YEAR 2002:
THE YEAR OF THE TELECOM MELTDOWN

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Year 2002 saw an entire industry, the telecom industry, and it’s supporting service industries embarrass itself.1 There have been few episodes in the nation’s business history that can compare. The railroad industries’ scandal ridden year of 18732 is the only analogy that comes to mind that can rival the depth and scope of the telecom industry’s mess in 2002. As books have been written about the railroad industry in the 1870s,3 so too will books be written about the telecom industry’s meltdown in 2002.4

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2. In 1873, the Credit Mobilier scandal erupted. The Credit Mobilier diverted profits of the Union Pacific Railroad stockholders to an inside group run by Oakes Ames, a Congressman from Massachusetts, and to his congressional and business cronies. The scandal reached the Supreme Court of the United States and the Vice-President of the United States. The same year it was revealed that Daniel Drew, Jim Fisk and Jay Gould had been milking the Erie Railroad stockholders in a similar fashion and that Leland Stanford, Charles Crocker, Mark Hopkins and Collis Huntington had been bilking the Central Pacific stockholders. See, e.g., THE RAILROADS: THE NATION’S FIRST BIG BUSINESS; SOURCES AND READINGS, (Alfred D. Chandler, Jr. ed., 1965); CHARLES FRANCIS ADAMS, JR. & HENRY ADAMS, CHAPTERS OF ERIE (1956) (market price of a state assemblyperson’s vote was $15,000).

One could also point to the electric component companies’ price fixing scandal of 1960. See Richard Austin Smith, The Incredible Electrical Conspiracy, FORTUNE, April 1961 and May 1961.

3. E.g., E. RAY McCARTNEY, CRISIS OF 1873 (1935).

The telecom industry will survive and there are some indications that it is creeping back into investors’ hearts. Nonetheless, it is worth a retrospective look at year 2002 to see what can be learned and to evaluate Congress’s reflex response, the Sarbanes-Oxley Act of 2002. The Act has changed corporate practice; the regulatory compliance costs of running a publicly traded corporation are higher. Scattered parts of the Act will improve some management practices. But the seed of significant improvement in management practices has been planted and will be grown by market pressure from more savvy investors. A remarkable private market correction appears to have begun.

I. THE TELECOM 2002 MELTDOWN

The revelations of 2002 were the product of problematic events that had taken place over the previous three or four years. But we discovered the depth of the industry’s problems in 2002. Global Crossing declared bankruptcy in January of 2002 and when WorldCom filed for bankruptcy in July that same year all the illusions of the industry’s health were unequivocally shattered. No one was spared the pain. Stockholders, bondholders, employees, and local communities all took it on the chin.

The telecom mess unfolded in waves. The first wave was the stumble of telecom equipment makers such as Lucent Technologies and Nortel Networks. The second wave was the devastation of the long-haul carriers such as WorldCom, Global Crossing, and Qwest Communications. The third wave was the swoon of the overseas

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5. See Bret Swanson, The Tech Comeback is Real, WALL ST. J., July 1, 2003, at B2 (noting new residential broadband users; new standards for extending high capacity optical fiber closer to homes and businesses and new products from Microsoft and Apple). See also Steven Rosenbush, Light at the End of the Fiber?, BUS. WK., Dec. 9, 2002, at 86; Steve Rosenbush, Poorer, But Happy to Be Here, BUS. WK., Feb. 17, 2003 at 66; Brian Grow, Profits: Now That's More Like It, BUS. WK., May 19, 2003, at 98 (describing rebound of “battered tech and telecom).


7. The definitive revelation was Steven Rosenbush, Inside the Telecom Game, BUS. WK., Aug. 5, 2002, at 34.

8. The equipment companies were the canary in the coalmine as they suffered defaults in their customer financing agreements with service providers that foretold the failure of those providers. See Ronald Fink, Most Dangerous Game?, CFO MAG., Mar. 2003. See also Dennis Berman, Lousy Sales Forecasts Helped Fuel the Telecom Mess, WALL ST. J., July 9, 2001, at B1 (faulting wildly optimistic equipment industry forecasts that fueled Wall Street earnings guidance).
telecom giants such as Deutsche Telekom and France Telecom. The fourth wave was the spill over effects on the older telecom giants in this country, AT&T, Verizon Communications, and BellSouth. Finally, the wireless industry joined the plunge.

