PAY + BOARD COMPOSITION + PERSONAL BEHAVIOR DOES NOT EQUAL CORPORATE GOVERNANCE: INSEARCH OF CONCEPTUAL CHANGE

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CORPORATE GOVERNANCE:

IN SEARCH OF CONCEPTUAL CHANGE

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Recent developments in our economy have made clear that substantial change in our corporate governance model and legal framework are essential so that we introduce an element of … corporate governance! Everyone agrees in principle that better governance is needed, but what is presently considered corporate governance too often involves decisional process instead of substance, chastising executives on account of their pay and related matters or personal behavior, or seeking to shape the composition of firms’ boards of directors, but ignoring their and their firms’ broader performance. As we have seen all too frequently in recent years, poor decisions by major firms can easily drag down not only such firms, their shareholders, employees, suppliers and customers, but also ‘innocent bystanders’. This article
is intended to elaborate upon and propose a way to rectify this anomaly, of governance law and doctrine emphasizing seemingly everything except actual governance.

In particular, it discusses why recent legislative action intended to improve governance in ‘too big to fail’ firms will not and is not doing so, and where governance law previously fell short and contributed to the 2008 financial meltdown and resulting Great Recession, prompting Congressional action intended to avoid a recurrence. After discussion of the nature of the problem and intended solution, specific changes in governance law and related law are proposed and put into context with a discussion of recently observed appropriate and inappropriate board responses to governance challenges.

What is Corporate Governance … and Why does it Matter?

The traditional concept of corporate governance promulgated by the internationally renowned Organisation for Economic Co-operation and Development (“OECD”) states that:

"Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." [emphasis added]

1 Quoted at www.appplied-corporate-governance.com/definition-of-corporate-governance, November 12, 2010
This makes a great deal of sense, as it incorporates as a major element, considerations of ‘how
the company is doing’ – i.e. the company’s objectives and performance - which should serve
to reduce the likelihood of disastrous management decisions imposing large costs on
shareholders and society in the manner we saw during the 2008 financial meltdown\(^2\). In the
midst of the financial meltdown, it was acknowledged by the G20 Finance Ministers that
better governance was needed to prevent a recurrence.\(^3\)

The need of the international economy for improved governance has also recently been
acknowledged by a blue ribbon forum of private market participants and some regulators,
considering what is needed to avert another financial meltdown. The panel included a task

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\(^2\) “A year ago, the collapse of Lehman Brothers set off a series of stunning events from which Wall Street is
still recovering.” Cnnmoney.com, September 14, 2009. A separate article on the same website on the same date
indicates that the AIG bailout alone cost the government $116 billion and the Troubled Asset Recovery Program
cost approximately $372 billion with $90 billion of that going to Citigroup and Bank of America alone. While
large amounts of several of these interventions have been recouped, it is still true that the government has
incurred large net costs, especially with respect to the AIG bailout. Yet another article enumerates some of the
asset writedowns attributable to the events of late 2008 and refers to $29 billion with respect to Washington
Mutual, $56 billion with respect to Wachovia and $40 billion with respect to Countrywide Financial. Eavis,
“Silent Treatment on Bank Write-Downs”, Wall Street Journal, September 21, 2009, p.C10. Of course, this is in
addition to the drastic reduction in lending, especially small business lending, and double digit unemployment
plaguing the country in the wake of the financial collapses.

\(^3\) Published at [www.g8.utoronto.ca/g20/2009/banking0905](http://www.g8.utoronto.ca/g20/2009/banking0905). In their September 5, 2009 Banking Statement they
propose a “framework on corporate governance and compensation practices” in an effort to “prevent excessive
short term risk taking and mitigate systemic risk.” Among the major steps they suggest are: “corporate
governance reforms to ensure appropriate board oversight of compensation and risk, including greater
independence and accountability of board compensation committees.” As discussed, infra, equating governance
and compensation is fundamentally flawed.
force discussing systemically important institutions – so called ‘too big to fail’ firms. One of the co-chairs of the task force stated the proposition quite succinctly: “In particular, we came to the view that for those that are systemically important financial institutions, a very much higher standard of governance was needed” to prevent failures.⁴

What is Today’s Concept of Governance?

However, in recent years, culminating with the Dodd-Frank law enacted in 2010 to improve regulation of financial firms, the mainstream concept has moved away from this consideration of results and risk-taking to focus on various matters which are peripheral, not to mention detrimental to the economy insofar as they divert attention from the quality of decision-making within firms.

While Congress rightly recognized the need for improved governance to forestall new financial crises, the actions which it took in this regard when it enacted the Dodd-Frank law⁵, have little to do with governance in the OECD sense and require substantial augmentation so that the dialogue and action pertaining to improvement of governance, proceeds in the appropriate context.

⁴ Statement of Ken Costa, Chairman of Lazard International, “Fixing Global Finance: Too Big to Fail”, Wall Street Journal, December 14, 2009, p.R5. The highest priority recommendation of the task force published in a sidebar to the article was “Hold systemically important institutions to higher standards of governance.” .

UCLA Law School Professor Stephen Bainbridge, in his abstract of a pending article\(^6\) which abstract is set forth below, aptly summarizes the corporate governance provisions of Dodd-Frank:

1. Section 951 creates a so-called “say on pay” mandate, requiring periodic shareholder advisory votes on executive compensation.

2. Section 952 mandates that the compensation committees of reporting companies must be fully independent and that those committees be given certain specified oversight responsibilities.

3. Section 953 directs that the SEC require companies to provide additional disclosures with respect to executive compensation.

4. Section 954 expands Sarbanes-Oxley Act’s\(^7\) rules regarding clawbacks of executive compensation.

5. Section 971 affirms that the SEC has authority to promulgate a so-called “proxy access” rule pursuant to which shareholders would be allowed to use the company’s


\(^7\) See N. 27, infra.
proxy statement to nominate candidates to the board of directors.

6. Section 972 requires that companies disclose whether the same person holds both the CEO and Chairman of the Board positions and why they either do or do not do so.

7. Section 989G affords small issuers an exemption from the internal controls auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act.

What is striking about the foregoing items is that none of them directly pertain to actual corporate performance or risk profile or make anyone accountable for it. They focus on board composition and management compensation, and related disclosures, none of which directly pertain to how the firm is actually operated or its results. One can make a case for all of these items having an indirect impact on performance, or otherwise being desirable, but they should not be proscriptive. While the new law was intended to reduce the likelihood of firms blundering into disastrous decisions requiring bailouts and the like, it is difficult to see how this laudable objective will be attained without addressing actual results.\(^8\)

\(^8\) A more graphic example of the divided focus of Congress in this regard is found in the requirement of Dodd-Frank that “[r]etailers carrying store-brand products … report annually whether the goods contain minerals from war-torn Central Africa ….” Holzer, “SEC Proposes ‘Conflict Mineral’ Report”, Wall Street Journal, December 16, 2010, p.B9. While it is laudable to seek to reduce demand for minerals which appear to be causing the violent conflicts in Africa, this has nothing to do with financial stability in the U.S., and it seems like a very curious use of the SEC’s time. By the same token, Dodd-Frank also requires the Federal Reserve to limit the transactional fees which debit card issuers may charge merchants. McGrane, Fitzpatrick, Smith, “New Debit-Card Fee Rules Hit Hard”, Wall Street Journal, December 17, 2010, p.C1. Perhaps this benefits consumers and retailers, but has nothing to do with financial stability or the health of the banking sector. In view of the scattershot approach of Dodd-Frank, we should not be surprised that its approach to governance is unfocused. When commenting on another provision of Dodd-Frank, this one addressing creation of a clearinghouse for all
As distinguished an observer as Nobel Prize-winning economist and Columbia University Professor Joseph Stiglitz exhibits similar confusion between governance and pay, when, despite acknowledging that poor governance played a major role in the meltdown, he characterizes governance as only “the manner in which incentives and pay get determined.”

