordination and convergence of national codes and of the way that they are enforced and monitored." *Id.*

9. Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 STETSON L. REV. 849, 887–88 (2004).

10. Roberts et al., *supra* note 5, at 218. Section 404 of the Sarbanes-Oxley Act requires "an annual evaluation of internal controls and procedures for financial reporting" and that "management assess and vouch for the effectiveness of these controls." *Id.* at 216. Subsection 404(a) requires both U.S. and non-U.S. issuers to file an annual report with the Securities and Exchange Commission (SEC) assessing their internal controls, while Section 404(b) requires that the issuer's auditor must attest to, and report on, the assessment of these internal controls. *Id.*

companies doing business in the United States therefore would find it in their best interests to understand the implications of the Sarbanes-Oxley Act on their businesses.[11]

This Article will present a general overview of the aforementioned corporate governance issues and their regulation in the United States in Part II. Parts III and IV will critically analyze the new corporate laws and the issues raised by crossborder application of these laws in the European Union, highlighting the implications, similarities, and differences.

11. "Although the precedent for applying US securities laws to non-US companies is of long standing, many in the European Union (EU), and elsewhere, have objected to the unilateral application of Sarbanes-Oxley to non-U.S. companies" with the objection being based on the fact "existing corporate governance regimes in Europe are more than sufficient to prevent such scandals [and] frauds" such as Enron and WorldCom. *Id.* at 218. The demise of Parmalat in December 2003 apparently proved this to be wrong. *See id.* at 219. Parmalat filed for bankruptcy in 2003 after acknowledging that its previous claims of an existing U.S. bank account holding $5 billion (USD) in cash reserves were actually untrue and that the account was nonexistent. *Id.* Investigators' examining how Parmalat could have concealed its actual debt and raised $1.5 billion (USD) in debt through bond issues led to discovery of, among other acts, *reports of padded sales*, the use of "irregular" and "suspect" accounting methods, and failure to apply basic accounting principles to account for expenses and losses. *See id.* (discussing how Parmalat's control systems did not verify irregular account entries and how its loss could increase if discovered that Parmalat further padded sales). Parmalat's irregular practices were carried out over a decade and could have been alleviated or greatly reduced by simple utilization of basic internal controls such as monitoring and review of cash reporting methods. *See id.* at 219–20.

Two opposing views as to the applicability of SOX to foreign issues are "[o]n the one hand, foreign issuer registrations and listings in the U.S. could decline" to the extent that it is detrimental to the markets in New York and beneficial for markets abroad (the London market in particular). *See* Karmel, *supra* note 9, at 886. On the other hand, worldwide corporate-governance standards could be harmonized to those utilized in the United States. *See id.* Indeed, one theory suggests that "in the context of increasingly global capital markets, both within the European Union (EU) and worldwide, the best way forward for the (EU) and the [United States] lies in the mutual recognition of each other's corporate governance regimes, rather than the unilateral extraterritorial application of corporate governance rules." Edward Greene & Pierre-Marie Boury, *Post-Sarbanes-Oxley Corporate Governance in Europe and the USA: Americanisation or Convergence?*, 1 INT'L J. DISCLOSURE & GOVERNANCE 21, 22 (2003).

II. SOME GOVERNANCE ISSUES IN THE UNITED STATES: AN OVERVIEW OF THE CORPORATE BOARD OF DIRECTORS

In the traditional model of corporate structure, the board of directors manages the business of the corporation.[12] Although boards generally do continue to maintain this central legal role, it is widely understood that the traditional managing model of the board is no longer accurate; rather, under modern corporate practice, the executives of the corporation hold the management function, not the board members.[13] Because the "managing model" is now an unrealistic description, especially in the last 25 years, the shift from a "managing model" to a "monitoring model" recognizes management function is exercised not by the board but by senior executives of the corporation.[14] Hence, in the classic governance theory with a separation of powers, the role of the board is to oversee and limit the exercise of power by the executive officers; the board is, in turn, accountable to the shareholders.[15] Consequently, "[b]y making executive officers responsible to directors and then making directors directly responsible to shareholders, the framework rests on the ability of the shareholders effectively to monitor and respond to the directors' oversight of the corporation."[16] This intended hierarchy between the board and management was commonly reversed in the past, however, with the directors' incentive to properly monitor management undercut by some factors.[17]

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12. MELVIN A. EISENBERG, CORPORATIONS AND OTHER ORGANIZATIONS CASES AND MATERIALS 198 (9th ed. unabr., 2005).

13. *See id.*

14. *Id.* at 199.

15. Greene & Boury, *supra* note 11, at 26.

16. *See id.* at 26–27.

17. *Id.* These factors include: "the compromised status of officers serving in a dual capacity as directors; domination of the board by executive directors, particularly where a majority of the board lacked independence; control by management of the supply of information to directors; the lack of sufficiently empowered or vigorous board committees; and subversion of non-executive directors' independence through connections with management, such as consulting contracts, and other business links." *Id.* at 27.

The issue of various constraints on the composition of the board is also an important factor to consider—"[t]he typical board includes a number of directors who are economically or psychologically tied to the corporation's executives, [especially] the

"Today, the monitoring model of the board has been almost universally accepted and adopted [by] large publicly held corporations" in the United States.[18] It is inadequate to say that "the monitoring model of the board rests on its economic advantage in providing an additional system to monitor the efficiency of management—in particular, of the CEO."[19]

But looking at the board from either a managing or monitoring perspective, the board of directors is made up of individuals selected by shareholders of a company[20] and is the ultimate decision-making body of a company.[21] The board selects the senior management team, acts as the advisor and counselor to the senior management, and ultimately monitors its

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CEO." *See* EISENBERG, *supra* note 12, at 198. Because a number of board seats are usually held by inside directors who are also executives of the corporation, the inside director is somewhat dependent on the CEO for both retention and promotion, and on other executives for day-to-day support. *Id.* He is therefore unlikely to dissent at a board meeting from a line of action determined by the CEO. *See id.*; Florence Shu-Acquaye, *Smith v. Van Gorkom Revisited: Lessons Learned in Light of the Sarbanes-Oxley Act of 2002*, 3 DEPAUL BUS. & COM. L.J. 19, 48 (2004) [hereinafter *Smith v. Van Gorkom Revisited*] (discussing the diminished "independent" character of board of directors and the compromised ability to monitor the governance of the company).

However, given the board's function of monitoring senior executives, proper and effective management of a corporation requires that the board consist of at least a majority of independent directors—independent of the executives. *See* discussion *infra* Part III.C. (discussing the Sarbanes-Oxley Act and its impact abroad).

18. EISENBERG, *supra* note 12, at 200; *see also* discussion *infra* Part II.

19. *See* EISENBERG, *supra* note 12, at 200.

20. MODEL BUS. CORP. ACT § 7.28 (1991). The state laws and articles of incorporation or bylaws determine the manner by which the directors are elected to the board. *Id.* A company may have a unitary board or staggered board of directors. *See* MODEL BUS. CORP. ACT § 8.06. In a unitary board system all directors stand for election each year, whereas with a staggered board, the directors are typically grouped into three classes. *Id.* In Section 8.06, the Model Business Corporations Act (MBCA) provides for the classification of a staggered board into two or three groups of as equal size as possible, with one class of directors standing for election each year. *See* CHARLES O'KELLY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 192 (3d ed. 1999). Theoretically, staggered terms ensure that a corporation will always have experienced directors in office; practically, two annual meetings would be required to replace a majority of the board of directors. *Id.* This invariably means that even a majority shareholder cannot easily change corporate policy by simply electing an entirely new board. *Id.*

21. *See* O'KELLY & THOMPSON, *supra* note 20, at 155. The directors' management power is exercised collectively, and individual directors are not given agency powers to deal with outsiders. *Id.*

performance.[22] Hence, the directors and management are said to have a contract with the corporation.[23] In fact, the corporation is often described as an organization consisting of a nexus of contracts[24] involving the employees, suppliers, contractors, shareholders, directors, and the corporation.[25] The agreement between the directors and the corporation is the most important contract because it relates to the directors' duties and obligations to the corporation.[26]

A director's powers to act on behalf of the corporation are derived from the state of incorporation. This regulation of the corporation by the laws of the state of incorporation is often

22. *Id.* at 155–56. The MBCA, which has been adopted by over thirty states (with some variation in certain states), provides that all corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and that the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors. MODEL BUS. CORP. ACT § 8.01(b); *see also* MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS STATUTES, RULES, MATERIALS, AND FORMS 747 (2004) [hereinafter EISENBERG SUPPLEMENT]. The Delaware Code imports the same principle as the MBCA. DEL. CODE ANN. tit. 8, § 141(a) (2005). The language of the MBCA emphasizes the board's responsibility to oversee management of the corporation. *See* EISENBERG SUPPLEMENT, *supra* at 747–48.

23. *See* O'KELLY & THOMPSON, *supra* note 20, at 45–46 (identifying contractual "relationships between and among [a corporation's] owners, agents, creditors, customers, and affected communities").

24. *See* Michael C. Jenson & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (formulating the argument that a corporation is a nexus of contracts); *Contra* Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of The Firm*, 24 J. CORP. L. 819 (1999) [hereinafter *Nexus of Contracts*] (arguing that the nexus of contracts description of a corporation is inadequate, given a corporation's dual nature of reciprocal arrangements and a bureaucratic hierarchy). Eisenberg stated that "[c]orporate law is constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those participating in the institution, and to delimit the powers of the institution vis-à-vis the external world." MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 1 (1976).

25. *Nexus of Contracts*, *supra* note 24, at 822.