By the end of 2002, equity investors had lost $2 trillion dollars of capital value, double the losses suffered in the dot-com crash and eight times the losses suffered in the savings and loan crisis of the late ‘80s. Telecom companies had lost, by the end of the year, close to 95% of their total capitalization. One-half a million telecom workers had lost their jobs. Hundreds of telecom companies were in bankruptcy and two rated as within the three largest bankruptcies in American corporate history. Telecom companies could not raise or borrow money and distressed companies could not sell assets, even at bargain basement prices. Telecom investment fell to less than 75% from its 2000 levels. 2002 saw a nine-year low in telecom venture capital investments and a 28-year low in telecom initial public offerings. Bank lenders still worry about tens of billions of dollars in exposed loans.

The enormity of the telecom collapse had three root causes. First, giant leaps in industry technology had fractured the market as participants raced to take advantage of the new developments. Excess expansion, failed expectations and overcapacity followed as they often

12. Rosenbush et al., supra note 9.
14. By March of 2003, 24 of the largest 30 publicly traded telecom service companies were bankrupt. Fink, supra note 8. On July 1, 2003, a Wall Street Journal editorial noted that there had been 1,000 telecom bankruptcies since 2000. See Swanson, supra note 5.
15. Among the bankrupt companies were Global Crossing, WorldCom, 360 Networks, PSINet, Williams Communications, XO Communications, Winstar, Genuity, and Net2000 Communications. WorldCom and Global Crossing ranked, at the time they were filed, as the world's first and third largest bankruptcies. WorldCom remains the largest, but Global Crossing has since slipped to fifth. See Rosenbush et al., supra note 9.
16. See Maney, supra note 11 (Global Crossing found few takers for its 100,000-mile fiber network).
17. Swanson, supra note 5.
18. Id.
have in the aftermath of a technology breakthrough. There was volatility in the business fundamentals. Second, federal regulation was both heavy-handed and shortsighted. The Telecommunications Act of 1996 was built on false assumptions and spawned unintended consequences. As the FCC and, inevitably, courts tinkered with the act in endless hearings, legal uncertainty and variability induced yet more volatility into the market. And finally, too many of the inside principals in the business were rogues and rascals. Fraud increased the stock market run up when people were duped and it increased the stock market decline when people learned the truth and lost trust. This essay focuses on the third cause of the collapse, the malefiance.

Some of the worst security frauds in American history came to light inside telecom companies – Adelphi Communications, Metromedia Fiber Network, WorldCom, Qwest, Global Crossing, and Enron. In


22. Rosenbush & Elstrom, supra note 21.

23. Id. See also Atkinson, supra note 20 (describing legal “gridlock” effects on the telecom sector: “Everything became a single high-risk roll of the dice. Now, every FCC decision—because it has such far-reaching application—literally becomes a ‘federal case’ and leads not to finality but to litigation, with fundamental decisions being made not by an expert agency but by judges and their law clerks’); Powell, supra note 19 (“We are always buffeted by the winds that come blowing out of judicial judgments and litigation, which are constantly putting the commission back on its heel . . . .”). See also Steven Rosenbush et al., What Hath the FCC Wrought?, BUS. WK., March 10, 2003, at 38.

24. Enron is not a telecom company but it did own a broadband subsidiary and promised videos on demand, a promise on which it did not deliver. Then CEO Jeffrey Skilling publicly touted the service and sold stock before the company acknowledged that the division had failed. Tyco Industries, another of the scandal-riddled companies in bankruptcy, also had a fiber optic subsidiary. One could, under a liberal classification, count both as also in the telecom industry.
the year 2002, 330 companies had to restate earnings, a twenty percent increase over any other year in American business history.25 Most of the restatements, certainty the largest of them, came from telecom companies.

Worldcom is restating revenue in 2001 and 2002 of $7.8 billion (and it may climb to $11 billion,26 which is greater than the Gross Domestic Product of Kenya in 200227). Worldcom is also taking write-downs of its goodwill of over $80 billion, the largest in history.28 The successor to WorldCom, whose 1999 to 2002 books are now known as the worst accounting and audit fraud in history, recently received the largest fine ever levied by the Securities and Exchange Commission (SEC), $500 million.29 Shareholders lost $180 billion on the company’s stock from its peak in 2000.30

Some of the worst cases in American history of private aggrandizement by managers also came to light. Managers of failing companies sold stock as stock prices peaked and declined, collecting staggering sums of cash: Gary Winnick of Global Crossing pulled $734 million out of a four-year-old company that never made a dime in profits.31 Philip F. Anschutz made over $1.4 billion in Qwest.32 Many of the “bubble beneficiaries” created business plans that raised investors’ expectations to unrealistic levels and sold shares before reality set in;33 others sold shortly before profit predictions were proved incorrect.34 CEOs of telecom companies borrowed huge amounts from compliant

