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Whistleblowing and the Public Director: Countering Corporate Inner Circles

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There have been startling cases of corporate fraud, self-dealing, and mismanagement, particularly among Chief Executive Officers ("CEOs"), Chief Financial Officers ("CFOs"), and other top executives of publicly traded firms. The scandals include executives at Enron, WorldCom, Global Crossing, Qwest, Adelphia, Dynergy, Tyco, Xerox, Vivendi, Sprint, and HealthSouth.[1] In these cases rarely, if ever, did a member of a company's board of directors, even an independent director (the director with no ties to the company, who has long been touted as the panacea for corporate governance reform),[2] identify the

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1 *See, e.g.*, Task Force on Corp. Resp., Am. B. Ass'n, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 BUS. LAW 189 (Nov. 2002) (listing various corporate scandals) [hereinafter *ABA Report*]; John A. Byrne, *Restoring Trust in Corporate America*, BUS. WK., June 24, 2002, at 30; *Capitalism and its Troubles*, THE ECONOMIST, May 18, 2002 (special insert dealing with scandals in U.S. corporations). For a harsh summary of the scandals and those who profited from them, by a securities lawyer who often represents shareholders, see William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders, the Rise of a New Corporate Kleptocracy*, 8 STAN. J.L. BUS. & FIN. 69 (2002).

2 *See generally* Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996). In discussing the implications of Enron, Vice Chancellor Strine of the Delaware Chancery Court observes that the scandal has greatly undermined the legal basis for the role of independent directors in corporate governance by showing how hollow that

wrongdoers at an early stage. Rather, many board members, if not active or indirect participants in a scandal, passively went along with the wrongdoing, were blind to it, resisted its uncovering, or intervened only when disaster had already struck their firm.[3]

The outside advisors of the scandal-ridden firms performed no better. Investment bankers, stock analysts, accountants, and lawyers, as well as corporate service professionals such as proxy and publicity firms, did little to detect problems or call executives to account for questionable transactions.[4] Instead, as sycophantic

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concept is, given all the ties that these directors have with management and how little time they give to their position. *See* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1374-95 (2002).

[3] A good example of passiveness is Enron's board. *See* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON GOV'T AFF., 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (Comm. Print 2002), *available at* http://news.findlaw.wm/hdocs/docs/enron/senpsi70802rpt.pdf.

> The Subcommittee investigation did not substantiate the claims that the Enron Board members challenged management and asked tough questions. Instead, the investigation found a Board that routinely relied on Enron management and Andersen representations with little or no effort to verify the information provided, that readily approved new business ventures and complex transactions, and that exercised weak oversight of company operations. The investigation also identified a number of financial ties between Board members and Enron which, collectively, raise questions about Board member independence and willingness to challenge management.

Id. at 14. *See also* William C. Symonds, *Tyco: How Did They Miss a Scam So Big?*, BUS. WK., Sept. 30, 2002, at 40 (describing "seemingly willful blindness" of Tyco board members in failing to discover Tyco's accounting scandal).

[4] The U.S. Senate noted that the Enron fraud was the work of highly educated professionals such as accountants and lawyers.

> The alleged activity Enron used to mislead investors was not the work of novices. It was the work of highly educated professionals, spinning an intricate spider's web of deceit. The partnerships—with names like Jedi, Chewco, Rawhide, Ponderosa and Sundance—were used essentially to cook the books and trick both the public and federal regulators about how well Enron was doing financially. The actions of Enron's executives, accountants, and lawyers exhibit a "Wild West" attitude which valued profit over honesty.

S. REP. NO. 107-146, at 2-3 (2002); *see also ABA Report*, *supra* note 1, at 7 ("[I]t is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover—and sometimes actually condone or contribute toward the creation of—the grossest of financial manipulations and fraud."). To this list of the culpably inactive should be added corporate compensation consultants, who invariably justified the high pay packages for the CEO and other top executives in a given company. *See* Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI.

cheerleaders of top executives and companies during the bubble of the late 1990s, they were often active participants in the fraudulent behavior or acquiesced in it. Moreover, they generally denied responsibility and blamed others when a scandal emerged.[5]

L. REV. 751, 789-91 (2002). *But see* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 61-67 (2003) (disagreeing that rent seeking by managers resulted in the high managerial stock options and attributing this to board misperception of the true economic costs of options).

[5] Professor Hrishikesh D. Vinod amusingly summarizes how so many individuals involved in Enron deny responsibility for the scandal. *See* Hrishikesh D. Vinod, *Winners and Losers in Multiple Failures at Enron and Some Policy Changes* (Apr. 9, 2002), *available at* http://www.ssrn.com. For example, David Bushnell, Citigroup Managing Director, said the following:

> But, let me be clear, while we regret our relationship with Enron, we acted in good faith at all times. Our employees, including the bankers who are here today, are honest people doing honest business. They did transactions that were common throughout Wall Street, and they believed those transactions were entirely appropriate.

Hearings on the Role of the Financial Institutions in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Gov't Aff., 107th Cong. 3 (2002) (statement of David Bushnell). Similarly, the Managing Director of J.P. Morgan Chase stated,

> It is our understanding that Enron recorded these transactions on its balance sheet; in other words, they were not "off balance sheet" transactions. As stated earlier, however, the manner in which Enron accounted for these transactions on *its* books of account and in *its* financial statements was a matter for Enron and *its* management and auditors.

Hearings on the Role of the Financial Institutions in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Gov't Aff., 107th Cong. (2002) (statement of Jeffrey W. Dellapina, Managing Director, J.P. Morgan Chase Bank). Of course, the denials do not always prove accurate, as the conviction and bankruptcy of Enron's outside accounting firm, Arthur Andersen, has shown. *See* Jonathan Weil et al., *Auditor's Ruling: Andersen Win Lifts U.S. Enron Case—Shredding Wasn't Factor in Verdict, Jurors Say, A Single E-Mail Was*, WALL ST. J., June 17, 2002, at A1. For example, Robert Roach stated,

> Numerous major financial institutions, both here and abroad, engaged in extensive and complex financial transactions with Enron. The evidence we reviewed showed that, in some cases, the financial institutions were aware that Enron was using questionable accounting. Some financial institutions not only knew, they actively aided Enron in return for fees and favorable consideration in other business dealings. The evidence indicates that Enron would not have been able to engage in the extent of the accounting deceptions it did, involving billions of dollars, were it not for the active participation of major financial institutions willing to go along with and even expand upon Enron's activities. The evidence also indicates that some of these financial institutions knowingly allowed investors to rely on Enron financial statements that they knew or should have known were misleading.

Statement of Robert Roach, Chief Investigator, *Hearings on the Role of the Financial Institutions in Enron's Collapse Before the Permanent Subcomm. on Investigations of the S. Comm. on Gov't Aff.*, 107th Cong. (2002). *See also infra* notes 32-40.

It is particularly ironic that today the same kinds of corporate advisors are profiting from the investigations, clean-up, and restructuring of firms undertaken because of the corporate scandals.[6] Nor are the members of the business media, who adulated CEOs in the 1990s and rarely conducted any hard-nosed investigation of the problem firms, without blame.[7]

In contrast to the behavior of executives, board members, and professional advisors was that of the corporate "whistleblower," the person who revealed the company's problems.[8] The whistleblower often worked with or was close to, but not in, the "inner circle" of top executives or board members. This individual's revelation of the problem or scandal, whether to others inside the firm or to someone outside it, usually met with resistance by members of the inner circle, who first denied any problem and treated the whistleblower with hostility, trying to demonize, expel, punish or, at least, isolate him.[9]

There is thus a list of whistleblowers that roughly corresponds with the list of corporate scandals. Sherron Watkins, who ex-

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[6] *See* Dan Carney, *Worldcom: A Gift to the Lawyers*, BUS. WK., Aug. 12, 2002, at 8 (describing how lawyers and bankers are profiting from WorldCom bankruptcy); Richard B. Schmitt, *Lawyers' Growth Industry: Corporate Probes for Lawyers*, WALL ST. J., June 28, 2002, at B1 (describing how law firms are profiting from corporate scandals). For a criticism of the role of lawyers in Enron's scandal and the profit lawyers are making from working on the scandals, see Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9 (2002).

[7] *See, e.g.*, David Rocks, et al., *What It Will Take to Win*, BUS. WK., Oct. 18, 1999, at 36 (celebrating strategy of Bernie Ebbers of WorldCom). *But see* AMY P. HUTTON, THE ROLE OF SELL-SIDE ANALYSTS IN THE ENRON DEBACLE 6 (Tuck Sch. Bus. Working Paper No. 03-17, 2002) (citing early warnings about Enron provided in the financial press).

[8] *See* C. FRED ALFORD, WHISTLEBLOWERS: BROKEN LIVES AND ORGANIZATIONAL POWER 17 (2001) (citing a definition of whistleblower as "one who (1) acts to prevent harm to others, not him or herself, (2) trying first to rectify the situation within the framework provided by the organization, (3) while possessing evidence that would convince a reasonable person") (citing MYRON PERETZ GLAZER & PENINA MIGDAL GLAZER, THE WHISTLEBLOWERS 4 (1989)).

[9] There is rich literature on the typical harsh treatment that a whistleblower can expect. *See* Elletta Sangrey Callahan & Terry Morehead Dworkin, *Who Blows the Whistle to the Media, and Why: Organizational Characteristics of Media Whistleblowers*, 32 AM. BUS. L.J. 151, 165 (1994) ("When a practice [in an organization] is questioned, there is commonly a tendency to respond with "retrospective rationality" and a marshalling of forces to justify the challenged decisions. The flow of information may be restricted, and there may be attempts to "kill the messenger." The wrongdoer's success in resisting change, suppressing information, and retaliating depends on his organizational influence.") (citations omitted). On the problems suffered by whistleblowers, see generally TERANCE D. MIETHE, WHISTLEBLOWING AT WORK 73-78 (1999).

posed Enron's enormous fraud, might be the most famous contemporary corporate whistleblower.[10] Also notable is Cynthia Cooper, the head of internal accounting for WorldCom, who, aided by her team of internal auditors, first identified the accounting fraud in the company and revealed it to government investigators, even though Scott Sullivan, the CFO and her boss, initially encouraged her not to report, or at least to delay reporting, her findings.[11] Other whistleblowers include James Bingham, a relatively senior executive in the Xerox finance department, who years ago identified Xerox's false accounting and was rewarded with constant stonewalling by the company and eventual dismissal.[12]

As suggested above, a stark contrast exists between the fate of those in a corporation's inner circle and the whistleblowers. For the most part,[13] while it remains to be seen what, if any, punishment awaits the top executives of the scandal-ridden firms, they,

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[10] *See generally* Tom Hamburger, *Questioning the Books: Enron Memo Shows Watkins Urged Lay to Restate Earnings*, WALL ST. J., Feb. 14, 2002, at A8 (describing efforts of Watkins to reveal problems with Enron to CEO Kenneth Lay). Even before Watkins' revelations, John Olson, a securities analyst with Merrill Lynch, first spotted problems in the company, but Merrill, which wanted to maintain its business relationship with Enron, fired him. *See* Charles Gasparino & Randall Smith, *Ties to Enron Before Congress: Yet a Veteran Analyst's Perspective on the Firm's Dealings Shows Pressure from Major Clients Existed*, WALL ST. J., July 31, 2002, at C1 (describing Enron's pressure on Merrill analyst John Olson).

[11] *See* Susan Pulliam et al., *Prosecutors Gain Key Witness in Criminal Probe of WorldCom*, WALL ST. J., July 3, 2002, at A1 (describing the discovery of WorldCom fraud by auditor Cooper and her internal efforts to have the problem addressed); Susan Pulliam & Deborah Solomon, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1 (describing the story of how Cooper and her team unearthed the WorldCom accounting fraud and tracked it through company accounts despite some resistance from executives engaged in the fraud). *See also House Comm. on Energy and Commerce*, WorldCom internal documents, *available at* http://energycommerce.house.gov. *But see* Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, at 188-90, *In re* WorldCom Inc., No. 02-15533 (Bankr. S.D.N.Y. June 9, 2003) [hereinafter 2nd Thornburgh Report] (describing history of WorldCom's internal audit department and effort to make it a profit center for the firm, rather than a policeman, and the department's limitations in failing to discover the scandal earlier). Watkins and Cooper are often discussed with a government whistleblower, FBI agent Coleen Rowley, who revealed that the FBI had information that should have put it on notice of the terrorist threat prior to September 11, 2001. *See How the FBI Blew the Case*, TIME, June 3, 2002, at 24.

[12] *See* James Bandler & Mark Maremont, *Seeing Red: How Ex-Accountant Added Up to Trouble for Humbled Xerox*, WALL ST. J., June 28, 2001, at A1 (describing saga of James Bingham's whistleblowing of accounting deception at Xerox and the troubles that he endured).

[13] Some professionals have suffered as a result of their inaction in scandals. *See,*

board members, and outside professionals deny involvement in the scandals and generally walk away with relatively little injury.[14] The whistleblowers, who have the company's interests most at heart,[15] are rarely forgiven by their firm,[16] or even by corporate America, and they spend their lives in misery, shunned by employers. For example, Watkins's revelation of fraud in Enron led the company initially to consider, with advice of outside counsel Vinson & Elkins, whether and how to fire her.[17]

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e.g., John A. Byrne, *Fall from Grace*, BUS. WK., Aug. 12, 2002, at 50, 51-56 (describing the destroyed career of Joseph Berardino, former CEO of Arthur Andersen).

[14] The civil liability of those in Enron's inner circle, particularly Enron's board members, is currently an issue in securities fraud litigation. *See In re* Enron Corp. Sec., Derivative Litigation & "ERISA Litig.," 258 F. Supp. 2d 576 (S.D. Tex. 2003) (dismissing Section 10(b) claims against outside Enron directors and allowing Section 11 claims against them to proceed). A major problem with securities lawsuits against directors and outside professionals is that the major antifraud suit under Section 10(b) of the Securities Exchange Act of 1934 requires a showing of scienter on the part of the defendant, and pleading standards require particularized pleading of scienter. It is difficult for a plaintiff to articulate adequate facts at the pleading stage that directors or advisors knowingly committed securities fraud (or were reckless in their behavior). *See* Lerach, *supra* note 1, at 76-77. For criminal convictions, see *infra* notes 33, 37.

[15] *See* Callahan & Dworkin, *supra* note 9, at 166-67 (describing typical whistleblower motives).

[16] For example, Xerox fought the unjust dismissal suit against James Bingham. *See* James Bandler & Barbara Martinez, *For Fired Xerox Staffer, a Measure of Triumph*, WALL ST. J., Apr. 2, 2002, at A4. Scholars observe that state statutes designed to protect whistleblowers generally offer little protection for a whistleblowing employee because at-will employment laws favor employers. *See* Cynthia L. Estlund, *Wrongful Discharge Protections in an At-Will World,* 74 TEX. L. REV. 1655, 1655-56 (1996) (observing that an employee has the burden of proof under most statutes designed to protect whistleblowers and that the employer, in dealing with an at-will employee, can fire someone for no reason or for a silly reason, so long as it is not for an improper reason). *See* also Terry M. Dworkin & Janet P. Near, *Whistleblowing Statutes: Are They Working?*, 25 AM. BUS. L.J. 241 (1987).

[17] *See* S. REP. NO. 107-146, *supra* note 4, at 5:

> For instance, a shocking e-mail from Enron's outside lawyers to an Enron official was uncovered. This e-mail responds to a request for legal advice after a senior Enron employee, Sherron Watkins, tried to report accounting irregularities at the highest levels of the company in late August 2001. The outside lawyer's [sic] counseled Enron, in pertinent part, as follows: "You asked that I include in this communication a summary of the possible risks associated with discharging (or constructively discharging) employees who report allegations of improper accounting practices: 1. Texas law does not currently protect corporate whistleblowers. The supreme court has twice declined to create a cause of action for whistleblowers who are discharged." In other words, after this high level employee at Enron reported improper accounting practices, Enron did not consider firing Andersen; rather, the company sought advice on the legality of discharging the whistleblower. Of course, Enron's lawyers would claim that they merely

I argue that the contrast between the behavior of the executives, board members, and corporate advisors who were reluctant to challenge the corporate misbehavior, and the small number of corporate whistleblowers who did, points to a disturbing social psychological reality that has been overlooked in the discussion and reforms addressing the corporate scandals: namely, a group dynamic that binds group members together and blinds them to their failings and abuses. This social psychological reality is extremely powerful, for not only does it prevent members of an inner circle from seeing the impropriety of the circle's behavior, but it also focuses them on the promotion of the group and group members. Its power is particularly demonstrated by the group's extreme negative reaction to the whistleblower, even if the whistleblower's assessment of a situation is correct, for he threatens the group's shared viewpoint and its very existence.[18]

I contend that this social psychological reality, long known to and studied by social psychologists, is a basic cause of the corporate scandals; only it can convincingly account for why so many respected executives, board members, bankers, and trained professionals participated in improper corporate action or turned a blind eye to it.[19] I further argue that, because corporate reformers have not recognized this reality, their reforms will be largely ineffective.

In Part I, I review the corporate scandals and the evidence of the social psychological phenomenon of the inner circle in them. I next explain how social psychological theories such as "groupthink" and the group production of evil account for why

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provided their client with accurate legal advice—there is no protection for corporate whistleblowers under current Texas law.

When Watkins tried to warn Enron CEO Kenneth Lay about the accounting fraud in his company, the same Vinson & Elkins, which had been instrumental in implementing the transactions on which the fraud was based, produced a self-serving review in which it found the transactions were proper. Watkins has now formed a firm that does corporate governance audits of companies, partly because she worries that most employers would be reluctant to hire a whistleblower. *See* Wendy Zellner, *Can She Whip the Rest of 'em Into Shape?*, BUS. WK., Aug. 5, 2002, at 14.

[18] It has of course long been known to social psychologists and socially-minded economists that groups impose restrictions on their members, who then come to embrace the group and generally adopt a negative attitude towards group outsiders. *See generally* ROGER BROWN, SOCIAL PSYCHOLOGY 551-63 (2nd ed. 1986).

[19] *See* Donald C. Langevoort, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1146-49 (2003) (attributing the scandals to the delusions of executives, board members, and advisors as to the economic reality of their businesses, delusions sustained by their belief that accounting was too old-fashioned to capture new businesses).

corporate inner circles behaved improperly. I also allude to evolutionary biological theories on group behavior, which complement the social psychological theories by explaining how compelling and, at times, irresistible inner circle membership is to an individual. The social psychological and evolutionary theories also help account for the harsh reaction of groups to whistleblowers and even the general uneasiness towards these individuals that people seem to share.

In Part II, I highlight several prominent corporate reforms addressing the corporate scandals. In particular, I look at the reform proposals of advisory groups on corporate governance, such as the Business Roundtable, and of self-regulatory organizations, such as the New York Stock Exchange. I argue that the reforms these groups propose are incomplete and will prove ineffective because their drafters fail to recognize the role of the inner circles in the scandals. I also suggest how social psychology may even explain why members of the reform groups cannot see the group aspect of the corporate scandals.

In Part III, I offer a reform, inspired by social psychological theory, that would help prevent future corporate scandals. Like many other corporate governance scholars, I argue that board behavior must change, and my focus is to keep boards from falling under the domination of an inner circle. I propose requiring public companies to have a significant minority of "public" directors who would be selected for shareholder election to boards from a group of individuals identified by a new government oversight board and whose basic goal would be to oppose and monitor a firm's inner circle. The oversight board would also provide training, establish general compensation guidelines, and monitor and review the public directors' board service. Since I assume that many existing board directors—who come from a few specific backgrounds and compose an elite—are particularly prone to joining inner circles, I argue that public directors should initially be drawn from outside this elite. I contend that the importance of investment in public companies, instead of in bank deposits, for most ordinary Americans justifies this ambitious reform. I then explain how the provisions in the Sarbanes-Oxley Act of 2002[20] and the implementing regulations of the Securities and Exchange Commission ("SEC") that deal with board prac-

[20] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

tices can be understood as an implicit, but imperfect, effort to create an oppositional attitude among board members and their advisors that would counter the rise of inner circles and their groupthink. I also argue that the reforms' inadequate grounding in social psychology will limit their effectiveness.

I

SOCIAL PSYCHOLOGY AND THE CORPORATE SCANDALS

Group psychology both leads executives, board members, and corporate advisors to form cohesive groups and blinds them to their collective faults and to those of group members. In many cases, it encourages them to pursue group and individual interests at the expense of outsiders, who are generally shareholders, bondholders, employees, customers, and others who deal with the firm and who, not being members of the inner circle, are not recognized by group members as individuals deserving of much care and attention. This inner circle phenomenon is at the heart of the United States corporate scandals and is so powerful that it sweeps within groups even people who would otherwise seem natural outsiders, including members of minority groups, academics, and representatives from nonprofit organizations.[21] It is necessary, once and for all, to acknowledge the power of this social psychological reality in the corporate executive suite and boardroom so as to begin to formulate strategies to address it effectively.

In this Part, I first explore the anecdotal evidence that the inner circle was a major cause of the corporate scandals. I then review the social psychological literature that explains how and why these groups are formed and how their focus on self-perpetuation and self-interest can lead to misbehavior and downright evil. In particular, I discuss the phenomenon of "groupthink,"

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21 *See, e.g.*, David Bank & Joann S. Lublin, *Giving at the Office: On Corporate Boards, Officials from Nonprofits Spark Concern*, WALL ST. J., June 20, 2003, at A1 (discussing how corporate board members drawn from executives at nonprofit organizations may be influenced by corporate donations to their organizations); Tom Hamburger & John Harwood, *Inside Deal: How Union Bosses Enriched Themselves on an Insurer's Board*, WALL ST. J., Apr. 5, 2002, at A1 (discussing self-interest by union presidents on the board of directors of a privately owned insurance company that supplied life and health insurance benefits to union members); Joanne S. Lublin, *Link to Enron Fuels Protest at Lockheed*, WALL ST. J., Apr. 24, 2002 at B1 (discussing efforts to oust Frank Savage, notable African-American financier).

whereby group members become uniform in their views and see only the positive about group attitudes and behavior, and discipline any member who does not stand uniformly behind the group's perspective. I next highlight a complementary evolutionary biological explanation of the inner circle phenomenon, which helps explain its constant appearance and force. More specifically, I point out how certain behavior, which helps bind together groups and which is hard-wired in us, has disastrous consequences in corporate decision-making circles because it undermines critical, rational thinking on the part of the circle's members, and because it promotes inappropriate behavior on the part of the circle's leader.

A. Group Misbehavior

A popular explanation of why so many corporate scandals occurred in the last few years[22] is the politically soothing reply that, because the 1990s was a period of great wealth and even excess, it was inevitable that some "bad apples" were able to assume important positions in firms.[23] These dishonest executives were revealed when the business cycle in their industries, as in telecommunications, turned downwards.[24] If this perspective is taken, no fundamental reform is needed of U.S. corporate governance—the power relations among owners, managers, and supervisors in the giant firms that possess so much of our nation's wealth. This political response is reinforced by a basic psychological tendency (which often produces cognitive errors) for peo-

[22] There is no question that there has been a marked increase in corporate scandals during the 1990s and early 2000s. *See* GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO-03-138, at 4-9 (2002) (summarizing data on the increase in financial restatements in period 1997-2001); GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENT DATABASE, GAO-03-395R (2003) (providing data about restatements from individual companies).

[23] *See* Langevoort, *supra* note 19, at 1141-42 (pointing out that this reaction is essentially conservative since it attempts to isolate the "rogues" and not to address structural problems with the power of managers, board members, or corporate professionals); *see also* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 19-20 (2002) (noting that those engaged in corporate scandals did not try to flee and were prominent members of the corporate elite with good reputations and thus not rogues).

[24] *See* Shane A. Johnson et al., *Executive Compensation and Corporate Fraud* 30 (2003) (drawing certain conclusions from the data, including that fraudulent firms had significant slowdowns in the year before the fraud began, were in slowing industries, and had executives with particular financial incentives to commit fraud), *available at* http://ssrn.com/abstract=395960.

ple to attribute all misbehavior to bad individuals.[25] The reasonable remedy is thus to have the appropriate authorities prosecute those responsible for the scandals, which will put fear into all executives and will help prevent future scandals.[26]

The problem with this view is, first, that it fails to explain adequately why so many scandals emerged at this time. Although members of the "Baby Boom" and "Generation X" generations that provided the players in the scandals are known more for rampant materialism (how else to account for the Hummer?)[27] than for self-sacrifice, it would be astounding, and indeed unlikely as a statistical matter, if for no systemic reason, current top executives, board members, and corporate advisors happened to include many flawed individuals. Second, the simplistic greed answer does not take account of the fact that the scandals were always the result of group, as well as individual, actions. If, therefore, the scandals have a properly social psychological cause or explanation, which would not be at all surprising since human beings are social by nature, the effort to explain the scandals by reference to individual failings and the scapegoating of a few well-known executives (like Martha Stewart)[28] are misguided and may not always be fair to the individuals who are singled out for punishment.

Indeed, the available evidence about the corporate scandals shows that, by and large, the transgressions were more a group than an individual problem.[29] Often a group or "inner circle" of top executives and advisors (and sometimes board members)

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[25] *See* John M. Darley, *Social Organization for the Production of Evil*, 3 PSYCHOL. INQUIRY 199, 217 (1992). ("Thinking about evil actions, we call to mind typical or modal representations ('prototypes' or exemplars) of such actions, and in examining those representations, we find that they include images of evil individuals. In our minds evil acts are committed by evil individuals.").

[26] *See, e.g.*, David M. Becker, SEC General Counsel, Speech Before the Glasser LegalWorks SEC Disclosure, Accounting & Enforcement Conference, (May 2, 2002) (pointing out the flaws in focusing only on individual executives), *at* http://www.sec.gov/news/speech/spch556.htm.

[27] *See* http://www.hummer.com/hummerjsp/index.jsp (last visited Oct. 2, 2004).

[28] I refer here to the criminal conviction of the well-known Chairperson and CEO of Martha Stewart Living Omnimedia, Inc., for her alleged trading on nonpublic information regarding ImClone Corp. and attempt to cover up the misappropriation of the information. *See* Indictment, United States v. Stewart, No. 03 Cr. (S.D.N.Y. June 4, 2003), *available at* http://news.findlaw.com/hdocs/docs/mstewart/usmspb60403ind.pdf. Ms. Stewart was convicted of four counts of obstructing justice and lying to investigators and sentenced to five months in prison and two years of probation.

[29] *See infra* text accompanying notes 31-65.

would take shape in a firm. In time, this circle began to operate the firm for its own benefit and for the benefit of individual group members, while to outsiders it promoted the creation of value for other participants in the firm, particularly shareholders. The circle's members may even have believed their own claims of self-abnegation. The nature of a cohesive group is that, acting within the group perspective, its members understand their actions as disinterested even if in reality they are designed to perpetuate the group and enrich its members.[30] It is impossible here to review exhaustively all of the corporate scandals, but a survey of the pertinent facts of the most noteworthy ones adequately makes my point about the inner circle.

Enron of course brought corporate scandals to popular attention, although it was by no means the first problem firm of the 1990s.[31] Certainly, as has been portrayed in the media, much of the scandal involved the kind of over-the-top excesses that characterize many of today's corporate executives, board members, bankers, accountants, and corporate lawyers.[32] There was clearly an inner circle at the firm composed of firm executives and outside professional advisors, including Kenneth Lay (CEO), Jeffrey Skilling (President), Andrew Fastow (CFO), Schuyler Tilney (a Merrill Lynch investment banker),[33] David Duncan (the rela-

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[30] *Cf.* Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 97.

> The deeper, more pernicious problem with corporate auditing, as it's currently practiced, is its vulnerability to unconscious bias. Because of the often subjective nature of accounting and the tight relationships between accounting firms and their clients, even the most honest and meticulous of auditors can unintentionally distort the numbers in ways that mask a company's true financial status, thereby misleading investors, regulators, and sometimes management.

Id.

[31] *See, e.g.*, Complaint, SEC v. Bergonzi, No. 1:CV02-1084 (M.D. Pa. June 20, 2002) (alleging accounting fraud perpetrated by top executives of Rite Aid from 1997 to 1999), *available at* http://www.sec.gov/litigation/complaints/complr17577.htm.

[32] *See* ROBERT BRYCE, PIPEDREAMS: GREED, EGO, AND THE DEATH OF ENRON (2002) (a tragi-comic description of the narcissistic behavior of many Enron executives).

[33] *See generally* Paula Dwyer et al., *Merrill Lynch: See No Evil?*, BUS. WK., Sept. 16, 2002, at 68-76 (describing connections between Merrill Lynch and Enron, and significant investments by Merrill Lynch executives in deals organized by Andrew Fastow). Four Merrill bankers (including its former head of Global Investment Banking) involved with a transaction with Enron involving its Nigerian power barges have been indicted on charges of criminal conspiracy, among other charges. *See* Superseding Indictment, United States v. Bayly, Cr. No. H-03-363 (S.D. Tex.

tionship partner of Arthur Andersen, Enron's outside accountant), Harry Reasoner (managing partner of Vinson & Elkins, Enron's main outside legal counsel), and certain Enron board members.[34] The group solidarity was reinforced through the social relationships of the Houston business elite.[35] As has now been revealed, the circle's members, who were reputed to be creating a public company innovatively maximizing shareholder value, were in fact conducting many transactions only for their own benefit.[36] Interestingly, additional subordinate groups ex-

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June 23, 2004) (describing how Merrill conducted a phony purchase of the barges to boost Enron financial results). These bankers were convicted of conspiracy and fraud. *See* John R. Emshwiller & Kara Scannell, *Enron Trial Results in Five Guilty Verdicts: Convictions of Merrill Bankers Show Advisers Can Be Held Liable for Helping to Mislead Investors*, WALL ST. J., Nov. 4, 2004, at C1. Bankers from other firms were clearly involved with top Enron executives in designing transactions whose purpose was to mislead investors about Enron's financial position. *See* Citigroup, Inc., Exchange Act Release No. 48,230, 80 SEC Docket 2116 (July 28, 2003) (describing Citigroup's role in designing structured finance transactions that misleadingly raised Enron's cash flow at certain financial reporting periods (when they were nothing more than loans from Citigroup) and Citigroup's settlement of the SEC's charges related to same for $120 million); Complaint, SEC v. J.P. Morgan Chase & Co. (S.D. Tex. July 28, 2003) (dealing with similar charges against J.P. Morgan and its $130 million settlement), *available at* http://www.sec.gov/litigation/litrealeases/lr78252.htm. Kenneth Lay and Jeffrey Skilling have been indicted on charges of criminal conspiracy to commit securities fraud, among other charges. *See* Superseding Indictment, United States v. Causey, Cr. No. H-04-25 (S-2) (S.D. Tex. July 7, 2004), *available at* http://news.findlaw.com/hdocs/docs/enron/usvlay70704ind.pdf.

[34] *See* BRYCE, *supra* note 32, at 81-84 (discussion of connections of board member Wendy Gramm to top Enron executives).

[35] *See* Anita Raghavan, *Accountable: How a Bright Star at Andersen Burned Out Along with Enron*, WALL ST. J., May 15, 2002, at A1 (describing, among other things, Duncan's social relationships with Enron executives). The social relationships among the Enron "players" are indeed Byzantine. *See* Mary Flood, *The Fall of Enron: Law Firm's Enron Work Comes Under Scrutiny*, HOUS. CHRON., Feb. 12, 2002, at A1 (describing social connections between Vinson & Elkins partner Reasoner and Lay), *available at* 2002 WL 3241135; Jennifer Frey & Hanna Rosin, *Enron's Green Acres; Those Millions Built Mansions and Purchased Ranches. Then the Company Bought the Farm*, WASH. POST, Feb. 25, 2002, at C1 (describing residential and country club ties among the top Enron executives), *available at* 2002 WL 13820081.

[36] The corporate scandal is explained at length in the following reports: Report of Harrison J. Goldin, Court-Appointed Examiner in the Enron North America Corp. Bankr. Proceeding, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Nov. 14, 2003) (describing involvement of financial institutions in Enron's fraud); Final Report of Neal Batson, Court Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Nov. 4, 2003) (discussing particularly the role of Enron's advisors and financial institutions in aiding Enron's fraud); Third Interim Report of Neal Batson, Court Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. June 30, 2003) (discussing particularly the role of financial institutions in

isted in the firm around members of the top group. For example, Fastow, who benefited so much from the special purpose entities that did transactions with Enron and that ultimately led to the firm's demise, had a group of his subordinates and professional advisors who administered these entities with him.[37] Arguably,

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aiding Enron's fraud); Second Interim Report of Neal Batson, Court Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003) (focusing on role of special purpose entities in the fraud); First Interim Report of Neal Batson, Court Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002); WILLIAM C. POWERS, JR. ET AL., SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATIONS (2002) [hereinafter ENRON SPECIAL INVESTIGATIVE COMM. REPORT]; *see also In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 613-37 (M.D. Tx. 2002) (describing in detail the Enron scandal); Joel S. Demski, *Corporate Conflicts of Interest*, 17 J. ECON. PERSP. 51, 66 (2003) ("In short, any attempt to blame the Enron meltdown solely on secretive or even fraudulent behavior by a handful of top Enron and Arthur Andersen executives does not hold water. Surely deceit and obfuscation were in play. Yet just as surely, the breadth of Enron's shortcomings and financial obfuscations was known by more than a select few."). Sometimes truth is stranger than fiction. This holds true for Enron, as well.