26. This is why it "is not surprising that fiduciary duties are used to describe the shareholder-manager relationship but not for other relationships, such as the creditor-manager relationship." *See* Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 390 (1990). A shareholder's residual return "depends on the discretionary performance of another," and should "require[] a different protection than the creditor's fixed return with a senior claim to the assets of the enterprise." *Id.*

referred to as the "internal affairs doctrine."[27] Consequently, state law, among other things, defines the directors' powers over the corporation;[28] in this vein, corporations are said to be the "'creatures of state law[,]' and it is state law that is the font of corporate directors' powers."[29] Whether state regulation results in efficient corporate law rules has been a scholarly debate. Some scholars espouse the view that, because the grants of corporate charters result in state tax revenue,[30] states tend to adopt statutes that are management friendly at the expense of shareholders.[31] Companies incorporated in Delaware are often said to be involved in "a race to the bottom."[32] Regardless as to

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27. *See* O'KELLY & THOMPSON, *supra* note 20, at 163. The internal affairs doctrine is also known as a choice of law rule because courts look to the laws of the incorporating state to determine the basic rights and duties applicable to a corporation. *Id.*

28. *See* Stephen M. Bainbridge, *A Critique of the NYSE Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 396 (2002). State law for example, determines the vote required to elect directors, powers of the shareholders to remove directors prior to the end of their term in office, etc. *See id.* at 397.

29. *Id.* at 397 (citation omitted); *see also* Burks v. Lasker, 441 U.S. 471, 478 (1979) (stating "it is state law that is the font of corporate directors' power"). However, the Sarbanes-Oxley Act and the SEC rules of implementation are said to have encroached upon state rights not only by regulating the internal affairs of the corporations, but also by being extensive in scope. *See* Greene & Boury, *supra* note 11, at 23. For example, the Act "assign[ed] particular responsibilities and tasks to executive officers in areas where previously matters were generally left to their discretion and that of the board," and it also mandated specific forms of corporate organization. *Id.*; *see also* discussion *infra* Part II.

30. The state of Delaware, the home of many publiclytraded corporations, derives about 30% of its state budget from corporate charters. Florence Shu-Acquaye, *The Taxonomy of Director's Fiduciary Duty of Care: United States and Cameroon*, 22 N.Y.L. SCH. J. INT'L & COMP. L. 585, 587 n.5 (2003) [hereinafter *Taxonomy of Director's Fiduciary Duty*].

31. O'KELLY & THOMPSON, *supra* note 20, at 163. This is the case because corporate managers decide upon the state of incorporation. *Id.* As incorporators, the owners of a firm may shop around and choose to incorporate in whichever state offers the most attractive rules. *Id.*

32. *See* Roberta Romaneo, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 720–25 (1987) (discussing in detail the concept of race to the bottom); O'KELLY & THOMPSON, *supra* note 20, at 165; *Taxonomy of Director's Fiduciary Duty*, *supra* note 30, at 587 n.5; *see also* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); *but see* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 722 (1998) (discussing evidence rejecting the race to the bottom hypothesis).

whether companies are racing to "the top" or to "the bottom," their state of incorporation determines how the board of directors, as the managing head of the company, is to exercise authority. This exercise of authority may, however, be subject to limitations placed by the shareholders in the articles of incorporation or bylaws.[33]

III. THE SARBANES-OXLEY ACT AND ITS IMPLICATIONS ABROAD

The unforeseen and shocking demise of companies—such as Enron, Adelphia Communications, WorldCom, Quest, and a few others—propelled Congress to approve the U.S. Securities and Exchange Commission's (SEC) recommendation to pass the Sarbanes-Oxley Act of 2002 as a means to boost investors' confidence.[34] "This failure of corporate governance, [compounded by] an enduring bear market, approaching mid-term elections and uncertainty about terrorism and war, placed the federal government under extraordinary pressure to act."[35] Hence, the passage of the Act was only natural. The Act has been said to be unprecedented because, in addition to regulating disclosure and securities trading, the traditional jurisdiction of U.S federal securities laws,[36] the law also addresses matters of substantive

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Michael Klausner, on the other hand, believes the incorporation influx to Delaware is based on "network externality." *See* EISENBERG, *supra* note 12, at 205. He analogizes this to using a particular software, such as Microsoft: "[j]ust as it may be desirable to use . . . Microsoft Windows, whether or not it is better than other software, just because so many other people use it and are familiar with it, so it may be better to incorporate in Delaware, whether or not Delaware is better than [any] other state law, just because so many other corporations use and are familiar with it." *Id.* (citing Michael Klausner, *Corporations, Corporate Law, and Network of Contract*, 81 VA. L. REV. 757 (1995)).

33. O'KELLY & THOMPSON, *supra* note 20, at 162. The articles of incorporation set forth the terms of a corporation's existence, usually filed with a state agency or office (usually the secretary of state) when the corporation is created. *Id.* at 161. Hence, these articles are public records that can be accessed by anyone, whereas the bylaws are internal administrative rules that are established after the corporation has been created, and therefore not public documents per se. *Id.* at 163.

34. *See D&O Market Still Faces Unresolved Securities Cases*, INS. J., July 19, 2004, http://www.insurancejournal.com/magazines/east/2004/07/19/features/44601.htm; Greene & Boury, *supra* note 11, at 26 (stating that the United States will restore confidence through Sarbanes-Oxley).

35. *See* Greene & Boury, *supra* note 11, at 22.

36. "Although the federal securities laws generally have been considered full-disclosure statutes, the U.S. Securities and Exchange Commission . . . has been

corporate governance and executive fiduciary responsibility.[37] These duties have historically been viewed as a prerogative of the states and self-regulatory organizations (SROs).[38] Whether these corporate scandals should call for more regulation is a scholarly debate between those favoring regulation and those favoring deregulation.[39] SOX has been said to have been significantly costly and the benefits elusive.[40] While the merits of the debate are significant, understanding the changes brought by the Sarbanes-Oxley Act is imperative to comprehending its broader impact beyond U.S. borders. This Article will now examine some of these changes.

A. Corporate Auditing

One of the major innovations of the Act was the creation of a Public Company Accounting Oversight Board (Oversight Board), a quasi-public accounting board that oversees audits of public companies that are subject to the securities laws.[41] The principal purpose of the Oversight Board is to protect the interests of investors and to engage public interest in the "preparation of informative, accurate, and independent audit

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interested in regulating the corporate governance of public corporations to the extent it has any authority to do so. The Securities Exchange Act of 1934 . . . established the SEC to administer both the Exchange Act and the earlier Securities Act of 1933 . . . . At that time, responsibility for regulating internal corporate affairs was left generally to state corporation law, state blue sky statutes, and stock-exchange-listing requirements." Karmel, *supra* note 9, at 849–50.

37. Michael Hein et al., *The Sarbanes-Oxley Act of 2002 Effects Sweeping Changes to the U.S. Federal Securities Laws*, GT ALERT, Aug. 2002, at 1.

38. *Id.*

39. *See* Greene & Boury, *supra* note 11, at 23. Deregulators argue that the scandals are a result of "over-confidence in the integrity of the markets stemming from their over-regulation . . . ." *Id.* Hence, the passage of SOX accordingly was largely a duplication of existing laws. *Id.*

40. Larry E. Ribstein, *Sarbanes-Oxley After Three Years*, (Ill. Law & Econ. Working Papers Series, Paper No. LE05-016, 2005) 21–22, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=746884. For a detailed understanding of the resulting costs from SOX, *see id.* at 7–19. These costs impact not only U.S companies, but also those non-U.S. firms that list or otherwise sell securities in the U.S., especially those firms that do not have U.S.-style governance structure. *Id.* at 16–17.

41. *See* EISENBERG SUPPLEMENT, *supra* note 22, at 1970.

reports."[42] This is a sort of a new federal "watchdog" for regulation of the public accounting profession. "Although the [Oversight Board] is not technically a government agency, it is closer to a full government agency than to a [SRO] or industry-based group such as the American Institute of Certified Public Accountants, which ha[s] been performing the standard-setting function since 1939."[43] The Oversight Board's specific responsibilities include: "the registration and inspection of all 'public accounting firms that prepare audit reports' for public companies; the adoption and modification of 'auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports' for public company audits; the investigation of registered firms for violations of rules relating to audits; and the imposition of sanctions for such violations."[44] Likewise, SOX contains some auditor-independence provisions that affect auditors, audit committee members, executives, and directors of public corporations; hence, an auditor for an issuer is prohibited from providing a list of nonaudit services.[45] In the same vein, rotation of an audit partner is required every five years, and anyone who was employed by an auditor for an issuer within a one-year period is prohibited from becoming the CEO, controller, CFO, or chief accounting officer of the issuer.[46]

While the Oversight Board's proposal has been generally hailed as appealing to resolving accounting problems in public corporations, it is not without its own shortcomings. The Oversight Board standards require external auditors to consider

42. *See id.*

43. Greene & Boury, *supra* note 11, at 25. A majority of its members were required to be external to the accounting profession, and the Oversight Board is subject to the SEC's supervision and approval of its standards. *Id.*

44. Karmel, *supra* note 9, at 877 (citation omitted).

45. *See id.* at 878. This includes: "(1) bookkeeping . . . ; (2) financial information systems designs and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment advisor, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the [Oversight Board] determines, by regulation is impermissible." *Id.* at 878–79 (citation omitted); s*ee also* Sarbanes-Oxley Act of 2002 § 201(g), 15 U.S.C.S. § 78j-1(g) (LexisNexis 2005).