25. E.g., Cassell Bryan-Low, Heard on the Street: Restatements Rise 22%, WALL ST. J., Jan. 21, 2002, at C3. (the 330 restatements in 2002 and 270 in 2001 were both all time records; there were, by comparison, only 116 restatements in 1997).
27. See POCKET WORLD IN FIGURES, (Economist, 2003), at 232.
28. See Dana Cimilluca, WorldCom Finds New $2b in Errors, SUN-SENTINEL (Fort Lauderdale), Apr. 1, 2003, at 1D. This is the 2002 GDP of Columbia. POCKET WORLD IN FIGURES, supra note 27.
29. Deborah Solomon & Shawn Young, MCI to Pay Investors $500 Million: Fraud-Charge Settlement Follows Audit Scandal of Historic Proportion, WALL ST. J., May 20, 2002, at A3. The previous single largest company fine had been $150 million against Citigroup’s Salomon Smith Barney.
30. Id. at A13. This is approximately the GDP of Austria. See POCKET WORLD IN FIGURES, supra note 27.
31. Rosenbush et al., supra note 9, at 34. His personal profit is larger than the GDP of at least eight of the world’s countries (e.g., Bhutan, Burundi, Eritrea, Gabon, Gambia, Guinea-Bissau, Liberia, and Sierra Leone). POCKET WORLD IN FIGURES, supra note 27.
32. See David Leonhardt, Bubble Beneficiaries, N.Y. TIMES, Aug. 25, 2002, § 3, at 10. See also Gretchen Morgenson, Getting While the Getting was Good, N.Y. TIMES, Mar. 24, 2002, § 3, at 1.
33. Leonhardt, supra note 32.
34. Id.
boards. Bernard Ebbers borrowed $400 million personally from WorldCom that he can never pay back.35

Telecom executives also were at the center of questionable stock deals with other companies. They took early stage (“friend of the company”) stock in suppliers that did deals with their own.36 They abused questionable tax shelter strategies.37 And they took preferred positions in hot IPOs on the understanding that they would direct their company’s business to the investment bankers doing the underwriting (“spinning”).38 Most of the sweetheart deals were not disclosed to shareholders.39 And there were the excessive salaries: cash, bonuses and stock options netted Kenneth Lay, for example, nearly $153 million in the year leading up to the companies collapse.40

Some of the worst abuses came as telecom executives struggled to delay the public’s realization that their companies could never deliver on their revenue promises. Using questionable or downright misleading accounting practices, the executives preserved the illusion of stability as they cashed in their options and their stock.41 In the first six months of

35. Rosenbush et al., supra note 9.
36. Gretchen Morgenson, Deals Within Telecom Deals: For Companies, Contracts. For Executives, Stock, N.Y. TIMES, Aug. 25, 2002, § 3, at 1 [hereinafter Morgenson, Deals]. The value came in a variety of forms: Sometimes it was warrants or options given in exchange for an established executive’s participation on an upstart company’s advisory board. Other times it was in initial offering shares designated by the issuer as part of the allotment destined for so-called friend and family. In still other cases executives were allowed to buy convertible preferred shares at bargain-basement prices when the company was still private; the shares were converted into common just before an IPO. Most of the deals were unseen from shareholders of either the telecom purchasing company or the upstart supplier.
38. Morgenson, Deals, supra note 36, at 10. See also Rosenbush et al., supra note 9, at 35 (Grubman doled out shares in hot IPOs to telecom executives); Kevin Maney & Noelle Knox, Failed Start-Up Land ed Among Scandals’s Debris, USA TODAY, Dec. 19, 2002, at IB (describing the spinning of Rhythms stock); Peter Larsen, Rhythms’ Debut and the Corporate Blues, FIN. TIMES (London), Sept. 1, 2002 at 21.
39. Morgenson, Deals, supra note 36, at 10,
40. SEATTLE TIMES, supra note 1. For examples of insider sales, see Berman, supra note 13 (e.g., insiders in a now-defunct wireless-data provider, Metricom Inc., where yearly revenues never exceeded $18.5 million managed to sell off more than $35 million in stock).
41. Rosenbush et al., supra note 9, at 37; Berman, supra note 13. For a case study, consider the actions of Catherine Hapka at Rhythms NetConnections. Maney & Knox, supra note 38. Rhythms raised $1.8 billion in capital by 1999 and by 2001 the company was bankrupt. It never showed a profit. When the company went public in 1999 the stock traded at $69 a share; the IPO price was $21. Hapka sold $12 million in stock in 2000, mixing statements of unbridled optimism with statements of caution. In September of 2002, after a Hapka conference call to analysts, the stock traded at $46. In February of 2001, the company reported a 2000 loss of $568 million; its shares traded at $1. Hapka resigned on May 1, after collecting a final $680,000 bonus despite leading the company to the brink of bankruptcy.
2001, for example, Qwest sold $857 million worth of network capacity to Global Crossing and other carriers and bought $450 million worth of capacity from those same carriers. The swaps raised Qwest’s revenue an additional 5% for the first half of the year, yet the swaps were in capacity in largely unused lines.