> Five years before Enron collapsed in a big accounting scandal, an executive joked at a party about making "a kazillion dollars" through something he humorously dubbed "hypothetical future value accounting," the Houston Chronicle reported yesterday.
>
> A videotape of a January 1997 going-away party for former Enron President Rich Kinder, features nearly half an hour of absurd skits, songs and testimonials by executives and prominent citizens—including President Bush, the newspaper said.
>
> Enron, which two years ago ranked No. 7 on the Fortune 500, declared bankruptcy Dec. 2, 2001, haunted by shady accounting, hidden debt and inflated profits.
>
> At the party, then-Texas Gov. George W. Bush said to Kinder: "Don't leave Texas. You're too good a man." Former President George Bush said, "You have been fantastic to the Bush family. I don't think anybody did more than you did to support George."
>
> In one skit, a pretend Kinder expressed doubt that then-President Jeff Skilling could pull off 600 percent revenue growth for the coming year.
>
> Skilling's response, read from a script: "We're going to move from market-to-market accounting to something I call HFV, or hypothetical future value accounting. If we do that, we can add a kazillion dollars."
>
> Skilling resigned from Enron in August 2001 before news of its troubles surfaced. He has professed ignorance about much of what went on. Three Enron workers have pleaded guilty to charges ranging from fraud to false tax returns, and ex-CFO Andrew Fastow has been indicted on 78 charges.

Enron Party Video Shows Joking About Accounting, LEXINGTON HERALD LEADER, Dec. 17, 2002, at C1.

[37] *See* ENRON SPECIAL INVESTIGATIVE COMM. REPORT, *supra* note 36, at 54, 64, 92-96, 125-28 (describing financial ties of Fastow, Michael Kopper, Ben Glisan, Kristina Mordaunt, Kathy Lynn, Anne Jaeger Patel); *see also In re Enron Corp.*, 235 F. Supp. 2d at 615-17. It is significant that Fastow and others within his circle, such as Michael Kopper, have pleaded guilty to criminal violations and are cooperating with

the entire culture of Enron, modeled after the behavior of the executive inner circle, encouraged executives and employees to form groups of mutual protection and benefit.[38] Even the whistleblower Watkins was reputed to be a member of a group, and her whistleblowing could be interpreted as an effort to align herself with Lay against Fastow (her immediate boss).[39]

After Enron, WorldCom is the most notable corporate scandal. There, transgressions by executives and others led to the demise of the once high flying and valuable telecommunications firm. The scandal was based on a group effort to maintain WorldCom's high stock price by numerous fraudulent methods, including moving expenses to capital costs, which raised the com-

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federal prosecutors. *See* Jen Rogers, *Fastow and His Wife Plead Guilty*, CNN MONEY, Jan. 14, 2004, *at* http://money.cnn.com/2004/01/14/news/companies/enron_fastows (reporting that Fastow settled criminal and SEC civil actions against him for ten years in prison and $23 million disgorgement); Jonathan Weil & Kathryn Kranhold, *First Guilty Plea in Enron Case Expected Today*, WALL ST. J., Aug. 21, 2002, at A1; *see also* Plea Agreement, United States v. Fastow, No. H-02-0665 (S.D. Tex. Jan. 14, 2004), *available at* http//news.findlaw.com/hdocs/docs/enron/usafastow11404plea.pdf.

[38] *See* Complaint, SEC v. Howard, No. H-03-0905 (S.D. Tex. May 1, 2003) (describing fraudulent practices of a group of executives at Enron Broadband Services, Inc., an Enron subsidiary, in which the executives touted a failed technology and business plan and fraudulently used a special purpose entity in order to realize phony profits for Enron from the phony sale of the technology), *available at* http://news.findlaw.com/hdocs/docs/enron/usafastow11404plea.pdf. Two of the seven charged executives have already reached plea agreements with prosecutors. *See* Kristen Hays, *Ex-Enron Exec Pleads Guilty to Conspiracy*, ASSOCIATED PRESS, Aug. 31, 2004, *available at* http://biz.yahoo.com/ap/040831/enron_broadband_4.html (last visited Oct. 16, 2004). The executives were quite brazen about the fraud, even doing a skit at a Christmas party that poked fun at it:

> The Christmas PowerPoint presentation joked about numerous fraudulent aspects of the Braveheart transaction and the underlying VOD business. For example, the presentation noted that EBS had been unable to obtain the assignment consent from Blockbuster needed to complete the transaction; that the set top boxes used to deliver movies to the customer had caught on fire during tests; and that the joint venture was only going to last one quarter after which it would have to be unwound. One portion, called "The Grinch that Stole VOD," pictured the Arthur Andersen auditors as Dr. Seuss's "The Grinch," trying to stop the transaction. This section included a piece of Seuss-like rhyme: "One Deal, Two Deal, Red Deal, No Deal. You cannot do it without GAAP. You can't do it because it's crap. You cannot do it for 25. What the hell, let's go for 65." Another portion likened Arthur Andersen to an iceberg that was going to sink the VOD ship.

Complaint, SEC v. Howard, ¶ 101.

[39] *See* ENRON SPECIAL INVESTIGATIVE COMM. REPORT, *supra* note 36, at 172-76; *see also* Jodie Morse & Amanda Bower, *The Party Crasher*, TIME, Dec. 30, 2002, at 52, 53, 55.

pany's reported earnings.[40] Like Enron, WorldCom entered bankruptcy once Cooper uncovered the scandal and, despite opposition from the executive inner circle, revealed it to the company's audit committee.[41] The exact composition of the inner circle among WorldCom executives and advisors has yet to be fully uncovered, but some facts have emerged so far.[42] There

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[40] The scandal is described at length in the following: Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, No. 02-15533 (Bankr. S.D.N.Y. Jan. 26, 2004) (discussing in more detail the fraud and potential causes of action against participants); 2nd Thornburgh Report, *supra* note 11; *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp 2d 392 (S.D.N.Y. 2003); First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, No. 02-15533 (Bankr. S.D.N.Y. Nov. 4, 2002) [hereinafter 1st Thornburgh Report]; DENNIS R. BERESFORD ET AL., SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF WORLDCOM, INC., REPORT OF INVESTIGATION (March 31, 2003) [hereinafter WORLDCOM SPECIAL INVESTIGATIVE COMMITTEE REPORT]; *see also* RICHARD C. BREEDON, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. 20-24 (2003) (offering a readable account of WorldCom's transgressions). Essentially, WorldCom was an overvalued house of cards in a highly competitive industry. Like so many other companies, it survived and prospered by growing big through acquisitions, not internally. WorldCom could buy other companies only by using its stock as acquisition currency, and its executives' wealth (particularly Ebbers' wealth) was dependent upon the stock's high price since they owned so many WorldCom shares and had huge stock options. They could thus not survive any drastic fall in the stock price, and so they did everything to prop it up (and, when they were not engaged in accounting fraud, they were taking any available cash still left in the company).

[41] WorldCom entered into a settlement with the SEC in the amount of $500 million on its violations of federal securities laws. *See* Consent and Undertaking of Defendant WorldCom, Inc., SEC v. WorldCom, Inc., No. 02 Civ. 4963 (JSR) (S.D.N.Y. May 19, 2003), *available at* http://www.sec.gov/litigation/litreleases/consent18147.htm. Judge Rakoff, however, initially declined to approve it. He eventually approved a settlement of $750 million after an additional hearing. *See* SEC v. WorldCom, 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003).

[42] WorldCom's own special investigative committee has identified the inner circle nature of the scandal:

> Had one or more of these individuals come forward earlier and raised their complaints with Human Resources, Internal Audit, the Law and Public Policy Department, Andersen, the Audit Committee, individual Directors and/or federal or state government regulators, perhaps the fraud would not have gone on for so long. Why didn't they? The answer seems to lie partly in a culture emanating from corporate headquarters that emphasized making the numbers above all else; kept financial information hidden from those who needed to know; blindly trusted senior officers even in the face of evidence that they were acting improperly; discouraged dissent; and left few, if any, outlets through which employees believed they could safely raise their objections.

WORLDCOM SPECIAL INVESTIGATIVE COMMITTEE REPORT, *supra* note 40, at 18. "The key financial information was shared only within a closed, inner circle of senior executives." *Id.* at 19.

was an inner circle composed of senior WorldCom executives engaged in the massive accounting fraud.[43] Several persons in the financial group, including WorldCom CFO Scott Sullivan, Controller David Myers, and director of general accounting Buford Yates, were members of this inner group.[44] The question is how much further the group reached. The unquestioned leader must have been CEO Bernard Ebbers, who by all reports dominated the company and all its policies.[45] Others in the group included Melvin Dick and Ken Avery, partners at Arthur Andersen, the outside accounting firm for WorldCom, and the infamous investment analyst Jack Grubman of Salomon Smith Barney (who attended WorldCom board meetings as a financial advisor), as well as other investment bankers who benefitted from WorldCom's investment banking business and gave WorldCom executives access to "hot" IPOs marketed by their firms.[46] Board members

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[43] Again, much of this corporate scandal was relatively straightforward. WorldCom booked as capital expenditures expenses that should have been booked as current expenses. This resulted in inflated earnings for the firm, since expenses must be deducted from revenues in a given year, whereas deductions for capital expenditures could be made over the life of the asset created by the expenditure.

[44] The role of these executives is described at length in the reports in note 40, *supra*. Scott Sullivan has been indicted on numerous counts of securities fraud. Indictment, United States v. Sullivan, No. 02 CR (S.D.N.Y. Aug. 28, 2002). Sullivan, Myers and Yates have all pleaded guilty to securities fraud, as have some lower level executives. *See* Susan Pulliam, *Over the Line: A Staffer Ordered to Commit Fraud Balked, Then Caved*, WALL ST. J., June 23, 2003, at A1 (describing participation of Betty Vinson, senior manager of WorldCom's corporate accounting). As in the case of Enron, this inner circle had lower ranking employees as supporters who participated in the fraud and received special compensation and favors from senior executives. *See* 2ND THORNBURGH REPORT, *supra* note 11, at 164-65, 171 (detailing Sullivan's payment of part of one of his retention bonuses to his subordinates). Ebbers himself lent a significant sum to the chief operating officer, Ron Beaumont. *See* WORLDCOM SPECIAL INVESTIGATIVE COMM. REPORT, *supra* note 40, at 24.

[45] *See* BREEDON, *supra* note 40, at 25-30, 33. Ebbers has been indicted on a number of counts, including securities fraud. *See* Indictment, United States v. Ebbers, No. S2 02 Cr. 1144 (BSJ) (S.D.N.Y. Mar. 2, 2004), *available at* http://news.findlaw.com/nytimes/docs/ worldcom/usbess304ind.pdf.

[46] *See* Yochi J. Dreazen & Deborah Solomon, *WorldCom Aide Conceded Flaws*, WALL ST. J., July 16, 2002, at A3 (describing involvement of Avery). Jack Grubman is deserving of special attention because, as an outside analyst, he participated in WorldCom board meetings and allegedly altered his valuation model for WorldCom (but not for other telecom companies) so that he could continue to recommend it as a "buy." *See In re* WorldCom, Inc., 294 F. Supp. 2d 392, 403-05 (S.D.N.Y. 2003). Salomon Smith Barney's allocation of hot IPO stocks to Grubman is further described in Eliot Spitzer's report. *See* Attorney General of the State of New York Bureau of Investment Protection, In the Matter of Citigroup Global Markets, Inc. (formerly known as Salomon Smith Barney Inc.), Assurance of Discontinuance Pursuant to Executive Law § 63(15), at 51-52 (Apr. 28, 2003), *available at* http://

were clearly also part of another inner circle that intersected with the main one; some were even known within company circles as "Bernie's Boys" because they slavishly supported CEO Ebbers and were richly compensated for this support.[47] In addition, Stiles Kellett, a long-standing board member and chair of the compensation committee that approved over $400 million of loans to Ebbers, received a "sweetheart" deal in leasing a WorldCom corporate jet.[48] The other board members were described as essentially passive in their monitoring of the inner circle around Ebbers and Sullivan; the accounting scandal is symptomatic of a complete breakdown in the corporate governance of WorldCom.[49]

Although it seems at first glance to be the work of mainly one individual, the scandal at Tyco International shows that, in fact, corporate scandals are rarely due to the transgressions of one person. As the scandal was first reported, the celebrated Tyco former Chairman and CEO, Dennis Kozlowski, who considered himself to be in the ranks of famous CEOs like Jack Welch of

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news.findlaw.com/hdocs/docs/ssb/nyagciti42803aod.pdf. It was a common practice for investment bankers looking to develop or maintain business relationships with CEOs to award them allocations in hot IPOs. *See* Susanne Craig & Charles Gasparino, *Salomon Used IPOs as Lure, Broker Says*, WALL ST. J., July 18, 2002, at C1 (describing lawsuit from former Salomon broker alleging that Salomon Smith Barney awarded IPO allocations to, among others, WorldCom CEO Ebbers); *Ex-friends of Frank*, ECONOMIST, Sept. 28, 2002, at 62 (describing how Frank Quattrone of Credit Suisse First Boston gave shares of IPOs to CEOs from whom he sought investment banking business). Restrictions on allocations of shares of IPOs to investment banking clients is a subject of the settlement between Spitzer, the SEC, and investment banks, as well as a recommendation of a joint NYSE/NASD committee. *See* NYSE/NASD IPO ADVISORY COMM., REPORT AND RECOMMENDATIONS 10-13 (2003).

[47] *See* Charles Haddad, *How Ebbers Kept the Board in his Pocket*, BUS. WK., Oct. 14, 2002, at 138 (describing the board inner circle of Max Bobbitt (a member of the Compensation Committee), Carl Aycock, and Francesco Galesi).

[48] *See* WORLDCOM SPECIAL INVESTIGATIVE COMM. REPORT, *supra* note 40, at 329-34.

[49] *See* 2nd Thornburgh Report, *supra* note 11, at 12 (detailing inadequate corporate governance (i.e., inadequate supervision of the inner group) regarding: acquisitions, which destroyed shareholder value; debt management, which allowed debt to spiral out of control; and loans and guarantees to Ebbers, which depleted company assets and revealed the shortcomings of internal legal review at the company). In the private securities class action against, among others, WorldCom directors, the court dismissed certain claims against board audit committee members because of their failure to allege that these directors acted with the requisite degree of scienter. *See In re* WorldCom, Inc. Sec. Litig. No. 02-Civ-3288, 2003 U.S. Dist. LEXIS 21363 (S.D.N.Y. Dec. 1, 2003).

General Electric,[50] committed, inexplicably (considering his great wealth), tax fraud involving personal possessions.[51] Yet this initial personal problem turned out to be the veritable tip of the iceberg, for there emerged a wide-ranging corporate scandal at Tyco involving an almost unprecedented example of corporate executives taking personal benefits from the firm and board members and advisors ignoring, or participating in, their actions.[52] Again, the sheer venality and vulgarity of Kozlowski's behavior are a rich subject for humor (e.g., the $6000 shower curtain and the $2.1 million Italian birthday party for his trophy wife—the video of which has been widely distributed—all paid for by Tyco)[53] and it alone might keep anyone from ever investing again in a public company. Yet, as the facts have emerged, there was clearly an inner circle, including, in addition to Koz-

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[50] As a result of his divorce proceedings, it has been revealed that Jack Welch was himself compensated by GE in an almost obscene way, both during and after his tenure with the firm. *See* Leslie Wayne & Alex Kuczynski, *Tarnished Image Places Welch in Unlikely Company*, N.Y. TIMES, Sept. 16, 2002, at C1 (describing Jack Welch's loss of reputation due to, among other things, revelations about his excessive retirement arrangement with GE).

[51] *See* Mark Maremont et al., *Tainted Chief: Dennis Kozlowski Quits Under a Cloud, Worsening Worries About Tyco*, WALL ST. J., June 4, 2002, at A1 (describing resignation for tax evasion).

[52] Among other things, Kozlowski and others allegedly abused two loan programs for executives—one that was designed to give them loans to pay taxes on stock grants (part of their compensation), and the other for relocation expenses. They allegedly used the loans for other purposes, particularly for funding their extravagant lifestyles and for purchasing palatial estates in various locations. The executives then conspired so that Tyco forgave many of the loans. They also received many extravagant perquisites from Tyco (e.g., rent-free luxury apartments, and purchases of their real estate by Tyco at above-market rates). For details of the scandal, *see* Tyco Int'l Ltd., Form 8-K (Sept. 10, 2002); Tyco Former Executives L. Dennis Kozlowski, Mark H. Swartz and Mark A. Belnick Sued for Fraud, SEC Litig. Release No. 17722 (Sept. 12, 2002); Complaint, SEC v. Kozlowski, No. 02 (S.D.N.Y. filed Sept. 12, 2002); Complaint, Tyco Int'l Ltd. vs. Kozlowski, No. 02-CV-7317 (S.D.N.Y. Sept. 12, 2002); Indictment, New York v. Kozlowski, No. 5259/02 (N.Y. Sup. Ct. Sept. 12, 2002); Indictment, New York v. Belnick, No. 5258/02 (N.Y. Sup. Ct. Sept. 12, 2002). The civil action against Kozlowski, Swartz and Belnick has been stayed pending completion of the criminal proceedings. SEC v. Kozlowski, No. 02 Civ. 7312 (RWS), 2003 U.S. Dist. LEXIS 6262 (S.D.N.Y. Apr. 15, 2003). Mark Belnick was acquitted of criminal charges, and the separate criminal trial of Kozlowski and Swartz resulted in a mistrial (they are to be retried). *See* Chad Bray & Colleen Debiase, *Tyco Ex-Lawyer Is Acquitted in Bonuses Trial*, WALL ST. J., July 16, 2004, at C1.

[53] *See* Mark Maremont & Laurie P. Cohen, *Executive Privilege: How Tyco's CEO Enriched Himself*, WALL ST. J., Aug. 7, 2002, at A1 (discussing lavish lifestyle of former CEO funded by company). A video of Kozlowski's extravagant apartment, paid for by Tyco, is also available.

lowski, the CFO and board member Mark Swartz, chief corporate counsel Mark Belnick (a former partner of Paul, Weiss and former federal prosecutor), and other top executives who improperly benefited from the firm.[54] Moreover, the group clearly extended to other board members[55] and likely included professional advisors as well.[56] Indeed, Tyco shows how the inner circle may claim the loyalty, or at least the acquiescence, of others not directly involved in the irregular behavior.

The scandal at Xerox revealed by James Bingham also involves accounting fraud perpetrated by a high-level inner circle, although it has received less press coverage because of Enron and WorldCom. Numerous Xerox senior executives colluded to overstate Xerox's revenues for years by, among other things, recognizing early revenues from leases that should have been recognized only in future years of the lease, so as to meet investment analysts' earnings forecasts.[57] The executives were able to re-

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[54] *See* Laurie P. Cohen & John Hechinger, *Tyco Dismisses General Counsel After Dispute*, WALL ST. J., June 11, 2002, at A1 (discussing excessive compensation of former Tyco general counsel). The saga of Belnick is particularly curious. *See, e.g.*, Laurie P. Cohen, *Two Journeys: Tyco Lawyer Channeled Windfall Into Unlikely Cause*, WALL ST. J., June 4, 2003, at A1 (describing how Mark Belnick—of Jewish background—converted to an extreme conservative sect of Catholicism and placed funds he took from Tyco with the sect).

[55] *See* Mark Maremont & John Hechinger, *Tyco Ex-CEO Invested $5 Million in Funds Run by Director of Firm*, WALL ST. J., Oct. 23, 2002, at A3 (describing financial relationships between Kozlowski and director Richard Bordman, who was a member of the audit and corporate governance committee). Frank Walsh, a board member and coincidentally chair of Tyco's Compensation Committee (and lead director!), also received an undisclosed $20 million finder's fee for Tyco's acquisition of the CIT Group. *See* Complaint, SEC v. Walsh, No. 02-CV-9921 (S.D.N.Y. Dec. 17, 2002), *available at* http://www.sec.gov/litigation/complaints/comp17896.htm. In a settlement with the SEC, Walsh agreed to disgorge the fee and be permanently barred from serving as an officer or board member in a public company. SEC Litig. Release No. 17896 (Dec. 17, 2002). Tyco is suing Walsh over his breach of fiduciary duty as a board member. *See* Tyco Int'l v. Walsh, No. 02 Civ. 4633(DLC) (S.D.N.Y. Feb. 28, 2003). All board members who were in office at the time of the scandal have been replaced. *See* Form 8-K, *supra* note 52.

[56] *See* Mark Maremont & Laurie P. Cohen, *Tyco Probe Expands to Include Auditor PricewaterhouseCoopers*, WALL ST. J., Sept. 30, 2002, at A1. Apparently, a Merrill research analyst, while not involved in the top executives' personal dishonesty regarding compensation, was part of the inner "cheerleading" group involving the company that allowed Kozlowski and his cronies to run the firm without any outside criticism. *See* News Release, National Association of Securities Dealers (May 28, 2003) (describing NASD charges against Merrill Lynch analyst Phua Young, who promoted Tyco despite his reservations about the company and received improper benefits from Kozlowski), *available at* http://www.nasdr.com/news/pr2003/release_03_022.html. Sadly, there was no whistleblower at Tyco.

[57] *See* Complaint, SEC v. Xerox Corp., No. 02-272789 (DLC) (S.D.N.Y. filed Apr.

ceive high performance bonuses and realize profits on their sales of Xerox stock because of the stock's artificially high price. Early on, they denied the fraud and attacked Bingham (then a respected accounting executive with the firm) when he demanded that the company cease its improper accounting practices. Participants in the inner circle included two former CEOs, the CFO, the comptroller, assistant comptroller, the director of accounting policy, and the firm's outside auditors, KPMG.[58]

It is unfortunate for corporate America (and indeed for all of us) that the list of scandals goes on and on. After Global Crossing, another major telecommunications company, filed for bankruptcy, it surfaced that the firm's top executives, as well as its investment bankers, profited greatly from the firm before its demise.[59] That the former Salomon Smith Barney's star telecommunications analyst, Jack Grubman, also appeared to be part of the inner circle of that company spurred the SEC and New York Attorney General Eliot Spitzer to investigate improper relationships between top executives, stock analysts, and the latters' employers (investment banks).[60]

Adelphia Communications (another bankrupt firm) presents a classic case of an inner circle based primarily on family relationships. According to the alleged facts, members of the Rigas fam-

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11, 2002); *In re* Xerox Corp. Sec. Litig., 165 F. Supp. 2d 208, 211-13 (D. Conn. 2001). In a settlement with the SEC, Xerox was required to pay a paltry civil penalty of $10 million. Complaint, SEC v. Allaire, Civ. Act. No. 03-CV-4087 (S.D.N.Y. June 5, 2003) (detailing $22 million settlement with executives involved in Xerox's accounting fraud), *available at* http://www.sec.gov/litigation/complaints/comp18174.htm; SEC Litig. Release No. 18174 (June 5, 2003) (same).

[58] *See* James Bandler, *Xerox Faces Criminal Inquiry Tied to Financial Restatement*, WALL ST. J., Sept. 24, 2002, at A1 (describing criminal inquiry); Susan Pulliam & James Bandler, *KPMG is Likely to Face Fraud Charges*, WALL ST. J., Jan. 23, 2003, at A3 (describing SEC investigation of former Xerox outside auditing firm); *see also* Opinion and Order, SEC v. KPMG, No. 03-CV-671(DLC), 2003 U.S. Dist. LEXIS 5669 (S.D.N.Y. Apr. 9, 2003) (denying KPMG's motion to transfer suit); Complaint, SEC v. KPMG LLP, Civ. Act. No. 03-CV-671 (DLC) (S.D.N.Y. filed Jan. 29, 2003).

[59] Global Crossing is the subject of a massive litigation by defrauded investors. *See In re* Global Crossing Ltd. Sec. Litig., No. 1630, 2004 U.S. Dist. LEXIS 21433 (J.P.M.L. Oct. 22, 2004).

[60] *See* Laurie P. Cohen & Dennis Berman, *How Analyst Grubman Helped Call Shots At Global Crossing*, WALL ST. J., May 31, 2002, at A1 (describing role of Salomon analyst Jack Grubman in management of Global Crossing); *see also* GENERAL ACCOUNTING OFFICE, INVESTMENT BANKS: THE ROLE OF FIRMS AND THEIR ANALYSTS WITH ENRON AND GLOBAL CROSSING, GAO-03-511, at 33-34 (2003) (describing, among other things, the role of investment bankers in misleading the public about the true state of the firms).

ily who had founded the firm, including CEO John Rigas and Executive Vice President Michael Rigas, as well as other Adelphia executives, engaged in widespread accounting fraud to cover the true financial position of the firm and used the firm's resources as essentially a piggybank for their own benefit.[61]

An investigation is also proceeding at the telecommunications firm Qwest.[62] It appears that, in yet another scandal, Sprint executives had the firm's outside accountants design an abusive tax shelter for them, which, when it was revealed, resulted in the dismissal of the top executives and threw the entire management team into disarray.[63] HealthSouth, the giant healthcare provider, is also mired in accounting fraud involving massive overstatement of revenues allegedly perpetrated by a circle around its flamboyant CEO, Richard Scrushy.[64] Likewise, a giant U.S. un-

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[61] *See* United States v. Rigas, 258 F. Supp. 2d 299 (S.D.N.Y. 2003); Jerry Markon & Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges*, WALL ST. J., July 25, 2002, at A3 (describing the inner circle); *see also* Complaint, SEC v. Adelphia Communications Corp., Litig. Release No. 17,627 (July 24, 2002). Adelphia is the object of multiple private securities lawsuits. *See In re* Adelphia Communications Securities Litigation, No. 02-1781, 2003 U.S. Dist. LEXIS 9736 (E.D. Pa. May 14, 2003); *In re* Adelphia Communications Corp. Sec. & Derivative Litig., 237 F. Supp. 2d. 1381 (J.P.M.L. Dec. 12, 2002). John Rigas and his son Timothy were convicted of conspiracy, bank fraud and securities fraud, while his son Michael was acquitted of conspiracy (the jury was hung on the other charges) and former Adelphia assistant treasurer Michael Mulcahey was acquitted of conspiracy and securities fraud.

[62] *See* Complaint, SEC v. Arnold, No. 03-Z-0328 (OES) (D. Colo. Feb. 25, 2003) (alleging that Qwest executives had engaged in a scheme to recognize fraudulent revenue that had not yet been earned in order to meet market expectations; they did this by recognizing income on the sale of equipment to Genuity when in fact the equipment was to be used to provide services to Genuity over the ensuing five years), *available at* http://www.sec.gov/litigation/complaints/comp17996.htm; SEC Litig. Release No. 17996 (Feb. 25, 2003). *See also In re* Qwest Communications Int'l, Inc. Sec. Litig., 241 F. Supp. 2d 1119 (D. Colo. 2002); New York v. Anschutz (N.Y. Sup. Ct. Sept. 30, 2002) (alleging that Qwest Chairman/Founder Anschutz and CEO Nacchio both received special IPO allocations from Salomon Smith Barney in return for Qwest's investment banking business), *available at* http// news.findlaw.com/hdocs/docs/worldcom/nyanschultz 93002cmp.pdf.

[63] *See* Rebecca Blumenstein et al., *Sprint Forced Out Top Executives Over Questionable Tax Shelter*, WALL ST. J., Feb. 5, 2003, at A1.

[64] *See* Complaint, SEC v. Healthsouth Corp., No. CV-03-J-0615-S (N.D. Ala. Mar. 19, 2003), *available at* http://news.findlaw.com/hdocs/docs/hsouth/sech south 31903cmp.pdf. It turns out that a low level accounting employee unsuccessfully tried to blow the whistle on HealthSouth. *See* Robert Frank & Ken Brown, *UBS Analyst Leaves His Job in HealthSouth Conflicts Flap*, WALL ST. J., July 3, 2002, at C1 (describing views of analyst who was close to company that contradicted his public support for the company); Carrick Mollenkamp, *Missed Signal: Accountant Tried in Vain to Expose HealthSouth Fraud,* WALL ST. J., May 20, 2003, at A1 (describing tribulations of accountant Michael Vines). On Scrushy's rise and lifestyle, see

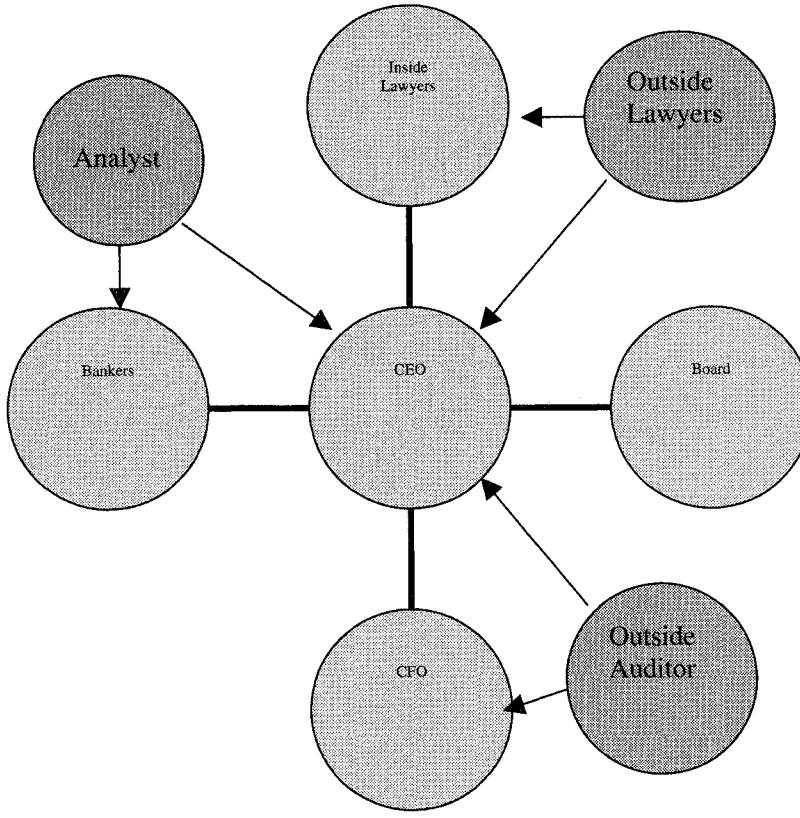
derwriter of funds for mortgages, Freddie Mac, is now restating its financial results because of accounting fraud.[65]

It is justifiable to believe that these situations, rather than being exceptional, represent only the tip of the iceberg of corporate scandals. Moreover, since the rogue's gallery of companies includes some of the most prominent, large-capitalization companies in corporate America, there is reason to think that an inner circle of executives, bankers, law firms, and accountants (as portrayed in the following drawing) similarly exists in many other firms. Indeed, revelations about IPO allocations, whereby investment bankers allocated shares in "hot" IPOs to top executives in return for investment banking business from the executives' firms, reinforce the conclusion that group self-interested behavior is widespread throughout corporate America.[66]

Charles Haddad et al., *Too Good to be True*, BUS. WK., Apr. 14, 2003, at 70; *see also* Indictment, United States v. Scrushy, No. CR-03-BE-0530-S (N.D. Ala. Oct. 29, 2003); SEC v. HealthSouth Corp., 261 F. Supp. 2d 1298 (N.D. Ala. 2003) (staying civil action against Scrushy pending resolution of criminal complaint); *In re* HealthSouth Corp. Sec. Litig., 213 F.R.D. 447 (N.D. Ala. 2003) (describing history of alleged HealthSouth fraud). Numerous HealthSouth executives have already pled guilty to securities fraud and other charges. *See* Press Release, Department of Justice, HealthSouth Executives Richard Botts and Will Hicks Agree to Plead Guilty to Conspiracy to Commit Securities Fraud, Mail Fraud (July 31, 2003), *available at* http://www.usdoj.gov/opa/pr/2003/July/03_crm_436.htm.

[65] *See* OFFICE OF FED. HOUSING ENTER. OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FREDDIE MAC (2003), *available at* http//www.ofheo.gov.media/pdf/specialreport122003.pdf; *Trouble at Home*, THE ECONOMIST, June 14, 2003, at 70.