46. Karmel, *supra* note 9, at 879 (citation omitted).

audit committee effectiveness as part of their overall review of a corporation's internal control over financial reporting.[47] According to Professor Cunningham, the Oversight Board reveals a flaw in the corporate governance system as a result of a mixture of state and federal law regulations.[48] He contends that, although audit committees are essential, no one other than boards and, after the fact, shareholders and courts should have the power to oversee them.[49] However, according to him, what SOX did was simply mandate characteristics and functions, while SEC and SROs mandated characteristic reports.[50] The disclosure to the Oversight Board requires auditors to include an audit committee review as part of the auditors' more general assessment of the company's internal control over financial reporting.[51] Cunningham asserts this results in major problems: First, it highlights the tension between state and federal law, as state corporation law empowers the board to choose the appropriate management tools for a corporation, while federal law mandates specific parameters of the audit function.[52] In this case, neither of these is complete, and even when combined, are still incomplete.[53] Second, the issue of how to monitor the monitors becomes imminent. The federally-prescribed audit

47. *See* PUBLIC ACCOUNTING OVERSIGHT BOARD, AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENT 1, 55–59 app. (2004). It is also worth noting, under the new standards, auditors must not only perform an audit of internal controls and provide opinions for financial statement users, they can also be found liable as a matter of law for failure to disclose certain control irregularities and their effects on the auditor's substantive testing as well. *See* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L.J. 1449, 1450 (2004). In the same vein, auditors, when giving such opinions on controls, are likely to become primary actors, exposed to liability to financial statement users when their disclosures concerning control effectiveness are materially misstated. *Id.*

48. Lawrence Cunningham, *A New Product for the State Corporation Law Market: Audit Committee Certifications*, 1 BERKELEY BUS. L.J. 327, 331 (2004) [hereinafter *New Product*].

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *New Product*, *supra* note 48, at 331.

committee is directed to supervise the external auditor, and the Oversight Board proposes to have the external auditor evaluate the audit committee.[54] While these evaluations may be feasible, it remains to be seen how they fit in squarely with state law.[55]

In sum, SOX provided the SEC the authority to restructure corporate audit committees:[56] the SEC may authorize the SROs to change their listing rules to meet certain standards, and mandate them to require a public company to disclose whether its audit committee includes a financial expert or explain why it does not.[57] This specific grant of authority to the SEC to

54. *Id.* at 332.

55. *See id; see id* at 331–34 (discussing how these problems may be addressed).

56. The SEC began advocating for audit committees comprised of independent directors as early as 1941, although it took no action on this idea until years later (in the 1970s), when it brought several enforcement cases in which there were consent injunctions ordering board restructuring that would reflect a board majority of independent directors. Karmel, *supra* note 9, at 870; *see also* SEC v. Killearn Props., No. TCA–75–67, 1977 U.S. Dist. LEXIS 16073, at *4–5 (N.D. Fla. May 2, 1977); SEC v. Mattel, Inc., No. 74 Civ. 1185, 1974 U.S. Dist. LEXIS 6489, at *12–15 (D.D.C. Oct. 1, 1974).

57. The SEC, under the mandate of the Act, indicates the required standard for this expert. The Act mandated that financial statement issuers maintain an audit committee comprised of at least one financial expert. It left the definition of "financial expert" to the SEC, but provided suggestions for the Commission to consider areas in which such expert should have understanding and experience. *See* Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C.S. § 7265(a)–(b) (LexisNexis 2005).

The SEC considered its own requirements and suggestions from the Act and issued a proposed definition for financial expert by soliciting comments from the financial and corporate community. Based upon consideration of comments received by the SEC, the Commission concluded that its original proposed definition was more restrictive than necessary to satisfy Congressional intent. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5111, 5113 (Jan. 31, 2003). The Commission's final definition for the purpose of financial statement filing requirements is for an "audit committee financial expert" rather than a "financial expert," and requires of such an expert the following attributes:

> [i] An understanding of generally accepted accounting principles and financial statements; [ii] The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; [iii] Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the small business issuer's financial statements, or experience actively supervising one or more persons engaged in such activities; [iv] An

regulate the structure and duties of the audit committee and the substantive standards contained in SOX affected entrenched governance norms by taking authority away from management and placing it in the hands of the audit committee.[58]

The next issue to consider is how these requirements and regulations affect foreign companies. As expected, foreign companies and countries doing business in the United States did not necessarily welcome the application of SOX,[59] and some took steps to put their own corporate governance reforms in place, possibly to preempt Enron-like occurrences.[60] The government of the United Kingdom, for example, "initiated a series of reviews, primarily under the auspices of the Department of Trade and Industry (DTI) to examine whether changes were necessary to regimes for the regulation of the UK audit and corporate governance."[61] In the same vein, The House of Commons Treasury Committee initiated its own inquiry: the Higgs

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> understanding of internal control over financial reporting; and [v] An understanding of audit committee functions.

Integrated Disclosure System for Small Business Issuers, 17 C.F.R. § 228.407(d)(5)(ii)(A)–(E) (2005).

Further, the SEC mandates that such attributes be acquired through any of the following four areas:

> [i] Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions; [ii] Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; [iii] Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or [iv] Other relevant experience.

Id. § 228.407(d)(5)(iii)(A)–(D).

58. Karmel, *supra* note 9, at 873.

59. *Id.* at 887–88.

60. *Id.*

61. *See* Ian P. Dewing & Peter O. Russell, *Post-Enron Developments in UK Audit and Corporate Governance Regulation*, 11 J. FIN. REG. & COMPLIANCE 309, 309 (2003). Some key recommendations of the DTI Report are that the independent regulator should have clear arrangements for accountability and transparency, and the recognition of professional supervisory bodies and qualifications should be delegated to an independent regulator and assumed by the Professional Oversight Board (POB). *Id.* at 312.

Report,[62] the Smith Report on corporate governance,[63] and the Coordinating Group on Audit and Accounting Issues (CGAA) were all welcomed and considered.[64] In particular, the 2003 CGAA report not only considered the issues of auditor independence, corporate governance, audit firm transparency, financial reporting standards and enforcement, and monitoring of audit firms; it also identified twentyseven conclusions and recommendations supporting initiatives including, *inter alia*, audit partner rotation by the Institute of Chartered Accountants in England and Wales (ICAEW), a principlesbased approach to financial reporting and auditing standards by the Accounting Standard Board (ASB) and, at an international level, by the International Accounting Standard Board (IASB) and the International Auditing and Assurance Standard Board (IAASB).[65] Other related reports on corporate governance include: the Greenbury Report, which focuses on disclosure of

62. The Higgs Report was issued in January 2003 and dealt with the review of the role and effectiveness of nonexecutive directors. DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS 5–6 (Jan. 2003), http://www.dti.gov.uk/files/file23012.pdf. The Higgs Report has been criticized in the United Kingdom as a rulebook and a step too far toward the U.S.-style rulesbased approach to corporate governance. *See* Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 DENV. J. INT'L L. POL'Y 147, 172 n.144 (2004) (citing Alexandra Johnson, *Kelley Rejects Higgs Criticism as 'Disturbing Complacency,'* ACCOUNTANCYAGE, Mar. 12, 2003, http://www.accountancyage.com/News/1132858.

63. The Combined Code Guidance, which is proposed by a Financial Reporting Council-appointed group chaired by Sir Robert Smith (the Smith Report), reviews the role and effectiveness of nonexecutive directors. ROBERT SMITH, FINANCIAL REPORTING COUNCIL, AUDIT COMMITTEES COMBINED GUIDANCE CODE § 3.1 (Jan. 2003), http://www.frc.org.uk/images/uploaded/documents/ACReport.pdf; *see also* Gregory Maassen et al., *The Importance of Disclosure in Corporate Governance Self-Regulation Across Europe: A Review of the Winter Report and the EU Action Plan*, 1 INT'L J. DISCLOSURE & GOVERNANCE 146, 148, 151 (2004).

64. Dewing & Russell, *supra* note 61, at 310.

65. *Id.* at 311. For more specific recommendations concerning transparency of audit firms and enforcement of accounting standards, read regulation concerning post-Enron development in U.K. audit and corporate governance. *Id.* at 309–13.

director pay;[66] and the Hampel[67] and Turnbell Reports, which review companies' approaches to internal controls.[68]

Likewise, the Canadian securities regulators in keeping abreast with the spirit of SOX (boasting investor's confidence) and aligning their corporate governance rules with those of the United States, unveiled initiatives in 2003 with regard to auditor oversight, officer certifications in companies' reports, and audit committees.[69] The Chairman of the Ontario Securities Commission requested the Canadian Institute of Chartered Accountants to address issues of audit independence and rotation of engagement partners and firms.[70]

The European Union Commission was concerned that European company issuers and auditors would be unfairly treated (because they were already subject to stringent measures in their home markets) and that added regulation would only impose unnecessary burdens and costs.[71] Indeed, a letter from Alexander Schaub, director-general of the Directorate-General for Internal Market and Services at the European Commission, to the then-Secretary of the SEC,

66. Garrett, *supra* note 62, at 171.

67. This report was issued in 1998 and became the Combined Code on Corporate Governance (supplemented by the Turnbell Report), which applies to all listed companies in the United Kingdom and requires that nonexecutive directors comprise at least one half of the total number of members on each board of directors. *See* FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE 83 (July 2003), http://www.frc.org.uk/documents/pagemanager/frc/Web Optimised Combined Code 3rd proof.pdf.

68. *See* Garrett, *supra* note 62, at 171.

69. Karmel, *supra* note 9, at 890. Corporate governance issues are complicated in Canada, however, because of the lack of a single national agency regulating securities. Garrett, *supra* note 62, at 161. There are thirteen provincial and territorial agencies responsible for the regulation of securities in Canada, which may explain the lack of harmonization among the provinces; this factor is only further complicated by bickering amongst the many provincial securities regulators. *Id.* In British Columbia and Alberta, for example, regulators favor a principlebased regulatory scheme, while regulators in Ontario favor a rulesbased scheme patterned after SOX. *Id.*

70. *See* Garrett, *supra* note 62, at 163.

