

2005

## Comment: Fiduciary Responsibilities under the Sarbanes-Oxley Design

Gordon S. Kaiser Jr.

Follow this and additional works at: <https://scholarlycommons.law.case.edu/caselrev>



Part of the [Law Commons](#)

---

### Recommended Citation

Gordon S. Kaiser Jr., *Comment: Fiduciary Responsibilities under the Sarbanes-Oxley Design*, 55 Case W. Res. L. Rev. 627 (2005)  
Available at: <https://scholarlycommons.law.case.edu/caselrev/vol55/iss3/13>

This Symposium is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

# COMMENT: FIDUCIARY RESPONSIBILITIES UNDER THE SARBANES-OXLEY DESIGN

Gordon S. Kaiser, Jr.<sup>†</sup>

I think perhaps because I come from the simple world of private practice, just a business lawyer, I view some of the issues we've been talking about a bit more simplistically than Professors Macey<sup>1</sup> and Fisch<sup>2</sup>. I have in response to what they have said, three or major points. The first issue is the view of Federalism that we've been hearing about, and how Elliot Spitzer's recent activities<sup>3</sup> play into that. There has been a suggestion that Congress and the SEC will be forced to respond to Spitzer's activity, particularly as it relates to the regulation of the financial services industry and capital markets industry. In a sense, I think that the congressional and SEC response so far amounts to the tail wagging the dog. What is going on with Mr. Spitzer is an interesting phenomenon, and he certainly has had significant impact on the financial services industry. But, that is not the corporate governance movement that I deal with day-to-day. That is not what has been affecting board rooms of publicly held companies. The closest Elliot Spitzer has gotten to board governance has been his activity regarding the compensation package for Dick Grasso, the former head of the New York Stock Exchange, as Professor Fisch pointed out, in order to address that issue, Spitzer had to reach to the fiduciary duties outlined in the criminal sections of the nonprofit cor-

---

<sup>†</sup> Partner, Squire, Sanders & Dempsey L.L.P., Cleveland, OH, J.D., Case Western Reserve University School of Law; B.A., Baldwin-Wallace College. The views expressed in this commentary are solely those of the author and do not necessarily reflect those of Squire, Sanders, & Dempsey L.L.P or its clients.

<sup>1</sup> Jonathan Macey & Maureen O'Hara, *Stock Transfer Restrictions and Issuer Choice in Trading Venues*, 55 CASE W. RES. L. REV. 587 (2005).

<sup>2</sup> Jill E. Fisch, *Institutional Competition to Regulation Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617 (2005).

<sup>3</sup> Fisch, *supra* note 2, at 620.

poration statute. These are principles that simply are not applicable to day-to-day corporate life.

Mr. Spitzer has not tried to attack in any significant way the corporate governance issues that Sarbanes-Oxley<sup>4</sup> addresses. Sarbanes-Oxley is a congressional and federal reaction to the failure of states to effectively implement a watchdog mechanism on management of the publicly held companies. The problems that gave rise to Enron, Adelphia, Tyco, Worldcom, and all the rest, were the result of a failure by watchdogs, the checks on management, that the investment community and the public were in place.

Those watchdogs certainly included boards of directors. Boards of directors were governed in that watchdog function, primarily—maybe even exclusively—by fiduciary duty relationships that arise from state law. The watchdogs' fiduciary duty really didn't derive, in any significant way from the federal securities laws. In fact, Congress had established pretty clearly that the federal securities laws were to be limited to disclosure-related issues prior to Sarbanes-Oxley.

While it's true that Commissioner Campos certainly discussed corporate governance,<sup>5</sup> he also tried to color that discussion in terms of supporting additional disclosure activity. What he said was that, in putting out regulations that relate to how corporations act internally, the SEC and Congress were attempting to further or to improve financial disclosure. I do not think improved disclosure is the primary motivator for the federal legislature and regulatory activity we have seen since 2002. I do not think that is what Sarbanes is primarily about.

Sarbanes-Oxley really represents a huge step, a watershed event, in terms of the federalization of corporate law. It is akin to what happened to regulation of the capital markets in the 1930s, with the passage of the 1933 and 1934 Acts. In the same way that those Acts ultimately overpowered the state regulation, state takeover laws notwithstanding. Sarbanes-Oxley is the first step in what will be, for publicly held companies, the federalization of corporate governance principles in general. While that can be scary to people who still believe in states' rights, or who perhaps, more accurately, like the control they have over state legislatures; I, for one, think Sarbanes-Oxley is probably a good thing.

That leads me to my second point. The title of this symposium is "Directors Versus Shareholders." I think this is an inappropriate jux-

---

<sup>4</sup> Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 STAT. 745 (2002).