Those in the service industries also made out like bandits, while turning their heads to the industry’s problems. Jack B. Grubman, an industry analyst at Solomon Smith Barney, wrote rosy reports on struggling companies and made $20 million a year. Audit companies charged up to $25 million for yearly audits, overlooked blatant questions in the numbers and collected up to an additional $25 million a year in consulting fees for other services. Law firms collected sizable fees for overlooking and, in some cases, creating legal shams and schemes.

It was, all and all, a sorry spectacle. The industry fell under the spell of some very shady characters. Some were crooks, others fell from grace trying to keep pace with the crooks, and others, who overlooked the artifice, just were along for the ride. In any event, we now watch the news for the indictments and see the lawyers of those who have not copped a plea all claim their clients were innocent, that they did not know and were duped by others. Some will never be indicted; some who are indicted will walk; and a few, a very few, will go to jail.

Those who study financial swindles in world history see predictable cycles and patterns. With a cool eye the historians claim that swindles are linked to prosperity, increase with financial distress, and precipitate a crash when revealed. Professor Kindleberger of MIT, for example, wrote in 2000 that

The stock sank to $0.19. Hapka had sold her shares for an average price of $21 a share. Once in bankruptcy, bondholders got 12 cents on the dollar and stockholders nothing.

42. Rosenbush et al., supra note 9.
43. Id.
44. For a discussion of Grubman’s practices, see id. Grubman reiterated his “strong buy” recommendation on WorldCom all through 2001 and in early 2002 and did not downgrade the company to a “neutral” until April 22, 2002, when the company had publicly announced that it was slashing its revenue targets for 2002 and shares had dropped 90% form their peak to $4 a share. See also Maney & Knox, supra note 38 (Grubman’s role in touting Rhythms NetConnections). Grubman’s practices and those of other telecom security analysts were the basis of a huge settlement agreement between ten large Wall Street brokerage operations and the State of New York and the SEC. For a description of the $1.4 billion settlement, see Stephen Labaton, 10 Wall St. Firms Settle With U.S. in Analyst Inquiry, N.Y. TIMES, April 29, 2003, at A1; Gregory Zuckerman & Susanne Craig, Wall Street’s Payout: Too Little and Late?, WALL ST. J., Apr. 29, 2003, at C1.
45. E.g., Richard Breeden, Manager’s Journal: The Chaperone, the Referee, and the Confessor, WALL ST. J., Apr. 1, 2002, at A12 (discussing the consulting fees of auditors; Mr. Breeden is a past chairman of the SEC).
Swindling is demand-determined . . . In a boom, fortunes are made, individuals wax greedy, and swindlers come forward to exploit that greed. The position is occasionally expressed elsewhere that sheep to be shorn abound and need only the emergence of effective swindlers to offer themselves as sacrifices . . . Greed not only creates suckers to be swindled by professionals but also pushes some of the amateurs over the line into fraud, embezzlement, defalcation, and similar misfeasance . . . .

Let us grant that swindling grows with prosperity. It increases further in financial distress from . . . prices that stop rising and begin to decline . . . When the swindle or embezzlement is revealed, distress is increased, often precipitating crash and panic.

Financial distress leads to fraud, so that the burden of losses can be dumped on others. If the market goes decisively the wrong way, for example, bucket-shop operators abscond . . . .

The last half of the 1990s was sufficiently prosperous in the United States to produce a bumper crop of scam, swindles, fraud, or actions of bad judgment or ethical ambiguity.47

Even so, there are levels of degree among swindles. And year 2002 has to be a high water mark for financial scandal.

What sets the 2002 telecom meltdown apart from other financial scandals is its depth, the pervasiveness of the scams across numerous, high profile companies in the telecom industry,48 its breadth, the aid and support of the auditors, investment banks, securities analysts, rating agencies, media pundits and lawyers,49 its sheer dollar size, and its variety in the types of scams perpetrated. There are many forms of financial malfeasance: The obvious ones— theft, misrepresentation and lying— and practices closer to, but still over the line— diversion of funds from a stated use to another; paying dividends out of capital or loans, dealing in company stock on insider information, selling securities without full disclosure of new information, using company funds for noncompetitive purchases from or loans to insiders, taking orders but not executing them, altering the company’s books, corrupting independent auditors, analysts or media, using political influence to derail investigations and so on. In the year 2002 one could find examples of all of them.

47. CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES 76-77, 85 (4th ed. 2000). Professor Kindleberger retired as the Ford Professor of Economics at MIT.
48. See Morgenson, Telecom, supra note 1 ("As [securities regulators] dig, they many discover a trait that distinguishes this financial mess form other: the role played by an extensive web of relationships among these companies.").
49. Id. See also Mehta, supra note 10 ("Telecom is the most incestuous industry anywhere.").
II. CONGRESS’S RESPONSE TO THE FRAUD: THE SARBANES-OXLEY ACT OF 2002

Congress’s response to the corporate corruption and fraud slice of the telecom meltdown was to pass the Sarbanes-Oxley Act of 2002.\textsuperscript{50} Congress passed the Act in some haste.\textsuperscript{51} The spectacular failure of Enron in late 2001 prompted the Senate and House to pass competing bills on corporate and securities industry reform. The Senate’s bill was somewhat tougher and the drafters had trouble reconciling the bills in the conference committee. The WorldCom scandal broke in June of 2002 and the renewed political pressure on Congress to respond kicked the bill out of conference committee and on to the President’s desk by July 30\textsuperscript{th} of that year.

The haste, urgency, and moral outrage attached to the legislation produced limited debate and a blizzard of reform proposals.\textsuperscript{52} Some of the reforms overlapped. There are overlapping provisions on CEO and CFO certifications, on internal accounting control systems, and on whistleblower protections. Some of the reforms, added in the heat of the moment from the floor of the Senate, were not subtle or nuanced – the blanket prohibition on loans to executives, for example.

But the Act served its political function: President George W. Bush when signing the Act on July 30\textsuperscript{th}, 2002, declared that there would be “no more easy money for corporate criminals; just hard time.”\textsuperscript{53} His words were tough and angry. He noted that “[i]n the aftermath of September 11\textsuperscript{th}, we refuse to allow fear to undermine our economy, and we will not allow fraud to undermine it either.” He attributed the need for the legislation to “corporate corruption” that “has struck at investor confidence, offending the conscience of our nation.” He referred to the Act as the “most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt.” Under President Roosevelt, Congress passed the Securities Act of 1933 and the Securities

\textsuperscript{50} Sarbanes-Oxley, supra note 6.


\textsuperscript{52} The Senate passed the Act without a dissenting vote, the same margin that passed our anti-terror legislation after 9/11. The House passed the act by a vote of 423 to 3. The overwhelming Congressional support stands in stark contrast to Congresses legislation a year earlier that had reduced the fees on SEC filings and legislation in the 90s that had reduced the SEC’s budget and otherwise blunted the SEC’s efforts to change accounting practices. Richard B. Schmitt, Michael Schroeder & Shailagh Murray, Corporate-Oversight Bill Passes, Smoothing Way for New Lawsuits, WALL ST. J., July 26, 2002 at A3.

Exchange Act of 1934. The ‘33 Act required the registration of public offerings of securities and the ‘34 Act created the Securities and Exchange Commission, the federal agency that regulates the securities industry, brought our national exchanges under its control, required the licensing of broker-dealers, and made securities fraud and manipulation a federal crime.

Selected high points of the bill are:

1. The creation of an independently financed Public Company Accounting Oversight Board and an independently financed accounting standard setting board;54
2. A requirement that principal executive officers to certify their periodic reports to the SEC;55
3. A requirement that public companies put in place disclosure controls and procedures that provide assurance that the company’s managers have all the information needed to accurately complete the firm’s annual and quarterly reports;56
4. A requirement that insiders must report their trades in firm stock within two days;57
5. A prohibition on “personal loans” to corporate officers;58
6. A penalty for corporate officers of companies that must restate earnings—they must disgorge their incentive related compensation;59
7. New criminal statutes on a “scheme or artifice to defraud” and false certifications;60
8. Increased disclosure requirements for pro forma financials, off balance sheet transactions, senior management codes of ethics and “material correcting adjustments”;61
9. New rules designed to eliminate the conflicts of interest of research analysts;62 and
10. Asks federal agencies to report on nine aspects of securities practices — on audit rotation; consolidation of auditing firms; credit rating agencies; aiding and abetting liability; SEC enforcement actions; investment banks; special purpose entities; principles based accounting; and sentencing guidelines.

55. § 302. See also 18 U.S.C. §1350(a)-(b) (1934 Act filings must be accompanied by CEO and CRO certifications of compliance with sections 13(a) and 15(d) of the 1934 Act).
58. § 402, 15 U.S.C. § 78m, k.
59. § 306.
Many of the provisions require SEC rule-making to implement the requirements and prohibitions.