71. Maria Camilla Cardilli, *Regulation Without Borders: The Impact of Sarbanes-Oxley on European Companies*, 27 FORDHAM INT'L L.J. 785, 791 (2004). For example, Germany enacted the Transparency and Publicity Act (TransPUG) in 2002 covering disclosure, transparency and accounting issues. *See* Garrett, *supra* note 62, at 166. This became effective on January 1, 2003. *Id.*

Jonathan Katz, belabored this point.[72] Regardless of what the rationale was for not wanting SOX to apply to these foreign companies, the enactment of SOX and its application undoubtedly extended to all foreign companies listed in the United States and their auditors, regardless of origin.[73] In other words, companies and auditors based in other countries or jurisdictions came under the direct jurisdiction of the United States authorities regardless of the legal and economic culture in their own country.[74] European Union auditors preparing or

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72. *See* Cardilli, *supra* note 71, at 791–92 n.31 (citing Letter from Alexander Schaub, Director General of the European Commission, to Jonathan Katz, Secretary of the SEC (Feb. 18, 2003), *available at* http://www.sec.gov/rules/proposed/s70203/aschaub1.htm. The letter states, in part:

> We request full recognition of equivalence of EU corporate governance systems. . . . [T]he SEC should be aware that EU companies and auditors are already subject to longstanding, well developed [m]ember [s]tate corporate governance requirements. These are tailored to their specific legal environments and are in their different ways as effective and efficient at providing investors protection as U.S. rules. Additional requirement of the [Sarbanes-Oxley Act] applied to EU companies and auditors would place on them an unnecessary additional layer of requirements—taken from completely different (US) corporate governance environment. We fail to see why EU companies and auditors should be overburdened with such duplicative requirements compared to their US counterparts. . . . Bearing this in mind, the SEC should recognize the equivalence of E.U. corporate governance systems and thus fully exempt not only EU lawyers but also EU companies and auditors from the [provisions of Sarbanes-Oxley], also with regard to audit committee requirements.

Id.

The SEC has, however, generally attempted to accommodate concerns of foreign issuers. With respect to the audit committee independence requirements, the SEC has clarified that employee representatives sitting on the board of directors or audit committee pursuant to home country law or listing requirements will count as independent. *See* Greene & Boury, *supra* note 11, at 30.

73. "In the past, foreign companies benefited from a general exemption from the application of American corporate governance rules[;]" foreign listed companies in the United States were "simply required to disclose their corporate governance arrangements[,] a solution that created no interference with the internal organization of most foreign issuers." *See* Cardilli, *supra* note 71, at 792. The underlying premise for this was the recognition of other national legal systems' ability to assure equivalent levels of investor protection. *Id.* This practice encouraged the listing of these foreign companies in the U.S. markets without necessarily triggering the complications that adapting to a system different from their own would have created. *Id.*

74. Dewing & Russell, *supra* note 61, at 318. It has also been said that the Act was passed with such haste (in an election year) that Congress did not apparently take the

involved in providing audit reports for their companies listed in the United States, were, for example, subject to the Oversight Board.[75] Should SOX, therefore, apply only to U.S. companies, thus excluding foreign companies? Given the number of foreign issuer registrants and international competition for investments and capital, it is harder for the SEC to apply a stringent rule to U.S. companies and not to foreign companies.[76] One of the risks inherent in the applicability of SOX to non-U.S issuers is that some of the Act's provisions may conflict with those in force in the companies' country of incorporation.[77] Because corporate governance laws tend to emanate from the country of incorporation, such laws may be very different—different legal systems, different regulations and accepted practices prevailing with a country that may conflict with those of SOX.[78] It was even observed that some foreign-listed companies considered delisting from the New York Stock Exchange (NYSE) or SEC because of SOX.[79] Looking at some particular provisions and its impact on foreign companies is therefore imperative.

B. Provisions relating to CEO and CFO; Criminal Sanctions

Section 302 of the Sarbanes-Oxley Act requires the SEC adopt rules requiring the CEO and CFO of a public company in each quarterly and annual report to personally vouch for the accuracy of the report, and to certify the accuracy of the company's financial statements and that the company has adopted adequate internal controls.[80] As stated earlier, this

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time to consider whether it was appropriate to include foreign issuers in the statutory framework. *See* Karmel, *supra* note 9, at 862.

75. Dewing & Russell, *supra* note 61, at 318.

76. Karmel, *supra* note 9, at 891.

77. Cardilli, *supra* note 71, at 791. European businesses, while in favor of improved corporate governance standards, were not very happy with the applicability of SOX to their companies. *Id.*

78. *Id.* Such concerns were expressed by the Union of Industrial and Employers' Confederation of Europe (UNICE)—an authoritative representative of business in Europe. *Id.*

79. *See* Karmel, *supra* note 9, at 887 (noting a February 2003 comment letter from the NYSE regarding the SEC's proposed audit committee standards).

80. Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress, in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495,

means, based on their knowledge, these executives claim the reports filed with the SEC do not contain any material misstatement or omission.[81] In particular, the CFO and CEO must certify: 1) that the financial statements and other financial information included in the reports are true and correct, and fairly present the financial conditions and results of operations of the issuer; and 2) that the company has implemented effective disclosure controls and procedures to assure transparency.[82] The conflict of this requirement with those of other countries is obvious; in Germany and France, the laws basically provide for the collegial responsibility of CEOs and CFOs with respect to the truthfulness and accuracy of financial statements.[83] Similarly, English corporate governance rules ignore the individual certification requirement and look to the collective responsibility of the board for the company's account.[84] Likewise, under Italian law, the annual accounts of a company are prepared by the entire board of directors on a collegial basis.[85] Consequently, the SOX requirement that the CEO and CFO individually certify the accounts transforms what was an internal responsibility to the company into a responsibility to all third parties.[86]

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516 (Nancy B. Rapoport & Bala G. Dharan eds., 2004); *see* Florence Shu-Acquaye, *The Independent Board of Directors and Governance in the United States: Where Is This Heading?*, 27 WHITTIER L. REV. 725 (2006) [hereinafter *Where Is This Heading?*] (discussing the interplay of the Sarbanes-Oxley Act, fiduciary duties, and corporate governance on the whole); *Smith v. Van Gorkom Revisited*, *supra* note 17.

81. *See* discussion *supra* Part III.A.

82. Cardilli, *supra* note 71, at 793. Also, the only exemptions from such executive certification requirements are employee benefit plans and 8–K reports. *See id.* at 794 n.41 (citing JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 675 (3d ed. 2001)).

83. *Id.* at 794; *see also id.* at 794 n.43 (referring to the French Code de Commerce L225–251, and in particular Article L232–1, concerning the preparation of the corporate balance sheets by the board of directors). In the same vein, the German Stock Corporation Act (Aktiengesetz) 93–11 recognizes the responsibility of the whole Vorstand. *Id.*

84. *Id.* at 794.

85. *Id.*

86. *Id.*

Section 304, which deals with forfeiture of certain bonuses and profits, requires the CEO and CFO to reimburse the company for any bonus, incentive, equitybased compensation, or any profit from the sale of securities of the company, received during the twelve months prior to any earnings restatement if such compensation is the result of material noncompliance by the company with any financial reporting requirements under the federal securities law.[87] This section appears to make the CEO and CFO responsible for reimbursing their bonuses and profits to the issuer even where others are found to have been responsible for the misconduct that led to the issuer's violation, and even if the CEO and CFO were not at all involved in the misconduct. Although this provision does not appear to have an equivalent rule in most European jurisdictions, it does create a problem of double regulation:[88] under Italian corporate governance rules, for example, the possibility of bringing actions that would require the directors to return a part of their compensation seems to exist only when those directors have caused harm to the corporation through failure to carry out their duties to the corporation.[89] France, on the other hand, recognizes the possibility for criminal jurisdictions to fine directors by an amount up to ten times the gains earned by directors in violation, although such sanctions could only be provided in the context of an action for damages.[90] Hence, France has no equivalence to SOX Section 304.[91]

Section 305 expands the SEC's ability to remove directors and officers and bar them from serving as such in a publiclyheld corporation by showing their unfitness to serve on the board as a result of violating the antifraud provisions of the securities laws.[92] The standard used prior to implementation of the section

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87. Paredes, *supra* note 80, at 516; Sarbanes-Oxley Act of 2002 § 304(a)(1)–(2), 15 U.S.C.S. § 7243(a)(1)–(2) (LexisNexis 2005).

88. Cardilli, *supra* note 71, at 797.

89. *Id.* at 797–98.

90. *Id.* at 798.

91. *Id.*

92. *See* Paredes, *supra* note 80, at 516; DORSEY & WHITNEY LLP, SARBANES-OXLEY ACT OF 2002: WHAT YOU NEED TO KNOW 5 (2002), http://www.abanet.org/rppt/publications/edirt/2002/sarbanes/dorsey.pdf.

was "substantial unfitness," which was apparently a higher standard and therefore more difficult to show than the section's requirement to show mere "unfitness."[93]

Section 906 provides for stiff criminal sanctions for CEOs and CFOs who fail to comply with certain financial certification requirements in addition to those under section 302.[94] Section 906 imposes a $1 million fine (USD), 10 years in prison, or both for persons who knowingly violate the certification requirement; and a $5 million (USD) fine, 20 years in prison, or both for willful violation of the provision.[95] In addition to the increased maximum criminal penalties, SOX also directed the U.S. Sentencing Commission[96] to review and amend federal sentencing guidelines for a number of criminal offenses relating to securities and accounting fraud; hence, the new guidelines which were already increased in 2002 were again increased in 2003 in response to the mandate contained in the Act.[97] The overall result is sentencing is now far more severe in the United States than it is in other countries. For example, under the new guidelines, the penalty for a CEO guilty of certain significant accounting frauds is life imprisonment, far more severe than the penalty for the federal crime of murder, which is imprisonment for 30 years to life.[98]

This Act was tested as Richard Scrushy, former CEO of HealthSouth Corp, "was acquitted of all eighty-five counts with which he was charged, including one of knowingly certifying

93. 15 U.S.C. 77t(e), 78u(d)(2), (2000), *amended by* Sarbanes-Oxley Act of 2002 § 305(a)(1)–(2), 15 U.S.C.S 77t(e), 78u(d)(2) (LexisNexis 2005). However, it is not clear from the legislative history that the change in language from substantial unfitness to unfitness was intended to reduce the quantum of proof required of the government. *See Smith v. Van Gorkom Revisited*, *supra* note 17, at 41 n.153 (citing Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391, 408 (2004)).

94. Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C.S. § 1350(c)(1)–(2) (LexisNexis 2005).

95. § 906(c)(1)–(2).

96. This federal agency is responsible for establishing sentencing policies and practices for the federal courts. *See* U.S. Sentencing Commission Homepage, http://www.ussc.gov/ (last visited Apr. 1, 2007) (giving news on, links about, and the history and practices of the U.S. Sentencing Commission).

97. Greene & Boury, *supra* note 11, at 25.

98. *Id.* at 25–26.

false financial statements in violation of Section 906 of the Act."[99] Supporters of the Act feel that Scrushy was acquitted under Section 906 because either the case was too complicated for the jurors or "because conviction under section 906 requires finding of guilt for other counts of fraud."[100]

The European Union High Level Company Law Experts reviewed whether—and, if so, how—the E.U. should coordinate and strengthen the efforts undertaken by member states to improve corporate governance.[101] The Experts' investigation raised four main focus points that similarly relate to the aforementioned discussions as a whole: 1) provision of information for shareholders and creditors, in particular better disclosure of corporate governance structures and practices; 2) strengthening shareholders' rights and minority protection, in particular supplementing the right to vote by special investigation procedures; 3) strengthening duties of the board, in particular the accountability of directors where the company becomes insolvent; and 4) recognizing the need for a European corporate governance code or coordination of national codes in order to stimulate development of best practices and convergence.[102] With specific consideration of the Enron disaster and implementation by the United States of the Sarbanes-Oxley Act, the Commission reviewed issues related to best practices in corporate governance and auditing, paying particular attention to the role of nonexecutive and supervisory directors, the remuneration of management, and the responsibility of management for financial statements and auditing practices.[103]

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99. *Where Is This Heading?*, *supra* note 80, at 739–40.

100. *Id.* at 739–40; *see* Jonathan D. Glater, *New Rules Make it Easy to Charge Executives, but Not to Send Them to Prison*, N.Y. TIMES, July 2, 2005 at C5 (noting the jury could not find Scrushy guilty under charges of fraud, and therefore could not find him guilty under section 906).

101. EUR. COMM'N, REPORT, *supra* note 4, at 43.

102. *Id.*

103. *Id*; *see also* COMM'N OF THE EUR. CMTYS., *supra* note 1, at 10–11 (discussing how recent scandals in the U.S. affected the E.U.'s approach to corporate governance).

C. Audit Committee Independence

Section 301, which, to some extent, encompasses the discussion above with regards to auditing, sets forth the independence requirements for members of the audit committee of listed companies.[104] Under the SEC provisions of Rule 10A-3 (as directed by Section 301 of the Act), the audit committee members of companies listed on securities exchanges must meet two specific conditions with respect to auditor independence: 1) they may not directly or indirectly accept consulting, advisory, or any other compensatory fees from the company or its subsidiaries other than board and committee fees; and 2) they may not be "affiliated" persons of the company or any of its subsidiaries.[105]

Implementation of Section 301 was convoluted and ambiguous to foreign issuers of Europe. For example, the Section provides that issuers should have an independent audit committee, but does not demand creation of audit committees from registrants.[106] Further, in the absence of an audit committee, the independence requirements of the Section still must be fulfilled by all of the board members of a registrant.[107] Such imprecise requirements were problematic for European companies listed in the United States, given some such companies are incorporated under the civil law systems of their respective countries, where the two-tier board requirement does not provide for independent directors on the executive or managing board level, and representatives of employees compose half of the supervisory board.[108] Hence, the impact on

104. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j–1(m) (LexisNexis 2005). *See also* discussion on corporate auditing *supra* Part III.A.

105. *See* Paredes, *supra* note 80, at 518 n.99. An "affiliated person" is one who directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the company or its subsidiary. *Id.* "'Control' means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership or voting securities, by contract, or otherwise." *Id.* However, a person who is not the beneficial owner of at least 10% of the voting securities of the company and is not an executive officer of the company is not considered an "affiliated person," *Id.*

106. Cardilli, *supra* note 71, at 802.

107. *Id.*

108. Karmel, *supra* note 9, at 874.

the different European corporate governance systems could not be ignored. Some commentors sought for the SEC to exempt the applicability of Section 301 based upon the doctrine of comity,[109] but the supposed harshness of Section 301 was mitigated by the SEC's final implementing rules. Under these rules, all foreign issuers listed in the United States are exempt from the obligation to have an audit committee, provided that: 1) the foreign issuer has an alternative structure such as a board of auditors according to its own national law; 2) the same board of auditors is separate and distinct from the board of directors; 3) no executive director is a member of the board of auditors; 4) the board of auditors is not appointed by the board of directors; 5) the foreign issuer's national laws provide standards that assure the independence of the board of auditors from management; and 6) the foreign issuer's national laws or its bylaws provide that the board of auditors is responsible for appointing and monitoring the activities of the outside auditor.[110]

D. Code of Ethics

In light of the Enron debacle, the defects in corporate governance also demonstrated the level to which business ethics had ebbed, thereby revealing lessons about business leadership, corporate regulation, and government regulation. Enron was characterized as "a culture that valued only deal-making and money."[111] It "failed because its leadership was morally, ethically and financially corrupt."[112] What, then, happened to corporate governance rules? Did they fail, or were they inadequate? As one scholar stated, "corporate governance is fundamentally a weak check and balances approach, in that it has historically relied on reasonably honest and honorable managers and directors (in the face of agency theory to the

109. *Id.*

110. Cardilli, *supra* note 71, at 803.

111. *See* Duane Windsor, *Business Ethics at "The Crooked E," in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS, *supra* note 80, at 659, 676 (citation omitted).

112. ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON 12 (2002).

contrary)."[113] "A financial and moral corruption machine emanating from senior management, ensnaring a trusting or negligent board, shaped the corporate culture and ethical climate, and ensnared the auditors, the external attorneys, and to some degree, the politicians and regulators."[114] In the face of these kinds of allegations and findings,[115] SOX enacted sections dealing with ethics. Section 406 required the SEC to implement rules mandating: 1) implementation of a code of ethics for senior financial officers (or persons performing similar functions) of financial statement issuers; and 2) disclosure by the issuers of whether or not such a code has been adopted, and, if a code has not been adopted, the reason why.[116]

These rules were also applicable to foreign issuers (over European objection), as they were similar to the European method of regulating corporate governance through codes and

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113. Windsor, *supra* note 111, at 677. The cost that must be incurred by the corporation is monitoring management to ensure their interests are aligned with those of the shareholders. Hence, shareholders may be able to reduce agency costs by devising incentives that would motivate management to maximize shareholder wealth. Such incentives include stock options and bonuses. *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888–96 (1998).

114. Windsor, *supra* note 111, at 677. The author goes on to say the "machine" was built around elements such as:

> 1) a shared ideology of free markets, deregulation and innovation; 2) systematic attempts at political influence of legislation and regulation; 3) Lay's philanthropic activities as (perhaps genuine) evidence of corporate citizenship and community leadership; 4) a cynical view that greed is good, personally and for society; 5) strong financial incentives for suborning checks and balances; and 6) hardball tactics.

Id.

115. In the May 6, 2002 report of the Chairman of the Senate Committee on the Judiciary, Senator Patrick Leahy recommended the proposed Corporate and Criminal Fraud Accountability Act of 2002. *Id.* at 673. A review of Enron's behavior revealed, *inter alia*, "imprudent behavior, self-dealing, defects of moral character, company code of conduct relaxation or violation, defects of corporate culture, and defects of corporate governance." *Id.* at 673–74.

116. Sarbanes-Oxley Act of 2002 § 406(a), 15 U.S.C.S. § 7264(a) (LexisNexis 2005) (entitled "Code of Ethics for Senior Financial Officers"). The Act also required the Commission to revise its requirements for prompt disclosure on Form 8–K by the issuing company to also include disclosure of any change in or waiver of such code of ethics for senior financial officers on a filed Form 8–K, or by dissemination on the Internet or other electronic means. § 406(b).

the subsequent compelling of issuers to disclose whether they comply with code recommendations, and if not, why not.[117]

The Act also suggested the code of ethics must include standards reasonably necessary to promote ethical conduct in handling conflicts of interest, disclosure in reports to be periodically filed by the issuer, and compliance with governmental regulations.[118]

Section 307, on the other hand, requires the SEC establish minimum standards of professional conduct for attorneys practicing before the SEC.[119] The Section also requires all lawyers to simultaneously report evidence of a material violation of fraud and other corporate misconduct to the company's senior management and, if necessary, to the board of directors.[120] This requirement is endorsed by the final 2003 rules implementing SOX provisions relating to "minimum standards" of professional conduct—attorneys representing issuers before the SEC are required to report violations of securities laws, breaches of fiduciary duty, or other similar violations by the issuer to the issuer's chief legal officer and CEO.[121] If no appropriate response is provided, then the attorney must report the evidence to the issuer's audit committee or the board of directors.[122] The enactment of Section 307 was said to be flawed, however, because it was a usurpation of the regulation of corporate law by the federal government from the states.[123]

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117. Karmel, *supra* note 9, at 869.

118. § 406(c).