Obviously, there is no “clearinghouse” compiling the reasons for bad business decisions. However the author’s direct experience and observations over several decades of practicing corporate law with clients of all sizes and in many industries, along with common sense, indicate that bad decisions result not only from skewed pay plans, and ‘old boy’ networks on boards, but also from factors such as ineptitude, ignorance of fact, law or market reality (sometimes willful, sometimes not), hubris, inertia, megalomania, emphasis on speed and “groupthink” where faddish practices are slavishly adopted. In the author’s experience, too many decisions of great importance are made for no reason other than to assert the authority of the decision-maker.

What Governance Initiatives are we Seeing?

derivatives trading, the Wall Street Journal aptly observed in a lead editorial what is true in this area as well: “But Americans have reason to wonder what any of this has to do with avoiding the next financial crisis.” Wall Street Journal, January 7, 2011, p.A12.

In the wake of Dodd-Frank, one sees as major current initiatives of the governance movement and SEC, not efforts to avoid horrible decisions, but matters such as the following:

- New, contested-in-litigation, SEC rules around proxy access for minority shareholders\(^{10}\);
- New SEC rules around ‘whistle-blowers’ encouraging employees to report management wrongdoing\(^{11}\) by paying them up to 30% of any recovery of monetary penalty resulting from the wrongdoing alleged by the whistle-blower;
- Governance devotees challenging public companies to require director candidates to obtain the votes of a majority of the outstanding shares for election, instead of a simple plurality\(^{12}\);
- Advisors to major institutional investors pursuing against portfolio companies, efforts to ban reimbursement of management for losses on home sales in connection with relocations\(^{13}\);

\(^{10}\) [http://www.sec.gov/rules/other/2010/33-9149.pdf](http://www.sec.gov/rules/other/2010/33-9149.pdf), explaining that the new rules have been stayed pending resolution of court challenges; the author’s strongly contrary views on this stay and the underlying issues, are found at The Conference Board’s Corporate Governance Center blog for October 6, 2010 at [http://tcbblogs.org/governance/2010/10/06/guest-contributor-expect-proxy-access-to-survive-legal-challenges/](http://tcbblogs.org/governance/2010/10/06/guest-contributor-expect-proxy-access-to-survive-legal-challenges/)


• As prompted by Dodd-Frank, the SEC, Federal Reserve and other banking regulators, are addressing whether to require financial firms to defer a large part of their executives’ pay for several years in order to mitigate a perceived short term emphasis on their part;

• SEC efforts to reduce ‘insider trading’ in stocks by those not in management but having access to sensitive information by virtue of some other relationship with a company.

Apart from, or perhaps prompted by governmental action, we see boards focusing more on management personal behavior than on business policy when evaluating and overseeing management.

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16 Perhaps the most prominent example of this tendency is found in a case where the SEC is pursuing claims against non-management railyard employees for their purchases of stock in their company based upon their surmise that it would be sold, as a result of their observation of unfamiliar men in business suits in their railyard. Sorkin, “So What is Insider Trading?”, Dealbook.blogs.nytimes.com/2010/10/25/sorkin-so-what-is-insider-trading/. One struggles to imagine how this sort of suit has any benefit for governance or compliance. An analogous example is found in the hedge fund claims, where the SEC is finding inappropriate so called channel-checking where an analyst seeks to determine distributor interest in and intentions regarding the subject company’s product. As noted by Todd Harrison, a longtime financial industry observer, in “Insider’s Take on the Insider Trading Scandal”, “Channel checks,” once considered hard work and due diligence, are now being fingered as proof-positive of wrongdoing. http://finance.yahoo.com/news/Insiders-Take-on-the-Insider-minyanville-3577425135.html?x=0&sec=topStories&pos=2&asset=&ccode=, November 23, 2010.

17 E.g. the Hewlett-Packard affair discussed infra at N. 52-57 and accompanying text, which has prompted its own insider trading inquiry by the SEC, Worthen, Scheck, Lublin, “SEC Probe Examines Hurd Exit from HP”, Wall Street Journal, December 21, 2010, p.A1, and the Tribune Company ouster of CEO Randy Michaels for maintaining a locker room atmosphere at headquarters but not for leading the company into, but not out of, a
As discussed immediately below, perhaps good policy arguments can be made for these things, but they have little to do with governance in the sense contemplated by the OECD and advocated by the author – i.e ‘how the company is doing and what should it be doing?’.

While broader proxy access is favored by the author who views the legal objections to the rules as weak\(^\text{18}\), and is seen by some knowledgeable observers as being of great significance\(^\text{19}\), simply changing the composition of boards without changing their roles and responsibilities has at best a tenuous connection to better governance. George Mason University Law Professor Bruner cogently explains why this is the case:

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“The Tribune Company’s board resolved on Friday what had been its preoccupation for most of the week: sealing the fate of Randy Michaels, the controversial chief executive whose boorish behavior and cronyism became a dark sideshow to his bankrupt company’s financial struggles.” To be clear, this is not to defend or rationalize the revolting behavior, but to wonder why it was such behavior which was needed to cause the board to act in the face of disastrous financial performance.

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\(^{19}\) One prominent corporate lawyer states that this change is “… the biggest change relating to corporate governance ever proposed by the SEC. Period. It gives activists the ultimate vehicle to express dissatisfaction with a board, the ability to replace board members at the company’s expense.” McCracken and Scannell, “Fight Brews as Proxy Access Nears”, Wall Street Journal, August 26, 2009, p.C1, quoting John Finley, Esq., former partner at Simpson, Thatcher and Bartlett, and presently general counsel at Blackstone Group. Similar sentiments are expressed in a less elegant manner by Nell Minow, a well-known critic of current corporate governance who stated “The only way you’re going to change things is to throw the bums out [referring to corporate directors].” Nocera, “Pay Cuts but Little Headway in what Matters Most”, New York Times, October 23, 2009. Pay practice is not what matters most; competent performance is, and after the fact removal from office does little to enhance performance in office.
Offering up proxy access and other forms of shareholder empowerment as a response to corporate governance problems precipitating the financial crisis is absurd. To the extent that excessive risk-taking led to the crisis, reforms like proxy access – aiming to empower the corporate constituency whose incentives are most skewed toward greater risk – simply don’t add up.  

Encouraging more whistle-blowing by paying whistle-blowers, does nothing to prevent, and may encourage, more wrongdoing by causing those with an opportunity to stop an incipient problem to ignore it until it ripens into a financially cognizable claim, and in any event, has nothing to do with honestly arrived at, but severely flawed, business decisions which are what we saw in most cases with the financial firms.  

The challenge to Apple, one of the world’s most legitimately successful firms in both a product and a financial sense, for its director election practices, which require only a majority of votes cast, illustrates the gap between today’s concept of governance and that preferred by the author and the OECD. Apple has done superbly by all concerned and imposed no costs on anyway from poor management, and no one has any reason to believe that this will change in ________________  

20 He supports the hypothesis by looking to the U.K.’s experience with rules similar to what have been adopted in the U.S.: “As I discuss in a recent paper examining U.S. and U.K. corporate governance crisis responses, the fact that the far greater governance power of U.K. shareholders appears to have done little to mitigate the (very similar) crisis over there ought to give pause to those suggesting that augmenting shareholder powers will prevent future crises over here.” Bruner, Proxy Access Forum, http://www.theconglomerate.org/2010/08/proxy-access-forum-christopher-bruner.html?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+theconglomerate%2Ffeed+%28Conglomerate%29&utm_content=Google+Reader

21 Witness the virtual absence of criminal or civil litigation brought – let alone sustained – against principals of financial firms at the epicenter of the meltdown.
the foreseeable future. For the head of the CALPERS corporate governance office to say that “There is systemic risk when directors are not accountable” when discussing the Apple matter, trivializes the issue of accountability. When a firm is delivering poor performance, accountability – beyond removal from office - is required. The Apple management and directors have delivered superb performance, such that it makes little sense to demand anything more from them. Emphasizing the mechanics of board elections in a case like this, indicates that today’s concept of governance has little to do with results.

Home loss reimbursements are nothing more than a diversion from the effort to improve governance.

Deferral of bankers’ pay seems to be a knee jerk reaction to some undeniably poor decisions in that sector, which is unsupported by any of the empirical analysis that has addressed the existence and extent of a link between pay and risk taking behavior.