<sup>5</sup> Roel C. Campos, *Remarks of SEC Commissioner Roel C. Campos*, 55 CASE W. RES. L. REV. 527 (2005).

taposition. I do not believe that the primary tension is between directors and shareholders; I think that the focus of governance activity is on the tension between a number of different groups and management. One of the main goals of Sarbanes-Oxley, one would hope, is a better alignment between director interest and shareholder interest, as well as a better alignment between the interests of some other constituents, including professional advisors, the regulatory authorities, and shareholders. In that sense, there really isn't an increased tension between directors and shareholders, but rather a more closely aligned interest between them.

The key to this greater alignment of interests lies in trying to find ways for management, directors, and professional advisors to publicly held companies to be more effectively held accountable for the fiduciary responsibilities they each have.

I do not think that anything we have talked about has really changed the fundamental fiduciary responsibility of each of those parties. Instead, the question should be focused on how we go about enforcing those fiduciary responsibilities. What kind of checks and balances do we have in place that will ensure those fundamental fiduciary duties are working?

Sarbanes-Oxley did a lot to increase accountability, at least from the standpoint of the directors and the accounting world. Perhaps more importantly, Sarbanes-Oxley also increased what directors and the accounting world perceived to be their accountability.

For accountants, the perception is also the reality. They need look no further than Arthur Anderson for a very unpleasant example of how accountable they can be held in the marketplace for failure to act in appropriate ways.

The directors, are also taking their responsibilities very seriously. While it may have been true in many corporations ten years ago or even five years ago that some, or maybe even a fair number of boards and directors, viewed themselves as very much aligned, or even the handmaidens of management; that is not the way boards of directors are looking at it today.

I have seen a real change in every board room I have been in during the last two years. I advise a number of boards of publicly held companies, and I talk to a lot of other board members. Directors are taking their roles much more seriously from a variety of standpoints.

While all of the principles encompassed in the new regulatory framework adopted by the stock exchanges and embodied in Sarbanes-Oxley, have had significant impact. Two of the changes have had particularly strong impact on how some boards operate. The first

one, which resulted in perhaps the biggest single change I saw in several boards, is the stock exchange requirement that boards meet on a regular basis in an executive session—that is, meeting without the CEO in the room. This requirement goes in part to the question of whether or not boards really are under the thumb of management or the CEO, and whether they can continue to stay that way. Most of the boards I work with actually hold executive sessions at every meeting. This practice has had a tremendous impact on how they communicate with one another and what they focus on as major issues: very bright, very well-meaning, very good directors behave differently when the CEO is in the room than they do when he or she is not there.

The other requirement I want to touch on concerns the requirement that the nomination committee be comprised of all independent directors. For some companies, this was a major change because if they had a nomination committee, it was frequently one that didn't act in a truly independent fashion. I believe that the combination of the perceived sense of director accountability in the performance of fiduciary duties and the responsibility for the nomination process in an executive session context will ultimately have a significant impact on how directors behave in the nomination process.

It will not be easy for any CEO under these circumstances to have an effective across-the-board control of the nomination process. Even if you have a CEO that shareholders believe is doing a good job and performing well, the nomination process will come down to who comprises the nomination committee. Directors will listen to the CEO, and while they may not listen or heed the CEO's advice all the time, it is going to be an important factor, when he or she has a nominee. However, selection of director nominees ultimately will depend on whether the committee feels that the CEO's nominee is a person the directors can work with, and whether the committee believes that the addition or maintenance of that person is going to be disruptive to the company.

The last point I want to make has to do with some of the other constituencies that failed in the watchdog role. In the scandals that came out of the late 1990s, many constituencies other than directors and accountants failed at least by omission, if not commission. Those constituencies include professional advisors other than accountants, and particularly includes lawyers.

The SEC has backed away somewhat from some of the harsher penalties and rules proposed for lawyers. I do not think that they have quite figured out who should be held responsible. To be honest, I have not figured it out either. However, what I do know is that, in

virtually every one of the major failures—Enron and Adelphia, for example—there were lawyers in the room. All of these companies had general counsel. They had outside law firms involved in a lot of their transactions, and in many cases, outside counsel came from very reputable firms. These were not cases of companies being advised by people who were not experienced or qualified practitioners. Yet, there was still a failure of the process. It might not have been as direct a failure as the accounting profession engaged in, but it was a failure nonetheless.

Lawyers are not the only ones who have yet to catch the real focus of legislative and regulatory change. I suspect that eventually, the focus will be more on lawyers, financial advisors, and some of the financial institutions that participated in those transactions.

I wish I had a good solution to the legal problems. I think that the noisy withdrawal plan of the SEC did more damage than good in terms of ensuring the fidelity of the relationship with our clients. I do not think you can be a good counselor if the essential basis of your relationship with your client is fear. That simply does not work. There must be another solution for this problem, and I believe that it is imperative that we find it sooner rather than later.