119. Sarbanes-Oxley Act of 2002 § 307(1), 15 U.S.C.S. § 7245(1) (LexisNexis 2005).

120. § 307(1)–(2).

121. § 307(1).

122. § 307(2); Cardilli, *supra* note 71, at 813.

123. Lawrence Fox, *The Academics Have It Wrong: Hysteria is No Substitute for Sound Public Policy Analysis*, *in* ENRON: CORPORATE FIASCO AND THEIR IMPLICATIONS *supra* note 80, at 851, 865–66. Not only did the SEC propose and ultimately adopt a regulation that requires lawyers for public companies to report up the corporate ladder, but it also proposed rules "that would literally destroy confidentiality between lawyer and corporate client, as well as pre-empt state substantive law addressing fundamental principles of corporate governance." *Id.* at 864. Mr. Fox said:

> [the] very idea of the Senate of the United States enacting or directing others to enact rules of professional responsibility for lawyers should be enough to

Again, the dilemma for the European community concerning this law was it would be inequitable to foreign lawyers, due to their conflicting home country ethics requirements and their lack of expertise in assessing violations of U.S. laws.[124] However, these rules will tend to exclude most foreign attorneys since the regulation applies to those licensed to practice law in the United States.[125] Indeed, the SEC responded to foreign concerns by excluding foreign attorneys who are not admitted to practice in the United States and do not advise on U.S. law (or would do so only on a consultative basis with a U.S. lawyer); also

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> cause collective professional indigestion and indignation. A foundation of our independent profession is that our rules of professional conduct are promulgated by the states. Time and again, we have quite correctly resisted efforts to have the federal government usurp—even for lawyers employed by the federal government—the traditional role of regulating lawyers through the respective state Supreme Courts.

Id. at 866.

Also worth noting is Section 806 makes employees, employers, and other specified persons civilly and criminally liable if they retaliate against "whistle blowers." Sarbanes-Oxley of 2002 § 806, 18 U.S.C.S. 1514A (LexisNexis 2005).

In the same vein, SEC regulation 17 C.F.R. § 205.3(d)(2) allows (but does not require) an attorney for a publiclytraded company to provide information to the SEC that would otherwise be privileged if the attorney reasonably believes such disclosure is necessary to 1) prevent the company from committing a material violation that is likely to cause substantial financial injury to the company or its investors; 2) stop the company from committing or suborning perjury or fraud in an SEC proceeding; and 3) rectify the financial consequences of a material violation in which the attorney's services were used. Steve Seidenberg, *SEC Trumps N.C. Ethics Rules*, ABA J. EREPORT, Vol. 5, Mar. 31, 2006, at 13. The regulation has been controversial ever since it was promulgated on January 29, 2003, pursuant to the Act. *Id.* The author further stated, although this "reporting out" rule poses no ethical problems for attorneys in most states (because fortytwo states have ethics rules that either allow or require attorneys to report out under these circumstances), the remaining eight states, however, have ethics rules that prohibit disclosure of such confidential client information. *Id.* Consequently, attorneys in those states find themselves in a dilemma. *Id.* The extent of the dilemma was realized in the summer of 2003 when two of the affected states, Washington and California, asserted the SEC's rule was trumped by contrary state ethics rules. *Id.* However, the SEC asserted the validity of its authority over any conflicting state ethics rules by reiterating the U.S. Supreme Court's ruling in Fidelity Federal v. de la Cuesta, 458 U.S. 41 (1982), which generally held that a federal regulation preempts conflicting state law if the agency intended to preempt state law, and the agency action was within the scope of its delegated authority. Seidenberg, *supra* note 123, at 13.

124. Greene & Boury, *supra* note 11, at 29. Attorney-client privilege may also become an issue.

125. *Id.* at 30.

exempt are foreign practicing attorneys if their compliance with the U.S. requirement would be prohibited by their respective foreign law.[126]

IV. CORPORATE TAKEOVERS, CONSTITUENCY STATUTES AND SHAREHOLDERS RIGHTS

The most fundamental principle of corporate governance is a function of the allocation of power within a corporation between its stockholders and its board of directors.[127] While the stockholders' major power is the right to vote on specific matters, paramount of which is the election of directors,[128] the power to manage the corporation, on the other hand, is vested in the corporate board,[129] which is duly elected by the shareholders.[130] While these fundamental tenets of corporate law provide for a separation of control and ownership, the shareholders' franchise has been characterized as the "'ideological underpinning[s]' upon which the legitimacy of the directors managerial power rests."[131]

Intertwined with the power vested in management is the corollary that they, as fiduciaries, have a principal duty to maximize the interest of shareholders.[132] But should this always be the case, or should some other constituencies be taken into consideration; and, if so, when and why should the shareholder interest become secondary?[133] In the United States, until the

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126. *Id.* The United States has historically deferred to home country rules in so far as it does not regulate the internal structures of foreign corporations. *Id.*

127. EISENBERG, *supra* note 12, at 193.

128. MODEL BUS. CORP. ACT § 7.28; DEL. CODE ANN. TIT. 8, § 212 (2001).

129. MODEL BUS. CORP. ACT § 8.01(b); DEL. CODE ANN. TIT. 8, § 141(a).

130. *See* EISENBERG, *supra* note 12, at 193–94.

131. *Id.* at 194; Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

132. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (noting the traditional view that a corporation is organized and carried on primarily for shareholder profit).

133. "The traditional law and economic perspective holds that in determining the maximands of the corporation, exclusive priority should be given to its residual claimants"—the shareholders. Amir N. Licht, *The Maximands Of Corporate Governance: A Theory Of Values And Cognitive Style*, 29 DEL. J. CORP. L. 649, 652 (2004). However, others "call for 'corporate social responsibility,' holding that in addition to shareholders'

mid-1960s, it was difficult to oust incumbent management of a publiclytraded corporation, simply because, among other reasons, it was difficult to acquire a corporation against the objection of its incumbent managers (which required their approval of the acquisition in the first place).[134] Hostile takeovers later became an important and common method by which to not only oust incumbent management but also to acquire the target company.[135] In other words, a tender offer for the shares is made by the acquirer directly to the *shareholders* of the target corporation (not to the board of directors for approval), the acquirer thereby bypassing the board and presumably facing little or no resistance.[136]

Consequently, in the late 1970s and 1980s, corporate charter amendments were adopted by a few corporations, which allowed directors in the face of a change in control to consider the social and economic effects of the acquisition on the target's employees, suppliers, customers, and others.[137] Today, many states have statutes that permit (or in one instance *require*) directors and

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interests, corporate officers must give weight to the interests of other corporate and societal constituencies," such as "creditors, employees, customers, local communities and the environment." *Id.* at 651.

134. EISENBERG, *supra* note 12, at 177. The acquirer could, however, oust the incumbent through the difficult and usually intermittently unsuccessful process of proxy fights. *Id.* Proxy fights occur during elections for directors when shareholders, through their proxy cards, can choose between two or more opposing slates of directors. Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U.L. REV. 379, 388 (1994).

135. EISENBERG, *supra* note 12, at 177.

136. *Id.* This is because, if and when successful, the acquirer may sometimes not only oust management but actually liquidate the firm's assets and fire most or all employees. *Id.* Incumbent management logically resists such takeovers by making the corporation take defensive actions to stymie a b*id. Id.* The pragmatic takeover that ostensibly dominated public perception at the time was the hostile "bust-up" takeover. Licht, *supra* note 133, at 701. This public image was intensified by colorful jargon to describe takeover activities—this jargon included words such as raiders, white knights, poison pills, shark repellants, greenmail, etc. *Id.* at 701 n.205. *See* O'KELLY & THOMPSON, *supra* note 20, at 816–17 (providing meaning and more on the jargon); *see also* Anne B. Fischer, *Oops! My Company is on the Block*, FORTUNE, July 23, 1984, at 16 (discussing why, with the impact of the merger and acquisition boom at that time and with management's defensive responses, stricter regulations of mergers and acquisitions were inevitable).

137. Licht, *supra* note 133, at 701.

officers of corporations chartered within their states to consider the interests of other constituencies beyond the corporation's shareholders, at least in certain situations, particularly with a change of control.[138] Delaware, a renowned state in regards to corporate law, which did not formally adopt a constituency statute per se, stated in its 1985 supreme court decision, *Unocal Corp. v. Mesa Petroleum Co.*,[139] that, in analyzing the effect of an imminent takeover on the "corporate enterprise," the directors may consider its "impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[140] The Delaware court qualified its decision in *Mesa* by stating in *Revlon, Inc. v. MacAndrews & Forbes, Inc.* that, once the target firm was clearly going to be sold, the duty of the target's board "changed from the preservation of [the target firm] as a corporate entity to the maximization of the company's value at a sale for the

138. *Id.* at 702. It is worthwhile to note that the federal Williams Act of 1933 regulated some aspects of takeover. Geoffrey Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 COLUM. BUS. L. REV. 51, 54 (1998); *see also* 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f). However, legislative history indicates that congressional policy was to adopt a neutral position between the interests of incumbent managers and those of bidders. *Id.* The Act, therefore, was generally consistent with this intermediate position, not unduly favoring bidders or targets. *Id.* The Act imposed some "regulation on the terms and procedure for takeover bids, require[d] prebid disclosure and create[d] a fraud remedy for communications concerning an offer." *Id.*

139. 493 A.2d 946 (Del. 1985).

140. *Id.* at 955. Courts in other jurisdictions followed the Delaware standard and approved constituencies' statutes, with the shareholder benefit considered to be of paramount consideration. Licht, *supra* note 133, at 702 n.210; *see also, e.g.*, Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1009 (E.D. Wis.), *aff'd*, 877 F.2d 496 (7th Cir.1989); GAF Corp. v. Union Carbide., 624 F. Supp. 1016, 1019–20 (S.D.N.Y. 1985) ("The protection of loyal employees, including managers, of the organization is not anathema . . . legitimate concerns for their past conduct of the enterprise and its requirements need not be left to the goodwill of an unfriendly acquirer of corporate control in the jungle warfare involving attempted takeovers.").