As to insider trading, a long time observer of the enforcement landscape notes that: “(There has been] a shift in insider trading jurisprudence away from its roots in deterring and punishing those who abuse special relationships at the expense of shareholders and into a

22 Lublin, supra, N.11.

23 Notes 44 - 48 infra and accompanying text. Similarly, the revelations that many executives did not understand what they were doing, N. 85, infra and accompanying text, belies the notion that it was their pay plan which caused them to do these things.
murkier area where the S.E.C. is policing general financial unfairness that has traditionally been considered beyond its authority to regulate.”  

Another commentator writes of this new approach being known as “mosaic theory” in that it involves the putative insiders ‘putting together the pieces’ as to corporate performance rather than being accused of trading on one piece of discrete non-public information. Even assuming it is fairer in some sense, the author can see no meaningful systemic policy benefit, in terms of better management or company performance or avoidance of disasters, being attained from this approach.

Governance, Pre-Dodd-Frank and Now

While its remedial action may be misdirected, Congress was correct in its observation that poor governance contributed to the 2008 financial meltdown, and that the prevailing legal regimen was not well suited to improvement.

The author has noted before the enactment of Dodd-Frank that governance law emphasized mainly various matters having nothing to do with firm performance, viz:

24 Joel Cohen, Gibson Dunn & Crutcher partner quoted by Sorkin, supra.


• Director independence, that is decision-making and oversight of management by a financially disinterested board of directors with “undivided loyalty” to the firm, one lacking any direct pecuniary interest in the particular matter on which the director is voting and requiring recusal in the particular case where this is not true; 27 The Sarbanes-Oxley Act of 2002 28 augments this emphasis on independence with its requirements for detachment from management for the members of public company audit committees 29; As we have seen, just because a director is independent in a financial sense, does not mean that they will be diligent or even competent.

• Officer/director responsibilities in connection with merger and acquisition situations 30 and other ‘major corporate transactions’, which is certainly a critical topic as it may

27 Delaware General Corporation Law Sec. 141. Loft, Inc. v. Guth 2 A.2d 225 (Del. Ch. 1938), cited approvingly in In re The Walt Disney Company Derivative Litigation, 907 A.2d 693, 750 (Del. Ch. 2005; hereinafter “Disney”). Corporate governance obligations are dictated by the laws of a corporation’s state of incorporation (and to some extent by the federal securities laws). In that Delaware is by far the most influential jurisdiction for American corporate governance as a result of it being the state of incorporation for over 50% of U.S. publicly traded companies and 63% of the largest companies comprising the Fortune 500 according the Delaware Secretary of State’s official website home page (corp.delaware.gov; December 30, 2010), this article emphasizes Delaware authority. The author is not aware of any authority to the contrary of the cited Delaware cases in any other commercially significant states. Cf. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928) which arguably originated this “duty of undivided loyalty” of corporate directors to their corporations.

28 P.L. 107-204 (numerous, scattered U.S.C. citations)


30 E.g. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985; detailing permissible and impermissible actions in response to a hostile takeover); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173 (Del. 1986; explaining nature of duties to maximize price when change of control is inevitable); Omnicare v. NCS Healthcare 818 A.2d 914 (Del. 2003 explaining how acquisition agreements may and may not be structured to encourage or discourage other bids)
lead to or prevent disasters, but not sufficient in itself as many poor courses of actions unfold gradually and are not embodied in one particular decision;

- Disclosure to public company shareholders of management remuneration\(^{31}\); again quite worthy, but unrelated to performance itself;
- Direct limitations on management remuneration\(^{32}\);
- Procedural and disclosure requirements around proxy contests for board seats and shareholder proposals\(^{33}\)

Too Much Process; Not Enough Substance

It is hardly a coincidence that the preceding points are the cornerstones of our governance framework and that assessment of results is not. The fundamental element of today’s corporate law is the so-called business judgment rule which effectively immunizes directors from liability for adverse, even catastrophic, results arrived at through impartial exercise of business judgment and appropriate “process”. While directors and officers are subject to a “duty of care” which nominally requires them to use reasonable care in performing their

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\(^{31}\) E.g. “Executive Compensation and Related Person Disclosure”, 17 CFR Parts 228, 229, 232, 239, 240, 245, 249 and 274, Rel. Nos. 33-8732A, 34-54302A; the extent of the discussion of these rules in the Code of Federal Regulations speaks for itself as to their scope and complexity. Their operation is illustrated in the text accompanying N. 49, infra, which contains excerpts from a recent IBM proxy statement.

\(^{32}\) Paletta, Hilsenrath, , “Bankers Face Sweeping Curbs on Pay”, Wall Street Journal September 18, 2009

\(^{33}\) Securities Exchange Act Schedule 14A, CFR 240.14a-101. The stayed proxy access rules implemented pursuant to Dodd-Frank and discussed supra at N.6 and accompanying text are a response to the perceived inadequacy of these rules.
duties even where their impartiality is not at issue, in practice, it means little other than jumping through the correct hoops, that is utilizing the appropriate process. If they do so, they receive the benefit of a ‘presumption’ in their favor which requires anyone seeking to establish liability based upon breach of this duty of care leading to poor results, to affirmatively prove that it was not met.

The business judgment rule ‘is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company’. The burden is on plaintiffs, the party challenging the directors’ decision, to rebut this presumption.\(^\text{34}\)

In practice, given the disparity in access to information between directors and outside shareholders, and the cost of discovery, this is often an insurmountable burden.

on plaintiffs.\(^\text{35}\)

In the face of an effort to hold directors responsible for catastrophic losses on mortgage loans at a major financial institution, requiring a large government bailout, the Delaware Chancery Court very recently proclaimed:

\(^{34}\text{In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106, 122 (Del. Ch. 2009; hereinafter “Citigroup”))}\)

\(^{35}\text{Citigroup, supra, 964 A.2d at 124 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))}\)
“[Where a BOD decision results in financial loss], director action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational **process** and considered all material information reasonably available …. [C]ompliance with a director’s **duty of care can never appropriately be judicially determined by reference to the content** of the board decision that leads to a corporate loss, apart from the consideration of the good faith or rationality of the **process** employed…. Thus, the business judgment rule is **process-oriented** and informed by a deep respect for all good faith board decisions”\(^\text{36}\) [emphasis added]

This court relied heavily upon the seminal Delaware Supreme Court case of *Smith v. VanGorkom*\(^\text{37}\) in which the court used the cursory process around the approval of a disastrous merger to hold responsible the directors who approved it. This case was relied upon by a generation of corporate practitioners and many judges to dictate spending (and demonstrating spending) sufficient time on the discussion of major corporate transactions and engagement of “experts” such as investment bankers to advise on them, along with ensuring that meeting minutes reflect the thoroughness of the board’s consideration. That is, it created the emphasis on process which is noted in the Citigroup case and quoted above. Professor Bainbridge again aptly summarizes its effect in an abstract of a paper:

\(^{36}\) Citigroup, supra, 964 A.2d at 122 (quoting from In re Caremark Int’l. Derivative Litig. 698 A.2d 959 (Del. Ch. 1996))

\(^{37}\) 488 A.2d 858 (Del. Sup. 1985)
Smith v. Van Gorkom arguably was the most important corporate law decision of the 20th century. The supreme court of a state widely criticized for allegedly leading the race to the bottom held that directors who make an uninformed decision face substantial personal liability exposure. [emphasis added]38

No one would disagree with the insistence that boards be fully informed, but in practice, the author believes that being informed is necessary but not sufficient. There needs to be – but is not in practice - accountability for what is done with the information.

The Citigroup court relied upon, inter alia, a prominent case in the last decade involving the Disney Company, to stress that this process orientation, which is a key element of its jurisprudence, is intended to avoid excessive risk aversion on the part of corporate decision-makers by absolving them of responsibility for poor results, so long as they acted “intelligently”.39 There is little doubt that excessive risk aversion has been avoided, but it is now time to reduce our concern with risk aversion, at least where risk embrace can do serious economic damage.