[66] *See* Susan Pulliam et al., *SEC May Punish Some Executives Who Snared Shares of IPOs*, WALL ST. J., Sept. 27, 2002, at C1; *See generally In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281 (S.D.N.Y. 2003) (describing interaction between investment banks and company executives). That almost every public company in the United States asserts (as did Enron before its fall) that it has good corporate governance may paradoxically be evidence of how many corporate governance problems exist. Following the corporate scandals, moreover, numerous scandals have appeared in the mutual fund industry, often involving groups benefiting themselves at the expense of fund shareholders. *See, e.g.*, Harvey J. Goldschmid, Mutual Fund Regulation: A Time for Healing and Reform, Speech Before the ICI 2003 Securities Law Developments Conference (Dec. 4, 2003), *available at* http://www.sec.gov/news/speech/spch120403hjg.htm.



The inner circles often revolved around charismatic individuals, but this individualist story must be understood in tandem with the group story. In most scandals, a leader, usually the CEO, formed the group and was able to exert considerable influence over it because of a personal quality or dynamism (e.g., confidence, optimism, even physical size), which suggests that this kind of leader is necessary for a group to coalesce. Another glance at the corporate scandals reveals that personal magnetism was significant in the formation and maintenance of the inner circles. Kenneth Lay of Enron, for example, was often described as an undaunted optimist, who remains positive even now, despite Enron's bankruptcy and a disgrace that would certainly drive a normal individual to despair.[67] Bernie Ebbers of

[67] *See* Bryan Gruley & Rebecca Smith, *Anatomy of a Fall: Keys to Success Left Kenneth Lay Open to Disaster*, WALL ST. J., Apr. 26, 2002, at A1 ("People rallied to the mission. They were making a lot of money, and they liked Ken Lay. He remembered first names. He jotted personal notes on memos. He liked jawing with pipeline operators and fellow Ph.D.s alike.").

WorldCom was portrayed as a cowboy capitalist (he owned an enormous ranch); a tall man, he exuded optimism,[68] was domineering,[69] and had a leadership role in a charismatic religious group. Dennis Kozlowski of Tyco, lionized in the business press in the 1990s, was known as one of the most aggressive, hard-driving CEOs in the United States.[70] Joseph Nacchio of Qwest International, who had the miraculous good fortune to cash out his stock holdings in the company right before its shares plummeted, was always described as "tough talking."[71] Richard Scrushy of HealthSouth was described as a "charismatic leader" who perpetuated the massive accounting fraud in his firm with a group known as the "family," composed of executives who received special benefits from Scrushy, including the almost surreal privilege of being able to play in his personal rock band.[72] Again, the list could go on and on.

The existence of inner circles formed around charismatic individuals in the corporate scandals suggests that some new perspective is needed to orient the regulation of public firms. It is time to do more than engage in the tired and tiresome debates about adequately motivating the corporate agents—the staple of corporate governance scholarship and the main basis for corporate governance reforms.[73] Because social psychological research

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[68] *Yesterday's Man -- WorldCom's Bernie Ebbers Goes*, THE ECONOMIST, May 4, 2002, at 64.

> In his cowboy boots and stetson hat, Bernie Ebbers made a splendid cover for any magazine that wanted to be abreast of the telecoms revolution of the late 1990s. His background, too, had just the sort of mix of hard grind, modest intellectual prowess and sporting vim that America likes in its hero-bosses.

Id.

[69] Ebbers (who started as a motel owner!) was reputed to have absolutely dominated the management and board of WorldCom, and single-handedly pushed through an inappropriate strategic plan for the firm. *See* 1st Thornburgh Report, *supra* note 40, at 6, 62-63.

[70] *See, e.g.*, Maremont et al., *supra* note 51.

[71] *See* Rebecca Blumenstein et al., *Qwest's Nacchio Resigns as CEO, Pressured by Frustrated Directors*, WALL ST. J., June 17, 2002, at A1.

[72] Chad Terhune et al., *Close Relations: Inside Alleged Fraud at HealthSouth, A 'Family' Plot*, WALL ST. J., Apr. 3, 2003, at A1.

[73] Of course, efforts can be made to rein in executives and corporate advisors on the basis of traditional financial and legal scholarship, which is grounded in agency theory, i.e., the theory of reducing agency costs that inevitably arise when the people managing money and property are not the same as its owners. *See* MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 46-49 (1998) (discussing agency theory). One can certainly argue that particular reforms to address self-interest and cronyism in executives are needed, and offering such reforms is the purpose

supports the view that group psychology and group pressures played a substantial role in the corporate scandals, this research must be taken into account in designing reforms.

B. The Social Psychological Basis of Group Pressures

Before discussing social psychological accounts of the inner circle, one point underscores the circle's power. Board members—who, if not major participants in the scandals, were most responsible for monitoring those who were—report that there is tremendous group pressure to go along with any proposal from the CEO that is echoed by the firm's professional advisors, even if a particular board member has different views about the proposal.[74] Certainly there are rational reasons for this passivity, long known to scholars of corporate boards.[75] A board member, particularly an outsider to the firm, may not completely understand its business and may be busy with his main position elsewhere. Consequently, a director has no time to investigate management proposals or come up with alternatives, limited as he is to the information about the firm supplied by management itself.[76] Directors also generally value board membership and are reluctant to upset executives who have a large say in whom is nominated to the board. Yet, on the basis of reports from the boardroom, there is clearly a kind of group psychological dynamic at work that cannot be reduced to individual rational rea-

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of much work in financial economics. *See* Ivan E. Brick et al., CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism (May 1, 2002) (presenting evidence suggesting that director compensation is negatively related to firm performance and positively related to CEO compensation, which points to the conclusion that excess compensation is due to a kind of cronyism between the CEO and directors who are not performing their monitoring task), *available at* http://www.ssrn.com/abstract=303574. *See also* RenJe B. Adams et al., Powerful CEOs and Their Impact on Corporate Performance (Sept. 10, 2003) (arguing that firms where more decision making power is given to CEOs have more volatility—they are likely to be extreme winners or losers—because CEOs make decisions themselves and need not compromise with other executives), *available at* http://www.ssrn.com/abstract=31218.

[74] *See, e.g.*, COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD 174 (2004).

[75] *See* Lin, *supra* note 2, at 914-16. *See* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 492 (1999) ("[B]oards of directors can be characterized as large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing.").

[76] I owe this observation to my colleague, Roberta Karmel, who has been on several boards of public companies.

sons for passivity, and that transforms an individual into a board member whose perspective becomes aligned with the group.[77]

Examples of the transformation of an individual into a "director" and acquiescent inner circle participant abound,[78] although, as I shall later explain, certain people may be particularly susceptible to the pull of an inner circle. One example underscores the frightening power of these circles. Professor Charles Elson, now frequently quoted on corporate governance matters in the *Wall Street Journal* and other business publications, occupies a high visibility position as the director of the Weinberg Center for Corporate Governance at the University of Delaware, and is a noted governance expert.[79] The business media made much of his experience as a director of Sunbeam Corporation, particularly when he and other board members ousted the firm's infamous CEO, "Chainsaw" Al Dunlap.[80] Indeed, Elson has been held up as a model independent board member in his role in Dunlap's dismissal, for Dunlap had appointed the then little-known law professor to Sunbeam's board and had become a personal friend

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[77] *See, e.g.*, Cynthia A. Montgomery & Rhonda Kaufman, *The Board's Missing Link*, HARV. BUS. REV., Mar. 2003, at 86, 90 ("Consider the forces at play when an individual joins a board. Typically, new members are added one or two at a time. This means that each new director is joining a group with already established norms."); *see also* Bebchuk et al., *supra* note 4, at 784 (when discussing why board members do not enter into strict contracts with CEOs on executive compensation, they note: "Even nominally independent directors are often connected to executives by bonds of interest, collegiality, or affinity."). A survey of board members by Korn/Ferry indirectly confirms this assertion, for board members report that rarely is a director dismissed because of conflict with the CEO, which suggests that they avoid these conflicts. *See What Directors Think*, KORN/FERRY INT'L & CORP. BD. MEMBER MAG., 2002, at 1, 17 [hereinafter KORN/FERRY].

[78] Other examples of co-opted board members exist. For example, one of the Tyco International's board members was the shareholder activist, Robert Monk. Yet Monk failed to notice the abuses of the inner circle of Dennis Kozlowski, whom Monk constantly praised. *See* Jonathan R. Laing, *Tyco's Titan: How Dennis Kozlowski Is Creating a Lean, Profitable Giant*, BARRON'S, Apr. 12, 1999, at 27, *available at* 1999 WL-BARRONS 3442041.

[79] Professor Elson has served on the National Association of Corporate Directors' Commissions on Director Compensation, Director Professionalism, CEO Succession, Audit Committees, and Strategic Planning and Director Evaluation. He is Vice Chairman of the ABA Business Law Section's Committee on Corporate Governance and a member of its Committee on Corporate Laws. Elson has been, and is, a director of numerous public companies. *Staff Biography*, at http://www.be.udel.edu/ccg/staff.htm; Virginia McMillan, *Who'd Be an Independent Director?*, INDEP. BUS. WKLY., Nov. 27, 2002, *available at* 2002 WL 11118086.

[80] *See, e.g.*, Geoffrey Colvin, *Bad Boards, Bad Boards—Whatcha Gonna Do?*, FORTUNE, Apr. 26, 1999, at 411. Dunlap was known as "Chainsaw" because he fired so many employees when he took over a firm.

of Elson's. Yet, before the crisis leading to Dunlap's removal, Professor Elson was the prototypical board member of the CEO's inner circle;[81] Elson constantly celebrated Dunlap as the kind of CEO who single-mindedly enhanced shareholder value, who deserved extraordinary compensation and whom all CEOs should imitate,[82] and he was even singing Dunlap's praises several weeks before the removal.[83] Elson only broke out of Dunlap's circle when the group in effect disbanded (and another circle of board members formed) because the problem with Dunlap could no longer be ignored.[84] This example demonstrates the sheer power of a firm's inner circle to pull within it even respected corporate governance scholars and advocates.

According to social psychological literature, what explains the creation of inner circles that can be so destructive of the interests of the firm and people outside them, and what makes respected individuals compliant members of the circles? As social psychologists have explained, human beings are social and derive much of their identity from membership in groups.[85] Yet this kind of group behavior is perverse. The one social psychological explanation that best captures the group blindness, pressure, and selfishness of the inner circle is the classic "groupthink" account.[86] According to this account, group members become uniform in their views and see only the positive, not the negative, about group attitudes and behavior. They will collectively discipline any member who fails to stand uniformly behind the group's perspective and are dismissive, even contemptuous, of those outside the group and of views other than their own.[87] While social co-

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[81] *See* Rex Henderson, *Shareholder Activist's Election to Sunbeam Board Draws Fire*, TAMPA TRIB., Sept. 27, 1996, at 1 (Business Section) ("Call shareholder activist Charles Elson a 'lapdog,' will you? Well 'woof, woof,' Elson said—then bared his fangs and growled.").

[82] Elson wrote a jacket blurb for Dunlap's book, *Mean Business*. *See* Colvin, *supra* note 80, at 411.

[83] Dana Canedy, *Did Sunbeam Go Too Far to Keep Dunlap in its Corner Office*, N.Y. TIMES, Mar. 18, 1998, at D6 (discussing lavish compensation arrangement of Dunlap). Sunbeam board member Charles Elson told the *New York Times*, "'There is clearly demand for [Dunlap's] services at many other companies which would be willing to pay him a lot more.'" *Id.*

[84] *See generally* JOHN BYRNE, CHAINSAW: THE NOTORIOUS CAREER OF AL DUNLAP IN THE ERA OF PROFIT-AT-ANY-PRICE (1999).

[85] *See* BROWN, *supra* note 18, at 551.

[86] *See* IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 174-77 (2d ed. 1983) (presenting a classic account of "groupthink").

[87] *See id.* at 242-59. *See generally* Jeffrey A. Sonnenfeld, *What Makes Great*

hesion and compatibility undoubtedly are necessary for, and foster, good group action, groupthink is a negative, passive cohesion because it permits no cognitive conflict and exploration of different views that would allow the group and its members to make better decisions and to perform their designated activities well.[88] Under the sway of groupthink, group members do not see themselves as mindless zombies, nor is their group unsophisticated. Rather, a group captured by groupthink might pride itself on its broad perspectives and consideration of different viewpoints because it has a member who is the ostensible critic of the group perspective (but who never really calls into question the fundamentals of the group's identity).[89]

Social psychological research suggests how groupthink can arise from the natural process by which people characterize themselves in a particular group's terms, although in the case of groupthink that process is taken to extremes.[90] An individual's self-esteem partly depends upon his self-categorization of place in society (called "social identification" under one social psychological theory); thus, because society is composed of groups, a person's self-esteem depends upon his belonging to a group or groups with a defined status.[91] Belonging to a group means adopting the features of that group, which suggests that an individual "depersonalizes" himself.[92] That is, a group member's

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Boards Great, HARV. BUS. REV., Sept. 2002, at 106, 111 ("Directors are, almost without exception, intelligent, accomplished, and comfortable with power. But if you put them into a group that discourages dissent, they nearly always start to conform."). Regretfully, silence and conformism are a part of everyday corporate life. *See* Leslie Perlow & Stephanie Williams, *Is Silence Killing Your Company?*, HAR. BUS. REV., May 2003, at 52.

[88] *See* Forbes & Milliken, *supra* note 75, at 499 (describing how groupthink is due to an absence of cognitive conflict).

[89] *See* JANIS, *supra* note 86, at 114-17.

[90] For a discussion of this social identification, see Michael A. Hogg, *A Social Identity Theory of Leadership,* 5 PERSONALITY & SOC. PSYCHOL. REV. 184 (2001).

[91] In the social psychological literature, this desire for a socially based self-esteem is one explanation for an individual's self-identification with a group. Another explanation or motivation, which may be more fundamental than self-esteem, is that categorizing oneself as a group member helps an individual reduce uncertainty and produce meaning (i.e., a cognitive approach) because it provides the individual with a set of conceptual and behavioral patterns; it helps one predict how others will behave and tells one how to behave in a given setting. *See* Michael A. Hogg & Barbara A. Mullin, *Joining Groups to Reduce Uncertainty: Subjective Uncertainty Reduction and Group Identification, in* SOCIAL IDENTITY AND SOCIAL COGNITION 249, 250-55 (Dominic Abrams & Michael A. Hogg eds., 1999).

[92] *See id.* at 254 ("Depersonalization refers to a process whereby individuality and concomitant unshared beliefs, attitudes, feelings, and behaviors are replaced by an

self-conception and self-perception become to an extent a product of the group because they are based upon a group "prototype" or model of behavior, attitudes, and feelings.[93] In cohesive groups, at least, all members base their views and behavior on this model, with the leader being the one who appears to group members to be closest to the group ideal (although other members may mistakenly attribute the leader's influence to his charisma). The more cohesive the group, the more prevalent the groupthink (based on the group prototype), which means individual group members and the group itself are less able to make decisions outside the group's perspective.[94]

Other social psychological theories help explain the dynamic of groupthink formation and existence. Social psychologists point to a "persuasion bias" affecting groups.[95] According to it, persuasion occurs among group members when a point of view is repeated, often by members occupying a strong and influential position in a social network. This means that those who best represent the group's norms or ideals define them for other group members.[96] Another well documented and related group psy-

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ingroup prototype that prescribes shared beliefs, attitudes, feelings, and behaviors. Depersonalization changes people so that they appear to agree more strongly with one another.").

[93] *See* Michael A. Hogg & Sarah C. Hains, *Friendship and Group Identification: A New Look at the Role of Cohesiveness in Groupthink*, 28 EUR. J. SOC. PSYCHOL. 323, 326 (1998); Deborah J. Terry et al., *Group Membership, Social Identity, and Attitudes*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION, *supra* note 91, at 280, 284; *see also* Dominic Abrams, *Social Identity, Social Cognition and the Self: The Flexibility and Stability of Self-categorization*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION, *supra* note 91, at 197 (discussing the complexities of self-categorization as a group member).

[94] Groupthink may particularly arise in cohesive groups when these groups are faced with situations of uncertainty, *see* Hogg & Mullin, *supra* note 91, at 267, a context often characterizing corporate decision-making groups such as boards. For discussion of an experimental study of the causal effects of cohesiveness in producing groupthink, see Hogg & Hains, *supra* note 93, at 337:

> We found that cohesiveness in group terms generally impoverished decision-making procedures—there was a stronger desire for consensus, a larger effort to reach agreement, stronger endorsement of majority decision making, greater deference to the group leader, more rationalization of decisions made, and a tendency for the group to comply with the leader in deciding not to leave the theatre open.

[95] *See* PETER M. DEMARZO ET AL., PERSUASION BIAS, SOCIAL INFLUENCE, AND UNI-DIMENSIONAL OPINIONS (MIT Sloan School of Management, Working Paper No. 4339-01, Nov. 2001), *available at* http://ssrn.com/abstract=293139.

[96] There is a rational explanation for why persuasion occurs in these circumstances: while the repetition of a point of view does not add new information to the group discussion, it conveys the *impression* that new information is being added.

chological phenomenon, group polarization,[97] may help explain the extremism of the groupthink of the inner circles. It is well accepted in social psychological literature that groups polarize in decision making; they move to extreme positions, either towards a position that is riskier (or more cautious) than the average position of the individuals in the group, although empirical studies show that the polarization is generally in the direction of the inclination of most group members.[98] An explanation for the phenomenon is that individuals make a decision in line with the norms or self-definition of the group, i.e., they make a decision in accordance with where they want to stand in the group and with whom they want to be identified (this is called "social comparison").[99] In a similar vein, groups can accentuate the kinds of cognitive biases that we all possess (and that certain executives may particularly possess), such as overconfidence.[100] Certainly, the above social psychological phenomena make sense of the dynamics of the groupthink of corporate inner circles producing the

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Psychologists have also documented a number of related self-serving individual biases that contribute to individuals' going along with their group and engaging in fraud or other questionable practices. *See* Bazerman et al., *supra* note 30, at 100 (discussing "familiarity" bias, under which "[p]eople are more willing to harm strangers than individuals they know, especially when those individuals are paying clients with whom they have ongoing relationships").

[97] *See* BROWN, *supra* note 18, at 200-48; CASS R. SUNSTEIN, THE LAW OF GROUP POLARIZATION 9-10 (John M. Olin Center for L., Econ., and Bus., Working Paper No. 91, 2nd Series, Dec. 7, 1999).

[98] *See* BROWN, *supra* note 18, at 34. Professor Sunstein argues that group polarization, rather than groupthink, better explains the evidence of the performance failure of groups. *See* CASS R. SUNSTEIN, WHY SOCIETIES NEED DISSENT 140-44 (2003).

[99] *See* James H. Davis, *Some Compelling Intuitions About Group Consensus Decisions, Theoretical and Empirical Research, and Interpersonal Aggregation Phenomena: Selected Examples, 1950-1990*, 52 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 3, 12-13 (1992) (discussing alternative explanations for group polarization).

[100] For a brief review of these biases and the legal literature on them, see James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1341-47 (2001); *see also* MAX H. BAZERMAN ET AL., ENLARGING THE SOCIETAL PIE—A COGNITIVE PERSPECTIVE (Harv. NOM Res. Paper No. 02-17, Sept. 2001) (arguing that group decision making—including large popular decision making—can magnify the individual biases or cognitive limitations that affect all people). This group magnification of an individual mistake becomes of special concern when a CEO is prone to a bias, such as excessive optimism, which the group around him or her accepts and magnifies; *see* Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. ECON. PERSP., Mar. 22, 2003, at 27, 36 (attributing earnings manipulation to managers' optimism); *see also* Dan Lovallo & Daniel Kahneman, *Delusions of Success: How Optimism Undermines Executives' Decisions*, HARV. BUS. REV. 56 (July 2003).

scandals, where a dominant CEO and his subordinate executives forcefully articulate a position or strategy and pull along board members, bankers, accountants, and lawyers, who are not inclined to challenge the CEO anyway.

Social psychological research suggests how groupthink, together with the related social psychological phenomena discussed above, can lead to the adoption of a given strategy or action that gradually results in massive corruption and scandal. The group, or even a few key individuals in a group, decide upon an action that may be improper, even if marginally so; the action then becomes the status quo; and groupthink reinforces the attachment to this status quo by all group members (who, as members of a cohesive group, then have a personal commitment to it).[101] The members then make or accept further decisions that are presented and seen as following naturally from the original decision, even if the consequences of those decisions do not reflect a firm's organizational purpose and, from an outside perspective, would appear certain to lead to disaster. Surely, each corporate scandal did not happen overnight. Instead, one decision or action that seemed to be for the firm's benefit was taken, others followed suit on the basis of the original decision, and eventually a massive scandal resulted in which all group members were enmeshed.[102] If the group is powerful or persuasive enough, it can even successfully project its vision of reality for a long time on

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[101] *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 89-90 (2002).

[102] Social psychologist John Darley has explained in this way the phenomenon of the group production of evil or scandal in organizations. He perceptively remarks that, when a scandal appears in the organization, the diffusion of organizational responsibility both allows superiors to deny their knowledge of and involvement in the scandal, and creates an incentive for them to deny, in the face of evidence to the contrary, that the scandal is serious. John M. Darley, *How Organizations Socialize Individuals into Evildoing*, *in* CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 13 (David M. Messick & Ann E. Tenbrunsel eds., 1996) [hereinafter Darley, *How Organizations Socialize*]. His remarks about an earlier scandal at Salomon Brothers, where brokers sold inappropriate securities to clients and where top management, which reaped the benefits of this sales activity, implicitly approved their conduct, could equally apply to many of the corporate scandals, particularly the involvement of investment banks. *See* John M. Darley, *The Dynamics of Authority Influence in Organizations and the Unintended Action Consequences*, *in* SOCIAL INFLUENCES ON ETHICAL BEHAVIOR IN ORGANIZATIONS 37, 46 (John M. Darley et al. eds., 2001). *See also* Bert Spector, *HRM at Enron: The Unindicted Co-Conspirator*, 32 ORG. DYNAMICS 207 (2003) (pointing out the failings of Enron's human resources management, which encouraged a culture that helped bring down the company); Chamu Sundaramurthy & Marianne Lewis, *Control and Collaboration: Paradoxes of Governance*, 28 ACAD. MGMT. REV. 397, 400-03 (2003) (describ-

those outside the group and prevent disclosure of the scandal.[103] Indeed, the group's violent reaction to the whistleblower occurs because the whistleblower calls into question the totality of the decisions, and the worldview, of the group; the whistleblower becomes the embodiment of the truth about the organization that the group cannot accept without admitting the massive impropriety at the heart of its existence.[104]

The social psychological literature on groupthink and on the related problems of group decision-making counters the common sense intuition about this kind of decision-making, which is enshrined at least in corporate law: that groups enhance the quality of a decision.[105] The general psychological research on groups suggests that individuals may well underperform complex tasks when doing them as part of a group.[106] It would be inaccurate, however, to say that the social psychological literature uniformly questions the value of group decision-making.[107] There is empirical evidence showing that, in certain circumstances, groups (and

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ing the "reinforcing cycles of collaboration" among executives and board members immersed in groupthink that lead to a firm's decline).

[103] *See* Steven C. Currall & Marc J. Epstein, *The Fragility of Organizational Trust: Lessons from the Rise and Fall of Enron*, 32 ORG. DYNAMICS 193 (2003) (describing how top Enron executives built up trust among those inside or close to the firm (board members, auditors) and those outside it (local communities, investment community), a trust that blinded others to Enron's problems).

[104] *See* ALFORD, *supra* note 8, at 99. *Cf.* Darley, *supra* note 25, at 215.

[105] *See* Davis, *supra* note 99, at 33-34 (observing that the best decision makers between individuals and groups are individuals who work alone). He observes, however, that one advantage of group discussion is that it may identify a person who will know the answer to what is usually a simple question and eliminate obvious errors shared by individual group members.

[106] They free ride on others (known as "social loafing") or, as noted above, express opinions because of their desire to compare themselves (and be compared) to others in the group. *See generally* SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 191-214 (1993). *But see* Frederick C. Miner, Jr., *Group Versus Individual Decision-Making: An Investigation of Performance Measures, Decision Strategies, and Process Losses/Gains,* 33 ORG. BEHAV. & HUM. PERFORMANCE 112, 123 (1984) (presenting experimental data showing that, on one complex task, when individual decisions precede a group decision, group performance is "better than individual averages and the selected best individual decision, and equal to the actual best individual decision"). Group members also do not always recognize the expertise of particular group members, or they attribute expertise to the wrong member. *See generally* Ethan Burris et al., The Role of Expertise and Reputation on Perceptions of Conflict and Influence within Groups 6 (on file with author).

[107] For an excellent review of much of this literature, see Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363 (2002).

thus boards) come to better decisions than individuals.[108] Everyday experience and anecdotal information alone would suggest that at times there are real benefits from group decision-making. For example, a group's members can use their experience to point out mistakes with a particular group member's views, or offer a range of views not available to any one group member.[109] One of the goals of organizational science is, in fact, to improve group decision-making and to take advantage of the benefits that come from a group.[110] An argument can even be made that the way boards and other decision-making groups within U.S. corporations now function, with excessive groupthink put in motion by charismatic CEOs, is not well designed from a cognitive and organizational perspective for them to reach the best decisions in their circumstances.[111]

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[108] *See, e.g.*, ALAN S. BINDER & JOHN MORGAN, ARE TWO HEADS BETTER THAN ONE?: AN EXPERIMENTAL ANALYSIS OF GROUP VS. INDIVIDUAL DECISIONMAKING (Nat'l Bureau of Econ. Research, Working Paper No. 7909, Sept. 2000) (presenting experimental data showing that groups outperform individuals). As management writers have succinctly expressed it, "the very existence of the board as an institution is rooted in the wise belief that the effective oversight of an organization exceeds the capabilities of any individual and that collective knowledge and deliberation are better suited to this task." Forbes & Milliken, *supra* note 75, at 490.

[109] There is considerable psychological literature on how groups can be composed to improve decision-making. *See, e.g.*, Roger J. Volkema & Ronald H. Gorman, *The Influence of Cognitive-Based Group Composition on Decision-Making Process and Outcome*, 35 J. MGMT. STUD. 105 (1998) (discussing under what circumstances teams composed of different kinds of individuals—psychologically defined—can outperform groups of similar kinds of individuals).

[110] *See* Forbes & Milliken, *supra* note 75, at 494-95 (discussing empirical research on what makes effective boards: norms of effort, cognitive conflict, use of available skills, cohesiveness, and task performance).

[111] *See* Bruce Cutting & Alexander Kouzmin, *Evaluating Corporate Board Cultures and Decision Making*, CORP. GOVERNANCE Feb. 2, 2002, at 27, 30 (describing the mistake of having a board follow a strong CEO with his vision of reality, since the goal of boards today should be to examine seriously alternative courses of action in fast-changing business reality and to consider these alternatives); *id.* at 31 ("Each director brings his/her own particular experience and worldview and very often that is all that has been asked of them—and sometimes even less in that all that is required is their acquiescence."); *see also* Ribstein, *supra* note 23, at 21 (arguing that corporate law, with its excessive deference to management decisions, may foster the sense of invulnerability of top management). *But see* ANTONIO E. BERNARDO & IVO WELCH, ON THE EVOLUTION OF OVERCONFIDENCE AND ENTREPRENEURS 2 (Yale Int'l Cen. Fin., Working Paper No. 00-48, June 2001) (pointing out the benefits of overconfident entrepreneurs or leaders who can convey information in an informationally complex world). Individuals like CEOs, may, however, be rewarded for performance that has nothing to do with them and is mainly due to external factors. *See* ALAN DURRELL, ATTRIBUTION IN PERFORMANCE EVALUATION 31 (Mar. 2001) (discussing literature, as well as experiment, showing that employers do not take

The problem here is that so few executive decision-making groups appear to live up to their possibilities. They do not allow critical discussion or conflicting perspectives to emerge, despite their protests to the contrary, particularly from people outside the inner circle (especially defectors). Rather, many organizations produce a culture or environment of silence, where negative news concerning the firm (even information about illegal activities) will not be mentioned, because many employees realize that it will be ignored and the messenger will be punished. The reasons for this "organizational silence" are complex and owe much to the groupthink and other social phenomena discussed above; thus, the silence has much to do with what typifies U.S. corporate culture—the promotion of self and group interests in the organization.[112]

Not recognizing, however, that groups, particularly boards of directors, have serious decision-making limitations, certain legal scholars use available social psychological research to argue that boards function well and that they are the best available form of corporate decision-making. Apologists of the status quo of U.S. board structure, these scholars significantly downplay social psychological literature that contradicts their views.[113] They seem

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account of external factors that make tasks difficult or easy when rewarding employees).

[112] *See generally* Elizabeth Wolfe Morrison & Frances J. Milliken, *Organizational Silence: A Barrier to Change and Development in a Pluralistic World*, 25 ACAD. MGMT. REV. 706, 706-25 (2000). Professors Morrison and Milliken attibute this silence to managers' fear of negative feedback and their uncritical acceptance of beliefs, such as that employees are selfish and untrustworthy, that management alone knows what is best for the organization, and that unity and agreement are signs of a good organization while disagreement and dissent are signs of a bad one (despite evidence to the contrary that disagreement improves decision-making). They contend that these beliefs owe much to management training in business schools, based as it is on the simplified view of human beings as self-interested economic actors. They also find that this organizational silence is prevalent in large, hierarchical organizations where there is considerable distance (social and otherwise) between employees and top executives and board members (who are often prestigious outsiders)—all the hallmarks of the large U.S. corporation. It may well be that the biases so prevalent in the corporate groups characterized by groupthink—the overoptimism, the attachment to an accepted strategy, hierarchical and simplified decision making—may well be due to the ideologies and cognitive styles of the people who occupy the executive suite and boardroom. *See* Philip E. Tetlock, *Cognitive Biases and Organizational Correctives: Do Both Disease and Cure Depend on the Politics of the Beholder?*, 45 ADMIN. SCI. Q. 293, 320-324 (2000) (finding correlations between ideologies and cognitive styles of managers and their views about cognitive biases).

[113] A prominent example is Professor Stephen Bainbridge, who praises the quality

also to be conveying a political message here: because board decision-making is part of private ordering by individuals, and because private ordering is highly valued from their perspective, as opposed to government regulation of and intervention in the corporation, the quality of the board's decision-making process must be defended at all costs.[114]

It is, of course, sensible to avoid the opposite extreme of concluding that all group decision-making, and thus board decision-making, is defective, and to acknowledge the advantages of existing institutional arrangements.[115] It is equally important not to draw conclusions too rapidly from fields as complex as social psychology and organization and management science.[116] On the

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of decision-making on U.S. boards. *See generally* Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002).

[114] The apologists may also belong to a group that is bound up with the existing corporate regime and that thus blinds them to its problems (or at least makes them reluctant to criticize the problems). Situated, as they are, at the top of the academic hierarchy and recipients of the consulting and other work (such as board appointments) that accompany this position, the apologists are situationally a part of the status quo and thus, from a social perspective, do not have the social distance to criticize it in any fundamental way. There is nothing new, of course, in this observation about the role of intellectuals in defending the status quo of which they are an important ideological part. For one of the most insightful and seminal discussions of this phenomenon, *see* PIERRE BOURDIEU, THE STATE NOBILITY (Lauretta C. Clough trans., 1989); *see, e.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 924 (Del. Ch. 2003) (discussing role of law Professor Joseph Grundfest of Stanford University School of Law as a member of the special committee of Oracle's board). To be charitable to these scholars, adhering to the status quo is a human characteristic. *See* Robert A. Prentice & Jonathan J. Koehler, *A Normality Bias in Legal Decision Making*, 88 CORNELL L. REV. 583, 589-90 (2003).

[115] Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003) (pointing out how, in approving the questionable transactions with the special purpose entities, the Enron board failed to monitor them and should have realized that no other monitor, i.e., the market, was available); *see also* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001) (accepting the primacy of the board while trying to advocate that it become more responsive to claimants other than shareholders). To be charitable, this may ultimately be Professor Bainbridge's point. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 606 (2003).

[116] Professor Gregory Mitchell makes a related point when discussing behavioral law and economics. *See* Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67 (2002). He argues that behavioral law and economics scholars (including me) have not been careful about their use of psychological research and thus make unwarranted assumptions about human behavior and decision-making in their policy discussions. Long a scholar of law and the organizational sciences, Pro-

other hand, it is also important not to allow the present state of research about group decision-making to be used as an argument against any change to the status quo. Current beliefs in the proper functioning of boards of directors are themselves based on an incomplete view of the social psychological literature, or have little social psychological basis.[117] Yet, because the beliefs represent the status quo, their proponents impose a higher burden on those who argue that the current state of affairs in the executive suite and boardroom is seriously flawed.[118] Social psychological evidence does not support either the assertion that decision-making groups are fatally flawed or that they are the best available decision-makers. All I contend is that the recent evidence of frequent board and corporate advisor participation or acquiescence in wrongdoing, and the social psychological research on group decision-making defects that makes sense of that evidence (like groupthink) are *enough* to justify my position.