Several commentators are claiming that the Act is more show than substance.63 Many of the prohibitions were already in place, either expressly or implicitly, in pre-existing rules. Others, including myself,64 argue that new rules affect stock prices in developed countries much less than believed by the pundits and that more aggressive, competent and better funded enforcement of basic anti-fraud rules is what is required to change corporate practice and culture and restore investor confidence.65


64. Dale A. Oesterle, Can Rule Changes Restore Confidence in Markets?, DAILY CAMERA (Boulder), Nov. 18, 2002, Business Plus Section, at 2 (citing studies):

[T]here is a substantial question over whether a change in the legal rules on corporate governance will affect the markets. Scholars have, for the past several years, been studying correlations between stock prices and corporate governance rules and practices.

They have found that in countries with developed economies and mature stock markets, such as the United States, a change in governance rules does not correlate with a change in stock prices. In emerging markets, such as South Korea, increases in the regulation of corporate governance do positively correlate to stock prices, but the correlation is absent in the United States.

Id.

See also Dale A. Oesterle, Illusions of Board reform, DAILY CAMERA (Boulder), May 6, 2002, Business Plus Section, at 2:

Reform minded government leaders and officials of our major trading markets, led by eager academics, have proposed a quick fix. Reform the structure of the board of directors of our publicly traded companies.

Mandate that every corporation have board subcommittees that oversee executive compensation and hiring, that nominate directors and that oversee the work of independent auditors. Staff those committees with independent, outside directors, directors not otherwise connected with the management of companies. Compensate those outside directors exclusively with stock and stock options. These subcommittees, the reformers tell us, will tie the managers’ incentives more closely to their shareholders’ long-term interests.

This is heady stuff. It is also wrong. Academic studies have shown there is no link between the number of independent directors and firm performance. Indeed, to the extent that there is a correlation between board structure and performance, those firms with fewer independent directors do better!

Folks also forget that Enron’s audit committee was composed of independent directors, including an ex-business school dean of a top ten school and the wife of a Senator. Our major exchanges, at the prodding of the Securities and Exchange Commission had, in 1999, required audit committees with a majority of independent directors and required (and this speaks volumes) that at least one of the subcommittee members could read a set of financials.

Id.

65. See id.:

Our existing rules, developed over a century, already prohibit most significant types of manager fraud. Tinkering with the rules will not produce major changes at the margin in the definition of prohibited conduct.
All agree, however, that the Act will add significant administrative expense to corporate management. A recent study found that the Act had increased legal costs of 32 publicly held companies by, on average, a whopping 90%. The Act will also materially change corporate board structure and the power relationships among corporate officials. The Act gives more power and responsibility to outside directors.

Outside directors must spend more time on company oversight, must have more expertise, and will demand more compensation; in short, the Act will professionalize the outside director position. Fewer will be qualified to be outside directors and fewer of those qualified will want the position due to the increased personal exposure to liability.

The Act also gives more power and responsibility to audit committees, creating the audit committees as an independent power base inside the firm. The chairperson of the audit committee will be a new position of considerable power inside any company.

Finally, the Act will increase a company’s overall dependency on legal counsel, who will become ubiquitous, counseling managers on procedures implemented in a wide array of contexts for minimizing the board’s risk of liability. In response to the CEO and CFO certification requirement, for example, lawyers have designed certification plans that branch out and down from the CEO to all a company’s divisions and major operating units; plant supervisors on up are now certifying their figures and the certifications telescope and compound, level by administrative level, up to the CEO.

The most important new rule in the Act, on standards of conduct, is the prohibition on loans to insiders, added at the last minute from the floor of the Senate. Corporations had abused the privilege of using such loans as a supplement to compensation and Congress took the right away. The rule, however, has no exceptions and will stop many routing compensation practices as well as abusive loans. Executives will no

Real changes come in the enforcement of existing rules against fraud and in a readjustment of the corporate culture. And the former will produce the latter. In sum, to the extent that government can affect investor confidence, it will likely be in the funding and empowerment of enforcement officials.

Id.