39 Disney, infra, 907 A.2d 693, 752 quoting from Prod. Res. Group, L.L.C. v. NCT Group, Inc. 863 A.2d 772, 777 (Del Ch. 2004) (emphasis added). As we have unfortunately seen in Citigroup and elsewhere, this encouragement was wildly successful in places, where, unlike Disney, risk-taking should not have been encouraged.
As if this body of common law is not enough to impede good governance, the Delaware General Corporate Law contains a provision, Section 102(b)(7), adopted soon after the Smith v. VanGorkom decision, which permits corporations to include in their charters (with shareholder approval) language which exculpates officers and directors for financial liability for breaches of their duty of care even if such breaches are based upon the use of poor process.\(^\text{40}\) Consistent with the sentiments in Citigroup, Delaware’s Vice Chancellor has stated that “[o]ne of the primary purposes of 102(b)(7) is to encourage directors to undertake \textbf{risky, but potentially value-maximizing}, business strategies, so long as they do so in good faith.”\(^\text{41}\)

In practice all of this has meant something of a ‘check the box’ approach where boards make sure they obtain pertinent ‘expert’ advice and spend sufficient time in the consideration of proposals outside the ordinary course of business. However, assuming they jump through these hoops, that is the extent of their responsibilities; they are not accountable in any way for using such advice or otherwise if the outcome is highly adverse. It is little comfort to those who have suffered during the financial meltdown and its aftermath that “proper” process was used to vet decisions which led to such catastrophic outcomes.

\(^{40}\) 65 DEL. LAWS. C.289 (1986)

\(^{41}\) Disney, infra, 907 A.2d at 752 (quoting Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 777 (Del. Ch. 2004))
By the same token, there is little or no authority specifying responsibilities involving process or substance for officers and directors in the conduct of their duties within the ordinary course, despite the potential for severe losses resulting gradually if matters are not properly handled or not handled at all – i.e. there is no specific decision to be made on a given transaction, but over time a course of action leads to disaster. One need look no further than the erosion of mortgage lending standards that led to our financial crisis. There was no one event which marked this change, but over 5-10 years, the change certainly had its effect. We need for boards to oversee the direction of ordinary course activity to the same extent as extraordinary activity, and speak up if this activity seems to present new risks. While there is a high quality jurisprudence in Delaware and elsewhere governing actions outside the ordinary course of business, it is time to develop comparable guidance for actions or inactions which are in the ordinary course, but which can still have huge implications.

Noted mutual fund executive and Harvard Business School senior lecturer Robert Pozen has similar observations as to the overemphasis on process and lack of substantive expertise when commenting on why so many large financial firms encountered so many problems, despite the attempt in the Sarbanes-Oxley Act to improve governance:\(^{42}\):

> I believe the problem is the current structure of corporate boards. In short, they are too big, members often don’t have enough relevant experience, and they put too much emphasis on procedure. Complex global companies need a new model. Boards should

be comprised of a small group of people with enough pertinent experience to hold management accountable . … Regulators, investors and directors should recognize that we do not need more procedures for corporate boards. Instead, we need more expert directors who view their board service as their primary profession – not an avocation.

The inadequacy of the current model governing board functioning is summed up by the business journalist Charles Gasparino when speaking of the Wall Street bets on mortgages and mortgage-based securities:

But a special place in the pantheon of irresponsibility belongs to the boards of directors who looked away from the risk taking; believed the best-case scenarios presented by management when they should have been preparing for the worst; and worst of all, left in charge management that didn’t have a clue how to manage leverage and risk.\(^{43}\)

With performance like this in such critical situations, a new model is needed.

To the author, perhaps the ultimate indignity and absurdity of this regimen is presented by the Apple situation discussed above where a company which is performing brilliantly by any standard is being assailed for the mechanical process and standards around its director

elections. In theory, perhaps, its process could stand improvement, but theory is irrelevant when the practical results are at such a high level. This concern by governance devotees contrasts sharply with the exoneration of the Citigroup board of any responsibility for its catastrophic losses which caused so much external damage.

What Needs to be Done … and Stopped … Theory and Practice

Governance law needs to be drastically reshaped to reflect today’s needs so as to de-emphasize peripheral matters and process and emphasize what the OECD does, namely meeting of objectives. Circumstances also call for a re-prioritization on the part of governance devotees so that reflexive opposition to increases in management compensation and demands for minority representation on proxy ballots and boards are not the focal point of the effort and do not impede efforts to address more substantive considerations.

Both law and observers must emphasize whether officers and directors are in fact bringing about respectable results, that at least maintain the viability of the firm and avoid its imposition of costs on society. This means understanding and critiquing firms’ strategy, financial performance and status in ‘real time’, when it can be changed or otherwise meaningfully addressed, as opposed to after the fact in connection with the CEO’s next compensation review.

While it is easy to say that at present, corporate governance is off the rails with its focus on peripheral matters, and is not doing much to honor the OECD definition and make firms run
better, it is considerably harder to specify what needs to be done to improve things. In the first instance, I suggest much less focus on management compensation and personal behavior.

While distinguished economists have argued that compensation and results are inextricably related, empirical evidence suggests that this is not necessarily the case. For example, the former CEO of Merrill Lynch, which imploded during the 2008 meltdown, explained that none of its executives even understood the perilous positions which it was taking prior to its downfall, making it disingenuous to conclude that pay formulae caused irresponsible actions. Professor Yermack took a broad look at the situation and concluded: “No evidence whatsoever indicates that errant executive compensation ‘caused’ the financial crisis of 2008 ….” Other analysts concur: “These studies suggest that bank executives were simply ignorant of the risks their institutions were taking – not that they were deliberately courting

44 Professor and Former Fed Vice Chairman Blinder posits: “Despite the vast outpouring of commentary and outrage over the financial crisis, one of its most fundamental causes has received surprisingly little attention. I refer to the perverse incentives built into the compensation plans of many financial firms, incentives that encourage excessive risk-taking with OPM – Other People’s Money….The source of the problem is really quite simple: give smart people go-for broke incentives and they will go for broke. Duh.” Alan Blinder, “Crazy Compensation and the Crisis”, Wall Street Journal, May 28, 2009, p.A15. Dr. Stiglitz makes the same argument that pay practices caused the meltdown, but cites no authority for the causal relationship, but simply notes under the heading “Corporate governance”: “The incentive schemes that produced misaligned incentives did not serve shareholders well, and did not serve the world well.” Stiglitz, supra at 149-155.

45 Story, “In Merrill’s Failed Plan, Lessons for Pay Czar” nytimes.com October 8, 2009; Finance.yahoo.com/tech-ticker/article/350268, October 7, 2009. The text accompanying N. 85 contains an eyewitness account indicating that Merrill executives literally did not know or understand what they were doing when they assumed many mortgage-related risks.

disaster because of their pay packages.” An analysis of the actual impact of the post-meltdown rule changes pertaining to pay is to the same effect:

A study prepared for an influential shareholder group [the Council of Institutional Investors] says rule changes meant to revamp Wall Street’s pay culture have been negative, concluding that pay practices at six U.S. banks have ‘worsened’ since the financial crisis.

Simply put, with all due respect to Prof. Stiglitz, et al, corporate governance is much more than pay or the identity of those doing the governing.

To the author, the endless discussion of compensation and perquisites undermines the credibility of the governance movement by indicating mere jealousy toward ‘rich executives’. A cursory glance at any substantial public company proxy statement reveals mind numbing verbiage dictated by SEC proxy rules around not only base salary and bonus, but matters such as:

47 Friedman, “Bank Pay and the Financial Crisis” Wall Street Journal September 24, 2009, p.A21 referring to very recent studies of the 2008 financial meltdown by Profs. Rene Stulz and Rudiger Fahlenbrach (available at SSRN.com) and Viral Acharya and Matthew Richardson


49 E.g. 2010 Proxy Statement of International Business Machines Corp. available at sec.gov: http://www.sec.gov/Archives/edgar/data/51143/000110465910012758/a09-36376_1def14a.htm

50 See N. 31, supra and accompanying text.
• Equity based compensation, including the details of grants and vesting;
• Retirement plans;
• Personal travel on company aircraft;
• Company-supplied club memberships;
• Company-supplied tax and financial planning;
• Company-supplied home security systems and services; and
• Company-supplied medical and life insurance.