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fessor Donald Langevoort similarly cautions about the use of behavioral insights for regulatory purposes. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation,* 97 Nw. U. L. Rev. 135, 187 (2002).

117 To take one example, it is commonplace that the expression of conflicting views always enhances group decision-making performance. However, evidence suggests that, even for relatively sophisticated groups engaged in complex decision-making tasks, too much expression of conflict may undermine group performance. *See, e.g.*, Carsten K.W. De Dreu & Laurie P. Weingart, *Task Versus Relationship Conflict, Team Performance and Team Member Satisfaction: A Meta-Analysis* 88 J. Applied Psychol. 741, 741-42 (2003). Vice-Chancellor Strine indirectly acknowledges the poverty of corporate law jurisprudence on social psychological matters:

> And it should not be our law. Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.

In re Oracle, 824 A.2d at 938 (internal citation omitted).

118 I suggest that Professor Mitchell falls into this error himself, although he asserts that he is not defending the status quo in his criticism of behavioral law and economics. I contend that he does it through the paralysis that his approach would produce in policy analysis, for he argues that no policy can be put forward without adequate psychological evidence, with psychologists like himself making the decision about what is adequate! This strategy of imposing a higher persuasion burden on someone challenging the status quo, as if the status quo position is entitled to this privileged position, is quite common in organizations in which individuals collectively refuse to see the harm the organization is causing. *See* Darley, *How Organizations Socialize*, *supra* note 102, at 20.

This position is that the present functioning of the corporate hierarchy, particularly the board, is flawed and there needs to be a sustained reflection on ways to improve it, other than the kind of incremental modifications to the status quo that now pass for reform. Because law and practice (and corporate scholars) place so much importance on the board, the significant evidence that it is a dysfunctional institution that cannot bear this importance is a reason for immediate concern and action.

C. *Evolutionary Biological Support*

The main theoretical inspiration of the arguments made in this Article clearly comes from social psychology. Evolutionary biology, however, may provide complementary support for my contention about the fundamental problem of the inner circle in the corporate scandals. Human beings have evolved to become highly social, and thus on average individuals are predisposed, or adapted (that is, hard-wired), to enter into and thrive in social and group life, which means implicitly understanding how groups function.[119] Moreover, if, as psychologists suggest, much of our thinking, feeling, and behavior is automatic because it arises from an "adaptive unconscious," which is programmed for our survival, it is almost certain that a good part of our behavior in groups has become natural and may not even rise to the level of consciousness.[120]

All I want to suggest here is that evolutionary biology, when coupled with social psychology, may provide a fuller understanding of the dysfunctional inner circles, if only because the attitudes and behavior in them are so natural.[121] The evolutionary biologi-

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[119] Noted neuroscientist Steven Pinker contends, however, that we cannot take social groups or society for granted. STEVEN PINKER, THE BLANK SLATE: THE MODERN DENIAL OF HUMAN NATURE 285 (2002) ("With a slightly different ecosystem and evolutionary history, we could have ended up like our cousins the orangutans, who are almost entirely solitary.").

[120] *See* TIMOTHY D. WILSON, STRANGERS TO OURSELVES: DISCOVERING THE ADAPTIVE UNCONSCIOUS 72-73 (2002).

[121] This line of thinking must face the common accusation that it reduces a complex human activity to biological origins. On the general fear of insights from biology and evolutionary studies, see generally PINKER, *supra* note 119, at ix ("The refusal to acknowledge human nature is like the Victorians' embarrassment about sex, only worse: it distorts our science and scholarship, our public discourse, and our day-to-day lives."). As Pinker notes, this kind of explanation flies in the face of an intellectual position, with a long pedigree since the Enlightenment, that regards the "mind" as superior to "matter" and that is particularly prevalent in intellectual disciplines, such as legal scholarship, that have little connection to the hard sciences. Yet

cal approach would posit that human beings are constrained by their evolutionary origins, which produced a species adapted to survive in the environment of its development. Because this adaptation still plays a dominant role today, but in very different circumstances, it may result in inappropriate thinking, feeling, and behavior. Take the example of the functioning of an inappropriately cohesive group around a CEO. I suggest that the dysfunctional aspects of corporate group decision-making like groupthink may well be produced by factors that during most of our evolutionary history had survival advantages, but that today impede good decision-making. These factors would include selecting and following a leader and a group on the basis of, usually, his dynamism, optimism, and energy, and even the leader's height and appearance.[122] These factors were no doubt important in the early days when bands of human beings formed, and thus survived, around strong, healthy, and energetic individuals.[123] Over millennia, recognition and acknowledgment of the importance of these factors and their role in group formation and survival became hard wired in human beings and thus passed along as genetic traits because, like other adaptive factors, they increased the probability of individual, group, and species survival.[124] Yet the exercise of these same factors in corporate decision-making groups, such as the board, may have disastrous consequences because it undermines critical, rational thinking on the part of the group's members, and because it may promote inappropriate behavior on the part of the CEO leader (e.g., belief in his invincibility).

It is undeniable that these factors played a significant role in the formation and functioning of the inner circles involved in the

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it is not being reductionist—indeed, it is being appropriately intellectual—to take into account the behavioral research pointing out that much human behavior, including decision-making, is due to modes of thought and behavior that are "hard-wired" in human beings as a result of our evolutionary development. *See also* MATT RIDLEY, NATURE VIA NURTURE: GENES, EXPERIENCE, AND WHAT MAKES US HUMAN (2003) (arguing against a stark nature/nurture divide because genes and human culture are interdependent).

122 Once a leader and group are selected, then a bias arises attaching individuals to them, which itself may have evolutionary origins. *See* Prentice & Koehler, *supra* note 114, at 634.

123 Admittedly, the traits have an even more complex evolutionary meaning, for reproductive success then depended upon them. *See* GEOFFREY MILLER, THE MATING MIND 191-92 (2000).

124 *See* JOSEPH LEDOUX, THE EMOTIONAL BRAIN 134-37 (1996).

corporate scandals.[125] As discussed earlier, the anecdotal evidence is considerable.[126] To underscore one example, before his downfall Andrew Fastow of Enron was seen as the young, energetic but hard-nosed finance leader to whom even Kenneth Lay deferred. The related party transactions between Enron and the entities that he established benefited him and the employees of his finance group, who were the modern day equivalent of a small tribe. Adulation and excessive deference of group members to their leader, such as from fellow executives and board members to the CEO, in turn trigger almost primeval behavior on the latter's part. The behavior exhibits itself in the leader's demanding, and expecting as natural, exorbitant benefits from the firm and those dealing with the firm (such as investment banks) and in taking other actions that have evident genetic meaning, such as having multiple sexual partners.[127] Indeed, executives, who in some cases are former athletes, have carried over to their groups the kind of primitive point of view that some athletes exhibit—they believe that their physical abilities demand that they should be treated with considerable permissiveness.[128]

Further support for the importance of the evolutionary-based traits on the functioning of inner circles comes from the work of management scholars. Professor Khurana of the Harvard Business School has found that, in recent years, boards of large public companies have required that CEOs be "charismatic" or motivational leaders, and in his view this demand echoes a general human characteristic of irrationally seeking as leaders individuals

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125 *See* John M. Levine & Lauren B. Resnick, *Social Foundations of Cognition*, 44 ANN. REV. PSYCHOL. 585, 601 (1993) (pointing out that groupthink is particularly present in cohesive groups with strong, directing leaders).

126 *See generally supra* text accompanying notes 32-72.

127 How else to explain the recent exploits of Jack Welch, former G.E. CEO, who had a well-publicized affair with the former editor of the *Harvard Business Review*. *See* Eli Mason, *Scorn, fury, and whistleblowers*, ACCT. TODAY, Mar. 17, 2003, at 6. On the sexual boasting of Jurgen Schrempp, CEO of Daimler-Chrysler, *see* Karen Lowry Miller & Joann Muller, *The Auto Baron*, BUS. WK., Nov. 16, 1998, at 83-90. For the ever-amusing blunders of former CEO Kozlowski of Tyco, whose fraud with Tyco coincided with his divorce from his longstanding wife, his multiple affairs, and his engagement to a waitress, *see* Maremont & Cohen, *supra* note 53, at A1 (describing his life with "tall, athletic blond" Karen Mayo). *See also* Colleen Debaise, *Executives on Trial: Kozlowski Aide Details Lucrative Salary, Benefits*, WALL ST. J., Nov. 14, 2003, at C9 (describing trial testimony of Kozlowski's intimate relationships with women employees in Tyco).

128 Or, as former top military officers, they expect to receive the unquestioned obedience characteristic of military life.

who are considered to have almost supernatural powers.[129] For him, this trend has been generally disastrous for public companies since it fails to take account of how little an individual can contribute to a firm's success, and leads firms to ignore people who might be better suited to a position, but who lack the requisite attribute of charisma.[130] Similarly, executives often attribute their success to an indefinable quality, such as intuition, and their followers affirm that the executives possess this special talent. However, as management scholars have explained, acting on intuition often means basing decisions on unconscious factors that were useful for life in primitive environments, but that do not help individuals or groups respond adequately to the complexities of decision-making in modern life and business.[131]

As is the case with social psychological literature, evolutionary biology does not necessarily lead small, cohesive management groups to become bands dominated by individuals only on the basis of traits having little meaning in our complex society. Certainly individuals can exert influence over a group by force of intellect or by a personality that is open to different viewpoints. Moreover, evolutionary biological research suggests—not without controversy[132]—that altruism, the predilection to benefit those not biologically related, may also be a foundational form of

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129 Rakesh Khurana, *The Curse of the Superstar CEO,* HARV. BUS. REV., Sept. 2002, at 60, 62 ("Finally, in all too many cases, the charismatic leader was supposed to have the power to perform miracles—to bring a dying company back to life, for instance, or to vanquish much larger, more powerful foes."). Although Professor Khurana draws his inspiration from Max Weber's work on charismatic leaders, my emphasis on the biological origins of charisma in no way contradicts his approach.

130 Professor Khurana develops his perspective in more detail in a fascinating book, RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR (2002). From a related psychological perspective, one could argue that U.S. companies place too much emphasis on the possession of such traits as optimism and control in top executives, when in fact those exhibiting these traits have severe forms of cognitive biases, which are disastrous for decision making because they lead individuals to take action uncritically. *See* Lovallo & Kahneman, *supra* note 100, at 3.

131 *See* Eric Bonabeau, *Don't Trust Your Gut*, HARV. BUS. REV., May 2003, at 116, 118 ("Intuition is a means not of assessing complexity but of ignoring it."). *See also* WILSON, *supra* note 120, at 93-115 (discussing how difficult it is for individuals to know why they think the way they do). Of course, some intuitions could represent a sophisticated, but unconscious (i.e., unavailable to the conscious mind), decision-making based on past circumstances and situations.

132 The controversy lies in whether altruism truly exists, i.e. whether there are situations where an individual benefits others who are not genetically related to him or her. *See generally* RICHARD DAWKINS, THE SELFISH GENE (1976).

human behavior.[133] Indeed, the contrast between the excessive self-focus of the inner circles and the altruism of the whistleblower raises fascinating questions about whether the nature and function of some groups may reduce or temporarily suppress altruism and whether inner circles are composed of the kind of people (e.g., other CEOs, top bankers, former government officials, even leaders of academic institutions and other non-profit organizations) who are prone to excessive self-interest and groupthink.[134]

The point here is a simple one: There is enough evidence regarding the inner circles involved in the corporate scandals to allow one to argue that they are functioning subject to ancient behavioral constraints that at times lead them to make disastrous decisions. Corporate policy makers thus ignore the evolutionary biological research, which complements the social psychological work, at their peril, particularly when their view of executive groups or boards of directors is that of a body composed of dispassionate individuals acting rationally and deliberately. But, as the next Part will show, this is exactly what policymakers have done.

II

THE SOCIAL PSYCHOLOGICAL INADEQUACY OF CURRENT CORPORATE GOVERNANCE PROPOSALS

In the wake of the corporate scandals, corporate policymakers tried to identify the causes of the scandals and proposed reforms to address them. They generally focused on corporate governance, particularly the behavior of members of the board of direc-

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[133] *See, e.g.*, ELLIOTT SOBER & DAVID SLOAN WILSON, UNTO OTHERS: THE EVOLUTION AND PSYCHOLOGY OF UNSELFISH BEHAVIOR 17-54 (1998).

[134] Janis appeared to believe that groupthink is a characteristic of groups, not of the individuals in the group. *See* JANIS, *supra* note 86, at 158. Thus, the same individual might suffer from groupthink in one decision-making group, but not in another group. *See id.* at 132-58 (describing how President Kennedy's inner circle avoided groupthink at the time of the Cuban missile crisis but suffered from it during the Bay of Pigs fiasco). For a somewhat surprising research result on CEOs, see ERNST FEHR & JOHN A. LIST, THE HIDDEN COSTS AND RETURNS OF INCENTIVES—TRUST AND TRUSTWORTHINESS AMONG CEOS (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 134, Nov. 2002) (presenting experimental data showing that CEOs are more trustful and exhibit more trustworthiness than student experimental subjects), *available at* http://www.iew.unizh.ch/wp/iewwp134.pdf. A cynical view of this data would suggest that CEOs leave the details to, and trust, others so that they can profit from good results and deny the bad ones.

tors and top executives, as well as of corporate advisors such as accountants, bankers, and lawyers. In this Part, I contend that these reflections and reform proposals are fundamentally flawed and will have little effect because policy makers fail to take adequate account of, and even to acknowledge, the social psychological dynamics and related evolutionary behavioral constraints that operate in the executive suite and boardroom, and that are a major cause of the scandals.

Since the number of responses to the scandals is great, it is impossible to cover them all. In this Part, therefore, I examine a few prominent examples, which can be divided into the following categories: (1) advisory groups' pronouncements on corporate governance, and (2) self-regulatory bodies' proposals on the same subject. I defer my analysis of the relevant reforms of the Sarbanes-Oxley Act and the implementing SEC regulations to the next Part.

A. Advisory Groups on Corporate Governance

A common response to the corporate scandals involved proposals to reform corporate governance—the basic relationships between participants in a firm—particularly the roles of shareholders and management.[135] Indeed, corporate governance became an issue of national attention, as was exemplified by President Bush's speech about corporate abuses in the early days of the revelation of the scandals.[136] Yet corporate governance

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[135] For a positive view of present U.S. corporate governance, see Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 8 (Spring 2003) (using stock and performance data to suggest that, despite the corporate scandals, U.S. corporate governance is not bad considering the better performance of the U.S. economy compared to that in other developed countries, even during the time of the scandals, and arguing against imposing too many governance restrictions on U.S. business).

[136] As President Bush stated,

> The 1990s was a decade of tremendous economic growth. As we're now learning, it was also a decade when the promise of rapid profits allowed the seeds of scandal to spring up. A lot of money was made, but too often standards were tossed aside. Yet the American system of enterprise has not failed us. Some dishonest individuals have failed our system. Now comes the urgent work of enforcement and reform, driven by a new ethic of responsibility.

President George W. Bush, Remarks on Corporate Responsibility (July 9, 2002), *available at* http://www.whitehouse.gov/news/release/2002/07/20020709-4.html (last visited Oct. 18, 2004). In his speech, the President outlined a plan of reform, which basically involved enhanced enforcement of the securities laws and increased penalties for their violation, as well as a call for more ethical behavior by corporate execu-

reform proposals completely ignored, whether consciously or not, the social psychological (and related evolutionary) basis for the scandals.[137]

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tives. One suspects that the current Administration will never fully appreciate the problems of the inner circle among corporate executives and boards because the President and so many leaders of his administration are former CEOs and board members. *See* Thomas Frank, *Get Rich or Get Out: Attempted Robbery with a Loaded Federal Budget*, HARPER'S MAG., June 1, 2003, at 32, 33 (referring to George Bush's "CEO" presidency); Harold Meyerson, *Smart Bombs, Dumb War*, WASH. POST, Mar. 27, 2003, at A21 (referring to the CEO-dominated Bush administration, such as Richard Cheney, Donald Rumsfeld, and John Snow).

[137] The scholarly responses to the scandals continue to surface and are referenced from time to time in the Article. Many scholars base their assessments of the scandals on the rational actor perspective and offer few social psychological insights. *See, e.g.*, OREN BAR-GILL & LUCIEN BEBCHUK, MISREPORTING CORPORATE PERFORMANCE (Harv. Olin Ctr. for L., Bus., & Econ., Discussion Paper No. 400, June 2003 revision) (modeling why managers might misrepresent the performance of their firm); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1411-13 (2002) (explaining in a perceptive way how it made sense for "gatekeepers" of our financial markets, the accountants and investment bankers, to turn a blind eye to corporate scandals; that is, how, in the case of accounting firms, corporate executives gained accountants' complicity by threatening to withdraw the lucrative consulting contracts, and how securities analysts celebrated dubious firms because so much of the analysts' compensation was dependent upon its employer's banking success); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections,* 69 U. CHI. L. REV. 1233, 1243 (2002) (arguing that a new kind of board might help prevent corporate misdeeds by executives in the future; a board of a public company should be composed of a majority of independent board members not nominated by management, but representative of the large institutional shareholders that hold much of a company's capital and that thus have more of a financial incentive to monitor management). Yet Gordon does not address how this new board will avoid groupthink or other social psychological biases, especially since representatives of the institutional shareholders have the same training and background as current managers and investment bankers; *see also* MARGARET BLAIR, POST-ENRON REFLECTIONS ON COMPARATIVE CORPORATE GOVERNANCE 5 (Georgetown Univ. Law Ctr., Working Paper No. 316663 in Bus., Econ. & Reg. L., 2002) (arguing that the corporate governance scandals show the need for more sustained scholarly attention to the promotion of trust in corporate governance since, in her view, all those involved in a firm—investors, employees and management—will be willing to rely upon management and the board to divide equitably the profits of the firm only if there is a mutual trust among them); Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885 (2003) (arguing that the scandal had much to do with the emphasis on the language and practice of shareholder primacy, and that the preferred approach to corporate law and practice should be "team production," which emphasizes cooperation among participants in a firm). Yet Professor Blair fails to explain how trust can be used, and indeed how it can be strong enough, to overcome the promotion of group self-interest that lies at the heart of the corporate scandals.

Other scholars have pointed to the group basis for corporate scandals. *See* Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Directors and Officers for Corporate Climate: The Psychology of Enron's Demise* 35

Professor William Bratton points out that Enron was a model firm on corporate governance because it implemented nearly all of the recommendations proposed by corporate governance authorities (e.g., it had prestigious independent directors who composed a majority of the board, an active audit committee, and a corporate governance charter). Yet, this model board failed to exercise the required oversight of Enron officers and corporate advisors.[138] Similarly, the other scandal-plagued firms such as WorldCom, Tyco, Xerox, and HealthSouth were not "penny stock" companies or dot-coms, but major companies with good corporate governance practices in a country reputed to have one of the best corporate governance systems in the world.[139] In light of this data, reforms that modify in small ways existing corporate governance practices inspire little confidence.

Yet this kind of reform, which does not even identify the problem of the inner circle and the fundamental ability of a board of directors to address (and not be co-opted by) the inner circle is precisely what the scandals have inspired in business circles. A particularly noteworthy example came from the Business Roundtable, which is an organization representative of corporate America that generally takes positions on matters of concern to

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RUTGERS L.J. 1, 42-55 (2003) (arguing on the basis of social psychological research that the ethical climate of firms involved in corporate scandals contributed to the scandals); Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002) (identifying problems with in-groups in top management and boards in hyper-competitive environments, like business firms); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003) (presenting Enron as a case study of groupthink); Ribstein, *supra* note 23, at 9-10 (acknowledging the group aspect to the corporate scandals). *See also* Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99 (2003) (discussing his preference for a federal securities law, rather than a state corporate law, solution to the scandals).

138 *See* William W. Bratton, *Enron and the Dark Side of Shareholder Value,* 76 TUL. L. REV. 1275, 1283-86 (2002) (pointing out, among other things, that Enron was a firm where stock value—the focus of much corporate governance literature—was the sole focus, with perverse results); *see also* Gordon, *supra* note 137, at 1241-44 (making same point and referring to problems in heuristics with respect to board functioning); BREEDON, *supra* note 40, at 30-31 (noting that, in form, WorldCom had met existing corporate governance standards); Sonnenfeld, *supra* note 87, at 106-09 (observing that there is little difference in board practices between successful firms and many unsuccessful firms, or those involved in scandals).

139 *See, e.g.*, Raphael La Porta et al., *Corporate Ownership Around the World,* 54 J. FIN. 471 (1999).

executives and board members.[140] Offering a reform proposal relatively early in the revelation of the scandals[141] and not recognizing that they amounted to a corporate governance crisis, the Roundtable made incremental reform suggestions. For example, it argued that there should be an increase in the number of independent directors on corporate boards and made the banal observation that board members should pay more attention to financial matters.[142]

The Business Roundtable completely missed the social psychological origin of the scandals in the formation of inner circles of executives, professionals, and board members. Indeed, rather than recognizing that creation of a group mentality could have contributed to the scandals, it emphasized that a board needs to be cohesive and advocated that board members should be other executives (unfortunately, the kind of people prone to excessive self-interest and groupthink).[143] The Roundtable could not envision the value that would come from having true outsiders on boards who would have, akin to whistleblowers, a critical distance or even alienation that would help them resist the attraction of the inner circle so as to advance perspectives that the group would otherwise ignore.

While the Roundtable's response is not surprising given its conservative and protective nature (i.e., protective of the privileged position of executives and board members in society), its principles were disappointing. Because the Roundtable is in a good position to observe the social psychological dynamic of inner circles in firms, it could address them, and its pronouncements would carry great weight in business circles. By contrast, the Roundtable only made an occasional observation that points to the existence of inner circles. For example, it recognized that there are relationships among board members, such as friendships, that do not raise obvious issues of conflicts of interest, but that could undermine the disinterestedness of a board.[144] But the Roundtable did not build upon this insight, which might have

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[140] *See* The Business Roundtable, *About the Business Roundtable*, *at* http://www.businessroundtable.org/aboutus/index.html (last visited Oct. 18, 2004).

[141] *See* The Business Roundtable, *Principles of Corporate Governance* (May 2002), *available at* http://www.businessroundtable.org/pdf/704.pdf.

[142] *Id.* at 5.

[143] *Id.* at 10-11 (offering the reason that these board members could contribute to the corporation because of their experience in other industries).

[144] *Id.* at 11-12.

led it to address the formation of an inner-circle mentality in and around the board.

As another example, the nonprofit Conference Board formed a commission to examine the corporate scandals, a commission composed primarily of CEOs and former high government officials, that is, the kind of people who sit on boards.[145] The Commission issued three reports dealing with the following corporate governance matters: executive compensation, general corporate governance, and auditing and accounting.[146] In each of its reports, the Commission made potentially important insights on the corporate scandals having a social psychological resonance. In its first report, for example, the Commission identified the group origin of the scandals by observing that the scandals were the product of more than executive and board action and included the activities of professional advisors such as accountants, compensation consultants, and law firms.[147] In particular, the Commission highlighted the excessively close relationship between executives and compensation consultants who recommend to the board appropriate levels of executive compensation.[148] Its solution was also attractive from a social psychological perspective, for it involved creating an alternative inner group within the firm on compensation matters: a board compensation committee, composed of independent board members, to whom the outside consultant would report.[149]

In its combined second and third report (on corporate governance and auditing), as in its first report, the Commission continued to make perceptive insights about inner circles, but left them undeveloped and even undermined them. It attributed the scandals to the domination of strong CEOs over boards and only indirectly recognized as part of the problem the complicity of

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145 THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 2 (Jan. 9, 2003) [hereinafter CONFERENCE BOARD COMMISSION] (listing Commission members such as John Snow, then CEO of CSX Corporation and now Secretary of the Treasury in the Bush Administration), *available at* http://www.conference-board.org/pdf_free/SR-03-04.pdf.

146 *See id.*

147 *See id.* at 5.

148 *Id.* at 6.

149 *See id.* Moreover, the Committee recommended that the chair of the compensation committee play an independent role in the firm, for example, by being available at shareholders' meetings to discuss issues of executive compensation with shareholders and by having the power to call board meetings and executive sessions. *Id.* at 10.

boards and thus group psychology.[150] The Commission asserted that board members should adopt an oppositional stance towards executives, which suggests a procedure to break the group dynamics, but was vague on how this was to be accomplished.[151] As in the first report, the Commission attempted to introduce an oppositional framework to the board by separating the position of CEO and board chairman (the latter being an independent director), or, if that failed, at least by having a lead independent director around whom the other independent directors could form an alternative group.[152] In discussing audit committees and auditors, the Commission continued this approach of encouraging the formation of an independent center of power in the board (here the audit committee).[153]

However, because the Conference Board Commission's insights are disparate and undeveloped, its reform proposals do not convincingly address the corporate scandals. Creating oppositional groups within a board, based around a lead independent director or a compensation committee, sounds good on the surface as a way to counteract the force of the inner circle, but it is not clear why these groups would be successful in addressing

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[150] The report stated:

> The Commission is profoundly troubled by the corporate scandals of the recent past. The primary concern in many of these situations is that strong CEOs appear to have exerted a dominant influence over their boards, often stifling the efforts of directors to play the central oversight role needed to ensure a healthy system of corporate governance. In such circumstances, boards have often either lacked the structure and information to perform their roles properly, or they have simply abdicated their responsibilities to provide the oversight required of them. In such circumstances, the board cannot properly oversee the CEO's performance.

See id. at 18.

[151] The report stated:

> Boards must be composed of qualified individuals, a substantial majority of whom are free from disqualifying conflicts of interest, who have and will devote the necessary time to fulfill their responsibilities, and who are able to understand the issues facing the company, challenge management with tough questions and goals, and take action when needed.

Id. at 20; *see also id.* at 30 ("Boards should develop norms that favor open discussion, and encourage the presentation of different views.").

[152] *Id.* at 29 (discussing reform suggestions).

[153] For example, the Commission usefully suggested that in certain common circumstances a board should consider rotating the outside auditing firm (and not just the auditing partner) and perceptively observed that this rotation might make the auditing firm more independent of management. *See id.* at 36. But it did not explore the social psychological basis for this independence, preferring to rely on the self-interest of the individuals involved.

groupthink. Composed of board members otherwise favorably disposed (and encouraged to be so disposed) to top management because, as will be discussed further below, they come from the same elite as management, any opposition they generate would be symbolic and thus toothless. Without any understanding of social psychology, the Commission is thus left appealing vaguely to the personal responsibility of each board member for making its proposed reforms work.[154] Accordingly, its insights fall on barren ground.[155] Ultimately, the Commission is doomed from the outset. Composed as it is of people who have been executives and board members and who are from the backgrounds from which board members are traditionally taken, its members have a difficult time envisioning what a truly outside perspective on board life would be.[156] It was also advised by people who appear to espouse a straightforward rational actor, cost/benefit economics, and who exhibit no awareness of social psychology.[157]

Regarding corporate governance responses to the scandals, I conclude by referring, almost for comic relief, to the reactions of a well-known corporate lawyer, Martin Lipton, one of the founding partners of Wachtell, Lipton, Rosen & Katz, a powerhouse mergers and acquisitions and general corporate advisory law firm. His remarks are particularly disappointing because they carry so much weight in the corporate world, and even in the legal academy; he is one of the few top legal practitioners who admirably and ably engages legal scholars in debates about corporate and securities law issues.[158] Yet his response to the scandals is simplistic, perhaps—to be fair to him—because he believes that the scandals, not being symptomatic of U.S. corpo-

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[154] *See id.* at 5.

[155] For example, the Commission recommended that there be outside professional advisors to the audit committee, who would not be "bound by the 'collegial' nature of boards of directors and would be free to ask the tough questions." *See id.* at 40. It is precisely this issue of collegiality and failure "to ask tough questions" that is a basic problem of the inner circles. But the Commission does not address it directly. I shall discuss similar reforms under the Sarbanes-Oxley Act below.

[156] *See id.* at 30-31 (discussing board qualifications, which are all the traditional ones).

[157] I refer here to people like the economist Carolyn Brancato, who works for the Conference Board and who advised the Commission. She has done useful work on corporate governance, but, to my knowledge, it has always been within the rational actor framework. *See, e.g.*, CAROLYN KAY BRANCATO, INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE (1997).

[158] *See, e.g.*, Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002).

rate governance, do not require governance reform. Lipton seriously argues that boards must have longer meetings; they can no longer follow the current norm of starting a meeting in the morning and finishing it by lunch! Rather, boards must begin with board committee meetings on one afternoon and then proceed with a board meeting the following day. For him, therefore, a minor process change to board meetings is adequate to address the scandals.[159] Indeed, this process-oriented proposal, which is typical of practicing lawyers who look to give their clients procedures to follow to avoid liability,[160] misses entirely the group psychological origin of the problem. While, as discussed below,[161] procedures matter, and process design can counter social psychological dynamics, these minor modifications to the status quo are inadequate responses to the corporate scandals.[162]

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159 *See* Memorandum from Martin Lipton on A Post-Enron Paradigm for Board Meetings, to Wachtell, Lipton, Rosen & Katz (June 2, 2002) (on file with author).

160 In this respect, early in the revelation of the scandals the American Bar Association ("ABA") made a preliminary reform proposal to counter corporate misbehavior. *See* ABA REPORT, *supra* note 1. As might be expected given that it originated from the corporate bar that provides services to corporate management, the proposal was based on the current model that leaves corporate governance to the private sector, preferably under the auspices of self-regulatory organizations like stock exchanges. Yet, like the Business Roundtable and the Conference Board, the ABA offered proposals that could have the effect of breaking up the corporate inner circles. For example, it proposed that there be a corporate governance committee composed exclusively of independent directors that nominate independent board members and select board members for committees. *Id.* at 18. This reform would have the salutary effect of creating an opposing power center in the firm that might undermine the uniformity of views so typical of boards. In a similar vein, the ABA recommended that every corporation's board should establish a hotline for employees to report violations of the law or breaches of duty by corporate officers to more senior officers or a board committee. *Id.* at 20. But without an articulated understanding about the problem of group uniformity at the heart of the corporate hierarchy, the ABA could offer only disparate reforms that, because they were not part of a program well grounded in social psychology, are unlikely to be effective.

161 *See infra* Part III.

162 Admittedly, Lipton has presented a more thoughtful reaction to the scandals elsewhere. *See* Martin Lipton, *The Millennium Bubble and Its Aftermath: Reforming Corporate America and Getting Back to Business*, THE M&A LAWYER, Jul./Aug. 2003, *at* http://www.realcorporatelawyer.com/m&a/m&a0703-0803.html. But even here he refers to procedural problems with board meetings, although he puts them in a larger context. *See id.* (pointing out that board members were often fellow CEOs who had no time for board meetings). *See also* Memorandum from Edward D. Herlihy et al., A Practical Guide for Directors of Financial Institutions in Responding to the Current Business Climate, to Wachtell, Lipton, Rosen & Katz 5 (Aug. 5, 2002) (on file with author) ("Where the system has failed, it has failed as often due to a desire to please and go along (and thus a failure to ask the hard questions and throw up road blocks where they should be established) as it has due to dishonesty or bad intent.").

B. Self-Regulatory Reform Proposals

Self-regulatory organizations ("SROs"), the stock exchanges, and other associations that provide markets for the securities of publicly traded companies, also addressed reforms of the kinds of firms that have been at the center of the scandals.[163] Like the reform proposals described above, those of the two most significant SROs, the New York Stock Exchange (the "NYSE") and the NASDAQ Stock Market ("NASDAQ"), also focus on corporate governance. They are designed to improve the functioning of the board of directors so that it would be better prepared to prevent the kind of executive abuse and overreaching that, in their view, produced the corporate scandals.[164] I contend that, like the Business Roundtable and the Conference Board, the SROs failed to identify the social psychological causes of the scandals and accepted a simplistic view of the executive dynamics that led to them. Because of this failure, these reforms are also unlikely to counter effectively the formation and continued power of inner circles in a firm.

The NYSE's response is a good example of the inadequacy of the SROs' approach to recognize and deal with the social psychological origins of the scandals. From the outset of the scandals, the NYSE has been active in proposing reforms to the govern-

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The Watchell memorandum also stated that:

> In the current environment in particular, however, directors should take extra care in establishing that they have a reasonable basis for such reliance—namely, by establishing that they have a strong foundation for trusting the integrity, honesty and undivided loyalty of the management team upon whom they are relying and the independence and expertise of the company's outside advisors and auditors.