66. Tamara Loomis, For Public Companies, a High Price for Compliance, NAT. L. J., May 12, 2003, at 18 (the average costs close to doubled from $1.3 to almost $2.5 million).
67. The NYSE has adopted new stock exchange listing standards that, in some cases, exceed the standards of the Act. The listing standards, for example, require that independent directors comprise a majority of any listed corporation’s board of directors. See, e.g., Stephen M. Bainbridge, A Critique of the NYSE’s Director Independence Listing Standards, 30 SEC. REG. LAW J. 370 (2002).
68. See Loomis, supra note 66 (directors’ fees have doubled since the Act).
69. Id. (supply of directors has shrunk since the Act).
longer be able to enjoy the cash-less exercise of compensatory stock options, for example.\textsuperscript{70}

An early survey of 137 CFOs and managing directors, an admittedly skeptical group on the Act, finds that while nearly 85\% said that the Act has changed the control and compliance practices in their companies, one-half of those responding said that the Act itself will have no impact on public confidence.\textsuperscript{71} Only one-third of those surveyed believe that the Act will bolster investor confidence.\textsuperscript{72} Only 9\% of the group believes that the Act is a good and adequate response to problems in accounting and reporting.\textsuperscript{73} Thirty-three percent said the law was a good “first step”; 15\% said that the legislation is “ill-considered and hastily passed.”\textsuperscript{74} Forty-two percent said that though the Act is a “well-meaning attempt” that the Act will impose unnecessary costs on public companies.\textsuperscript{75}

There are several deeper regulatory themes in the Act. First, the Act further federalizes control over the management structure of publicly traded firms.\textsuperscript{76} With the passage of the Act, states lost a fair amount of control and influence over the practices of publicly traded firms. Second, the Act invigorates SEC enforcement actions; but Congress has shown that it is more willing to get involved in the details of corporate practice (on loans to officers, for example) and reclaim some of the discretion it has historically ceded to the SEC. Finally, the Act shows a return to structural and process regulations and less trust of conduct based regulations.\textsuperscript{77} By structuring boards, board committees, information processes within firms, structuring analysts’ independence, and requiring senior manager certificates, Congress believes it can increase the likelihood of ethical business conduct. The Act thus builds on and expands the model of the Foreign Corrupt Practices Act of 1977.

As a general public condemnation of poor corporate practice and an exhortation to prosecuting officials to catch the crooks, the Act serves its purpose. On the issue of whether Congress and to some extent the SEC have designed efficient and effective corporate governance procedures, I

\textsuperscript{70}. In the basic cash-less exercise procedure, the company loans an executive the strike price of an outstanding option, the executive exercises the option and sells the underlying stock, paying back the loan from the sale proceeds.

\textsuperscript{71}. Loomis, supra note 66 (19\% expect a moderate impact, 9\% expect a small impact, and 3\% anticipate a major impact).


\textsuperscript{73}. Id.

\textsuperscript{74}. Id.

\textsuperscript{75}. Id.

\textsuperscript{76}. E.g., Stephen M. Bainbridge, The Creeping Federalization of Corporate Law, REGULATION MAG., Spring 2003, at 26.

\textsuperscript{77}. There is also conduct regulation (loans, improper influence over auditors) in the Act.
am less sanguine. Even if superior when designed, the procedures will ossify and stagnate over time and policy makers will have difficulty removing or amending them. With strong conduct based rules against fraud, effectively enforced, firms will develop governance procedures (and change them over time) that insure compliance with the conduct based standards that will work better than the government designed structures and procedures.

There may even be a downside to these new structural and procedural requirements for corporate boards. The standards may bog down directors with regulatory checklists, leaving them with less time for the more critical task of advising and critiquing top management on straight business decisions. Enron, for example, satisfied all the new board structural requirements in 2001.78 This hyper attention to procedural details may not create what we really need, a change in the mindset of the corporate director.79 Our problem is not structural but social; boards need to shed themselves of group-think, dissent needs to be encouraged and not regarded as a breach of etiquette, rolodex boards with fellow CEOs, social and business contacts, and sports or political celebrities need to be disbanded in favor of boards of cross-benchers.

III. MARKET SELF-CORRECTION

The value in the 2002 Act may be not in its detail but in the Act as a market signal. The Act is an unequivocal declaration that the public is profoundly unhappy with the business ethics of American business in general and the telecom industry in particular. This signal, as well as the signals given off by sagging stock prices, may stimulate a market-based correction, that is, voluntary business practice improvements in response to investor pressure.

Those who remain in the telecom industry now have very strong incentives to prove to investors, consumers, creditors, potential employees and others that they are not like WorldCom and Global Crossing. The telecom meltdown then could be a real opportunity for telecom companies to distinguish themselves with innovative internal restructuring, an opportunity that did not exist during the ‘90s boom.80 If so, we should expect savvy telecom companies searching for new capital to voluntarily experiment with governance changes in an effort to restore

78. Overheard at a conference among Chief In-house Legal Counsel was the dry comment that the Act did not mean that we should use Enron as an example.
80. There was no need; money was flowing to all telecom companies.
confidence in their bone fides. As the markets reward some internal reforms and ignore others, companies would gravitate towards changes that have a real impact on corporate conduct.