For example, the IBM 2010 Proxy Statement, which the author considers to be quite straightforward by large company standards, says the following to introduce the subject of director compensation:

**2009 Director Compensation Narrative**

*Annual Retainer:* In 2009, non-management directors received an annual retainer of $250,000. Chairs of the Directors and Corporate Governance Committee and the Executive Compensation and Management Resources Committee received an additional annual retainer of $10,000, and the chair of the Audit Committee received an additional annual retainer of $15,000. Under the IBM Deferred Compensation and Equity Award Plan (DCEAP), 60% of the total annual retainer is required to be deferred and paid in Promised Fee Shares (PFS). Each PFS is equal in value to one share of the Company’s common stock. When a cash dividend is paid on the Company’s common stock, each director’s PFS account is credited with additional PFS reflecting a dividend equivalent payment. With respect to the payment of the remaining 40% of the annual retainer, directors may elect one or any combination of the following: (a) deferral into PFS, (b) deferral into an interest-bearing cash account to be paid with interest at a rate equal to the rate on 26-week U.S. Treasury bills updated each January and July, and/or (c) receipt of cash payments on a quarterly basis during service as a Board member. The Company does not pay above-market or preferential earnings on compensation deferred by directors. IBM had a retirement plan for directors which was eliminated effective January 1996, and the Company credited the PFS accounts with retirement PFS equal to the benefits accrued under that retirement plan. For 2009, all directors made elections under the DCEAP to defer 100% of their annual retainer in PFS. Under the IBM Board Corporate Governance Guidelines, within five years of initial election to the Board, non-management directors are expected to have stock-based holdings in IBM equal in value to five times the annual retainer initially payable to such director. Stock-based holdings mean (i) IBM shares owned personally or by members of the immediate family sharing the same household and (ii) DCEAP PFS. Stock-based holdings do not include (i) unexercised options and (ii) any amounts credited to the PFS account in connection with the elimination of the retirement plan.

A footnote to a nearby table elaborates as follows:

Amounts in this column include the following: for Ms. Black: $40,623 of dividend equivalent payments on PFS; for Dr. Brody: $15,000 contributed by the Company under the matching grants program; for Mr. Chenault:
$26,189 of dividend equivalent payments on PFS; for Mr. Eskew: $16,234 of dividend equivalent payments on PFS and $18,761 contributed by the Company under the matching grants program; for Dr. Jackson: $13,939 of dividend equivalent payments on PFS and $15,000 contributed by the Company under the matching grants program; for Mr. Owens: $12,754 of dividend equivalent payments on PFS; for Ms. Spero: $17,769 of dividend equivalent payments on PFS and $10,000 contributed by the Company under the matching grants program; for Mr. Taurel: $23,821 of dividend equivalent payments on PFS and $10,000 contributed by the Company under the matching grants program; and for Mr. Zambrano: $18,699 of dividend equivalent payments on PFS.

In case the preceding is overly simple, the same document says the following in a footnote to a table containing officer compensation:

*Other Compensation.* The SEC disclosure rules require that companies include certain items in the Summary Compensation Table column entitled “All Other Compensation.” At IBM, many of these items are available to all employees. In fact, additional programs that are restricted to senior executive participation amount to less than 1% of their total compensation on average. These programs are limited to services with a direct bearing on individual productivity or security. IBM’s security practices provide that all air travel by the Chairman and CEO, including personal travel, be on Company aircraft. IBM does not provide any tax assistance to Mr. Palmisano in connection with taxes incurred for personal travel by him on the corporate aircraft. While the cost of corporate aircraft usage varies year to year based on several external factors such as fuel costs, using corporate aircraft for all travel is a prudent step to ensure the safety of the Chairman and CEO given the breadth of IBM’s operations in over 170 countries which includes many emerging markets where security concerns are a reality. Given the personal travel security practice for the Chairman and CEO, family members periodically accompany him on the corporate aircraft. In accordance with tax requirements, income was imputed to Mr. Palmisano for personal travel by his family members on the corporate aircraft. In recognition of his family’s personal travel, Mr. Palmisano has contributed $63,000 to the IBM International Foundation to fund contributions to Columbia University.

So many of the amounts contained in disclosures of this nature are immaterial, and few if any of them give us any insight into how officers or directors approach strategic business decision-making. Why should anyone care about the interest paid to directors on deferred compensation? The word “petty” comes to mind when characterizing requirements for disclosures of this nature. The author is much more concerned with whether someone’s business strategy makes – or ever did make – sense in the present market environment, and how the directors are making such determination, than whether or how much the company is paying their home security service or whether their spouse used a company plane for a shopping trip.
One sees this taken to absurdity in the effort of institutional investors to stop home loss reimbursements for relocating executives, which are immaterial in amount and totally unrelated to performance. Even the insistence on full disclosure of compensation and perquisites, which seems innocuous on its face, often seems punitive in nature as a result of its burdensome nature and lack of connection to performance and potential for innocent missteps inviting legal challenges.

This is most definitely not a defense of lavish executive compensation. Far too many executives are doing poor jobs and are overpaid. The same is true for the board members responsible for overseeing them, but doing little of the sort. However, the relevant consideration for society should be the poor performance, irrespective of pay. We are not well served by even the gratuitous performance of services by an executive or director of a firm which is being put into, and is putting our public fisc into, serious jeopardy.

How are Boards Responding in the Wake of Dodd-Frank?

The most prominent example of board scrutiny of management, post-Dodd-Frank is not encouraging in this regard. Hewlett-Packard ousted its CEO, Mark Hurd, in August 2010 as a result of revelations of his involvement with a female company contractor and possible expense irregularities relating to the episode. While there is little reason to commend his behavior or decry his ouster, what is striking is that afterword, we heard revelations as to his

51 N. 12, supra, and accompanying text

52 Gregory, “Corporate Scandals: Why HP had to Oust Mark Hurd”, http://www.time.com/time/business/article/0,8599,2009617,00.html, August 10, 2010
flawed business policies, specifically suppression of capital expenditures jeopardizing HP’s competitive posture. Yet, it appears that the HP board was prompted to act only by the tawdry personal matters, which had little impact on the company’s position in the marketplace, and either did not understand or did care about the much broader strategic matters.

Making their behavior even more suspect is their choice of a replacement for Mr. Hurd, Leo Apotheker, who may have been deeply involved in highly questionable conduct involving possible trade secret misappropriation by his former employer, SAP, Inc. This situation resulted in litigation against SAP in which $1.3 billion in damages was awarded.

Apparently as a result of this situation and concern about being subpoenaed to testify in the

53 IBM’s CEO Samuel Palmisano spoke of Hurd’s approach and its effect: “H-P used to be a very inventive company…. Hurd cut out all the research and development.” Ante, “IBM’s Chief Thumps Hurd”, Wall Street Journal, September 15, 2010


55 Tuna, “Jury: SAP Owes Oracle $1.3 Billion”, Wall Street Journal, November 24, 2010, p.B1 It appears that the SAP board authorized the acquisition despite having learned in due diligence that the acquired company was in fact engaged in the behavior which prompted the suit. “Did SAP’s executive board know that its new division’s business model depended on stealing Oracle’s code? Stunningly, it did. A crucial piece of evidence in the lawsuit is a presentation made in January 2005 to the SAP board by executives arguing in favor of the purchase. One of the slides acknowledges that TomorrowNow used “nonproduction copy” — i.e. unauthorized copy — of Oracle’s software.” Nocera, supra. While SAP is a German company, the problem is HP, an American company, disregarding Mr. Apotheker’s involvement in this episode.
litigation, it was impossible to determine Mr. Apotheker’s whereabouts during the first few weeks after he started his position with HP.  

This series of events suggests to the author that the HP board does not see itself as an overseer of management performance and its impact on the company’s position in the marketplace. While Hurd’s alleged misbehavior was unseemly, it had nothing to do with HP’s dealings with anyone; Apotheker stands accused by at least one commentator of unlawful conduct involving a major transaction squarely on behalf of SAP.

This does not appear to be a board clearly focusing on protection of their company, but blinded by titillating or disgusting peripheral matters.