Id. at 4. Although lacking in specifics, this latter recommendation at least shows *some* recognition that action must be taken to counter the group dynamics at work in management. For an updated, expanded version of this memorandum, see Memorandum from Edward D. Herlihy et al., A Practical Guide for Directors in Responding to the Current Business Climate, to Wachtell, Lipton, Rosen & Katz (May 28, 2003) (on file with author).

163 Under U.S. securities law, much regulation of securities markets and their participants is self-regulation with SEC oversight. Because firms whose securities are traded in public markets are participants in these markets, they are regulated by self-regulatory organizations or SROs. *See generally* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 734-35 (4th ed. 2001).

164 The reform proposals predated the Sarbanes-Oxley Act. However, since they were pending before the SEC, which must approve any SRO rule changes, at the time of passage of that Act and since the legislation affected SRO regulation, the proposals had to be modified. It is worthwhile to consider them separately from the Sarbanes-Oxley Act since they were private reforms, albeit influenced by the legislation.

ance of the public firms whose shares trade on its market. Its attention makes sense; if investors lose confidence in the securities markets, the NYSE will surely suffer. A more cynical view is that the NYSE and its members sought (as it proved, unsuccessfully) to head off any government regulation of corporate governance by taking the initiative in addressing the scandals. It first established a committee, the Corporate Accountability and Listing Standards Committee, that issued a report on ways to improve corporate governance.[165] Following up on the Committee's recommendations, the NYSE board proposed changes to its listing standards for companies,[166] a proposal further revised as a result of the Sarbanes-Oxley Act.[167]

In accordance with the status quo perspective for enhancing board performance, the NYSE proposed increasing the role of independent directors. The Standards Committee asserted, among other things, that listed companies should have a majority of independent directors, should place only independent directors on the important board committees, and should enable the independent directors to meet separately from management and inside directors on a regularly scheduled basis.[168] Understandably enough, the NYSE board adopted this approach in the

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165 *See* NEW YORK STOCK EXCHANGE CORP. ACCOUNTABILITY & LISTING STANDARDS COMM., N.Y. STOCK EXCHANGE, CORPORATE GOVERNANCE REPORT (June 6, 2002) [hereinafter NYSE REPORT], *available at* http://www.nyse.com/pdfs/corp_govreport.pdf; Press Release, New York Stock Exchange, NYSE Approves Measures to Strengthen Corporate Accountability (Aug. 1, 2002).

166 *See* N.Y. STOCK EXCHANGE, CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS AUGUST 1, 2002 (August 16, 2002), *available at* http://www.nyse.com/pdfs/ corp_gov_pro_b.pdf.

167 *See* Order Approving Proposed Rule Changes and Amendments Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003) (final SEC order approving governance changes) [hereinafter Order]; Notice of Proposed Rule Change and Amendment No. 1 Thereto Relating to Corporate Governance, Exchange Act Release No. 47,642, 68 Fed. Reg. 19,051 (Apr. 17, 2003) (original proposal, followed by Amendments Nos. 2 and 3) [hereinafter Amendment No. 1]. Part of the original rule proposal dealt with equity compensation and proxy voting. At the request of the SEC, these aspects were broken away from the corporate governance proposals and have been approved. *See* Notice of Proposed Rule Change Relating to Shareholder Approval of Equity Compensation Plans and the Voting of Proxies, Exchange Act Release No. 46,620, 67 Fed. Reg. 63,486 (Oct. 11, 2002); Order Approving Proposed Rule Changes, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

168 *See* NYSE REPORT, *supra* note 165, at 2.

change to its listing standards.[169] In particular, the governance change included a requirement that listed companies have a corporate governance/nominating committee composed only of independent directors, that nominates directors and promulgates a corporate governance code for the company. Also required is a compensation committee, similarly composed, that establishes procedures for determining and reviewing executive compensation.[170] Moreover, the change enhances the power of the audit committee, again composed of independent directors, because it, rather than the chief executive, will hire and fire auditors and supervise the overall audit of the company.[171]

Yet the NYSE reforms will have little long-term effect, although there may be a short-term impact, precisely because, as noted above, the NYSE fails to recognize the social psychological origins of the scandals. One can only speculate about the reasons for this failure. Likely, it is due to the particular perspective of the NYSE and its professional advisors, which assumes that groups composed of executives, board members, and advisors work in a rational, deliberative fashion. Their worldview, which may be unconscious on the part of NYSE officials, may also contribute to the NYSE's limitations; any significant reform to corporate management could undermine the settled world of those individuals (i.e., CEOs, board members, top bankers, and lawyers serving corporate clients) who are influential at the NYSE.[172] Thus, while the NYSE's reforms counter the CEO's

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[169] *See* Order, 68 Fed. Reg. at 64,157-58; Amendment No. 1, 68 Fed. Reg. at 19,053-54 (discussing requirement that non-management directors meet in regular executive sessions apart from management).

[170] *See* Order, 68 Fed. Reg. At 64,158; Amendment No. 1, 68 Fed. Reg. at 19,054-57.

[171] Following the SEC's rulemaking with respect to SRO standards dealing with audit committees, *see infra* notes 284-95, the NYSE amended its listing standards to reflect the enhanced requirements pertaining to a listed company's audit committee. *See* Order, 68 Fed. Reg. at 64,158-59; Amendment No. 1, 68 Fed. Reg. at 19,055-56. *See infra* text accompanying notes 283-93 (discussing possible value of enhancing role of audit committee in corporate governance).

[172] Indeed, the NYSE has become the latest of U.S. companies or organizations to be involved in a corporate scandal when it was revealed that its longtime president, Richard Grasso, received a lavish compensation package, similar to that of a CEO in a top investment banking firm, and that the compensation committee awarding it was composed of investment bankers and company CEOs that the NYSE regulated. *See* Kate Kelly & Susanne Craig, *NYSE to Disclose Grasso Pay Among Changes*, WALL ST. J., June 6, 2003, at C1. This package was universally condemned and spurred inquiries by the SEC's Chairman into the NYSE's own governance. *See also* Deborah Solomon & Kate Kelly, *SEC Head Demands Details on Pay Deal for*

inner circle by creating an alternative power center on the board, such as the audit committee or independent directors led by a lead independent director, its lack of a basis in social psychology and its basic conservatism doom the NYSE's efforts.

An example suffices. As explained above, the NYSE's reforms are based upon an enhanced role for the independent director.[173] Yet the NYSE fails to consider that this kind of director has been easily affected by the force and attraction of the inner circle and has thus failed to carry the weight reformers of corporate governance have put on him. Furthermore, its definition of independence does little to change the status quo because it focuses on the threats to independence arising from a board member's "material relationship" with the company, "material" meaning the classic view of a financial relationship.[174] The NYSE's reforms might undermine the management inner circle through their creation and fostering of an oppositional power center of independent directors (particularly through regular meetings of non-management directors). Yet it is questionable how effective this

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NYSE's Grasso, WALL ST. J., Sept. 3, 2003, at C1 (describing Chairman Donaldson's inquiry to NYSE concerning the extraordinarily large compensation package). As a result of the furor over his pay, Grasso resigned. *See* Kate Kelly et al., *Closing Bell: Grasso Quits NYSE Amid Pay Furor*, WALL ST. J., Sept. 18, 2003, at A1; *see also* Susanne Craig et al., *Taking Stock: As End Neared, Grasso Held On In Hopes Pay Furor Would End*, WALL ST. J., Sept. 26, 2003, at A1 (describing the resignation process). It is telling that the main legal advisor to Grasso at the time of his resignation was Martin Lipton. *See* Laurie P. Cohen, *NYSE Faces Pressure, and Grasso a Decision*, WALL ST. J., Sept. 24, 2003, at C1 (describing Lipton's involvement with Grasso). New York Attorney General Eliot Spitzer is suing Richard Grasso seeking a return of much of this compensation. *See* Michael Bobelian, *Compared to What? Spitzer Calls Richard Grasso an Overpaid Nonprofit Chief*, N.Y.L.J., July 29, 2004, at 5.

[173] *See* Order, 68 Fed. Reg. at 64,157; Amendment No. 1, 68 Fed. Reg. at 19,053. The NYSE's rules identify categories of cases in which a director is deemed not to be independent. A company's board may decide, however, despite this presumption of non-independence, that a director is in fact independent, provided that the board explains its decision.

[174] *See* Order, 68 Fed. Reg. at 64,157; Amendment No. 1, 68 Fed. Reg. at 19,053. It is true that the NYSE includes in its rules a potentially broad definition of factors that may play a role in the independence determination. *See* Amendment No. 1, 68 Fed. Reg. at 19,053 ("Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships among others."). Yet, so much of the materiality discussion revolves around employment and other financial relationships with the company. *See id.* On this point, the NYSE reduced from five years to three years the "look-back" period when a former executive of a company is presumed not to be independent, which clearly favors the kinds of people who appear on boards (i.e., former executives). *See* Order, 68 Fed. Reg. at 64,157.

group is likely to be, outside of a crisis.[175] The NYSE reformers fail to recognize how the dominant inner circle can undermine independent directors by drawing them into the circle, thus neutralizing the oppositional group.[176]

Only by acknowledging the force of the inner circle and by attempting to understand its dynamics would the NYSE be able to offer effective reforms. To do so, as discussed in the next Part, may well involve taking a perspective that significantly conflicts with the status quo, such as viewing the kinds of people now in the executive suite and boardrooms, whether independent or not, as those who are particularly prone to excessive self-interest and groupthink and who reproduce themselves on boards. Yet the NYSE cannot even imagine this kind of perspective (and perhaps it is expecting too much for it to do so). Instead, it calls for ethical directors,[177] but feels that there is little that companies can do to find them.[178] It is also no surprise that the NYSE gives a lukewarm endorsement to policies designed to encourage whistleblowers who resist inner circles. The NYSE states only that there must be a way for employees to communicate company misdeeds, but it offers no concrete suggestions other than that listed companies should have whistleblowing channels and a policy of not retaliating against whistleblowers (which is now the law).[179] The juxtaposition of a reaffirmation of the traditional

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[175] Generally, boards, like all groups, really "wake up" only when there is a crisis and thus when it is too late to prevent much of the damage from a scandal. The whole point about corporate governance reform is to impose oversight systems that would prevent a crisis.

[176] *See* Bank & Lublin, *supra* note 21, at A1 (discussing how John Mendelsohn, head of a Houston cancer center that received millions in contributions from Enron, was a board member on the audit committee of the company). Moreover, under the new NYSE rules, the executive sessions of the non-management directors include directors who are not independent (such as the recent CEO of the company) and who might well be a member of the CEO's inner circle. The rules also call for a meeting of independent directors only once a year. *See* Order, 68 Fed. Reg. at 64,158.

[177] *See* Order, 68 Fed. Reg. at 64,159; Amendment No. 1, 68 Fed. Reg. at 19,057.

[178] *See* Amendment No. 1, 68 Fed. Reg. at 19,057.

[179] *See* Order, 68 Fed. Reg at 64,159.

> Encouraging the reporting of any illegal or unethical behavior. The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure

view of the importance of the independent director and a call to corporate ethics with the lukewarm promotion of whistleblowing suggests that, at base, the NYSE is reluctant or unable to imagine reforms that would effectively address the problem of corporate inner circles.[180]

III

SOCIAL PSYCHOLOGICALLY-BASED BOARD REFORM

A. The Public Director and the (Really) Monitoring Board

The contrast is stark between the strength of the social psychological pressures and the complementary evolutionary factors that led to the corporate scandals, and the poverty of many reform proposals. The status quo of current corporate governance and governance reforms makes it likely that corporate scandals will recur and society will again be dependent upon the occasional whistleblower who, at great personal expense, reveals corporate wrongdoing. The basic problem lies in the formation and behavior of the corporate inner circles, and whistleblowing attacks that come only from the outside.

The focus for reform must be the board of directors because the corporate scandals represent, at base, a board failure. Boards are the ultimate legal authority for the corporation,[181] and the

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that employees know that the company will not allow retaliation for reports made in good faith.

Amendment No. 1, 68 Fed. Reg. at 19,057-58.

[180] The NASDAQ made, and had approved, corporate governance reforms essentially similar to those of the NYSE and the reforms thus suffer from the same defects as the NYSE's. *See* Order, 68 Fed. Reg. at 64,161-66; Notice of Proposed Rule Change and Amendment No. 1 Thereto Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,451 (Mar. 25, 2003); National Association of Securities Dealers (NASD), SR-NASD-2002-141, Relating to Proposed Amendments to Rules 4200 and 4350 Regarding Board Independence and Independent Committees (Mar. 17, 2003); NASD, SR-NASD-2002-139, Requiring Issuers to Adopt Codes of Conduct (Oct. 9, 2002); NASD, SR-NASD-2002-140, Relating to Shareholder Approval for Stock Option Plans or Other Arrangements (Oct. 11, 2002); NASD, SR-NASD-2002-139-Amendment 1 (Jan. 15, 2003).

To be fair to the NYSE and the other organizations discussed in this part, one might expect that, composed as they are of busy businesspeople and professionals, they would not be at the forefront of thinking innovatively about corporate governance. Since corporate law and finance scholars themselves have not uniformly developed a social psychological approach to corporate reform, see *supra* note 137, it may be too much to expect practitioners to espouse this approach.

[181] *See generally* JAMES D. COX & THOMAS L. HAZEN, CORPORATIONS § 9.05, 152-54 (2d ed. 2003).

reality of U.S. corporate governance is board rule.[182] Certainly bankers, accountants, lawyers, and securities analysts contributed to the scandals, but having a board or board members not join or passively acquiesce in, and actively resist, inner circles around the CEO would have neutralized these contributing causes. It is thus appropriate to center reform efforts on the board, and not limit them to secondary participants in corporate governance.

A major purpose of board reform would be to resist the self-interest that became the perverse goal animating inner circles.[183] Self-interested behavior obviously exists and, without it, commercial exchanges would not occur.[184] Yet inner circle members appeared to unleash their self-interest so that it had no limits, which resulted in CEOs, board members, and corporate advisors demanding huge compensation packages, consulting arrangements, and perquisites or fees for themselves and for the groups or teams that would work together in a single transaction or for a firm.[185] The goal here should be uncontroversial, for it is to address the longstanding problem in business organizations—self-dealing by corporate agents—that clearly existed in the scandals

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[182] This rule is celebrated from very different political perspectives. *See* Blair & Stout, *supra* note 115, at 418-22; Bainbridge, *supra* note 115, at 559-63.

[183] For an acerbic criticism of the unthinking acceptance of this ideology, see KHURANA, *supra* note 130, at 219-20.

[184] *See* JENSEN, *supra* note 73, at 11-50 (representative work). *See also* RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 53-54 (2003).

[185] Board members might not receive much direct compensation from a firm, but, as the scandals have shown, they could receive indirect benefits. And, when they are CEOs of other firms, the benefit could be particularly indirect (e.g., having the CEO of the firm where they serve as a director on their own board's compensation committee). For a similar discussion of executive abuses of a "new managerialism" that in effect promoted executive and board self-interest under the guise of helping shareholders, see Dallas, *supra* note 107. A good analogy to this self-interest is that of professional athletes, often pampered stars who are rewarded in an extreme fashion and who regularly consider themselves to be above the law. It may, in fact, be no accident that many executives and bankers played high school and college sports and are direct or indirect products of the new sports culture (which, through the media, pervades U.S. culture). It is ironic that executives use ideologies of team spirit and self-sacrifice from an earlier time in sports to inspire their employees (even if they do not themselves subscribe to them). *See, e.g.*, Michelle Conlin, *CEO Coaches*, BUS. WK., Nov. 11, 2002, at 98 (speaking of the ex-CEO of Charles Schwab: "He reveled in teamwork—if he was the captain. Ideas were great, but only if they were his. Try challenging the former All-Ivy wrestling champ, and you could find yourself caught in a corporate full-nelson—left with a lot of bruised feelings and a trampled ego."). There are exceptions. *See* Peggy Noonan, *Privileged to Serve*, WALL ST. J., July 15, 2002 (discussing Army enlistment of football star Pat Tillman). Tillman later died in combat in Afghanistan.

and that so much of corporate law is designed to prevent.[186]

This unchecked self-interest also undermined human qualities such as cooperation, trust, and altruism that lead people to look beyond a small, almost tribal inner circle,[187] and that also allow markets, other exchange systems, and large corporations to function.[188] Without these characteristics, firms, and even society, would disintegrate as each individual sought to benefit himself and the small groups to which he belongs.[189] In the financial

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[186] *See* COX & HAZEN, *supra* note 181 §§ 10.12-11.10, at 204-58. But existing law does not adequately recognize the group behavior of the board that allowed the self-dealing to occur and, as is well known, this law is deferential to the board when there are no obvious benefits coming to the board members. *See* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 171-73 (2003) (discussing the U.S. corporate law doctrine of the "business judgment rule" under which courts decline to review directors' decisions in the absence of fraud or self-dealing). *But see supra* note 114.

[187] *See generally* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001). It appears that people do care about such issues as honesty and fairness, despite the economic focus on self-interest. *See, e.g.*, John H. Evans III et al., *Honesty in Managerial Reporting* 10 (May 2001) (on file with author) (discussing experiments showing lack of conformity of subjects' behavior with self-interest model). Scholars of evolutionary behavior contend that there is an overall altruism that is hard-wired into our selves. *See* Ernst Fehr & Simon Gächter, *Altruistic Punishment in Humans*, 415 NATURE 137, 139 (Jan. 10, 2002). *See also supra* note 132.

[188] The pursuit of self-interest undermined both business firms and nonprofit institutions that relied upon their largess. The best example of the corruption of a nonprofit institution is the 92nd Street Y, which admitted Jack Grubman's children to nursery school in return for a large capital contribution from Citigroup. On the corruption in the 92nd Street Y, see Assurance of Discontinuance Pursuant to Executive Law § 63(15), In the Matter of Grubman, at 31-32 (N.Y. Bureau of Inv. Prot. Apr. 21, 2003) (describing Grubman's and Citigroup's CEO Sanford Weill's effort to use Citigroup assets to get Grubman's children into a prestigious nursery school), *available at* http://www.oag.state.ny.us/investors/grubman/jack_grubman_aod.pdf. Sadly, the 92nd Street Y is not alone in being beholden to the moneyed class. *See, e.g.*, Juliet Chung & Daniel Golden, *At Elite Prep School, Parents Do the Math*, WALL ST. J., Aug. 25, 2003, at A1 (describing outsized compensation of headmaster of elite private school St. Paul's); Daniel Golden, *Extra Credit: At Many Colleges, the Rich Kids Get Affirmative Action*, WALL ST. J., Feb. 20, 2003, at A1 (describing how many colleges give wealthy applicants special admissions).

[189] Scholars have written:

> Belief-dependent cooperation can be viewed as a social interaction effect that is relevant in many important domains. For example, if people believe that cheating on taxes, corruption, or abuses of the welfare state are widespread, they are themselves more likely to cheat on taxes and are more willing to take bribes or to abuse welfare state institutions. It is therefore important that public policy prevents the initial unravelling of civic duties because, once people start to believe that most others engage in unlawful behaviour, the belief-dependency of individuals' cooperation behaviour may render it very difficult to re-establish lawful behaviour.

world, the breakdown of larger social bonds would take the form of a loss of investor confidence that would threaten the existence of financial markets and the stability of the economy.[190] Addressing excessive self-interest also recognizes that there might be a systemic cause or causes of the scandals.[191]

Ernst Fehr & Urs Fischbacher, *Why Social Preferences Matter—The Impact of Non-Selfish Motives on Competition, Cooperation and Incentives*, ECON. J., at C1, C16 (Feb. 1, 2002). *See also* ARMIN FALK ET AL., TESTING THEORIES OF FAIRNESS—INTENTIONS MATTER 16 (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 63, Sept. 2000) (presenting evidence that people care both about the intentions of actors, as well as the results of actions), *available at* http://www.iew.unizh. ch/wp/iewwp063.pdf; ERNST FEHR & KLAUS SCHMIDT, THEORIES OF FAIRNESS AND RECIPROCITY—EVIDENCE AND ECONOMIC APPLICATIONS (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 75, Dec. 2000) (discussing the need for an economic theory that takes into account individuals' desire for fairness). This concern about the social consequences of the decline in trust and cooperation echoes other accounts about the breakdown in social behavior. *See* ROBERT H. FRANK, LUXURY FEVER 146-58 (1999).

[190] According to Alan Greenspan,

> In recent years, shareholders and potential investors would have been protected from widespread misinformation if any one of the many bulwarks safeguarding appropriate corporate evaluation had held. In too many cases, none did. Lawyers, internal and external auditors, corporate boards, Wall Street security analysts, rating agencies, and large institutional holders of stock all failed for one reason or another to detect and blow the whistle on those who breached the level of trust essential to well-functioning markets.

[191] *Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before the S. Comm. on Banking, Housing, and Urban Affairs* (July 16, 2002) (testimony of Alan Greenspan, Chairman, Federal Reserve), *available at* http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm.

On criticism of self-interest and excess in executive compensation, see Joseph Fuller, *A Letter to the Chief Executive*, HARV. BUS. REV., Oct. 2002, at 94, 98-99 ("At this point, I don't think it's an overexaggeration to say that the fundamental, underlying logic of our executive compensation program is in tatters."); Khurana, *supra* note 129, at 63 ("What makes today's profound faith in the charismatic CEO so troubling is the lack of any conclusive evidence linking leadership to organizational performance."); MARGIT OSTERLOH & BRUNO S. FREY, CORPORATE GOVERNANCE FOR CROOKS? THE CASE FOR CORPORATE VIRTUE 19-20 (Inst. for Empirical Research in Econ., Working Paper No. 164, July 2003) (arguing for reduced and fixed compensation for executives because current compensation systems crowd out any pro-social tendencies in them and discourage social behavior in other employees), *available at* http://www.iew.unizh.ch/wp/iewwp164.pdf. Professor Khurana argues that a shift to investor capitalism led boards of directors irrationally to look for "charismatic" CEOs, rather than executives capable of competently doing the job, and led boards to reward them with pay packages not at all proportional to their minor contribution to the value of a firm. *See* KHURANA, *supra* note 130, at 188-95. The debate on appropriate levels and design of executive compensation is active and ongoing. *See, e.g.*, John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 298 (2004) (arguing that the scandals had a lot to do with executives attempting to maximize

Yet focusing board reform on restraining self-interest run amok in the corporate inner circles is only one goal. It is also necessary for this reform to address the group origins of the scandals. The reform must counter the natural inclination of those at the summit of the corporate hierarchy to form self-contained groups that are characterized by groupthink and other negative group dynamics.

The whistleblower brings together these two goals of board reform. On the one hand, a board member should have the prosocial perspective of the whistleblower that would allow him to keep in check self-interest and to focus on the benefits of groups, including shareholders, other claimants in the firm, employees, customers, and the local community, rather than an inner circle, when fulfilling his legal duty.[192] On the other hand, board members should have the ability of a whistleblower to resist the at-

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their compensation under stock option plans, which promoted excessive compensation in short periods). For an interesting general discussion on executive compensation, see *What's Wrong with Executive Compensation? A Roundtable Moderated by Charles Elson*, HARV. BUS. REV., Jan. 2003, at 68-77; *see, e.g.*, *id.* at 71 ("We also need greater director independence, though that's not an easy issue. We are dealing with people, by and large, who know one another and have common experiences, and it's not an environment likely to foster a great deal of independence from the CEO among board members.") (remarks of lawyer Joe Bachelder). *But see* RICHARD S. TEDLOW ET AL., THE AMERICAN CEO IN THE TWENTIETH CENTURY: DEMOGRAPHY AND CAREER PATH (Harv. NOM Research Paper No. 03-21, Feb. 2003) (arguing that CEOs are special and providing the following assumptions).

> I. People matter. While acknowledging that the "resource dependence" view of the firm provides an important perspective and a brake on the "great man" theory of history, we find it impossible to look at business history without concluding that different people facing similar situations make different decisions.
>
> II. Because people matter, we must know as much about them as we can in order to understand the behavior of firms. This knowledge includes their demographics, psychographics (i.e., life style), and even individual psychology. Such factors form the prism through which these people view the world.
>
> III. The most important person in the corporation is the chief executive officer. He or she can make decisions no one else can.
>
> IV. Because the CEO is so important to understanding the firm, one must understand the mechanisms through which an individual becomes CEO. How do you place yourself in the set of people evoked for consideration at the time of succession?

Id. at 29.

192 Although there is debate concerning for whom the directors supervise the firm, with shareholder primacy being the norm, *cf.* Montgomery & Kaufman, *supra* note 77, at 91-93 (discussing proposals that are designed to make individual board members more responsible to shareholders), corporate law specifically embraces a perspective of discretion to directors to consider other constituencies. *See* Margaret

tractions of an inner circle and not fall into groupthink, nor be easily swayed by the biological factors contributing to the group dynamic. Like a whistleblower, an individual board member must be able to confront and oppose the dominance of the CEO and the inner circle that forms around him.[193] Indeed, a forceful opposition by a board member, in contrast to the token disagreement of the house critic, would better create the cognitive conflict that makes group decision making work well.[194]

As whistleblowing scholars explain, the problem is the difficulty of identifying people who would be whistleblowers, those who have a social orientation and are resistant to groupthink, and who would thus be ideal candidates for corporate boards.[195] Contrary to what the identity of many recent high-profile corpo-

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M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 287-97 (1999).

193 *See* Susan Mohammed, *Toward an Understanding of Cognitive Consensus in a Group Decision-Making Context,* 37 J. APPLIED BEHAV. SCI. 408, 417 (2001) ("Specifically, under dominant directive leaders, groups may not feel ownership over the process or develop the social interaction mechanisms for developing cognitive consensus.").

194 Organizational scholars have pointed out the advantages of this kind of conflict in group decision-making. *See generally* Volkema & Gorman, *supra* note 109, at 117-18 (discussing the advantages of having what they call "multi-temperament groups" make decisions); *see also* Susan G. Cohen & Diane E. Bailey, *What Makes Teams Work: Group Effectiveness Research from the Shop Floor to the Executive Suite*, 23 J. MGMT. 239, 272-73, 275-76 (1997) (discussing studies showing that diversity of backgrounds (function, education, etc.) produces more strategic openness among management groups); Dallas, *supra* note 107, at 1403-05 (arguing on the basis of social psychological literature for more diverse boards that would be better at monitoring management and critically evaluating diverse strategies). In a related vein, scholars have argued that "[c]orporate governance is now quite clearly an expression of political processes but has retained the formal arrangements that are more suitable to earlier times—namely, the times of the rapidly expanding capitalist entrepreneur or the more stable managerialist process-oriented environment." Cutting & Kouzmin, *supra* note 111, at 35; *see also id.* at 37-38 (arguing for a board with three centers of power: the CEO, a separate board chair, and a director in charge of auditing, each with separate staffs and resources).

195 *See generally* MIETHE, *supra* note 9, at 44-67. Scholars investigate whether it is possible to make generalizations on the backgrounds of individuals likely to exhibit "pro-social" behavior (i.e., where their action cannot be explained by self-interested reasons or reciprocity). *See* BRUNO S. FREY & STEPHAN MEIER, PRO-SOCIAL BEHAVIOR, RECIPROCITY OR BOTH? (Institute for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 107, 2002) (presenting empirical evidence on pro-social behavior), *available at* http://www.unizh.ch/cgi-bin/iew/pubdb2. Whistleblowing could originate from the well documented characteristic of individuals to punish both those who benefit themselves at a group's expense (although for the whistleblower, the group is all society) and those who decline to punish the self-interested. *See* Herbert Gintis, *Strong Reciprocity and Human Sociality*, 206 J. THEORETICAL BIOLOGY 169, 169 (2000) ("A strong reciprocator is predisposed to coop-

rate whistleblowers suggests, research does not show that those who are obvious outsiders in corporate boardrooms, such as women and members of minority groups, are necessarily more likely than others to be whistleblowers.[196] They are often highly educated people who have significant, even executive positions in firms; whistleblowers are not so very different from the board members and corporate advisors who do not blow the whistle, although they are not generally at the very top of the corporate hierarchy where the inner circles are formed.[197]

The continuing power of inner circles, with their characteristic excessive self-interest, in publicly traded firms does not allow reformers the leisure to wait until behavioral scientists can confidently identify *ex ante* the kinds of people with a pro-social orientation who would resist groupthink and other group pressures and who could be placed on boards of public companies. It is critical now to counter corporate inner circles through board reform, which will help prevent the future losses to all corporate constituencies that will likely come from such reforms. There are a number of possible reforms to accomplish these goals, and I shall offer one here.[198] The reform would require each public company to nominate a "critical mass"[199] of "public" directors for inclusion on its board of directors. This critical mass would not be a majority of directors, for, as discussed below, a firm needs to select directors who could provide board services that are likely to be beyond the ability of public directors. It is important, however, that the public directors be numerous enough so as to be able to form on the board not only a group of resistance

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erate with others and punish non-cooperators, even when this behavior cannot be justified in terms of self-interest, extended kinship, or reciprocal altruism.").

196 *See* MARCIA P. MICELI & JANET P. NEAR, BLOWING THE WHISTLE 120-23 (1992) (describing costs and benefits).

197 *See id.* at 109-12, 115-20, 125-27, 134-35 (describing the empirical evidence that whistleblowers are generally well educated and often occupy supervisory positions).

198 This Article is part of an ongoing research project designed to look at multiple solutions to the corporate inner circle problem.

199 *See* Grutter v. Bollinger, 539 U.S. 306, 335 (2003). The Court uses the term to describe the benefits arising from enrollment of minority students in professional schools, which would appear to require having more than a few representatives of a particular group. My concern with having a "critical mass" of public directors is slightly different, although related, since it is designed to ensure that public directors are not isolated on a board. *See also* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 816 (2001) (discussing need to have a "critical mass" of certain kinds of directors).

to the attraction (and to the inevitable hostility) of the inner circle but a monitoring group defined by its opposition to that circle and by its wider social orientation. A counter group would also satisfy the public directors' natural inclination to identify with a group,[200] and would help address the psychological isolation that threatens an opponent of an inner circle, as seen with the fate of whistleblowers. The reform would thus mandate that regardless of the size of its board a public company have, at a minimum, public directors equal in number to the greater of three or one-third of its board members and appoint a public director to each major board oversight committee (e.g., executive, audit, compensation, or nominating).[201]

The mandatory nature of the reform and its significant intrusion upon public company corporate governance demand that it be accomplished through federal legislation. A basic reason for a

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[200] *See* PLOUS, *supra* note 106, at 202 (describing how, in group situations, the existence of several "oppositional" members enables other members to think on their own and to resist any group consensus). Since public directors will be defined from the outset as different from elite board members, social psychological literature suggests that they are likely to be ignored and marginalized by the elite (unless they have other characteristics, such as educational affiliation, shared by elite members). *See* James D. Westphal & Laurie P. Milton, *How Experience and Network Ties Affect the Influence of Demographic Minorities on Corporate Boards*, 45 ADMIN. SCI. Q. 366, 369 (2000). This is an additional argument for having a minimum number of public directors. Since public directors will be in a position of heightened uncertainty, where individuals often seek groups to deal with the uncertainty, the formation of a counter group is necessary to prevent the public directors from joining the inner circle to deal with that uncertainty. *See supra* note 94. Professor Khurana thinks that boards can change their behavior and the closed nature of CEO selection on their own, with the help of market participants. *See* KHURANA, *supra* note 130, at 211-16. One questions how realistic that would be. Some aspects of my proposal are similar to those offered by William Lerach. *See* Lerach, *supra* note 1, at 107-08 (proposing a system under which the SEC selects a lead independent public director for each public company board, to be a member of the audit and compensation committee). Lerach, however, makes this proposal only in passing and does not develop it.

[201] There is no magic to these numbers, but they are the minimum necessary. One or two public directors would risk isolation. There is precedent for three-person groups in corporate law practice. *See* 2 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 122 (1994) (describing practice of special litigation committees of boards having three members). The requirement of the greater of three or one-third is designed to ensure that public company boards do not increase the number of their board members to make the public directors an insignificant group on a board. The public director may, in truth, be isolated on committees, but he or she could draw support from the other public directors in full board sessions on any sensitive issue discussed in a committee. Public directors may also form alliances with other directors for any number of reasons (e.g., similar gender or minority group status).

governmental solution, rather than one of private ordering, is that, as the reforms of the Business Roundtable and the NYSE discussed earlier demonstrate, private parties and the market have done little or nothing to counter corporate inner circles.[202] Indeed, the business elite does not even recognize the circles as a problem and vigorously opposes any reform to the composition of boards of directors.[203] *Federal*, rather than state, legislation and intervention in the selection and oversight of public directors of boards of publicly traded companies is needed for several reasons. Although state prosecutors, particularly New York Attorney General Eliot Spitzer, have been vigorous and successful in pursuing participants in corporate scandals,[204] there have been no active proposals to reform state corporate law, which regulates corporate governance, to address the inner circles. Indeed, any such reform would likely be slow, involving as it would the laws of fifty states, and there would be no assurance that it could even be achieved in the important State of Delaware, given that

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[202] The reform is paternalistic insofar as it would compel public companies to change the composition of their boards. However, as discussed below, the reform would leave considerable choice for public companies (i.e., they can choose the particular public directors to propose to shareholders, as well as follow traditional selection procedures for the rest of their directors). *See generally* CASS R. SUNSTEIN & RICHARD H. THALER, LIBERTARIAN PATERNALISM IS NOT AN OXYMORON 26 (AEI-Brookings Joint Ctr. for Regulatory Studies, Working Paper No. 03-2, 2003) (proposing a form of paternalism that directs consumer choice to address human decision-making flaws while leaving considerable individual freedom of choice).