Other forms of such statutes included laws restricting the voting rights of shares acquired by a bidder in a takeover unless the remaining shareholders approve (control share statutes); laws restricting rights of a winning bidder to consummate a merger or other business combination with the target for a substantial period of time after the bid (business combination freeze statutes); and provisions requiring the bidder to pay as much at the freezeout stage of an acquisition as it pays to tendering shareholders in the takeover bid (fair price rules). *See* Miller, *supra* note 138, at 55.

stockholders' benefit."[141] In other words the "board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."[142] Apparently, the board's responsibilities under *Unocal* were altered in that the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders.[143] Subsequently, the same Delaware court held in *Paramount Communications, Inc. v. Time, Inc.*[144] that "directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[145] Although when looked at as a whole, these Delaware cases tend to show an erratic approach in regulating incumbent managers' duties in responding to unsolicited takeover bids, one thing appears to be consistent in these cases: the Delaware courts tend to give victory to the party which (when considering marketplace realities of the bid) is most likely to end up with control over the assets; that is, "the Delaware courts pick winners."[146] Regardless of case law, the widespread adoption of constituency

141. 506 A.2d 173, 182 (Del 1985).

142. *Id.* at 182; *see also* E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?*, 149 U. PA. L. REV. 2179, 2184 (2001) ("[T]he interests of stockholders are primary and may not be trumped by that of other constituencies, although those interests may be considered if congruent with interests of the stockholders.").

143. *Revlon*, 506 A.2d at 182. *Revlon* therefore appeared to be "restricting the power of incumbent managers to control the takeover process." *See* Miller, *supra* note 138, at 57.

144. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989). Here, Time's management rejected an all-cash offer from Paramount that was financially better than a proposed merger by Warner Brothers. *Id.* at 1142. The court held the deal with Warner Brothers did not trigger the *Revlon* duty to auction and Time's response to Paramount was reasonable to the threat posed. *Id.* However, the court retracted from this position in *Paramount Commc'ns Inc v. QVC Network*, 637 A.2d 34 (Del. 1994). *See* Miller, *supra* note 138, at 57 ("Paramount's board [of directors] approved a merger with Viacom and adopted defensive measures to block an unsolicited, more valuable tender offer from QVC Network."). Here the court held that "the *Revlon* duties applied to actions of Paramount's board, and [the board was therefore in breach of its fiduciary] duty by rejecting the QVC b*id.*" *Id.* at 57–58.

145. *Time*, 571 A.2d at 1154.

146. *See* Miller, *supra* note 138, at 58.

statutes in the United States, whether in takeovers or otherwise, at least demonstrates a trend, and, therefore, is here to stay.[147]

What is the position of foreign countries and, in particular, the European Union?[148] The American corporate governance system, as seen above, adheres to the idea of shareholder primacy. Because the United Kingdom, Austria, and Canada share a legal system based on English common law and equity principles, they are similar to the United States—shareholder primacy is the predominant norm in each of these countries. In England, for example, Section 309 of the Companies Act of 1985 requires incumbent managers to take into account the interests of employees as well as shareholders when making decisions about takeovers, hence the applicability of the equivalence of constituency statutes in the United States.[149] Indeed, case law in England emphasizes that fundamental decisions regarding takeovers are the prerogative of shareholders and not management.[150] Hence, management action that may serve to

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147. As part of an effort by state legislatures to protect local companies and jobs, about thirty states have adopted other constituency statutes, with most of them providing that in determining the best interest of the corporation, directors may consider the interests of suppliers, employees, customers, and affected communities. *See* O'KELLY & THOMPSON, *supra* note 20, at 266–67. Thus it is obvious that these statutes broaden the direction entrusted to directors beyond takeovers. *See id.* For example, a controversial 1990 Pennsylvania statute states that "directors . . . shall not be required . . . to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor." 15 PA. CONS. STAT. § 1715(b) (1990).

148. The OECD Principles IV reiterates that "[t]he corporate governance framework should recogni[z]e the rights of stakeholders as established by law . . . and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises." OECD, OECD PRINCIPLES OF CORPORATE GOVERNANCE 21 (2004), http://www.oecd.org/dataoecd/32/18/31557724.pdf. OECD Principle VI also states that "[t]he board should . . . take into account the interests of stakeholders," with the annotation explaining "boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities." *Id.* at 24, 58. In the same vein, the International Corporate Governance Network (ICGN) is in agreement with OECD that the board should be accountable to shareholders and responsible for managing successful and productive relationships with the corporation's stakeholders. *Id.* at 58.

149. Miller, *supra* note 138, at 59 n.17.

150. *Id.* at 59. In *Hogg*, where the court held even if the incumbent board honestly

defeat such shareholder control falls outside the scope of delegated management authority.[151]

On the other hand, some countries such as Germany and Japan feature stronger protection for the employees, creditors, and other nonshareholder constituencies as a whole—a prime example of a stakeholder-orientated system.[152] German corporate law creates a fiduciary duty between managers and a diverse group of constituencies, including shareholders, employees, and society.[153] Consequently, the hallmark of the corporate system is its codetermination regime—a regime that provides employees with structural protection through representation in corporate institutions.[154] Therefore, the German two-tiered board calls for the companies to be managed by a managing board (Vorstand)[155] that conducts day-to-day business of the firm and a supervisory council (Aufsichtsrat)[156] that elects and monitors the firm's management and approves major corporate decisions.[157] Similarly, in Austria, Denmark,

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believed keeping the management of the company in the hands of the incumbent board would be more advantageous to the shareholders than if it was taken over, such a decision properly belonged to the shareholders and not management. *See id.* (citing Hogg v. Cramphorn, Ltd., [1967] Ch. 254, 265 (1963)).

151. *Id.*

152. *See* Licht, *supra* note 133, at 734–37.

153. *Id.* at 734–35.

154. *Id.* at 735.

155. *Id.* The managing board is usually appointed by the members of the supervisory board. *Id.*

156. *Id.* at 735. Members are comprised of representatives of shareholders and workers. David Charny, *Special Symposium Issue: The German Coporate Governance System*, 1998 COLUM. BUS. L. REV. 145, 149 (1998). These shareholder representatives, as a practical matter, are usually representatives of the main creditor groups, the banks. *Id.*

157. Miller, *supra* note 138, at 735. "Private corporations with five hundred or more employees and public corporations organized under German law are required to have [such] a two-tiered board structure," with "supervisory functions in the first-tier board, the aufsichtsrtat (supervisory board), and management function in the vorstand, the second-tier board (management board)." Lynn L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board Ombudsperson*, 54 WASH. & LEE L. REV. 91, 138 (1997). The supervisory board supervises management. *Id.* This two-tiered system is similar to the unitary boards in the United States, where the board of directors is designed to supervise management. *Id.* The U.S. boards appoint and determine the compensation of senior executives. *Id.* In the same vein, the German supervisory board appoints and determines the compensation of directors on the management board. *Id.*

Luxembourg, the Netherlands, and Sweden, employee participation in the supervisory board is mandated.[158] France, Ireland, Portugal, and other E.U. member states have enacted laws that merely include aspects of employee participation in corporate governance.[159] For example, in France, when employees' shareholding reaches 3%, employees are given the right to nominate one or more directors subject to certain exceptions.[160] Although employee representation on the board does not give them decision-making power per se, their structural involvement as nonshareholder constituencies of the firm is effective in mitigating informational asymmetries, thereby facilitating informal negotiations among corporate constituencies.[161]

Because company law is one area of law that is criticized for not keeping up with the integration process of the European Union,[162] much work is underway to maximize harmonization, in spite of the obvious differences and inherent difficulties in doing so.[163] One major area in which this has occurred is

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However, the German supervisory board has less control over management and the corporation. *Id.* For the German boards, this formal structure with the division of interest representation among different groups and its confinement to a separate board is said to foster managerial dominance. *See* Charny, *supra* note 156, at 149. This managerial dominance translates into advantages such as superior access to information, control over information flow to the supervisory board (monitors), de facto independence in day-to-day decision making, and so forth. *See id.* at 149–50.

158. Licht, *supra* note 133, at 735 (citing Luca Enriques, *Silence Is Golden: The European Company Statute as Catalyst for Company Law Arbitrage*, ECGI Law Working Paper No. 07/2003, at 10 n. 38 (2003); COMPARATIVE STUDY, *supra* note 1, at 44.

159. *See* Licht, *supra* note 133, at 735 n.338 (citing Uwe Blaurock, *Steps Towards a Uniform Corporate Law in the European Union*, 31 CORNELL INT'L L.J. 377, 390 (1998); Karel Lannoo, *A European Perspective on Corporate Governance*, 37 JOURNAL OF COMMON MARKET STUDIES 269 (1999), *available at* http://www.blackwell-synergy.com/doi/pdf/10.1111/1468-5965.00163).

160. COMPARATIVE STUDY, *supra* note 1, at 34.

161. Licht, *supra* note 133, at 735–36.

162. *See* Andrea J. Gildea, *Uberseering: A European Company Passport*, 30 BROOKLYN J. INT'L L. 257, 258 n.8 (2004).