Even the SEC’s reaction to this affair reflects a skewed focus. Its interest is apparently whether Mr. Hurd shared with the female contractor any non-public information on an HP acquisition which occurred in 2008, and to some extent on his expense reimbursements. In addition to its obsolescence and the immateriality of the expense issue, the SEC involvement reflects a troubling inability to grasp what is important to shareholders and the economy.

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56 [http://www.reuters.com/article/idUSN0912464620101110](http://www.reuters.com/article/idUSN0912464620101110) suggesting that he may have been trying to avoid being served with an Oracle subpoena.

57 Worthen, Scheck, Lublin, “SEC Probe Examines Hurd Exit from HP”, Wall Street Journal, December 21, 2010, p.A1. The SEC does not appear to have reason for concern that the contractor actually traded on the information which she may have obtained from Hurd.
While slightly less prominent than the HP episode, the conduct of the Tribune board discussed above\textsuperscript{58} in which it seemingly cared little about drastic financial deterioration, but acted only upon revelations of gross personal behavior by the CEO, is equally discouraging.

In a very recently brought case, shareholders have sought to hold accountable directors and management of a firm which has not experienced major financial reversals, but which has encountered legal compliance problem as a result of product recalls. Specifically, Johnson & Johnson, the well-known pharmaceutical firm has experienced a number of product recalls on account of concerns that its drugs were poorly manufactured and were either dangerous or ineffective. Shareholders allege that its board and top management affirmatively ignored information which put it on notice that there was a significant and worsening problem.\textsuperscript{59}

\begin{quote}
In the lawsuit, the shareholders allege the board of directors ignored a whole host of "red flags," including warning letters from federal regulators, subpoenas and two criminal plea agreements for violating government regulations that go to the heart of the company’s business: marketing prescription medicines.

"Defendants were well aware that the consequences of permitting or fostering a culture of legal non-compliance could be catastrophic to J&J’s business," the lawsuit said.

"Inexplicitly, instead of remedying these drug and medical device manufacturing and marketing violations," the suit continued, "the misconducted continued unabated and in many ways it proliferated."
\end{quote}

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\textsuperscript{58} N. 16 supra
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It must be stressed that the preceding is only an allegation which has not even been the subject of a response by the defendant, let alone any adjudication. However, if true, it reflect the sort of board behavior that must be promptly improved for the betterment of our economy.

**New Standards Going Beyond Process and Pay**

What standards should be made part of a new governance regimen? There is obviously no clear answer, but the author feels strongly that directors and executives must in some sense be financially accountable for severely adverse, but avoidable, business outcomes, especially those having major implications beyond the company and its stockholders. This can take many forms, but must not impinge upon bona fide entrepreneurial risk-taking. We must accept that risk-taking drives our economy and employment, such that we do not punish those who oversee failed business ventures simply because of the failure.

Rather, we must carefully isolate situations where more than simple poor results are at issue. Even under present law, there is and will remain, liability for management or director dishonesty or divided loyalties leading to shareholder loss. Our focus for change must be on situations where management and directors acting in good faith without a personal stake and using proper process, made specific decisions or knowingly or recklessly ignored circumstances that could have been dealt with or reversed, and that led directly to large losses extending beyond their organization itself.
The purpose of incorporating such a standard is to deter – not punish after the fact - occurrences such as, but certainly not limited to, the gradual but radical decline in mortgage lending standards which felled and impaired so many of our financial institutions during the last five years, and business acquisitions made without a bona fide understanding of their implications, even if the correct process was used. Process evaluation can not be always be the principal yardstick for governance.

While hindsight is always 20/20, there were those who spoke out against financial market excesses at a time when at least some of their consequences could have been prevented, yet few major institutions heeded the warnings. These institutions blindly heeded the judgment of rating agencies, despite it being palpably evident from public accounts of lax underwriting, that such judgments had little or no basis in reality. There must be real consequences for such willful or reckless disregard of gathering storms, especially when there were credible voices who spoke up when there was still time to avert at least some of the harms.

Similarly, in the SAP case discussed above, SAP’s exposure arose from the wrongful activity of a company which it acquired named Tomorrow Now and top management’s and

60 Stiglitz, supra at p.18-19 identifies several prominent economists who spoke up before the onset of the crisis – e.g. Nouriel Roubini, Paul Krugman, George Soros, Stephen Roach, Robert Shiller and Robert Wescott.

61 Stiglitz, supra at p.7: “The ‘market’ badly misjudged the risk of defaults of subprime mortgages, and made an even worse mistake trusting the rating agencies and the investment banks when they repackaged the subprime mortgages, giving a AAA rating to the new products.” and at p.94: “In the current crisis and in the East Asian crisis before it, too many people, especially regulators and investors, were outsourcing their responsibilities to the ratings agencies.”

62 N. 52-58 and accompanying text
the supervisory board’s disregard of the activity of which it learned in its due diligence.\textsuperscript{63} That is, management was aware of the unlawful activity on the part of the acquired company but went ahead with the deal anyway, and is now enmeshed in major litigation as a direct result. This is unacceptably poor governance.\textsuperscript{64}

The author believes and has argued elsewhere\textsuperscript{65} that there are certain events which at least presumptively should be considered indicative of poor governance. While observers may genuinely disagree about one or more of these as well as others not on the list, as well as specific levels of loss from them which should trigger consequences, items such as:

- Criminal or serious civil legal proceedings against the firm (or management/directors with respect to firm business) alleging more than breach of contract or simple negligence and involving financially material amounts (not ‘slip and fall’ cases) which are not summarily resolved;
- Filing for bankruptcy or insolvency;
- Receipt of extraordinary governmental assistance as a result of financial distress;
- Large asset write-downs; or
- Large goodwill write-downs following an acquisition of another business,

\textsuperscript{63}See N.53 and accompanying text.

\textsuperscript{64}SAP is based outside the U.S. so that new standards in governance for U.S. companies would not impact it. Nevertheless, this is an example of where there needs to be more accountability for an avoidable poor outcome, at least if it impacted those outside the ranks of the company and its shareholders.

\textsuperscript{65}Robins, supra at N. 25.
should at least prompt discussion about the conduct of management and directors. Even if one disagrees as to these specific items, the author believes that proper guidance requires promulgation of some sort of list of occurrences which may trigger liability. Intentionally omitted from this list are large operating losses. As noted, it is essential that any change in law take heavily into account the need to avoid discouraging new business start-ups and innovation by existing businesses. Since both of these things are often associated with large losses, both at inception and when the ‘best laid’ plans fail, it is imperative that no one be punished as a result of their efforts to innovate, even if doing so involved a good deal of risk taking.

To What and Whom Should the Standards Apply?

One should also question where any new standard should be applied. Should new standards apply only to publicly traded companies or to all companies? If applied only to public

66 The author agrees with Dr. Stiglitz that it is essential to distinguish between real innovation manifested in new products, and the sort of sophistry which passed for innovation in the financial sector. Stiglitz, supra, at p. 8, 114.: “The sad truth is that in America’s financial markets, innovations were directed at circumventing regulations, accounting standards and taxation….No wonder then that it is impossible to trace any sustained increase in economic growth (beyond the bubble to which they contributed) to these financial innovations…. [i]t is hard to point to any clear link, for instance, between ‘financial-sector innovations’ and increased productivity.”

67 Indeed, there is a real question as to who should enact the new standard. In the U.S. corporate law is almost exclusively state law, so the ideas contained in this article would need to be enacted by state legislatures, presumably beginning with those in the states of greatest commercial significance, such as Delaware. While one could argue, and a prominent corporate governance authority has argued, for a federal corporation law to expedite this process, McRitchie, corpgov.net, April 22, 2010, http://corpgov.net/?s=%22marty+robins%22+and+%22outcome-oriented+model%22, there is little reason to believe that this is feasible during the lifetime of any reader of this article. For such action to make economic sense and not unduly burden the business community, it would need to be coupled with action at the federal level.
companies, should there be a size threshold? If so, should it involve assets, revenues, stock value, number of employees, number of shareholders or something else?