[203] This assertion is supported by the current business opposition to an SEC proposal to allow shareholders to place their own board nominations on a company's proxy statement (under current law, shareholders would have to undertake their own proxy solicitation if they wanted to nominate board members). *See* Henry A. McKinnell, *Bad Medicine for Good Governance*, WALL ST. J., Oct. 21, 2003, at A18 (Chairman/CEO of Pfizer, also co-chair of the Business Roundtable, expressing opposition to the SEC proposal). On the background to the proposal, which summarizes the opposition of business, *see* DIVISION OF CORPORATION FINANCE, SEC STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 5-6, Appendix A (July 15, 2003) [hereinafter STAFF REPORT]. For the proposal, see Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (proposed rule that would allow a shareholder or shareholder group holding five percent or more of the voting securities of a firm to use company's proxy to nominate a certain number of directors in limited circumstances). Corporate law firms almost uniformly have opposed this proposal, which alone demonstrates how these law firms have become nothing more than spokespersons for their corporate clients. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 43 (2003) (presenting predictable arguments against shareholder participation in elections).

[204] *See* Attorney General of the State of New York Bureau of Investment Protection, *supra* note 46.

state's pro-management tilt. Through reform to the Securities Exchange Act of 1934, Congress could reach at once all public companies, which are regulated under the Act as participants in the public securities markets.[205] Federal legislation would have the justification given in the Sarbanes-Oxley Act, which is that federal oversight is needed because of the tremendous amount of personal savings now invested in the public securities markets, rather than in bank savings deposits, that are so important in the retirement savings of many citizens.[206]

The proposed federal legislation would establish and fund an oversight board, whose members the SEC would appoint, that would regulate the selection of public directors by public companies and, to some extent, the terms of their participation, and would review their performance on boards.[207] The primary task

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[205] Federal legislation is needed for the following reason. Requiring public company boards to have public directors would interfere with the internal governance of companies, a traditional province of state corporate law. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). If the SEC attempted to enforce a public director requirement through its own regulation, which would likely involve mandating stock exchanges to effect this through their rules, its regulation would be challenged as outside its powers, which, in the absence of specific additional legislation, are generally limited to disclosure matters. *See* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (striking down SEC regulation attempting to enforce one share/one vote as a stock exchange listing rule). Congress could itself change (or empower the SEC to change) public company corporate governance to require the appointment of public directors, as it did in the Sarbanes-Oxley Act with respect to board audit committees. *See infra* text accompanying notes 283-87.

[206] *See generally* Joseph Tracy & Henry Schneider, *Stocks in the Household Portfolio: A Look Back at the 1990s*, 7 CURRENT ISSUES IN ECON. & FIN. 1 (Apr. 2001) (describing household investment in publicly traded stocks). The large public firm is not necessarily the end point of every firm in every industry; *see generally* Naomi R. Lamoreaux et al., *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, 108 AM. HIST. REV. 2 (April 2003) (describing downfall of large, vertically integrated firms at end of last century and the need to realize that different models of firm structure can work at different times and in different industries). It is, however, the kind of firm in which most of the public invests. The enhanced oversight of the corporate governance of public companies that I propose is similar to the oversight that bank management traditionally receives from federal regulators. Public companies are now the investment vehicle of the public, much in the way that banks formerly were.

[207] Others have proposed the creation of organizations similar to my oversight board to address the corporate governance scandals. For example, business professors Paul Healy and Krishna Palepu propose that the quasi-public stock exchanges, instead of companies, hire auditors and that a nonprofit organization (like *Consumer Reports*) review companies' performance. *See generally* Paul M. Healy & Krishna G. Palepu, *How the Quest for Efficiency Corroded the Market*, HARV. BUS. REV., July 2003, at 76 (arguing that the scandals owe much to the encouragement of price competition for auditing services, which led to lower quality audits and the abolishment of fixed commissions that formerly paid for investment research, which

of the oversight board would be the most difficult and the most controversial—to identify persons eligible to be public directors who could help satisfy two goals of board reform. They would have to have a wide social orientation, not the excessive self-interest of members of inner circles (the first goal), and they must understand their responsibility and be committed to monitor and resist corporate inner circles (the second).[208] Where would the oversight board look for potential board members? As discussed above, current corporate governance reform remains resolutely within the status quo; it demands only an increase in the number of independent board members, with independence being more difficult for an individual to meet than in the past, but finds nothing wrong with the present pool of potential board members—other CEOs and high company executives, as well as retired CEOs and executives, high ranking government officials, heads of nonprofit organizations, top corporate advisors, and high-prestige academics and deans.[209]

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forced analysts into investment banks with the resulting conflicts; price competition also led to the widespread acceptance of efficient markets, which resulted in more index investing and less fundamental analysis by money managers).

An obvious model for the oversight board is the Public Company Accounting Oversight Board established by the Sarbanes-Oxley Act. *See infra* note 294. Legislation could also confer the oversight power on the SEC, rather than an independent board. However, as discussed below, because the goal of the reform is to have people other than the traditional elite as public board members, and because some SEC commissioners and high staff members may be seen as being too close to this elite, it may make more sense to have a separate oversight board. Admittedly, the same elite could capture the oversight board and neutralize the reform. *See generally* William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1033-34 (2003) (discussing capture). *Cf.* Mike McNamee, *Accounting Watchdog—or Lapdog? Here's How You'll Know*, BUS. WK., Nov. 11, 2002, at 37 (observing how the new accounting oversight board is likely to be co-opted by the accounting firms). As discussed below, the legislation has to be crafted so that the oversight board cannot select current board members as public directors.

[208] The end product of the oversight board's identification process would be a list of prospective public board members, not unlike the list of eligible arbitrators that arbitration associations establish. *See, e.g.*, AMERICAN ARBITRATION ASS'N, COMMERICAL ARBITRATION RULES AND MEDIATION PROCEDURES (INCLUDING PROCEDURES FOR LARGE, COMPLEX COMMERICAL DISPUTES) R-3 (July 1, 2003).

[209] On the background of board members, see the classic JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 17-35, 174-75, 188-89 (1989), whose description of and comments on board composition (i.e., primarily composed of CEOs and former CEOs and others in leadership positions) still seem true today. *See id.* at 175 ("In making these suggestions, we are endorsing the prevailing viewpoint that leadership experience is important for a majority of directors."). Available evidence shows that board members compose an elite, even if not as narrow an elite as that found in other countries.

By contrast, my proposal is the opposite of the status quo.[210]

Of the 1,727 largest corporations in the United States as of December 2002, there were 16,406 directorships held by 12,794 individuals. *See* JACKIE COOK, CORPORATE AND DIRECTOR INTERLOCKS IN THE USA: 2003 5 (2003). This is out of a U.S. population of 288.4 million people. In addition, the larger the company in terms of market capitalization, the more restrictive is the group from which directors are drawn (e.g., directors in the top decile sit on an average of 2.31 boards). *See id.* at 7; *see also id.* at 8 (pointing out that those holding multiple directorships is an even more restricted group: fourteen percent of directors (1640) hold two positions; six percent (791) hold three or more); *id.* at 15 (noting that forty-six of companies in the S&P 500 have interlocking directors and that these generally involve CEOs); *id.* at 17 (observing that, as a company's market capitalization increases, so does the number of other CEOs sitting as "outsiders" on its board); *id.* at 21 (noting that 5000 individuals sit on the boards of companies in the S&P 500). Indeed, Cook's work is a first step in determining the power relations among the board elite.

In light of this data, it is disappointing that Professor Breedon, in his role as corporate monitor of the former WorldCom and in his otherwise useful report, proposes corporate governance changes that would have the company select most of its board members from those with traditional backgrounds, although he attempts, by means of an expanded definition of independence, to ensure that the board members would have no ties whatsoever to the company. *See* BREEDON, *supra* note 40, at 58-62, 75. As will be explained below, *see infra* note 308, the Sarbanes-Oxley Act further narrows this already small pool by emphasizing the importance of financial expertise for board members.

Not surprisingly, empirical research on boards has similarly been status quo oriented; it asks whether independent directors or the size of the board affect firm performance. While generally inconclusive, this research makes interesting findings about boards (e.g., that outside directors improve stockholder returns in a takeover situation, and smaller boards are more effective in terms of firm performance). *See generally* Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 FED. RES. BOARD N.Y. ECON. POL'Y REV. 7-26 (Apr. 2003) (surveying empirical results); *id.* at 20 (admitting that there is no accepted understanding why boards exist, other than the view that they are a response to the agency problem in large firms). By contrast, some organizational scholars believe that certain boards have improved their monitoring of management without changing the basic composition of board members, and they attempt to explain how this improvement can co-exist with the monitoring ineffectiveness of many other boards. *See, e.g.*, James D. Westphal & Edward J. Zajac, *Defections from the Inner Circle: Social Exchange, Reciprocity, and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161 (1997) [hereinafter Westphal & Zajac, *Defections from the Inner Circle*] (presenting data suggesting that board independence comes from board members' experience of activism on other boards); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity and New Director Selection*, 40 ADMIN. SCI. Q. 60 (1995) (presenting data showing that CEOs try to have board members who are demographically similar to themselves, and that powerful boards do the same); Edward J. Zajac & James D. Westphal, *Director Reputation, CEO-Board Power, and the Dynamics of Board Interlocks*, 41 ADMIN. SCI. Q. 507 (1996) (presenting argument and data that there has developed in the United States two different markets of directors, the passive and the activist, and that CEOs and boards favor members from either market in board member nomination depending on whether they want passive or activist boards).

[210] The reforms proposed here are thus "progressive." *See* Langevoort, *supra*

The public oversight board would not include individuals who have participated in boards, or who are likely to be selected as board members in the present system. Those members of the small circle from which directors are now drawn would be presumed ineligible for inclusion on the list of public directors.[211] This ban need not be permanent, nor even immediate, but the oversight board would have to identify new individuals who could be public board members. The basic justifications for this exclusion are that these individuals have been formed in a board culture typified by excessive self-interest and by the self-referencing inner circle around the CEO, that they found the inner circles with the self-interest focus compatible and natural, and that they have become an elite with these characteristics.[212] I believe that—and this is controversial—many past and current board directors (and people drawn from the same milieu) would do more harm than good as public directors because the public director role would conflict with a fundamental part of their identity.[213]

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note 19, at 1142 ("To the progressive, Enron is a story about arrogance and abuse, and a call for wide-ranging reforms designed to reduce the rents from corporate stewardship."). As Professor Langevoort suggests, the scandals may have created considerable uncertainty about how safe stock market investing is in the United States. *See id.* at 1164-65.

211 Of course, some existing board members may have already performed well as monitors and would be suitable as public directors. In the application procedure, they would have to rebut their presumption of ineligibility by establishing their individual contributions to well-functioning boards. The legislation might even direct the SEC to select a majority of the new board from consumer and corporate governance advocates (like Nell Minow), as well as from whistleblowers.

212 Those who have studied board behavior note this tendency of board members to fall within an uncritical, team-oriented role on boards. *See* LORSCH & MACIVER, *supra* note 209, at 91-95.

213 For this assertion, I rely on social psychological support. *See* Darley, *How Organizations Socialize*, *supra* note 102, at 38-39 (observing how an evil-doing organization can spread corruption as successful individuals in the organization move to other organizations and implement the destructive practices of the first organization); Darley, *supra* note 25, at 208-11 (arguing that the socialization to evil occurring in the first organization can irreparably corrupt individuals); Demski, *supra* note 36, at 67 ("Moreover, this systemic problem may involve an element of contagion, where poor business practices spread to otherwise healthy firms."); *see also* Langevoort, *supra* note 137, at 971 (referring to psychological literature describing people at the top of organizational pyramids):

> At the very top of the organization, we see a rarefied group of survivors very adept at producing, but with diminished capacity to see things as they really are. Indeed, the noted organizational psychologist Michael Macoby has claimed that the ultimate tournament survivors in high-growth "intangible"-based firms is often the hard core narcissist—a personality trait (dis-

An obvious question is how, in one sweep, so many existing and potential board members can be sidelined without seriously harming public companies. Wouldn't the proposal result in failing to use valuable human resources that have ensured our economic prosperity? It is important to be clear about one point of the reform: existing board members (and those like them) are not being banned from membership on boards of public companies, but from service as public directors. They still remain eligible for the majority of board positions and the proposal thus does not significantly threaten their elite status.[214] According to organization literature, directors provide the following two major services to firms, in addition to monitoring management: (1) providing the CEO and other company executives with strategic business advice, and (2) supplying the firm with useful business,

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order in severe instances) that often produces highly charismatic leadership coupled with a strong disinclination to accept or admit the truth.

But see JANIS, *supra* note 86, at 158 (suggesting that groupthink is contextual and not linked to persons as such). As organizational scholars have noted, current top executives and board members are particularly responsible for the organizational silence of many large firms that, often caused by groupthink, directly or indirectly led to the scandals. *See* Morrison & Milliken, *supra* note 112; Tetlock, *supra* note 112, at 323 (speculating that decision-makers are often not affected by evidence before them, given that ideology may dominate their thinking). In other words, current board members may be the kinds of people who will never adopt the critical stance necessary to resist the groupthink of the inner circle, short of a public crisis in the firm. From a more charitable perspective, they may be reluctant to ask hard, but obvious, questions because they may be *too* appreciative of the complexities of business issues and thus inclined to be deferential to management. *See* LORSCH & MACIVER, *supra* note 209, at 84-88.

In my doubts about the monitoring effectiveness of the governing elite, I may be at odds with other corporate scholars. For example, Professor Lynn Stout (who is well versed in social psychological literature) believes that the institution of the board works because its members generally act altruistically (i.e., their rewards and punishments, being so trivial in relationship to the compensation they receive from their regular jobs, could not motivate them) and because it is possible to identify beforehand board members who will act in this way. *See* Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003). Yet she does not highlight the symbolic and network benefits coming to the elite from board service, as well as the negative social pressures on board members discussed in this Article. It may well be that the board elite historically acted (or aspired to act) more altruistically, *see* LORSCH & MACIVER, *supra* note 209, at 43-49, but that the current elite, socialized into the acceptability of the single-minded pursuit of self-interest (to the point of lawlessness) in the 1980s and 1990s, no longer exhibits this altruism.

214 This fact alone should satisfy anyone who is concerned about the elite or who believes that many individual elite members have done or will do an adequate job of monitoring executives. For a discussion of board reform that attempts to make the existing elite more effective, see CARTER & LORSCH, *supra* note 74.

finance, accounting, legal or government connections and expertise. Admittedly, these are the kinds of services that current board members may be uniquely qualified to offer.[215] Public companies will continue to receive the two services by having these individuals as directors. But current directors have not adequately performed the board task of monitoring management in an effective way, which requires us to rein in the inner circles that are blinded by their groupthink and that benefit themselves at the firms' and society's expense. Restricting the current board elite from service as public board members, which would reduce their numbers on boards, means losing some, but by no means

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215 On this categorization of board tasks, see Forbes & Milliken, *supra* note 75, at 492 (describing one of the main tasks of a board being its "service task," which is "its potential to provide advice and counsel to the CEO and other top managers and to participate actively in the formulation of strategy"); *see also* Mason A. Carpenter & James D. Westphal, *The Strategic Context of External Network Ties: Examining the Impact of Director Appointments on Board Involvement in Strategic Decision Making*, 44 ACAD. MGMT. J. 639 (2001) (examining how board member involvement in a firm's strategic decision-making can be enhanced by board members' service on boards of other firms, which provides access to current industry and other strategic information); Jerilyn W. Coles & William S. Hesterly, *Independence of the Chairman and Board Composition: Firm Choices and Shareholder Value*, 26 J. MGMT. 195, 202 (2000) (emphasizing that two of the major attributes of board members are the ability to have access to and to understand corporate information and the objectivity to evaluate and act upon it); Catherine M. Daily et al., *Corporate Governance: Decades of Dialogue and Data*, 28 ACAD. MGMT. REV. 371, 375-76 (2003) (discussing multiple tasks of boards and pointing out that there is an excessive focus on board members as monitors of management); Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781 (2003) [hereinafter Dallas, *Multiple Roles*] (discussing different board roles in relational and strategic management, in addition to monitoring); Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 10-16 (1996) (same); Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 ACAD. MGMT. REV. 409 (1996) (identifying function of board members as giving a firm a connection to valuable resources); Langevoort, *supra* note 199, at 801-05 (discussing typology of board tasks using organizational studies); SCOTT RICHARDSON ET AL., ACCOUNTING FOR TASTES: BOARD MEMBER PREFERENCES AND CORPORATE POLICY CHOICES 28 (MIT Sloan Sch. Mgmt., Working Paper No. 4307-03, 2003) (finding correlation between individual board members and corporate policies of a firm, which could be explained by individual board member effects on these policies), *available at* http://ssrn.com/abstract=405101. However, one should not exaggerate the value of board members' contribution to strategic decision-making. The contribution often amounts to little more than supporting a particular corporate strategy, such as pursuing a merger, because others firms are following it, which means that board members can be instruments of irrational contagion. On company pursuit of one value-destroying strategy, see James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249 (2001).

all, strategic advice and expertise from board members while significantly enhancing the board's monitoring function.

Moreover, many people are better qualified than members of the existing elite to be *monitoring* board members. This assertion contradicts prevalent corporate governance thinking, which concludes that board members need to be even more specialized than they are now, particularly in financial matters.[216] Indeed, whenever there is a proposal to change the director selection process so that board members might be elected from different backgrounds than those of current board members, CEOs (and their corporate law firms) claim that the new members will be incompetent in comparison to current directors.[217] Certainly a board member must have a basic understanding of business, accounting, and finance to be an adequate monitor, but the corporate scandals did not involve financial machinations that were

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216 *See Board Members Facing Public Scrutiny Should Bone Up on Finance, Accounting*, KNOWLEDGE@WHARTON, June 18, 2003, *at* http://knowledge.wharton.upenn.edu/index.cfm?fa=viewarticle&id=800.htm (last visited Oct. 23, 2004); Paul M. Healy & Krishna Palepu, *Governance and Intermediation Problems in Capital Markets: Evidence from Enron* 17-18 (Harv. NOM Res. Paper No. 02-27, Aug. 2002) (pointing out the need for more expertise in auditing committee members). A later version of this paper was published as *The Fall of Enron*, 17 J. ECON. PERSP. 3 (2003). Admittedly, Healy and Palepu's account of Enron's business and accounting problems support their assertion that a board member needed to be relatively sophisticated in business and financial matters even to understand what Enron's business was. Yet their criticism of Enron's audit committee does not go to complex accounting issues as it does to such matters as the committee's failure to question management about the purpose of the transactions with the SPEs, the conflict of interest transactions, and disclosure—all matters that do not require one to be a financial and accounting expert. *See id.* at 19.

217 *See* STAFF REPORT, *supra* note 203, at 12-13 (noting company and law firm objections to allowing shareholders to nominate board members by way of a company's proxy statement). Indeed, Roman Weil, a Professor of Accounting at the University of Chicago, contends that many current board members are themselves incompetent in matters of accounting and finance, and that there are numerous qualified people who could sit on boards, but who do not have the name reputation that CEOs are looking for:

> CEOs, Weil adds, want other chief executives on their boards because of their experience and their name-recognition value. But he says most board members, even those who are accomplished executives, "are not interested and not trained to understand" important accounting issues. "The CEO says, 'I don't want a technical nerd on my board.'" I tell CEOs there are about 1,500 [unemployed] former Arthur Andersen people who understand these issues [and would love to serve on boards] but their names don't have marquee value. I believe there are plenty of people who could do it.

Board Members Facing Public Scrutiny Should Bone Up on Finance Accounting, *supra* note 216.

beyond the ability of a person of ordinary intelligence with some business, accounting, and financial knowledge if only he or she, as a director, vigorously pressed executives for an explanation of the questionable transactions or financial arrangements. Enron shifted its bad assets off its balance sheet to special purpose entities that it in fact owned and then essentially entered into transactions with itself;[218] WorldCom moved current expenses to capital assets, thus pumping up its earnings; Xerox anticipated revenues before they were earned; Tyco executives took massive benefits from the firm for themselves (as did former NYSE CEO Richard Grasso). It is wrong to suggest, as many in the business community now do, that the problem lies in the inadequate training of directors to understand the transactions, and that existing board members simply need to go to director education programs where they will be better "schooled" to recognize fraud.[219] If board members are now unprepared to monitor public corporations, and if they are mainly CEOs and former CEOs of these same firms, what does that say about the competence of corporate leadership in this country?

The problem lies not with board members' expertise, but with their excessive self-interest and their groupthink arising from an equally excessive group cohesion. This cohesion is a characteris-

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[218] For a straightforward explanation of the Enron fraud that does not eschew complexities, see Bratton, *supra* note 138. *But see* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245 (2003) (contending that Enron's demise lay in its derivative trading, which was not understood even by sophisticated analysts and whose role in Enron's collapse is still misunderstood).

[219] *See* Press Release, The Business Roundtable, The Business Roundtable Corporate Governance Survey Highlights 2003 (Feb. 4, 2004), *available at* http://www.businessroundtable.org/document.cfm/969 (describing how "[n]inety percent of Roundtable companies now encourage, require, or have in place director education programs for new (54 percent), and in some cases all (36 percent), directors, compared to 76 percent in 2002"). Even lawyers at Wachtell Lipton assert that the obligations of a board member are straightforward and thus certainly within the reach of many individuals. They say that a director should have the following skills:

> That job, while more difficult in the current climate, is not an impossible one. Importantly, it requires as much an exercise of common sense business judgment as it does any particular extension of technical expertise (though all directors, and audit committee members in particular, should have a level of financial literacy). It requires skepticism, diligence and a willingness to ask tough (and oftentimes basic) questions, while insisting that the answers received are understandable.

Memorandum from Wachtell, Lipton, Rosen & Katz, A Practical Guide for Directors in Responding to the Current Business Climate 1 (May 28, 2003) (on file with the author).

tic of current boards that defenders of the status quo extol (and argue is threatened by new kinds of directors) without acknowledging its destructive consequences.[220] To make boards further restrictive by demanding specialized financial training or experience is to shrink the pool of eligible board members even more, so that it ends up composed only of CEOs, CFOs, former executives, investment bankers, and accounting partners—in many cases, not necessarily the most effective board members for monitoring purposes. The solution lies, rather, in opening board membership to competent individuals who have not been contaminated by the experience and norms of current boards, who have a social, not excessively self-interested, orientation and who, as a result, will be able to provide the necessary cognitive conflict in the boardroom and be effective monitors of corporate inner circles.[221]

Enhancing, indeed finally achieving, the monitoring role of the board is justification enough for the reform. The reform may also serve the beneficial social purpose of increasing whistleblowing. Current board directors of public firms are among those who benefit most from a society increasingly characterized by considerable wealth disparity, which itself threatens social stabil-

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220 *See* STAFF REPORT, *supra* note 203, at 12-13. According to organizational scholars, cohesion promotes communication among board members and can thus enhance group decision-making because, without group cohesion, majority members would not listen to dissenting views. *See, e.g.*, Westphal & Milton, *supra* note 200, at 367. It seems, however, that group cohesion has been used too often to mask conformity and groupthink. *See* LORSCH & MACIVER, *supra* note 209, at 167 ("To gain real governing power, [directors] must first understand, and then overcome their dependence on, the CEO."). *But see id.* at 169-71 (arguing that directors need to develop a "group cohesion" independent of the CEO so that they would have a group power to better resist the CEO). Professor Langevoort proposes a solution to the opposing board needs of cohesion and cognitive conflict: having certain board members mediate between outside board members and insiders, *see* Langevoort, *supra* note 199, at 814-16. But, in my view, he errs in his support of the status quo. *See id.* at 816-17.

> We should end this Article by looking more closely at its underlying message: that on questions of board independence and accountability, the law should play a minimalist role, leaving most of the work of promoting a monitoring mindset to the more flexible but fairly powerful marketplace norms that have evolved over the past two decades.

Id. at 831.

221 Moreover, since boards (like all elites and indeed all groups) tend to perpetuate themselves, they are unlikely on their own to select new kinds of board members. *See* Matthew D. Lynall et al., *Board Composition from Adolescence to Maturity: A Multitheoretic View*, 28 ACAD. MGMT. REV. 416, 424-25 (2003).

ity.[222] The passivity and silence of existing board members in the face of the scandals underscore the continuing divide between members of the corporate elite, who often found nothing wrong with the excessive self-interest of an inner circle, and other employees in a firm, who may have objected to the behavior but who saw board members as unapproachable, self-regarding mandarins to whom they could not communicate their concerns.[223] Bringing onto the board those outside the elite could contribute to the breakdown of this organizational silence and lack of communication by making whistleblowing procedures established by a firm more effective and by encouraging more cooperative, rather than self-interested, behavior that is necessary for the firm's survival.[224]

The oversight board would thus establish eligibility criteria for public board members and a list from which public companies could draw them. Because a public board directorship would be a limited public service, the criteria should be as expansive as possible and designed to identify individuals who have basic financial, accounting, and business competence and some experience in an occupation involving those skills or in volunteer activities.[225] The oversight board would provide nonexclusive examples of ways to qualify for eligibility.[226] It is important not to

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[222] *See* FRANK, *supra* note 189, at 45-63, 122-45 (describing the disastrous social and psychological effects of wealth disparities).

[223] *See* Morrison & Milliken, *supra* note 112.

[224] Bringing onto the board people other than the elite will thus counter the ultimately antisocial behavior of current board members, who focus on their inner group's benefits but who neglect benefits for the company and society. *See* OSTERLOH & FREY, *supra* note 191, at 18 (arguing that it is necessary to select employees with "pro-social intrinsic preferences"). In their view, if the firm's leaders exhibit self-regarding behavior, altruistic employees will become discouraged. *See id.* at 15. Moreover, the domination of the board elite reinforces the passivity of so many Americans who invest in public companies, a passivity accentuated by the lack of control that they have over these investments. This lack of control is a commonplace criticism in corporate law scholarship. *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994). Expanding the pool of board members would also give at least some individuals the opportunity to abandon this passivity, which could have wider effects as they become active in other areas of social life. *See generally* Dana Brakman-Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829 (2003).

[225] There would thus be an age requirement as well as an experience requirement, which would ensure that eligible persons have some work or comparable volunteer experience.

[226] For example, the oversight board might list examples such as an M.B.A. degree followed by four years in business, J.D. degree followed by legal representation of business, and a professor of finance or business law, as well as stay-at-home

be naïve here; as Enron demonstrates, groups focused on the pursuit of the self-interest of their members are found throughout all levels of corporations and indeed throughout our society. The reform should not substitute for those now on boards lower-level individuals with the same self-interested, group-oriented characteristics of the board elite. It is thus important for the oversight board to put in the eligibility pool individuals who are from groups that have not been traditionally represented in the boardroom and who have demonstrated a broader social perspective, such as government employees (other than high government executives), a broad range of academics (other than university presidents and deans), whistleblowers, public interest and community activists, and members of minority groups (other than just the elite of these groups).[227]

The oversight board would require that prospective public directors who have been selected by public company nominating committees and elected to boards attend training programs certified by the oversight board. There is no shortage of director institutes, which have sprung up like mushrooms in the waste of the corporate scandals.[228] Yet the current institutes need to be transformed before receiving the oversight board's certification since they now are a part of, support, and further the status quo of maintaining current board membership.[229] As a general mat-

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mothers or fathers with experience on boards of local community organizations. Leo Strine, Vice-Chancellor of the Delaware Court of Chancery, has suggested that companies might look for board members among lower level executives who have significant organizational responsibilities. Leo E. Strine, Jr., Remarks at Sloan Project on Business Institutions, Georgetown University Law Center, Nov. 6-7, 2003.

227 On the value of having board members other than the traditional white male executive over fifty years in age, see David Carter et al., *Corporate Governance, Board Diversity, and Firm Value*, 38 FIN. REV. 33 (2003) (presenting data showing that the presence of women and members of minority groups on boards enhances firm value and discussing reasons for this correlation).

228 *See, e.g.*, The Conference Board, Directors' Institute: Programs for Corporate Board Members, *at* http://www.conference-board.org/knowledge/govInstitute.cfm (last visited Oct. 23, 2004).

229 This status quo bias of the present institutes is best exemplified by the well known Directors' College at Stanford Law School. Directed by Professor Joseph Grundfest (himself an establishment figure) and with speakers drawn from the usual elite of law firm partners, top SEC officials, Delaware Chancery Court judges, and executives, the College covers the kinds of predictable, nuts-and-bolts topics (e.g., a seminar entitled "The New World of Director and Corporate Liability") that practicing lawyers specialize in giving to directors. The College includes a smattering of well known plaintiffs' attorneys and a few academics to demonstrate its broad-mindedness. *See generally* http://www.law. stanford.edu/programs/execed/programs.html (last visited Oct. 23, 2004).

ter, the institutes would introduce the public directors to the practical and legal basics of the director position and the companies would supply further specific orientation as to the company and its industry. More particularly, the institutes would emphasize the importance of the public directors' monitoring role and provide them with social psychological explanations and training, which would help them understand the social pressures that they will encounter from the inner circles and, to the extent possible, would give them strategies to counter these pressures.[230]

How would the selection of public directors work in practice? The board nominating committee of a public company would be required under law to review the list of eligible public directors and to select from it the appropriate number of public directors for the firm. The committee would then put these individuals on the shareholder ballot in the company's proxy statement, explaining the basis for their selection. Shareholders would vote on these directors as they do on other board nominees. Because shareholders invariably support the board's recommendations, and because directors are elected by a plurality vote, the public directors will likely be elected to boards.[231] If one or more public directors are not elected, the current directors must temporarily remain in office. In this exceptional case the board must select other individuals from the public director list to nominate as a public director and call a special meeting for the purpose of electing the required public directors.[232]

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230 For example, the training could suggest to public directors particular strategies by which they could make their contributions to board discussion more acceptable to the elite board members. *See* Westphal & Milton, *supra* note 200, at 369-70 (discussing ways in which demographic minorities on boards can make themselves more effective by minimizing the biases of majority board members to outsiders and by thus lowering the social barriers to effective communication).

231 The shareholder vote with respect to public directors is no more an empty formality than it is for the election of any other director; it acts as a check on the board's nomination process in extreme cases (e.g., significant dissatisfaction with a particular board member). Moreover, as discussed below, to remove board and shareholder involvement in the placement of public directors (i.e., by having the oversight board simply select public directors for the firm) is not necessary to achieve the reform and has the beneficial result of allowing public director selection to fit within the current board nomination and election procedure. The oversight board would also encourage shareholders of public companies to recommend individuals for inclusion on the public director list.

232 As an alternative, the board could simply name another individual from the public director list as a public board member until the occurrence of the next annual shareholders' meeting or a special meeting called for the election of the public director. Under standard corporate law, directors can select an individual to fill a direc-

The oversight board needs to pay particular attention to the compensation of this new kind of director with several goals in mind.[233] The board should not place too much emphasis on compensation when attracting public directors because an excessive focus on it could send the wrong signal—that prospective public directors should be interested in the position for self-interested rather than social reasons.[234] Compensation should not be the primary reason why individuals accept the position, but it must be adequate to pay the public directors for their work. The task of a public director will include service on only one board and one or more board committees in an environment where board service is more burdensome than in the past because of recent corporate reforms and where a public director will be in the uncomfortable position of being an outsider to the firm and the board elite. There would also be an equity concern: public directors could not generally be paid less than other board members. To do otherwise would make them second-class directors. It is even possible that because public directors, unlike the existing board elite, may not hold other highly lucrative positions contemporaneously with their board service, their board compensa-

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tor vacancy. *See* DEL. CODE ANN. tit. 8, § 223 (2003); N.Y. BUS. CORP. LAW § 705(b) (2004). Complications also arise from board classification. For example, assume that a board has a nine member classified board where three members are elected for three year terms each year. If three public directors would be placed on this board, several possibilities arise. One solution is to elect them all at once (as one class), so that they would immediately have an effective public director group and not be isolated on the board. Another option is to elect one with each class, but this means that the first public director would be alone for the first year and his effectiveness as a monitor might well be limited. There are compromise solutions, such as nominating two public directors in the first class and then another in the second class.