163. Some corporate governance harmonization challenges stem from the fact (as discussed *supra*) that, in some member states, the governance issues center primarily on the ability of the supervisory body, in either the supervisory board (in a two-tier system) or a board of directors (in a unitary system), to hold managers accountable to a relatively dispersed group of shareholders; while, in other member states, issues center around

takeovers. By harmonizing takeover law, the E.U. has furthered its underlying goal of creating a larger union of member states and taking advantage of the economic power and growth that a larger union could generate.[164] After the announcement of a takeover bid, a management board may not take any action outside the ordinary course of business that could prevent the offer from being successful unless it is specifically authorized in a general meeting.[165] In a dual board system, this authorization may be given by the supervisory board—assuming that both boards represent the interests of the company.[166] In other words, the boards have the authority to take action against a hostile takeover if they both agree on the same strategy.[167] The board is to act in the best interest of the corporation,[168] but, because of the different corporate structure that exists in Europe, it may be difficult to determine what the company's best interest is (or even to establish who is entitled to define it), especially during a takeover bid.[169] Unfortunately, there has been no consensus (and therefore no national rules adopted) regulating takeover bids in Europe because of friction—and perhaps national pride.[170] Presently, it appears that only the

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protecting minority shareholders to ensure fair treatment where there is a dominant shareholder, as well as ensuring that a dominant shareholder does not overly influence supervisory and managerial bodies. *See* COMPARATIVE STUDY, *supra* note 1, at 33.

164. *See* Barbara White, *Conflicts in the Regulation of Hostile Business Takeovers in the United States and the European Union*, 9 IUS GENTIUM 161, 181–82 (2003).

165. Viviane de Beaufort, *National Systems or European Harmonization of Corporate Governance? Approach to the Consequences of the Application of Corporate Governance Principles During a Takeover Bid in the European Union*, 1 INT'L J. OF DISCLOSURE & GOVERNANCE 372, 375 (2004).

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *See id.* at 377–78 (discussing failed attempts to achieve consensus in the E.U.). Different countries within the E.U., as a result of feeling invaded by other countries' corporate entrepreneurs, are questioning whether indeed all barriers be removed to allow free flow of productive resources. White, *supra* note 164, at 183. For example, when the French executives, out of their own frustration with the Italians making inroads into ownership of French companies, assisted Societe Generale de Belgique to fend off the hostile Italian entrepreneur De Benedetti's efforts to acquire shareholder control, it became apparent Europeans needed some rules and regulations of takeover activity. *Id.* However, the paradox is that, while in the end, $3 billion (USD)

United Kingdom has an effective takeover regulation.[171] England's openness to hostile takeovers is reflected in its large number of successful takeover bids; in fact, England is the host of 90% of all European takeovers.[172] England's takeovers tend to be governed by market forces rather than private or public regulation.[173] It seems even more apparent national pride and other considerations make it even harder to attain national regulation. By looking at Germany's actions or rationale prior to the European Parliament's failed vote on the E.U.'s directive for regulating hostile takeovers, one can see the goal may be farfetched.[174] Germany implemented takeover legislation in November 2001, basically following the principle of maximizing shareholder value, providing for full disclosure to shareholders and granting the target board some limited power to adopt defensive measures under certain conditions.[175] The E.U.'s proposed measure, which was rejected by Germany because of the E.U.'s strongly-held position that target boards behave neutrally in the face of a hostile bid, was in opposition to Germany's measure of granting the target board the ability to take defensive measures in the face of a hostile bid.[176] Germany's negative vote created a deadlock at the European Parliament in July 2001, in spite of the fact the E.U. draft had adopted fifteen amendments to allow for national differences.[177] Germany nonetheless passed its 2001 legislation, which became

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was spent collectively by all sides in the takeover war; Societe Generale itself was only worth about half that amount, per stock market prices. *See id.* Likewise, this hostile takeover war also made it obvious that the intrinsic nature of the companies in each nation needed to be reexamined, because the structures themselves often prohibited free movements of resources that would assist existing companies in becoming more efficient. *Id.* at 183–84.

171. *See* White, *supra* note 164, at 183.

172. *See* Miller, *supra* note 138, at 60 (citing Mervyn King, *Take-Over Activity in the United Kingdom, in* MERGERS AND MERGER POLICY 99 (James Fairburn & John Kays eds., 1989); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 136 (1993)).

173. *See* Miller, *supra* note 138, at 60.

174. *See* White, *supra* note 164, at 184.

175. *Id.* at 185–87. The measures adopted by the board, if falling within the scope of shareholder authority, must be approved by the current shareholders before the bid is made. *Id.* at 185–86.

176. *Id.* at 185–87.

177. *Id.* at 186–87.

effective in January 2002, with no E.U. takeover directive in force—although a new proposal is being developed.[178] Hence, although shareholder wealth maximization is the most widely-held method for promoting economic growth and efficiency, it is certainly not the only one that will achieve positive economic ends.[179]

V. CONCLUSION

This Article has demonstrated that the European Commission's Action Plan to modernize company law and enhance corporate governance in the European Union apparently has broadly identified the same problems and goals as the United States. In responding to perceived market failure (as depicted by Enron and its progeny), to generate dependable corporate governance, the United States seemingly replaced its traditional reliance on state law, self-regulatory organization rules, and best practice codes with government-mandated uniform requirements (a one-size-fits-all law),[180] with the hope of dealing with and preventing similar corporate governance failure. As a result, the United States moved towards greater regulation (while Europe has been traditionally heavily-regulated domestically) and now is moving away from

178. *Id.* at 187.

179. *Id.* at 190. There is still support for deviations from the perfect shareholder maximization model. *See id.* at 195 n.27 (citing Mark Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251 (2002); Henry Hansmann & Reinier Kraackman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 458 (2001)). In the same vein, some studies have examined differences in economic structure: the degree of shareholder diffusion compared with concentrated controlling blocks, the liquidity of the country's securities markets, and the country's relationship to ownership concentration. *Id.* at 192. Other studies examined the difference in corporate governance: the role of shareholders in the decision-making process, the role of financial intermediaries, and the role that unions play. *Id.* Yet others look at the political and governmental institutions: the impact of E.U. activities, the reach of U.S. laws abroad, different countries' regulations of takeover, or the impact of the law itself in providing protections and disruptions. *Id. See id.* at 191–94 (providing more citations and discussion on the issue).

180. Greene & Boury, *supra* note 11, at 31. The passing of SOX signals a move away from reliance on marketdriven rule-creating mechanisms towards legislative rule-creation and, accordingly, towards greater government involvement and increased centralization. *See id.*

prescriptive, national legislation in corporate governance and attempting to embrace a more uniform law. Unfortunately, this adoption of a uniform approach to corporate governance has been hampered by inherent factors, such as different corporate governance structures among member states. For example, the European Commission, in its Action Plan, acknowledged the virtual impossibility of creating a single E.U. corporate governance code, and instead opted to rely on disclosure as a tool to promote good corporate governance; and on a substantive level, the E.U. sought only to adopt a common approach covering a few essential rules.[181]

In other words, as with SOX (which required compliance or, failing this, disclosure as to why a corporation is unable to so comply), the E.U. approach to corporate governance is one of self-regulation by corporate governance codes; public companies then reveal whether or not they are in compliance.[182] As such, companies are expected to make an annual statement disclosing compliance or explaining their failures to comply with national codes of corporate conduct.

Does this mean corporate governance systems between the United States and the European Union are following converging trends? If so, one would expect this to be even more obvious with the extraterritorial application of SOX to foreign companies registered on the U.S. stock markets.[183]

It is worth noting that the E.U. initiatives (at various stages of adoption and implementation) also have the potential to create new, significant regulatory obligations for both E.U. and non-E.U. companies, such as the United States.

However, an expected convergence is not necessarily the case within Europe, where the diversity of firm structures, the fragmentation of political and economic power, the role of employees in corporate governance in some states, the primacy of shareholder interests, the rights of minority shareholders,

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181. *See id.* at 32–33.

182. *See* Karmel, *supra* note 9, at 887–88.

183. Greene & Boury, *supra* note 11, at 33. Like the United States, the European corporate governance codes emphasize the need for effective separation of managers and supervisors, including a prohibition on a company's CEO also serving as its chairman. *Id.* at 32.

board structures, and relationships between management and supervisory body all differ so greatly and consequentially that no common system is apparent or likely to emerge.[184] Logically, it follows without uniform corporate governance in Europe, a substantive convergence between the United States and Europe is unlikely,[185] leaving the somewhat amicable option of recognizing each other's systems as the best way forward. Mutual recognition is ideal, as no system is assumed to be optimal; each is accepted as equally valid, subject to its compliance with certain core principles.[186]

Overall, therefore, the spate of new legislation and regulation on both sides of the Atlantic underscores the need for U.S. and European business communities to work together for their common good. Cooperation, therefore, should no longer be a matter of courtesy, but rather, obligation. This does not mean the business communities will have to adopt an identical approach; instead, they should agree to make their different approaches mutually consistent and effective in achieving the same goals. A very good example of this approach is the converging of International Accounting Standards and U.S. Generally Accepted Accounting Principles (GAAP).[187]

Regardless of which side of the Atlantic one is referring to, it is undoubtedly true corporate governance has drawn tremendous attention in light of a growing consensus that an effective corporate governance system may be a crucial precondition for a thriving and sustainable market economy.

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184. *See* Cadilli, *supra* note 70 at 817 (observing that these differences cause the European Union hardships when promulgating common standards for corporate transactions and behavior).

185. Greene & Boury, *supra* note 11, at 33. One impediment to complete convergence is explained by the philosophical approach to governance regulations, with a distinction being made between: 1) a principlesbased approach to governance, one in which guidelines are clear, but compliance with them is voluntary; and 2) a lawbased or rule-based approach to governance, where the legislation, regulations, and stock exchange listing requirements relating to governance are very detailed. *See* Garrett, *supra* note 62, at 149.

186. Greene & Boury, *supra* note 11, at 33. Mutual recognition is said to be ideal because it would allow capital-market unification without requiring burdensome legal unification, a process that would generate unacceptable costs, as exemplified by the extraterritorial application of SOX. *Id.*

187. *See* Cardilli, *supra* note 71, at 820.