The author believes that any new standard should be applied to all companies, public or private, that have sufficient connection to the rest of the economy that their impending demise would necessitate significant government assistance or would have significant effects outside their shareholders and employees. In a rudimentary effort to be more specific, he has proposed that this would encompass regulated financial firms and other firms with total assets exceeding $50 billion or total obligations, broadly defined to include notional value of derivative securities based upon its common stock, exceeding $100 billion.

There is no magic associated with this effort and it is in need of substantial refinement. Significant consideration must be given to the determination of where the new standard should apply, so that we tailor it to those firms which have the most significant interconnections to the rest of the economy. Professor Hal Scott of the Harvard Law School argues persuasively that the extent of interconnectedness is not well known, but likely to exist outside the traditional financial sector:

68 There is current precedent for distinguishing between public and private companies when setting standards for external conduct, specifically with respect to accounting standards. In “Private-Company GAAP: Setting the Right Goal”, Pounder, cfo.com, December 10, 2010, there is an extensive discussion of the emerging movement to have different accounting standards for public and private companies and the reasons why this makes sense.

69 Robins, supra, N.25 at p. 59.
If large losses by institutional investors and other stakeholders are the real reason why we are concerned with interconnectedness and ‘systemic risk’, then we would have to regulate all large global corporations, not just financial ones, whose failures could trigger similar losses – an impossible task….Clearly we need to know far more about the facts of interconnectedness….Congress, as part of its reform legislation, should mandate the creation of a new expert commission designed to fully investigate the extent and consequences of interconnectedness before any new regulation of systemically important institutions is actually adopted.\(^\text{70}\)

The author disagrees with Professor Scott that it is impossible to impose a new standard outside the financial area, but strongly endorses his call for a proper study to identify where such standard is most needed.

The important thing is to acknowledge that there are some firms that have such external significance that a pure laissez faire approach to their governance can no longer be justified. Governance luminaries such as James McRitchie, the principal of the renowned governance site corpgov.net, argue that this approach of targeting enhancements in governance obligations is insufficient, and that it is needed ‘across the board’.\(^\text{71}\) The author respectfully


\(^{71}\) “Robins is too modest in his proposal, many elements of which should be extended well beyond the scope of companies that are too big to fail, especially the ideas of flipping the business judgment rule presumption and requiring affirmative proof of reasonable care, going beyond process, if specified events have occurred.” McRitchie, corpgov.net, April 22, 2010, http://corpgov.net/?s=%22marty+robins%22+and+%22outcome-oriented+model%22
disagrees and invokes the infamous Disney case\textsuperscript{72} as an example of where no enhanced obligations are needed.

This case involved a claim by Disney shareholders against former officers and directors alleging that the directors’ actions in entering into and performing an employment agreement and severance contract with a former executive constituted, inter alia, a breach of the duty of care discussed above which was at issue in \textit{Citigroup}.

Making such claim superficially appealing is the fact that the executive received an amount of cash and stock exceeding $100 million, despite having worked at Disney for slightly more than one year and not being recognized as a major contributor to the company’s results during such tenure.

The court found in favor of the defendants with respect to all claims involving the duty of care, despite its disdain for the manner in which the situation was handled. The court applied the business judgment rule, with its strong presumption\textsuperscript{73} to make clear that so long as directors are properly informed and act in good faith, the “content of the board decision” is

\textsuperscript{72} In re Walt Disney Company Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005).

\textsuperscript{73} Id at 747
not subject to review, even if it is deemed to be “stupid”, “egregious” or “irrational”\textsuperscript{74}. This led the court to hold that while the directors’ conduct fell far short of “best practices”, it did not breach the duty of care.

One can argue persuasively that the director conduct in \textit{Disney} cries out for improvement to the same extent as the director conduct which contributed to the financial meltdown. While this may be true, the critical difference is that the extravagant payments did not have any material impact beyond the Disney company. We simply did not see the sort of interconnection between Disney and anyone else to cause large scale economic fallout of the sort we saw in 2008. As such, the result is a good one for this case and there is insufficient justification for new rules applicable to such cases, which may impede the sort of risk-taking which is needed to drive job creation.

Apart from the empirical considerations discussed above, the political obstacles associated with any change of this nature, persuade the author of the merits of targeting any legal changes only to those firms where there exists the greatest potential for external harm.

\textbf{What Behavior Needs to be Changed by the New Standard? How Do We Avoid New Economic Burdens?}

\textsuperscript{74} Id at 750
But what is to be targeted? As noted above\textsuperscript{75}, the business judgment rule encourages risky behavior by all firms, as a result of its emphasis on process and express disregard for outcomes, as a means of encouraging entrepreneurial activity. This makes sense for firms lacking systematic importance, but not otherwise.

Thus, it is suggested that for firms meeting the criteria noted above\textsuperscript{76}, the business judgment rule be suspended by state legislative action, so that when any of the specified adverse events occur, officers and directors be affirmatively presumed to have breached their duty of care and required to affirmatively prove otherwise. This would entail reversal of the present strong presumption in favor of such persons when there is a challenge to the manner in which they have carried out their duty of care to the firm\textsuperscript{77}.

To mitigate the risk aversion associated with such change, it may make sense to introduce procedural safeguards such as a short statute of limitations, attorney fee shifting for unsuccessful claims of this nature and limited director/officer insurance.

More importantly, in order to keep the focus on actual corporate decision-making, it is suggested that these changes be accompanied at the federal level\textsuperscript{78} by substantial relaxation of

\textsuperscript{75} N.33-40, supra and accompanying text

\textsuperscript{76} N. 69, supra and accompanying text

\textsuperscript{77} N. 33, supra and accompanying text

\textsuperscript{78} Since U.S. corporate law is left to the states, but securities regulation is mainly a federal matter, the actions which are suggested herein would require action at both levels. The modification of the business judgment rule
compensation-related regulation, both with respect to disclosure and recoupment. This would entail among other things, repeal of sections 951-954 of the Dodd-Frank law and elimination of all SEC proxy rules requiring disclosure of non-cash compensation, and streamlining of those pertaining to stock options and other equity-based items.

If boards and management are properly serving shareholders and other pertinent constituencies, and not creating inordinate risks to the economy, the author’s somewhat radical assessment is that their remuneration is unimportant, but if the opposite is true, their exposure should go far beyond their pay, but should reflect in some manner the damage they have caused.

It is time to abandon the notion that so long as proper process and disclosure are utilized in the business world, society will be well served, and acknowledge that our economy is in its current state of affairs because of some truly horrible business decisions made by officers and directors acting in good faith. One way or another, we need to take steps to prevent such bad decisions from recurring.

When Congress acting in the immediate aftermath of the financial meltdown does nothing about governance other than address executive pay and board composition, and as noted in the *Citigroup* discussion, no one who made the horrible decisions is held responsible for them,

would have to happen in Delaware and other major commercial states, while the repeal of the superfluous provisions of Dodd-Frank would have to come from Congress and the SEC.
this sends to all concerned – management, investors, employees, legislators - a message that there is no real accountability.

In more practical terms, it also diverts scarce resources of investors, advisors and companies from addressing the ultimate issue of performance, to the peripheral matters of justifying, disclosing and contesting remuneration. One can make a strong case for the part of Dodd-Frank that allows proxy access for minority holders as being part of improved governance, in that it facilitates the removal of poorly performing directors\textsuperscript{79}, but the other provisions which purport to fit in this genre are misguided. Perhaps it is heretical, but if someone is doing a good job of running their firm, and avoiding the sorts of risks that have laid low our economy for so long, there is no reason to begrudge them or even concern ourselves with their pay. If someone is doing the opposite and putting society at risk of disaster, it is of no comfort to the author that their pay is ‘in line with the companies’ peer group’ or even zero – there must be a way and an incentive to stop the problematic behavior before it manifests itself.

Re-Engaging Boards … Real Governance

To make meaningful these changes, boards need to make sure they understand and intelligently evaluate and where necessary, object to, business strategy long before making personal behavior an issue. This is not to condone sexual harassment or similar behavior, but is to state that it does not present the economic or social risk that a flawed business strategy can and that personal behavior must not be a high priority of boards. In order to do this,

\textsuperscript{79} Although doing so after the fact and without financial consequences, dilutes the benefit.
directors must possess the appropriate body of knowledge about the firm, its industry, and economics and finance in general before they are elected.