233 Board member compensation has received scholarly and practical attention, with the discussion being generally based upon agency theory. For a traditional article on this subject, see Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996).

234 *See* OSTERLOH & FREY, *supra* note 191, at 9-11 (discussing how intrinsic, prosocial motivations may be undermined or "crowded out" by self-interested or extrinsic motivations). It may well be that even treating executives and board members as purely self-interested parties may undermine their desire to behave fairly (i.e., to avoid shirking and to go the extra step to act in an altruistic fashion). *See* ERNST FEHR & SIMON GÄCHTER, DO INCENTIVE CONTRACTS CROWD OUT VOLUNTARY COOPERATION? (USC Ctr. for Law, Econ. & Org., Research Paper No. C01-3, Feb. 2001) (presenting experimental data suggesting that agents provide less additional effort when acting under incentive contracts, i.e., contracts that reward high efforts, but punish low efforts, as opposed to situations when generous offers are made inviting reciprocal behavior), *available at* http://papers.ssrn.com/abstract_id=229047.

tion may turn out to be higher than the income from their ordinary job (if they have a job). As discussed below, one would address the risk that a public board member would be bought or co-opted by the compensation through term limits and through the review of their performance.

The oversight board could not micro-manage compensation for public directors in all companies, for director service in one company might well take more time than for service in other companies. The board would thus set general guidelines keyed to the size of the company and the number of committees on which a public director would sit and leave the specifics to the company. Because public directors would not be long-term directors, the oversight board would require that they be paid primarily in cash and not receive stock options.[235] Nor should they receive pensions and other, often excessive, perquisites that some board members award themselves. The oversight board's restrictions on a public director's compensation could thus affect that of the nonpublic directors. If, for example, the oversight board prohibited public directors from receiving director pensions, this determination might make it difficult for a company to give pensions to other board members.[236] This result would, in fact, be an additional benefit, for it would help eliminate inappropriate forms of director compensation that have become popular and that are difficult for shareholders to eliminate.

It is unlikely that public directors, even with their social psychological training and social motivation, will remain impervious to perverse group pressures like groupthink. The experience of socialist countries also provides a warning that well-meaning, pro-social reforms can end up creating a new elite or elevating new individuals to an existing elite, as has arguably happened with current board members who were drawn from other than

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235 A public director might receive a basic cash payment with additional restricted stock that would have to be sold when he or she left the board. For an excellent argument for paying all directors primarily in cash and then compelling them to reinvest a portion of their compensation in company stock, see BREEDON, *supra* note 40, at 77-78.

236 Admittedly, boards can vary compensation among directors, provided that they can justify the differences. For example, boards pay additional compensation to those who chair a board committee or to a lead director. It would not be as easy to justify different compensation for directors who perform the same tasks, however. Non-public directors might receive pensions simply because, unlike public directors, they could have their directorships continue indefinitely until the mandated retirement age.

the traditional backgrounds of directors.[237] The goal is to make service as a public director a public service, not a continuing privilege, nor a stepping stone to lucrative employment and consulting positions in private industry, as can typify government service today.[238] Yet these directors, like all directors, need time and experience to become effective. The reform legislation must then set both service and term limits for public directors. In the interest of maximizing the number of people who could be public directors and not creating a public director elite, the law would specify that any individual elected to the public director list could serve on only one company's board at a time. The law would also provide that, at his option and assuming satisfactory performance, the public director would be eligible for reelection as a director for a maximum of six years.[239] The goal here is to strike a balance between allowing a board member time to develop ex-

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237 One has only to think of board members like Vernon Jordan (former civil rights activist and former president of the United Negro Fund), who, in an irony that George Orwell would have appreciated, has become as much an establishment figure in the corporate community (a member of ten boards, including Xerox's) as any White Anglo-Saxon Protestant, collecting $503,500 in directors' fees alone in 2001). *Big Debts Keep Law Grads Out of Low-Paying Public Service Jobs*, WASH. POST, Nov. 18, 2002, at E1. To be fair to Jordan, one could argue that he needs to be on numerous boards to generate enough personal prestige so as to be taken seriously by more establishment board members. *See* Westphal & Milton, *supra* note 200, at 391. Moreover, he is from a small group of individuals of minority background deemed acceptable for board membership. The problem may be that board nominating committees do not look to other individuals of similar backgrounds but always return to the same "safe" people.

238 Because many individuals who work for the government trade their expertise and government connections for lucrative positions in private industry, the oversight board has to be careful about using an individual's government service as an automatic sign of his eligibility to be a public director. In an environment where government regulations affect so many industries, it is not surprising that private industry seeks out former government officials for employment.

239 By eligible I mean that, once an individual is elected as a public director, the board would be required to renominate him or her for reelection up to the maximum number of years. Once again, there is no magic to these numbers, which would have to be debated and modified. *See* BREEDON, *supra* note 40, at 55-56 (recommending that MCI directors have term limits of ten years). My colleague Roberta Karmel (who has been on public company boards) tells me that it would take a board member at least six years to understand a company's business. This six-year term of office is not far off from the average term of current board members, which is approximately nine years. *See* COOK, *supra* note 209, at 7. One can draw support for this term limit concept from the literature on term limits for political office. *See generally* Einer Elhauge, *Are Term Limits Undemocratic?*, 64 U. CHI. L. REV. 83 (1997); Einer Elhauge et al., *How Term Limits Enhance the Expression of Democratic Preferences,* 5 SUP. CT. ECON. REV. 59 (1997); William Kristol, *Term Limitations: Breaking Up the Iron Triangle,* 16 HARV. J.L. & POL'Y 95 (1993).

pertise in monitoring a particular company without permitting him to become entrenched as part of an inner circle and a member of the board elite. Following his service as a public director, an individual (subject to a performance review as discussed below) would be removed from the public director pool, would be ineligible for employment by the company or its affiliates or by any company or organization where a fellow director is a director or officer, and could also not be nominated as a nonpublic director of any public company—all for "cooling off" periods to be established by the oversight board.[240]

The oversight board would also review the annual performance of public directors and discipline those who perform inadequately. This review would be in addition to the existing power of the company's shareholders not to reelect directors.[241] This performance review is a difficult issue for several reasons. As is well known, it is not easy to assess the performance of individuals in the group activity that is board decision-making.[242] Evaluation of board members generally occurs through peer review by fellow directors or by the CEO, but because public directors will not be from the traditional elite, CEOs and other directors may be inclined to penalize the new kind of directors and protect themselves in this review, particularly if the public director has

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[240] The focus here is to ensure that a public board member is not co-opted by promises of employment or benefits following his term as a public board member and that he or she is not drawn into the elite, for example, by being immediately appointed as a non-public director following his service as a public director. The goal is to bring new individuals into board service. Accordingly, one possible result is that, short of a national emergency, board service as a public director may become a one-time service for most directors, much in the way that the military draft formerly worked. The oversight board would have to establish cooling off periods after consultation with the public and interested parties. These periods restricting a former public director's employment by the company, its affiliates (as defined in 17 C.F.R. § 230.144(a)(1) (2003)) or by a company or organization where a fellow director is an officer or director would have to be long enough (five to ten years) so as to discourage any capture of public directors by inner circle members.

[241] Absent circumstances discussed below, the board would be required to renominate a public director up to his term limits. The shareholders, of course, could decline to elect a particular public director, in which case a special election would be needed for his replacement. As Montgomery and Kaufman discuss, it is difficult as a general matter for shareholders to determine whether a board member has performed adequately because they have no indication what she or he has individually done (e.g., they don't know how an individual has voted on a particular issue). *See* Montgomery & Kaufman, *supra* note 77, at 93. Shareholder removal of a public director is therefore likely to be rare.

[242] *See id.* (discussing problems with board evaluation).

been vigorous in challenging management.[243] The oversight board would thus have to design its own review system, which would incorporate the peer review by the public director's fellow directors, a public director's self-assessment of his performance, and evidence of the shareholders' reaction to a director.[244] If, on the basis of this review, the oversight board determined that the public director was incapable of performing his duties, it could remove the director from the public company board.[245] In addition, following an individual's service on a board, the oversight board would conduct an overall evaluation of the director's performance and, if it so determined, would remove the individual from eligibility for future board service as a public director. Alternatively, or in conjunction with this review, the agency could rate public directors and include this rating in the individual director's file, accessible to board nominating committees. Again, because there would be cooling off periods after board service, and because the service would generally be a one-time event, the disciplining and rating process would not be the major task of the oversight board, except in extreme cases.[246]

Certainly, this reform calling for the appointment of public directors to boards needs development and refinement, like every significant change to the status quo.[247] It is not new. Indeed, this type of reform has been demanded repeatedly during the history of large public firms in our country, but has never been adopted,

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[243] *See* Press Release, The Business Roundtable, *supra* note 219 (referring to director peer evaluation).

[244] One source of evidence could be a significant number of shareholder "no" votes when a public director is renominated for service.

[245] Because a public directorship is a quasi-government service, a procedure would have to be in place for some government review of the oversight board's assessment of the director, which would provide the director with appropriate due process. The oversight board would have to conduct this annual review well before the company distributes its proxy statement for the annual meeting so that, if there was a problem with a particular public director, he could be replaced with another individual from the public director list.

[246] This disciplining power of the oversight board would not be unprecedented. *See* Sarbanes-Oxley Act of 2002, § 305, Pub. L. No. 107-204, 116 Stat. 745, amending § 21(d)(2), 48 Stat. 881 (1934), 15 U.S.C.A. § 78u(d)(2) (West 2004) (enhancing the SEC's ability to bar "unfit" individuals from being officers or directors of public companies).

[247] For example, the law might require public directors to prepare a separate report on the company to be included in the company's annual report. One would also have to consider how public directors might be named by a party proposing a change of control transaction through a proxy fight (the simple answer is that a company would have to place the requisite number of public directors on its slate, unless it decided to keep the existing ones).

partly because the election of independent directors to boards was viewed as the appropriate solution to the board's inability to fulfill its monitoring role. In 1939, when surveying the board scandals that contributed to the Stock Market Crash of 1929 and the Great Depression, William O. Douglas, then SEC Chairman, called for the appointment of public directors who would monitor corporate management on behalf of all corporate constituencies, including shareholders.[248] In 1975, following the revelation of scandals in which corporations broke domestic and foreign laws or conducted actions that, while not illegal, were socially undesirable (e.g., polluting the environment or selling dangerous products to consumers), Professor Christopher Stone argued that public firms of a certain size should have "general public directors" who would be nominated by a Federal Corporations Commission and then selected by the company's board, and who would spend half of their time on a particular directorship.[249] Speculating that they could be retired executives or practicing academics, he explained in words that resonate today that the public directors would bring public and social responsibility concerns squarely before other board members, monitor firms for compliance with laws and social norms, and act as recipients of whistleblower complaints about harms to the public from corporate actions.[250] He also suggested, implicitly rather than explicitly, that these directors would break up the clubbiness of the board.[251] At about the same time, Ralph Nader and his col-

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[248] *See* WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 53 (James Allen ed., 1940):

> Furthermore, the paid director would revive and strengthen the tradition of trusteeship. His job would not be to represent the management or to represent himself. It would be primarily to represent the stockholder—to return to the stockholder the protection which today's stockholder has too frequently lost. In a larger sense, he would not be so much a paid director or a professional director as a *public* director, representing not only the present but the potential stockholder, and representing the general public as well.

[249] *See* CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 152-73 (1975). The number of general public directors would be determined by the size of the corporation (i.e., ten percent of the board for every $1 billion of sales or assets, whichever was greater). Stone also proposed the appointment of special public directors to deal with specific problems in firms. *See id.* at 174-83.

[250] *See id.* at 167 ("The ordinary outside director, whose primary employment lies elsewhere, is too distant in every sense—not only physically and hierarchically, but usually even in terms of what the employee presumes him to be concerned about.").

[251] *See id.* at 171. Although Professor Stone did not speak of groupthink, he

leagues, while not advocating the appointment of public directors, argued that each public company director should be responsible for a specific business or public issue in order to break down the clique nature of a board that revolved around the CEO and to make the firm more responsible to social concerns.[252] The public director proposal offered here is akin to the

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showed an awareness of social psychology and organizational theory and the social constraints in an organization, for his book was part of a project on corporate behavior that involved psychologists and organizational scholars. *See id.* at ix-x, 235-36.

[252] *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION 118-28 (1976). He and his co-authors noted that "a board which monitors rather than rubberstamps management is exactly what is necessary to diminish the unfettered authority of the corporate chief executive or ruling clique." *Id.* at 122. And they, too, argued for extending director eligibility broadly through the citizenry and putting term limits on directors:

> A second objection is that once all interlocks are proscribed and a full-time outside board required, there will not be enough qualified directors to staff all major firms. This complaint springs from that corporate mentality which, accustomed to 60-year-old white male bankers and businessmen as directors, makes the norm a virtue. In fact, if we loosen the reins on our imagination, America has a large, rich, and diverse pool of possible directorial talent from academics and public administrators and community leaders to corporate and public interest lawyers.
>
> But directors should be limited to four two-year terms so that boards do not become stale. And no director should be allowed to serve on more than one board at any one time.

Id. at 127. Much of their and others' motivation for corporate reform came from a concern that corporations were becoming more powerful than governments, but had no governance structure that would enable them to take public concerns into account. *See also* John J. Gibbons, *Governance of Industrial Corporations in an Industrial Democracy*, 31 BUS. LAW. 1393 (1976).

> Perhaps the present method of corporate governance by a self-selecting meritocracy is the best possible compromise between the need in a democracy for limitations upon the exercise of power and the need in an industrial society to get the job of production done. But the subject has hardly been explored, and until it is more thoroughly explored we should be unwilling to accept that conclusion on our faith in a remnant of a nineteenth-century legal institution.

Id. at 1400. A way to answer this concern was to have representatives from groups affected by corporations on their boards, or to have a public director. *See* Phillip I. Blumberg, *The Role of the Corporation in Society Today*, 31 BUS. LAW. 1403, 1405-07 (1976). *See also* Phillip I. Blumberg, *Reflections on Proposals for Corporate Reform Through Change in the Composition of the Board of Directors: "Special Interest" or "Public" Directors*, 53 B.U. L. REV. 547 (1973) (reviewing various proposals for changing composition of the board). Professor Blumberg perceptively pointed out then that the move to put outside directors on boards did not really change the kind of person who would be put on a board, nor, in his view, would the call to have professional directors:

> The successful movement for the designation of "outside" directors generally represents an effort to get "public" representation on the board. The difficulty has been that selection of "outside" directors from within the

proposals of the public director movement of the 1970s, although it is motivated by the corporate scandals of today that harm shareholders, not by the corporate misbehavior of that time which often dealt with corporate harms to those outside the firm.

Some twelve years ago, moreover, Professors Ronald Gilson and Reinier Kraakman proposed that public companies have professional directors.[253] According to them, institutional investors should establish a nonprofit organization that would identify individuals who could become professional directors and who would serve on up to six boards at a time.[254] Through agreements among themselves, these investors would ensure that the directors were elected to public company boards. Gilson and Kraakman argued that professional directors, unlike current independent directors, would have time to spend on board matters and the motivation to do a good job.[255] Since these directors would clearly be loyal to institutional shareholders, they would be ideal monitors and would not be overly concerned with pleasing the CEO and conforming to norms of boardroom collegiality.[256]

Theirs is a powerful proposal and is likely to receive renewed attention in light of the current dissatisfaction with the nomination of board members and the composition of boards.[257] It is

> "club"—corporate executives, commercial or investment bankers, insurance company executives, corporate attorneys, university presidents or business school professors—has not placed persons on the board with new values or different concepts of the role or responsibility of the corporation in society.

Id. at 558.

253 *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 883-92 (1991).

254 *See id.* at 886-87.

255 *See id.* at 885.

256 *See id.* at 889. They intended their proposal to be practical and capable of being readily implemented, but institutional investors did not take it up, although individuals, aligned with institutional investors and well suited for the role of professional directors (such as Professor Elson), are on boards. Their proposal may be resurrected in light of the SEC's proposal to allow shareholders to use a company's proxy statement to nominate board members. *See* discussion of SEC proposal, *supra* note 203.

257 Others have recently made similar proposals. *See* Cutting & Kouzmin, *supra* note 111, at 42-43 (discussing a possible structure with professional board members); Henry L. Tosi et al., *Why Outsiders on Boards Can't Solve the Corporate Governance Problem*, 32 ORGANIZATIONAL DYNAMICS 180, 188 (2003) (proposing that one board position go to a representative of individual shareholders and another to a representative of institutional shareholders and that part of the board selection process move outside the firm to an independent organization).

thus important to explain why Gilson and Kraakman's market-based solution[258] would not adequately deal with the problem addressed by the public director proposal—inner circles animated by their members' excessive self-interest. They rely, for their professional directors, upon members of the same elite who are prone to joining inner circles and falling into their groupthink; their primary examples of possible professional directors are partners of accounting and consulting firms![259] They want to expand the pool of professional directors to include academics (like themselves),[260] but they are insensitive to how this may only broaden the board elite while maintaining it as an elite. This insensitivity is further evidenced by their failure to impose term limits on the professional directors or to worry much about their compensation.[261]

More troubling, Gilson and Kraakman's professional director is based upon agency theory's self-interested rational actor model and has nothing of the socially oriented vision of a public director (tellingly, Gilson and Kraakman do not even cite the public director movement of the 1970s). For them, professional directors will be adequately motivated (by money) to do their job, and institutional investors will be adequately motivated (again, by money because they have so much invested in firms) to "watch the watchers." Only in a brief footnote do Gilson and Kraakman observe that their professional directors, like the public directors of my proposal, would think of themselves as fulfilling a public service and would also be motivated by an idealism to improve corporate governance.[262] As the corporate scandals have shown us, however, those with a similar exclusively self-interested perspective and motivation, whether they be executives, bankers, accountants, lawyers, *or* institutional investors, are prone to fall into or under the sway of inner circles that exacerbate their self-interest beyond all limits. After all, institutional investors were only too ready to turn a blind eye to and profit from the corporate scandals.[263]

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[258] *See* Gilson & Kraakman, *supra* note 253, at 886. Perhaps the market focus of their proposal reflects the deregulatory political orientation of the early 1990s when they made it.

[259] *See id.* at 885.

[260] *See id.*

[261] *See id.*

[262] *See id.* at 891 n.88.

[263] *See* Coffee, *supra* note 191, at 298-99 (explaining how institutional investors' herding contributed to the scandals). It has long been recognized that some institu-

Despite this different approach, Gilson and Kraakman's professional director proposal complements the public director reform in several ways. They convincingly argue that adding a third kind of director to the existing inside and outside directors is essential for the board to fulfill adequately its monitoring function,[264] and that the presence of this director will not hinder other directors from performing important board services.[265] They explain that, rather than destroying board collegiality (the bugbear of the Business Roundtable), professional directors will put an end to board complacency and with their own assertiveness help existing outside directors become more critical of management (in my terms, prod outside directors away from an inner circle).[266] Their comments could apply equally to the effect of public directors. Indeed, professional and public directors are by no means exclusive reforms, and each new kind of director would find an ally in the other; the professional director would use his

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tional investors are unlikely to be good monitors of boards, either because they have conflicts (e.g., mutual funds manage 401(k) programs for companies) or because they are unwilling to expend funds to do the monitoring. *See, e.g.*, Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994).

264 *See* Gilson & Kraakman, *supra* note 253, at 875-76. Professor Lynne Dallas makes a proposal to enhance the monitoring and other functions of public company boards. She would divide the board into two tiers, with one composed of independent directors and monitoring managers, and the other composed of both inside and outside directors, contributing to relational and strategic management. *See* Dallas, *Multiple Roles*, *supra* note 215, at 816-17. Although her proposal recognizes, as does mine, the multiple roles of board members, she uses the existing board elite in her two-part board.

265 *See* Gilson & Kraakman, *supra* note 253, at 888-89.

266 *See id.* As organization scholars observe, the key difficulty to achieving a well-functioning board is to balance cohesiveness or collegiality, which allows for the trust that promotes full communications among and extensive service by board members, as well as genuine self-criticism, made possible by cognitive conflict among them. *See* Sundaramurthy & Lewis, *supra* note 102, at 408-10. If anything, the importance of cohesiveness among board members is greatly exaggerated. *See* Hogg & Hains, *supra* note 93, at 338 ("[T]oo much cohesiveness is probably risky in almost all group decision making contexts."). It is thus disappointing that the assertion about the need for board collegiality is commonly accepted, even among those upset by the corporate scandals. *See, e.g.*, BREEDON, *supra* note 40, at 35 ("Confrontation and dispute are not conducive to a successful company, and positive chemistry among the members of a board and between the board members and the CEO is very important."). *But see id.* at 44 ("Perhaps more than speeches from lawyers, every board can use a curmudgeon or two, and every company needs a few people who have a keen sense of smell.") (footnote omitted). There would be little concern that these assertive directors would not be given access to information about the company and that they would be tricked and bullied by management. *See* Ribstein, *supra* note 23, at 28-29 (pointing out existing inadequacies of independent directors).

expertise to help the public director, the public director would keep the professional director from falling under the inner circle's influence, and together they would form a strong, psychologically cohesive monitoring group on the board.[267] Professional and public directors may even form an alliance with traditional outside board members and inspire them to take their directorships more seriously, for when these outside directors see the assertiveness and vision of the new board members, particularly public directors who do not come from the board elite, they may become more active on the board as a way of demonstrating their expertise and justifying their own elite status.[268] In this situation, the board would become a place for a positive, rather than a destructive, socialization of board members.

I am unaware of any exact domestic or foreign equivalent to the public director proposal.[269] The U.S. Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), which are both private corporations owned by stockholders but chartered by Congress and regulated by the Office of Federal Housing Enterprise Oversight to fulfill a public purpose (i.e., make available affordable mortgages), at first glance have a corporate governance structure akin to my proposal. Their charters require that the President appoint five directors to their boards while their shareholders elect the remaining thirteen members. However, at least three of the Presidential appointees must be from specified housing-related industries, with the other two representing, separately, consumer interests and low-cost housing.[270] In other words, Fannie Mae and Freddie Mac have only one public, or non-industry, director, and he is a political appointee, which is very different from the proposed public director.[271] Under its former govern-

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[267] *See* John M. Levine et al., *Social Foundations of Cognition*, 44 ANN. REV. PSYCHOL. 585, 591 (1993).

[268] *See* Westphal & Zajac, *Defections from the Inner Circle*, *supra* note 209, at 177-78 (explaining how directors on activist boards may become more activist in other contexts).

[269] Professor Stone discussed the few historical U.S. examples of public directors, which occurred in industries (railroads and satellite construction) where the federal government played a significant role in the funding of the enterprise. *See* STONE, *supra* note 249, at 153-58.

[270] *See* 12 U.S.C. § 1723(b) (2000) (for Fannie Mae); 12 U.S.C. § 1452(a)(2) (2000) (for Freddie Mac).

[271] Freddie Mac is now immersed in its own scandal over its accounting improprieties, which led to the resignation of its top management. *See* BAKER BOTTS L.L.P., REPORT TO THE BOARD OF DIRECTORS OF THE FEDERAL HOME LOAN MORTGAGE

ance structure, the NYSE's board of directors had twelve public directors as well as twelve industry directors (in addition to up to three NYSE officers on the board). However, the public directors were not drawn from the public as such, but were identical in composition to the outside directors of a typical public corporation. That is, they simply could not come from NYSE members. Moreover, at least two of the public directors had to be from companies listed on the NYSE and two from financial institutions that were significant equity investors.[272] The NYSE public directors in office at the time of the Grasso pay scandal were members of the board elite (seven out of eleven of them were CEOs and ex-CEOs, like Mel Karmazin, CEO of Viacom, and Gerald Levin, former CEO of AOL-Time Warner, while others were elite political figures like former New York State Secretary Carl McCall, and former U.S. Secretary of State Madeleine Albright, who had moved into the private sector from government).

Examples of board members in foreign countries who are drawn from outside business circles do not reflect the public director proposal's purpose of enhancing board monitoring within a private company framework. For example, in Western European countries, government officials were placed on boards of privatized companies. These officials, however, were often drawn from the same social elite as other board members and were on the board to ensure that privatized firms were operated, when necessary, for government purposes.[273] The German example of codetermination, where one-half of the members of a large company's supervisory board (a board that stands over the smaller board composed of the top executives of the firm) are selected by employees, also comes to mind. Yet this board composition is thought to allow employee directors to advance the

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CORPORATION (July 22, 2003), *available at* http://www.freddiemac.com/news/board_report/. *See also Trouble at Home*, *supra* note 65.

[272] On December 17, 2003, the NYSE changed its governance structure to have a board consisting of between six and twelve independent directors, a Chairman (John Reed, who replaced the disgraced Richard Grasso) and a CEO (John Thain), with a separate advisory panel from the financial industry. Yet this board's members were typically drawn from the board elite and were, in some cases, the same individuals who had been public directors on the previous NYSE board. *See Leadership*, *at* http://www.nyse.com/about/the organization/1022221392205.html (last visited Jan. 25, 2005).

[273] *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); *see also* James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investors*, 21 BROOK. J. INT'L L. 1, 56-67 (1995) (discussing continued French State control of privatized companies).

interests of employees in firms, at the expense of shareholders, and even to promote social democratic policies espoused by the government, goals much broader than the limited purpose of preventing public firms from being operated for corporate inner circles.[274]

Costs of this reform are an obvious concern, especially because the Sarbanes-Oxley Act already imposes new regulatory burdens on public companies. Public companies would be assessed an annual fee to pay the expenses of the oversight board, much in the way that publicly traded firms now fund the budget of the Public Company Accounting Oversight Board and any accounting standards-setting body under the Act.[275] Although the expenses of the oversight board would not be negligible,[276] the real cost concern would come from the increased bureaucratization of public company governance that the reform creates, which could interfere with managerial and entrepreneurial behavior.[277] The worry would be that public directors would create so much dissension on a board that it would prevent rapid strategic and other decision-making by the board in the competitive market or markets of a firm. This could ultimately lead to considerable loss of shareholder value.

These costs and burdens should not be trivialized or ignored, but they should also not foreclose discussion of the reform. Balanced against them are the costs of not implementing the reform and not receiving the benefits that would result. The costs of not breaking down the inner circles are all too clear in terms of loss of shareholder value and the destruction of firms.[278] And bal-

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[274] For a scholarly discussion of German co-determination, see generally ROE, *supra* note 186, at 29-37.

[275] *See* Sarbanes-Oxley Act of 2002 § 109, 15 U.S.C.A. § 7219 (West 2004).

[276] Professor Joel Seligman has remarked that costs of complying with the Sarbanes-Oxley Act are very small for a large public firm, which has an existing compliance bureaucracy. *See supra* note 163. The concern would be the effect of the imposition of these costs on smaller firms. It may therefore be appropriate to exempt firms of a certain size from the public director requirement, an exemption that makes sense because public investment is concentrated in large public firms.

[277] *See* Ribstein, *supra* note 23, at 35-43. Scholars with a psychological or social psychological bent are sensitive to the cost/benefit calculus regarding reform proposals. *See, e.g.*, Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1221-23 (2003) (explaining asymmetric paternalism as paternalism that helps boundedly rational individuals without imposing excessive costs on individuals acting rationally).

[278] *See supra* Part II.A.

anced against the unknown, nebulous costs of the loss of cohesion on boards and potential hindrance to decision-making are the equally unknown, nebulous costs arising from the loss of investor confidence and an increased public cynicism about the investment world and the potential benefits of holding in check inner circles.[279] Moreover, the potential increased bureaucratization of the public corporation that the reform represents should not be exaggerated and is by no means necessarily negative. The reform leaves much of the current board nomination process and thus board composition (and strategic decision-making) unaffected, and it puts the final selection of the public directors in the hands of the board and shareholders, not government officials, who would basically establish lists of persons eligible to be public directors. Furthermore, bureaucratization is beneficial if it means that the reform will finally subject CEOs and their inner circles to formal rules and checks and balances on their power, which current legal corporate governance has failed to do.[280] Insofar as the reform would check the power of the board elite, which has created a closed shop for boards of public companies, it may even enhance the market for directors and improve the governance of public companies that are so important in our market capitalism.[281]

B. The Failure of Sarbanes-Oxley to Counter Inner Circles

Given the significance of the proposed reform involving public directors, it is important to ask whether the Sarbanes-Oxley Act makes it unnecessary. The short answer is that both Congress and the SEC, which implemented the legislation, failed to recognize the social psychological origins of the scandals in the inner circles and thus did not design their reforms to deal adequately with this social phenomenon. The crisis in public company gov-

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279 Enhanced corporate governance monitoring by public directors may well be worth the costs. As noted earlier, WorldCom now has a corporate governance monitor in Richard Breedon (former SEC Commissioner), and he has been perceived as adding considerable value to the firm through his monitoring. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

280 *See* Bruno Frey, *Corporate Governance: What Can We Learn from Public Governance?* 30-31 (2003) (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 166) (discussing the value of importing ideas and procedures from public governance into corporate governance so as to restrain executive power), *available at* http://www.iew.unizh.ch/wp/iewwp166.pdf.

281 *See* RAJAN & ZINGALES, *supra* note 184, at 158-64 (discussing why government action may be needed to counter the power of anti-competitive elites).

ernance, however, allowed policymakers to make significant legal changes to the status quo. Accordingly, the Sarbanes-Oxley Act's reforms addressing executives, board members, and corporate advisors may achieve, almost inadvertently, a partial reduction in the power of the inner circles. They may do this by creating a group on the board in opposition to its inner circle and by partially eroding the power of the natural leaders of these circles, the CEOs and CFOs.[282] In sum, the Act complements, but does not make unnecessary, this Article's proposal.

To understand the contribution of the Sarbanes-Oxley Act in this way means to give its reforms the social psychological justification not made by policymakers. The Act primarily addresses the inner circle and its CEO or CFO leaders by establishing in a public firm an oppositional *group* and an alternative leader. The social psychological justification for this approach (absent in the legislative history) is that independent board members and others would be better able to oppose the natural psychological attraction of the inner circle, and thus be more resistant to groupthink, if they have another leader and group supportive of them and with which they can identify.[283] The Sarbanes-Oxley Act basically attempts to facilitate the creation of the oppositional group in the audit committee, whose members cannot be inside directors.[284] The oppositional leader may well be the fi-

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[282] *See* Joann Lublin et al., *How Real are the Reforms?: Corporate-Oversight Bill Will Mean Change, Confusion; Boards to Be 'More Nervous'*, WALL ST. J., July 29, 2002, at B1.

[283] Individuals are better able to resist group pressure if they have another group that provides them with an alternative source of social "intensity". *See* BROWN, *supra* note 18, at 24-30 (describing Latane's Law of Social Impact, which relates the intensity of social pressures on an individual to three factors: the strength of each pressure influencing an individual (e.g., status), its immediacy (e.g., closeness), and the number of the individuals (e.g., how many are exerting the social pressure)).

[284] *See* Sarbanes-Oxley Act of 2002 § 301, Pub. L. No. 107-204, 116 Stat. 745, amending § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1 (West 2004). This provision directs national securities exchanges and associations to prohibit the listing of a security of a company that does not have an audit committee in accordance with the standards set forth by the Act. The SEC implemented Section 301 by its rule-making, which in turn affects stock exchange rules. *See* Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274); Securities Act Release No. 8173, 68 Fed. Reg. 2638 (Jan. 17, 2003) (proposed rule). The NYSE and the NASDAQ implemented these requirements by changes to their rules. *See supra* notes 167, 180. Other board committees, such as those mandated by the self-regulatory organizations (a nominating/corporate governance committee or a compensation committee), may also serve as alternative power centers, as might the independent directors as a whole. Since, however, most regulatory attention has

nancial expert who must be on the audit committee.[285] The power and independence of the committee comes from its authority to hire its own independent consultants and its direct line of communication with employees and the inside auditors.[286] Most significantly for breaking up the inner circle, the audit committee controls the outside auditing function—the basic review of management—by hiring and firing outside auditors, who report to it.[287]

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focused on the audit committee, and since a lead or presiding director was not mandated by the legislation or by the SRO rule, the audit committee is likely to be the main power center juxtaposed to the inner circle.