Some companies have already sought to distinguish themselves willingly by higher levels of voluntary disclosure,\textsuperscript{81} by adopting liberal accounting practices such as expensing options,\textsuperscript{82} or by using different executive incentive plans (requiring longer holding periods for compensatory stock or options, for example).\textsuperscript{83} Another voluntary effort to attract investor confidence could be the simple expedient of removing all firm specific anti-takeover devices and waiving all applicable state anti-takeover statutes. By doing so the firm’s managers signal their intention to run the firm as well as any potential takeover management team might. Firms could also voluntarily make deep structural changes. Firms could, for example, empower their largest shareholders to select the firm’s auditor or to put a competing slate of candidates for the board of directors on a firm’s proxy card.\textsuperscript{84}

Investor services, such as Institutional Shareholder Services (ISS),\textsuperscript{85} have created corporate governance ratings that seem to affect the


\textsuperscript{82} See Howard Stock, FASB Formally Adopts Study on Expensing Options, INV. REL. BUS., Mar. 24, 2003 (noting Coca-cola’s voluntary practice).

\textsuperscript{83} See Amy Borros & Dean Foust, A Battle Royal Against Regal Paychecks, BUS.WEEK, Feb. 24, 2003, at 127 (describes abandoning compensatory options in favor of restricted stock).

\textsuperscript{84} As all stockholders asked to vote on proxies know, there is only one slate of candidates on the firm’s proxy. A stockholder can vote yes for each candidate or abstain. She cannot vote no (unless state law recognizes the vote), nor can she vote for another candidate, nor can she write in another candidate. This one slate proxy solicitation card is permitted by express SEC rule.

A stockholder thus has no choice among candidates in 99.9% of the board elections. Only when a dissident shareholder group seeks control in “proxy fight,” and mails a separate, different colored proxy card, is there a choice. And the dissident group, usually losers, must foot a whopping bill, $2 million and up, for the costs of its own mailings.

The CEO controls who gets on the firm’s proxy and seats are usually held for one year. Upset the CEO and a director is not on next year’s ballot. Just ask former Hewlett-Packard director Walter Hewlett. If a firm has a nomination committee to select directors, the members of the nomination committee are in favor with the CEO.

A firm could voluntarily put in another system that would allow, for example, a firm’s largest shareholders to put up alternative candidates for the board. If the largest shareholder declines, the next largest could have the honor, until the shareholdings are less than, say, 1%, or until the top ten have declined.

\textsuperscript{85} Institutional Shareholder Services is the world’s leading provider of proxy voting and corporate governance services. Located in Rockville, Maryland, ISS provides proxy research, voting recommendations and governance advisory services to financial institutions and corporations worldwide. Founded in 1985, ISS has satellite offices in New York, Chicago, London, Toronto, Manila, and Tokyo. The ISS explains its rating service as follows: “Ratings are calculated on the basis of eight core categories, including: 1) board of directors, 2) audit, 3) charter and bylaw provisions, 4) takeover practices, 5) executive and director compensation, 6)
investment practices of large institutional shareholders. They call the rating a Corporate Governance Quotient (CGQ). We can expect that this and other ratings systems, now fairly crude, will mature as correlations between performance and corporate structure and practices are chronicled and integrated into the scales.

These market driven changes may offer more hope in the long rule than the protections in the Sarbanes-Oxley Act.

IV. CONCLUSION

The telecom mess has largely run its course and played out. As for those who made obscene gains while dumping the burden of losses on others, they followed the cynical directions of Jonathan Swift, commenting on the infamous South Sea Bubble:

Get money, money still
And then let virtu follow, if she will.

 qualitative factors, 7) ownership, and 8) director education.” Available at http://www.issproxy.com/pdf/cgq_corporate_issuers_5_14_. The score for each core topic reflects a set of key governance variables. The current list comprises 61 of these sub-issues. In addition, “some variables are reviewed together under the premise that corporate governance is enhanced when selected combinations of these variables are adopted.” Id. For example, a board with a majority of independent directors and all-independent key board panels (audit, nominating and compensation) receives a higher rating for each of these attributes than it would if it had either one of them in isolation. Id. The CGQ scores, which appear on the front page of each ISS proxy analysis, are provided to ISS institutional clients as an enhancement to its current research service.


87. KINDLEBERGER, supra note 47, at 80. Kindleberger gives the last word to Balzac: “The most virtuous merchants tell you with the most candid air this word of the most unrestrained immorality: ‘One gets out of a bad affair as one can.” Id.