While this means that we must consign ‘old boy boards’ where a principal qualification is having a golf handicap higher than that of the CEO or having children in the same school as the CEO’s children, to the economy’s trash heap, it also means that directors installed through the new proxy access rules must have real business expertise and not view themselves as the voice of labor, the downtrodden, the environmental movement or some other limited constituency. It is likely to require formal training in many cases. 80

This also means that boards must be engaged with management on an ongoing basis to see if ‘ordinary course’ activity is taking on a different connotation, despite there not being on the table any M&A activity, major financing or the like.

More importantly, they must take some action when they have reason to believe that something is seriously amiss. Whether “some action” is simply a raised eyebrow in a board meeting, an off the record chat with the CEO to express concerns over the strategy being pursued, voting ‘no’ when the matter comes on for formal consideration, removing the CEO or resigning if none of these things is possible or effective, of course, depends on the circumstances.

80 See, Robins, “Directors Elected through Proxy Access”, corpgov.net, July 1, 2010 arguing for formal training for such directors before they are seated. Pozen also argues that lack of expertise regarding their companies’ business is a major reason why directors are not holding management accountable for poor decisions. Pozen, supra, N.41 and accompanying text.
To be sure, we are only addressing situations where there is a risk of grave harm to the organization with material external implications as well. However, even then, it would make no sense to demand that the most onerous alternative be immediately pursued. From the author’s own experience, there are many situations when well meaning managements have lost perspective, and are likely to recover it and reverse course, with a gentle nudge from their colleagues or superiors.

Where this is not the case, more drastic action would be required. Even where it is taken, it may be ineffective at preventing the harm, but those who have taken it – e.g. board members voting ‘no’ or firing a miscreant CEO would avoid liability if they can demonstrate they took the action at a time which was reasonable under all existing circumstances.81

While no legal standard will ever avoid all harm, what must change is the passivity of boards and officers which we have witnessed in recent years in the face of decisions and courses of action which were palpably questionable at the least. Observers ranging from Prof. Blinder to New York Governor (formerly Attorney General) Andrew Cuomo have lamented the need to overcome this passivity. Prof. Blinder succinctly notes: “Quite plainly, many [boards] were asleep at the switch, with disastrous consequences.” 82 while Governor Cuomo when speaking of the Merrill Lynch episode said that he “wonders broadly where the boards were in

81 It would be for the trier of fact to determine whether the substance and timing of the response were reasonable under the circumstances taking into account the shifting of the burden of proof as part of the suspension of the regular business judgment rule.

this financial crisis and whether B of A directors ‘protected the rights of shareholders, were they misled, or were they little more than rubber stamps for management’s decision-making?’

A close observer of the realpolitik of Wall Street, Charles Gasparino of Fox Business News, and formerly of CNBC, was quite blunt about the inadequate role of boards in Wall Street firms which were at the epicenter of the financial meltdown:

Of Lehman Brothers and its CEO, Richard Fuld: “His board of directors remained silent as his risk taking grew ….” Of Bear Stearns and its CEO, James Cayne: “… the board barely debated the firm’s risk taking …” Of Merrill Lynch and its CEO, Stanley O’Neal: “His board was clueless….”

An eyewitness to the Merrill episode, John Thain, who was Merrill’s CEO at the time it was forced to combine with Bank of America, explains the role of ignorance in creating its plight:

“There is no chance that pretty much anybody understood what they were doing with these securities. Creating things that you don’t understand is really not a good idea no matter who owns it.” [emphasis added] Such ignorance by management and its disregard by boards can no longer be tolerated. Boards must understand material strategies themselves and ensure that managements have done likewise or take meaningful action.

83 “With Subpoenas, Cuomo throws Himself in BacMer Imbroglio”, wsj.com, September 17, 2009


85 Finance.yahoo.com/tech-ticker/article/350268, October 7, 2009
Given the need for substantial change in boards’ historical passivity, any new rules which are adopted should give the benefit of the doubt when evaluating the behavior of boards who do take meaningful action where they do have reason for concern. As noted, we must always be cognizant of avoiding excessive risk aversion which will inhibit employment. In view of the current culture of passivity, this means not letting our desire for a perfect response overshadow a ‘good’ response which fails to prevent the harm. Of course, even if a board is deemed to have properly discharged its duty of care in unsuccessfully addressing flawed business policy pursued by management, this would not absolve those in management who directly pursued such policy from any liability which otherwise exists.

Proper Director Behavior

Some boards seem to ‘get it’ as to their role and focus. An example of a board engaging with a CEO on the appropriate level is found in the case of MPG Office Trust Inc. (formerly known as Maguire Properties). In this case, the company’s CEO left the company as a result of disagreements with the board over strategic issues such as “raising equity, selling properties and whether the company should be put on the block”, prompting the CEO to state in a letter that there was no shared “common vision for the strategic direction” of the company. While it is obviously inappropriate to comment on the merits of either side on these issues, it is clear that the board was looking at the right things in order to determine whether the CEO was on the right track. It is quite revealing to contrast this level of

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86 Pruitt, “Dispute with MPG Board Preceded CEO Exit”, Wall Street Journal, November 24, 2010, p.C6. The subhead is also instructive: “Conflict was Focused on Best Way to Improve Embattled Company’s Fortunes; …”
engagement with the concern with tawdry CEO behavior, instead of strategic issues, we saw from the HP and Tribune boards.

Another recent example of proper director engagement is found in the resignation of a Chiquita Brands International director, Durk Jager. In his resignation letter he stated:

The Company faces declining revenues, deteriorating profits, and a severe drop in its stock price. I have lost the confidence that we have the strategies and plans that can reverse this situation. Chiquita also lacks the capabilities to address basic operational requirements for a sound business.

The fact that Management did not want or could not respond to a request for a realistic 2011 forecast six weeks prior to the start of the new fiscal year is simply one such illustration.\(^87\) [emphasis in original]

Again, there is no way to know for sure who is right on the merits, but Mr. Jager is motivated by the appropriate concerns. One wonders why he is seemingly the only Chiquita director acting in this manner.

While it appears that these boards were engaged at the appropriate level, it is essential that if the new standards are adopted in any form, that boards resist the urge to become overly involved with genuine day to day matters, not presenting significant systemic risk.\(^88\) Even today, the author has encountered several notable examples of boards undermining management by engaging with subordinates and addressing routine business matters, where

\(^{87}\) [\url{http://dealbook.nytimes.com/2010/12/01/not-a-happy-split-from-chiquita/?nl=business&emc=dlbka22}, forwarded by Ethisphere/Corpedia as part of its daily note, December 2, 2010.]

\(^{88}\) “[T]he board Is not supposed to get involved in day-to-day company management.” Pozen, supra, N.41.
the company is clearly not at risk of implosion. If a board feels that management is not capable of keeping the company out of serious trouble or generating appropriate returns on capital, it needs to install new management – not look over the shoulder of existing management every day. Even where a board or board member has reason to doubt the wisdom of a particular decision, intervention to reverse it will be counterproductive by wasting time and undermining management authority, unless the matter truly is of dire significance. The standards which are suggested here are intended to be used judiciously to forestall catastrophe, and not to change the historical roles of directors and management.

Congress, like Dr. Stiglitz, was correct in its recognition that poor governance has done serious damage to our economy and that corrective action is needed. It was correct to make the topic a key part of the Dodd-Frank law. However, the law which was enacted skirts around the periphery of the topic and is at best, irrelevant, to the need for better decisions, and, at worst, detrimental to this cause if it causes people to believe that no further action is needed.

What we see in the wake of the law, with the SEC and boards going off on tangents involving pay, personal behavior, identity of decision-makers and insider trading, while ignoring fundamental matters, confirms the fear that we have not actually improved governance and prompts these sentiments. Knowledgeable observers can and should disagree about appropriate steps needed to augment Dodd-Frank in the governance area, but it is past time to begin that discussion. To do so, we need real dialogue about the genuine nature of governance.