285 In essence, the Sarbanes-Oxley Act requires the SEC to promulgate rules that compel public companies to disclose the identity of a financial expert on their audit committee or the reasons for his absence. *See* Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C.A. § 7265 (West 2004). The SEC implemented the statute by rule, which in effect expands the statute's definition of who can be a financial expert. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110 (Jan. 31, 2003) (17 C.F.R. pts. 228, 229, 249); Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8138, 67 Fed. Reg. 66,208 (Oct. 30, 2002) (proposed rule). The final rule emphasizes the role of the expert in the analysis of the company's financial statements and requires disclosure of whether this expert is independent. As the final rule makes clear, there was considerable debate on the definition of financial expert, which was first drawn too narrowly to refer to only those individuals who had experience in preparing financial statements.

286 *See* 15 U.S.C.A. § 78j-l(m)(4)-(6) (West 2004); Securities Act Release No. 8220, 68 Fed. Reg., at 18,798. The audit committee is to be the group in the firm to which anyone concerned about firm misbehavior, particularly accounting problems, reports. *See* Sarbanes-Oxley Act of 2002 § 301, Pub. L. No. 107-204, 116 Stat. 745, § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1 (West 2004). ("COMPLAINTS. Each audit committee shall establish procedures for—(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."). A Senate Report offered little justification for this amendment. *See* S. REP. No. 107-205, at 25 (2002). The SEC adopted rules mandating that SROs require listed companies to have their audit committees set up whistleblowing procedures. *See* Securities Act Release No. 8220, 68 Fed. Reg., at 18,798. The requirements are part of the adopted NYSE and NASDAQ rules. Law firms are already advising companies on how to implement the rules. *See, e.g.*, Memorandum from Wachtell, Lipton, Rosen & Katz, Audit Committee Whistleblower Procedures Under Sarbanes-Oxley (Jan. 23, 2003) (on file with the author).

287 *See* 15 U.S.C.A. § 78j-l(m)(2) (West 2004). The Senate Report noted:

> Witnesses at the Committee's hearings suggested that the auditing process may be compromised when auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. For this reason, the bill requires audit committees to be directly responsible for the appointment, compensation, and oversight of the work of auditors, and requires auditors to report directly to the audit committee.

Related to the establishment of an alternative group to the inner circle is the Sarbanes-Oxley Act's effort to bind the firm's professional advisors to that group.[288] The main focus of this effort, understandably enough, is a firm's outside auditors. As discussed above, nearly all the corporate scandals involved misleading financial statements that were prepared often through the collusion of inside and outside accounting professionals. Outside accountants (particularly engagement partners) were clearly drawn into and became participants, whether essential or peripheral, of the inner circles. Any effective reform would thus have to encourage, or even force, accountants to resist the temptation to be part of the "team" created by top executives.[289] The

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S. REP. NO. 107-205, at 23-24. *See also* Exchange Act Release No. 33,8220, 68 Fed. Reg. at 18,798.

288 Others have speculated on ways of breaking the psychological dependence of outside auditors on their clients. *See* Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002) (proposing a system whereby companies purchase financial statement insurance, i.e., insuring the accuracy of their financial statements, from insurance companies, which in turn hire auditing firms to verify the accuracy of the statements).

289 Reflections on the accounting aspects of the scandals have often missed this necessary social psychological goal of reform. *See* Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure?*, 48 VILL. L. REV. 1057 (2003) (pointing out how Enron's financial reporting did not comply with accounting standards); Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows,* 57 BUS. LAW. 1421 (2002) (arguing that scandals could be avoided if lawyers were adequately trained in accounting and insisted upon asking probing questions about a company's financial statement). While lawyers should certainly have more accounting training, it is doubtful whether the scandals arose because the lawyers involved did not know enough about accounting to detect the fraud. Rather, immersed in the team mentality that they shared with executives and the other corporate advisors, they became blind to their improper behavior. By contrast, whenever a scandal erupts, lawyers point to their limited competency in accounting. However, one should not take their protests of lack of accounting competence (self-serving in today's litigation) at face value.

For a more realistic view of the role of accountants in the scandals, see SEAN M. O'CONNOR, THE INEVITABILITY OF ENRON AND THE IMPOSSIBILITY OF "AUDITOR INDEPENDENCE" UNDER THE CURRENT AUDIT SYSTEM (Working Paper, 2002) (observing how difficult it is for outside accountants to fulfill their public service responsibility when they are paid by the firms that they are auditing and when they are themselves profit-making businesses, which at least points to rational reasons for the pressures on accountants that draw them into an inner circle), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181; *see also* GENERAL ACCOUNTING OFFICE, ACCOUNTING PROFESSION: OVERSIGHT, AUDITOR INDEPENDENCE, AND FINANCIAL REPORTING ISSUES (GAO-02-742R May 3, 2002) (noting with skepticism the current system of self-regulation of company auditing by accountants themselves, which has allowed the profession to use its special, government-approved status for personal benefit while ignoring its public responsibilities and arguing that a new independent governmental body is needed to oversee the public

most effective reform, from a social psychology perspective, would be to align accountants with a group or circle different from, and even structurally in conflict with, the inner circle.

The Sarbanes-Oxley Act thus makes outside auditors part of the audit committee's circle, rather than the CEO's.[290] These au-

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company audit function and thus the behavior of independent public accountants fulfilling this function—a proposal since adopted by Congress), *available at* http://www.gao.gov (last visited Oct. 24, 2004). A social psychological perspective would have enabled the GAO better to support and refine its proposal, for it suggests that government oversight (not accountant self-regulation) is needed to keep outside accountants from falling within the sway of inner circles.

[290] A similar kind of perspective could be taken as to the regulation of lawyers representing public companies. The Sarbanes-Oxley Act required the SEC to issue rules of professional conduct that would compel lawyers practicing before the SEC to report violations of the securities laws or breaches of fiduciary duties or "similar violations" to a company's chief legal officer or CEO and, if appropriate action is not taken by such executives, to the audit committee, another board committee, or to the entire board. *See* Sarbanes-Oxley Act of 2002 § 307, Pub. L. No. 107-204, 116 Stat. 745, 15 U.S.C.A. § 7245 (West 2004). The SEC subsequently issued a rule mandating attorney reporting of company misconduct, basically establishing an "up the ladder" reporting requirement for lawyers, both inside and outside counsel to a public firm, who become aware of violations of the securities or other laws. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, 68 Fed. Reg. 6296 (Feb. 6, 2003), 17 C.F.R. pt. 205; Securities Act Release No. 8155, 67 Fed. Reg. 71,670 (Dec. 2, 2002) (proposed rule). The rule directs an attorney to report a violation to an appropriate company chief legal officer (the "C.L.O.") or an established qualified legal compliance committee ("Q.L.C.C.") (composed of independent board members), and, if reasonable action is not taken by such officer or committee, to a higher authority in the firm, including the company's board. The SEC has made it clear that the Q.L.C.C. could be the same as the audit committee. *See* Securities Act Release No. 8185, 68 Fed. Reg. at 6304. For discussions of the Sarbanes-Oxley Act's and the SEC's regulation of attorneys, see STEPHEN M. BAINBRIDGE & CHRISTINA J. JOHNSON, MANAGERIALISM, LEGAL ETHICS, AND SARBANES-OXLEY §307 (U.C.L.A. Sch. of Law Research Paper No. 03-13, 2003) (arguing that the Act, including its attorney conduct provision, was designed to counter managerial power in U.S. firms, but questioning the Act's likely success in this area), *available at* http://ssrn.com/abstract=434721; Jill E. Fisch & Kenneth M. Rosen, *Is There A Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097 (2003) (discussing factors that tie attorneys to management and expressing skepticism about the efficacy of the Sarbanes-Oxley Act in prying attorneys away from management). In my view, however, both sets of authors remain too wedded to the status quo of attorney-client relationships and fail adequately to imagine the perspective an attorney might adopt on a client's transactions if he were not captured by the inner circle, but were aligned with an oppositional group of the board.

Similarly, by restricting the ability of research analysts to help their investment banking divisions, which are allied with companies' inner circles, the Sarbanes-Oxley Act tries to remove the analysts from the circles. Sarbanes-Oxley Act of 2002 § 501, 15 U.S.C.A. § 78o-6 (West 2004) (adding new Section 15D to the Exchange Act); Regulation Analyst Certification, Securities Act Release No. 8193, 68 Fed. Reg. 9482 (Feb. 27, 2003), 17 C.F.R. pt. 242; Securities Act Release No. 8119, 67 Fed. Reg.

ditors report to the audit committee any disagreements that they might have with executives over any aspect of a firm's accounting treatment.[291] The Act also tries to prevent the establishment of direct or indirect ties between the outside auditing firm and the inner circle by prohibiting the former from providing certain lucrative non-audit services for an auditing client such as management consulting, financial reporting systems preparation, and legal services.[292] To further this separation, partners of an auditing firm who are engagement or reviewing partners on an audit must be rotated after five years (although there is unfortunately no mandatory rotation for the auditing firm itself).[293] Auditing partners cannot receive non-audit related compensation from a company, and there must be a one year cooling-off period before an auditing partner can accept a senior position with the company.[294]

51,510 (Aug. 8, 2002) (proposed rule). On the Act's focus on lawyers and analysts as corporate governance participants, see generally Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance,* 48 VILL. L. REV. 1189 (2003).

291 *See* Sarbanes-Oxley Act of 2002 § 204, Pub. L. No. 107-204, 116 Stat. 745, amending § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1(k) (West 2004). The auditors would have to discuss with the committee, among other things, alternative treatments of financial information and their ramifications. *See id.* § 78j-1(k)(2) (requiring timely reporting of "all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm"); *see also* Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, 68 Fed. Reg. 6006, 6048 (Feb. 5, 2003) (laying out new rule 17 C.F.R. § 210.2-07).

292 *See* Sarbanes-Oxley Act of 2002 § 201, Pub. L. No. 107-204, 116 Stat. 745, § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1(g) (West 2004) (listing the prohibited activities). Sections 201 and 202 also provide that an audit committee needs to preapprove an auditing firm's provision of non-audit services that are not on that list, as well as a de minimis exception for this preapproval requirement where the services constitute no more than five percent of the revenues received by the auditing firm from the company. *See* Securities Act Release No. 8183, 68 Fed. Reg., at 6045-47.

293 *See* Sarbanes-Oxley Act of 2002 § 203, Pub. L. No. 107-204, 116 Stat. 745, § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1(j) (West 2004). *See* Securities Act Release No. 8183, 68 Fed. Reg., at 6046 (requiring in addition a five-year "time out" before returning to that audit service for such partners after that rotation, and a seven-year limitation for certain other significant audit partners, with a two-year time out).

294 *See* Sarbanes-Oxley Act of 2002 § 206, Pub. L. No. 107-204, 116 Stat. 745, § 10A, 48 Stat. 881 (1934), 15 U.S.C.A. § 78j-1(l) (West 2004). *See also* Securities Act Release No. 8183, 68 Fed. Reg., at 6045. The Sarbanes-Oxley Act also established a Public Company Accounting Oversight Board, to which all public firms and

The Sarbanes-Oxley Act also compels publicly traded firms to rein in the power of the CEO and other top executives to create and dominate an inner circle by partially isolating these executives. From a social psychology perspective, the effort is not so much to separate board members from top management's inner circle, as in the reforms dealing with the audit committees, but to distance executives from their groups, which would erode the groups' power by removing their natural leaders. The most prominent example of this legislative and regulatory strategy is the well-publicized requirement that a CEO and CFO (or equivalent) certify a firm's periodic reports and the existence of control systems in the firm.[295] The social psychological force of the certification requirement comes from its preventing inner circle members from falling on their swords, that is, taking the

accounting firms must belong. *See* Title I of Sarbanes-Oxley ("Public Company Accounting Oversight Board"). Indeed, this board could well be a model for an oversight board for the public directors. *See also* Securities Act Release No. 8109, 67 Fed. Reg. 44,964 (July 5, 2002) (proposing establishment of such a board). The accounting oversight board is an independent nonprofit organization under the jurisdiction and oversight of the SEC—and funded by mandatory fees from accountants and issuers—whose five members are selected by the SEC in consultation with the Chairman of the Federal Reserve Board and Secretary of the Treasury. *See* Sarbanes-Oxley Act of 2002, §§ 101, 107, 109. The board sets guidelines for accounting of public firms, reviews and inspects accountants firms' auditing work, and disciplines public accountants. *See* Sarbanes-Oxley Act of 2002, §§ 103-105. This board thus provides external oversight of the public accounting firms to ensure that they remain separate from management. *See generally* http://www.pcaobus.org (for organization, rules and proceedings of the new organization). Sarbanes-Oxley and SEC rules also require auditors to retain work papers for five years in order to facilitate investigations of improper auditing. *See* Sarbanes-Oxley Act of 2002 § 802, 18 U.S.C.A. § 1520 (West 2004); Retention of Records Relevant to Audits and Reviews, Securities Act Release No. 8180, 68 Fed. Reg. 4862 (Jan. 30, 2003), 17 C.F.R. pt. 210; Exchange Release No. 33,8151, 67 Fed. Reg. 71,017 (November 27, 2002) (proposed rule).

[295] *See* Sarbanes-Oxley Act of 2002, §§ 302 ("Corporate Responsibility for Financial Reports"), 404 ("Management Assessment of Internal Controls"), 906 ("Corporate Responsibility for Financial Reports"), 18 U.S.C.A. § 1350 (West 2004) (subjecting executives to criminal penalties for false certifications); Certification of Disclosure in Companies' Quarterly and Annual Results, Securities Act Release 8124, 67 Fed. Reg. 57,276 (Sept. 9, 2002), 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, 274; Exchange Act Release No. 46,300, 67 Fed. Reg. 51,508 (Aug. 8, 2002) (revised proposed rule); Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877 (June 20, 2002) (proposed rule offered before passage of the Sarbanes-Oxley Act, made because investors were losing confidence that executives are paying attention to company disclosure). *See also* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33,8238, 68 Fed. Reg. 36,636 (June 18, 2003) (final rule under which managers of a public company must report on and certify internal control systems in their company).

blame for any accounting or disclosure problems, all on behalf of the leader (the paradigm of the group).[296] Rather, liability must fall on the certifying executive. This liability could create a built-in opposition from the outset in the company's hierarchy, as the certifying executives may become suspicious of those in their inner circle who might report its improper activities to the audit committee or even to government authorities and who, despite being group members, cannot sacrifice themselves for the executives.[297]

The Sarbanes-Oxley Act, moreover, makes other efforts to isolate top executives from their inner circles and to prevent them from being the symbolic and actual recipients of the circles' largesse. They are prohibited from influencing outside auditors' preparation of financial statements.[298] They are required to return their bonuses or other equity-linked compensation attributable to a period if there is a material restatement of the company's financial results for the period.[299] An executive's ability to receive loans from his company—a subject of considerable past abuse—has been restricted to loans offered to other borrowers on market terms.[300] They must make rapid disclosure of any transactions in their own company's securities under a modified Section 16,[301] and their trading in company securities is

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296 The great problem with being able to hold top executives responsible for the scandals is that they often give implicit directions to their circle members to engage in wrongdoing (e.g., "Meet the quarterly numbers at all costs!"), yet they maintain "deniability"—the ability to claim they never actually gave explicit instructions to do such. This allows circle members free rein to meet the leader's wishes while protecting the leader.

297 *See*, *e.g.*, Memorandum from Wachtell, Lipton, Rosen & Katz, Due Diligence Procedures for New CEO/CFO Certification Requirements 4 (July 2002) (on file with author) (observing that some CEOs are considering whether to hire their own counsel in preparing certifications).

298 *See* Section 303 of Sarbanes-Oxley; Improper Influence on Conduct of Audits, Exchange Act Release No. 47,890, 68 Fed. Reg. 31,820 (May 28, 2003) (final rule); Exchange Act Release No. 46,685, 67 Fed. Reg. 65,325 (Oct. 24, 2002) (proposed rule). The final rule aims to prevent officers and directors from, directly or indirectly, improperly influencing the outside auditor's conduct of the audit that would result in a company's financial statements becoming materially misleading.

299 *See* Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C.A. § 7243 (West 2004).

300 *See* Sarbanes-Oxley Act of 2002 § 402, Pub. L. No. 107-204, 116 Stat. 745, § 13, 48 Stat. 894 (1934), 15 U.S.C.A. § 78m(k) (West 2004). The Senate initially proposed only that there be enhanced disclosure regarding insider loans. *See* S. REP. No. 107-205, at 30. For an empirical study on executive loans, see Kuldeep Shastri & Kathleen M. Kahle, *Executive Loans* (Feb. 18, 2003), *available at* http://www.ssrn.com/Sol3/papers. cfm?abstract_id=423447.

301 *See* Sarbanes-Oxley Act of 2002 § 403, Pub. L. No. 107-204, 116 Stat. 745, § 16,

almost completely banned during pension plan "blackout" periods.[302] The SEC can also temporarily freeze executives' assets if they have received an improper payment from their corporation.[303]

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48 Stat. 896 (1934), 15 U.S.C.A. § 78p (West 2004). *See also* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 46,421, 67 Fed. Reg. 56,462 (Sept. 3, 2002) (final rule); Exchange Act Release No. 46,313, 67 Fed. Reg. 51,900 (Aug. 9, 2002) (describing provision requiring reporting of such trading within two business days of trade).

[302] *See* Sarbanes-Oxley Act of 2002 § 306, 15 U.S.C.A. § 7244 (West 2004); *see also* Insider Trades During Pension Fund Blackout Periods, Exchange Act Release No. 47,225, 68 Fed. Reg. 4338 (Jan. 28, 2003) (adding final rule on Regulation Blackout Trading); Exchange Act Release No. 46,778, 67 Fed. Reg. 69,430 (Nov. 15, 2002).

[303] *See* Sarbanes-Oxley Act of 2002 § 1103, Pub. L. No. 107-204, 116 Stat. 745, amending § 21C, 104 Stat. 939 (1990), 15 U.S.C.A. § 78u-3(e)(3) (West 2004). Through disclosure, the Sarbanes-Oxley Act also tries to curb practices that, if unchecked, could be used (because they have been so used in the scandals) by inner circles to further their self-interest. It requires the SEC to promulgate rules forcing a company to make more rapid disclosure of new company financial information that is material; *see* Sarbanes-Oxley Act of 2002 § 409, Pub. L. No. 107-204, § 13, 48 Stat. 894 (1934), 15 U.S.C.A. § 78m(l) (West 2004). *See also* Sarbanes-Oxley Act of 2002 § 401(a), Pub. L. No. 107-204, amending § 13, 48 Stat. 894 (1934), 15 U.S.C.A. § 78m(j) (West 2004). Section 401(a) requires that the SEC promulgate rules mandating annual and quarterly reports to disclose

> material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.

See also Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, 68 Fed. Reg. 5982 (Feb. 5, 2003), 17 C.F.R. pts. 228, 229, 249; Securities Act Release No. 8144, 67 Fed. Reg. 68,054 (Nov. 8, 2002) (proposed rule); Sarbanes-Oxley Act of 2002 § 401(b), Pub. L. No. 107-204, § 13, 48 Stat. 894 (1934), 15 U.S.C.A. § 78m (West 2004) (requiring the SEC to issue rules compelling companies to make materially accurate pro forma disclosures and show reconciliations with GAAP numbers); Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8176, 68 Fed. Reg. 4820 (Jan. 30, 2003), 17 C.F.R. pts. 228, 229, 244, 299; Securities Act Release No. 8145, 67 Fed. Reg. 68,790 (Nov. 13, 2002) (proposed rule). Sarbanes-Oxley also demands disclosure on whether a company has a code of ethics. *See* Sarbanes-Oxley Act of 2002 § 406, 15 U.S.C.A. § 7264 (West 2004) (requiring a company to disclose whether it has a code of ethics for senior financial officers and, if not, the reasons for this absence). The code deals with conflicts of interest for officers and is aimed at preventing the kind of behavior that Andrew Fastow exhibited in Enron. The SEC has implemented rules requiring the code to apply to CEOs as well as financial officers such as CFOs and comptrollers. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, 68 Fed. Reg. 5110 (Jan. 31, 2003), 17 C.F.R. pts. 228, 229, 249; Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8138, 67 Fed. Reg. 66,208 (Oct. 30, 2002) (proposed rule). Even before passage of the Sarbanes-Oxley Act, the SEC

The Sarbanes-Oxley Act and the SEC regulations implementing it may well succeed in partly undermining, or at least checking, the exercise of unrestrained power by inner circles dominated by CEOs in public firms. One should never underestimate, however, the power of a CEO to form a group despite regulatory hurdles, especially since, as discussed below, corporate governance participants have not changed.[304] It is most likely that the social pressure exerted by the dominant group will continue to be strong, thus undermining the creation of an oppositional group on the board. Although the benefits of the Sarbanes-Oxley Act, if achieved, are worth its costs, the Act does not substantially lessen the power of the inner circles.[305]

Ultimately, the Act did not succeed in dealing with the inner circles because legislators and the SEC have not even recognized this social phenomenon and its dangers, mainly on account of their ignorance of social psychological literature and their fear of moving away from the social status quo of corporate America.

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enhanced the critical disclosure under Management's Discussion and Analysis of Financial Statements (MD&A) on matters that had been at the heart of the corporate scandals (e.g., disclosure of off-balance sheet contingencies, liquidity, and related-party transactions). *See* Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8056, 67 Fed. Reg. 3746 (Jan. 25, 2002) (commission statement about enhancing MD&A); Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies, Securities Act Release No. 8098, 67 Fed. Reg. 35,620 (May 20, 2002) (proposed rule). These enhancements were folded into SEC releases implementing the Act. The Commission also adopted a major revision to Form 8-K, in particular to require companies to disclose information of the kind that inner circles of scandal-ridden companies had kept to themselves. *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8400, 69 Fed. Reg. 15,594 (Mar. 25, 2004), 17 C.F.R. pts. 228, 229, 230, 239, 240, 249; Securities Act Release No. 8106, 67 Fed. Reg. 42,914 (June 25, 2002) (proposed rule) (listing, for example, Form 8-K disclosure items such as material contingent commitments, material transactions by company, ending material transactions, and departure of executive officer or board member and reasons therefore).

304 On the continuing power of CEOs, see Tosi, *supra* note 257, at 181-87. The HealthSouth scandal, discussed earlier, is a good example because, although the accounting fraud involved was occurring before passage of the Sarbanes-Oxley Act, the Act did nothing to check the CEO and his inner circle's power. One also thinks of the executive compensation scandal at the NYSE that occurred since passage of the Act.

305 On concern over costs in the new regulation of public companies, see Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 69 (2002) (discussing costs and also observing that there may well be overregulation of accountants under the mistaken assumption that financial statements, and their review thereof, produce hard, as opposed to soft, information about a company's financial position).

The failure of the Sarbanes-Oxley Act then lies in the blindness of its drafters and the SEC to the fact that radical measures must be taken to disrupt the formation of inner circles in public corporations, measures such as the introduction of individuals different from the current elite as public directors and special oversight of these directors.[306] Instead, the Act maintains the status quo emphasis on independent board members, which means that its drafters cannot, or refuse to, imagine a different and effective way of monitoring the inner circles. This is shown by the fact that, under the reform, the very kinds of individuals who are prone to becoming members of inner circles and who have shown little pro-social behavior—active or retired CEOs and CFOs, investment bankers, top lawyers and accountants, representatives of institutional investors, prominent public servants, and academic officers[307]—continue to dominate boards. Indeed, the new regulatory focus on the audit committee and on the financial expert on that committee[308] means that the group juxtaposed against the inner circle will be composed of the same people who make up the circle itself.

Even if, as a result of the Sarbanes-Oxley Act and the new SEC regulations, more former government and financial regulators become board members, this result will not solve the inner circle problem. Some government officials clearly have the wider social orientation that one would want in a public director. How-

306 *See, e.g.*, Ken Brown, *Wall Street Plays Numbers Game With Earnings, Despite Reforms*, WALL ST. J., July 22, 2003, at A1 (describing how companies continue to mislead investors); Carol Hymowitz & Joann S. Lublin, *Boardrooms Under Renovation*, WALL ST. J., July 22, 2003, at B1 (describing how little effect the Act has had on board behavior).

307 *See* KORN/FERRY, *supra* note 77, at 16 (reporting how many directors are presidents, CEOs, board chair, or retired CEOs).

308 The SEC rule defines a financial expert as someone who has the requisite financial expertise stated in the rule that he or she has obtained from:

(1) 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;

(2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

(3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

(4) Other relevant experience.

See Securities Act Release No. 8177, 68 Fed. Reg. at 5127.

ever, the public service dedication of many of these individuals should be viewed with great skepticism, for in financial services and in public companies, private and public sector elites are now so intertwined because public service is often a sure path to the board elite (indeed, the path to private industry and wealth may be a major reason why some people enter public service in the first place).[309] Unfortunately, recent reforms contribute to this movement between public and private sector elites. The final SEC rule on the audit committee financial expert points to former government officials as eligible persons, thus simultaneously encouraging government officials to profit from their government service and the private sector to hire them.[310] Moreover, the definition of an independent board member adopted by the SEC (some of whose commissioners, such as its chair, are drawn from the financial and board elite), which essentially relies upon SRO definitions of the same, puts no roadblock on the elite's movement back and forth between company boards, professional service organizations, and the government.[311]

It is thus disheartening, but not at all surprising, that the predictable is happening. What is needed is for some board membership to become a public service, with boards to include a very different kind of person from those who have been members until now and with the new members not becoming themselves part of the elite. What is happening, by contrast, is that the same elite, perhaps with more ex-government officials as new members, continues to dominate boards and audit committees, with the law doing nothing about limiting the number of board posi-

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309 The examples here are too numerous to cite. At the highest level, there is The Carlyle Group, a merchant banking firm that has as partners former government officials because it recognizes how interconnected finance and industry have become to politics. *See* Jackie Calmes, *Venture Fund Aims to Cash In on Security*, WALL ST. J., Feb. 25, 2003, at A4 (describing the Group as "politically well-connected") For every Richard Breedon, there is a Wendy Gramm as a director of Enron or a Madeleine Albright as a director of the NYSE.

310 *See* Securities Act Release No. 8177, 68 Fed. Reg., at 5115 ("For example, certain individuals serving in governmental, self-regulatory and private-sector bodies overseeing the banking, insurance and securities industries work on issues related to financial statements on a regular basis. We believe that such experience can constitute a very useful background for an audit committee financial expert."). *See also* BREEDON, *supra* note 40, at 145 (stating that the senior ethics officer should be an experienced attorney whose experience "should have included service in a regulatory or law enforcement agency of government").

311 *See* Securities Act Release No. 8173, 68 Fed. Reg. 2638, at 2640-42 (Jan. 8, 2003) (not making the issue of independence depend on an individual's former positions).

tions any individual may have and about imposing term limits on this elite.[312] Board service thus remains what it has become—spoils of financial or political (and, in some cases, academic) power.

Even more disheartening is that the Sarbanes-Oxley Act and SEC regulations have ultimately done little to discipline corporate advisors or prevent them from joining inner circles. Instead, the reforms have become a full employment act for the very professionals who participated in, or who turned a blind eye to, the corporate scandals. Investment bankers have paid a relatively small price (compared to their outsized gains during the 1990s) for becoming part of CEOs' inner circles, contributing to the groups' financial machinations, and neutering their own analysts.[313] The new analyst regulation will do little to keep their cheerleading from recurring.[314] Arthur Andersen is no more, but the law in many cases offers little more than window dressing on the separation of the outside auditor from the inner circle. Only an engagement auditing partner, not the auditing firm itself, needs to be rotated, the movement of accountants from auditing firms to companies is delayed only by a year, and auditing firms' provision of tax services to firms is not prohibited.[315] And the Act certainly gives the remaining big accounting firms plenty to do.[316]

It is a boom time for corporate and securities lawyers, who explain the Sarbanes-Oxley Act and the new SEC regulations to boards, help them establish procedures to satisfy the new legal requirements, and conduct the necessary investigations of the corporate scandals. One would have to look long and hard today for a lawyer from a corporate law firm who would say that he is *not* competent to give a firm advice on all these matters, including accounting (particularly when capital market and merger-related work has been at low levels). Yet lawyers were, in many

312 *See* Joann S. Lublin, *Boardrooms Under Renovation: Independence of Directors is Elusive Goal of Reform*, WALL ST. J., July 22, 2003, at B1 (describing, through a few examples, such as ex-Senator George Mitchell and super-lawyer Larry Sonsini, how the same elite remains on boards despite the Sarbanes-Oxley Act).

313 *See supra* note 33.

314 *See supra* note 290.

315 *See* Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, 68 Fed. Reg. 6006, at 6045-48 (Jan. 28, 2003), 17 C.F.R. pts. 210, 240, 249, 274.

316 *See* Michael Schroeder, *Cleaner Living, No Easy Riches,* WALL ST. J., July 22, 2003, at C1 (describing how audit fees have tripled).

cases, either more than willing to go along with the transactions devised by corporate inner circles or careful not to ask too many questions of the transactions and clients that were enriching them.[317]

CONCLUSION

We have been living through a disturbing period in the history of publicly traded U.S. firms. From 2001 until recently, it seems as if a day did not pass without a new scandal surfacing in a U.S. public company or the U.S. financial industry, and problems in other firms are still being uncovered.[318] These scandals always involved a corporate inner circle, usually dominated by the CEO, misleading public investors and others and reaping enormous benefits for its members. It is particularly striking that the scandals were not uncovered by board members who had the task of supervising the firm or by those corporate advisors who through their positions, ethical obligations, or legally privileged roles were granted a special involvement in or oversight role with the firm. Rather, these individuals either participated or acquiesced in the activity of corporate inner circles. Revelation of the scandals was left to corporate whistleblowers, who were generally executives outside the inner circle and who paid a high personal and professional price for what can only be termed their noble activity while, with a few exceptions, corporate fiduciaries and advisors suffered little personal harm.

It is tempting, and indeed politically expedient, to attribute the scandals to the greed and moral failings of a few executives and corporate advisors. No doubt self-interest played a role, particularly during the 1990s when the pursuit of instant and boundless wealth became celebrated in the United States by the media and was acquiesced to by politicians of all political stripes. Yet greed is only part of the story, and a focus on it without tying it to corporate inner circles obscures the structural problems with corporate governance that produced the corporate scandals and that

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317 *See In re* Corp. Sec., Derivative & "ERISA" Litig., 235 F. Supp. 2d 549, 704-06 (S.D. Tex. 2002) (discussing Vinson & Elkins' and Kirkland & Ellis' involvement in Enron).

318 At this writing, the scandal of the day has become widespread abuses by insiders in the mutual fund industry. And, once again, whistleblowers often alerted authorities to the mutual fund scandals. *See* Henny Sender & Gregory Zuckerman, *Behind the Mutual Fund Probe: Three Informants Opened Up*, WALL ST. J., Dec. 9, 2003, at A1 (discussing the role of whistleblowers in fund scandals).

remain, despite recent reforms. I contend that the contrast between the behavior of the whistleblowers and that of board members and corporate advisors points to the problem of the inner circle, with its social psychological origins reinforced by behavioral patterns long ago established in human beings' evolution. As I have argued, inner groups composed of the CEO and other top executives, board members, and corporate advisors formed in many public firms and, within their groupthink, operated the firms for a self-interest taken to extremes and group self-perpetuation, as opposed to the interests of firm's shareholders, employees, and customers, as well as society. I supported this argument by reference both to the evidence available on the corporate scandals and to social psychological literature.

I proposed in the Article one method for countering the corporate inner circles. I argued that, while the formation of corporate inner circles, like the creation of any human group, is natural, this particular formation is destructive because the circles draw from an elite whose members are particularly prone to groupthink. Accordingly, I asserted that a method of preventing the formation of inner circles in the top management of firms, or at least checking and monitoring their power, is to create the position of public directors on boards and to draw different kinds of people to this position, which will be a limited public service, not a privilege of a new or established board elite. To achieve this reform, a government oversight board needs to be established to identify potential public directors whom companies could nominate for shareholder election to their boards, and to train and review the performance of these directors. I then explored how the reforms of corporate governance in Sarbanes-Oxley and the implementing SEC rules fall short of what is necessary to curb inner circles because they lack social psychological underpinnings, and they may actually reinforce the position of the existing board elite.

An impoverished view of human, and particularly of group, behavior plagues policymaking on corporate governance. It may well be that this view is useful for the existing elite. For if human beings are seen as basically rational individuals who primarily act in their own self-interest, and if groups are seen as the most effective decision-making bodies balancing these interests, any problems in public corporations must be due to the occasional wayward executive or some erroneous procedure in an otherwise

effective process. The status quo is thus acceptable, although incremental refinements to it can be suggested and made. I paint a different picture, both about individuals and groups. Even admitting all the idiosyncratic motives that might lead one to be a corporate whistleblower, the existence of whistleblowing calls into question the impoverished view of human beings as purely self-interested or narrowly group-interested and shows how an individual can adopt a view that goes beyond that of a narrow circle of cronies. Yet the power of groups to bind individuals to them and to blind them with their narrow focus must be recognized and dealt with if public corporations are truly to be operated for more than their inner circles.