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Introduction

F. Scott Kieff and Troy A. Paredes

Although a number of factors contributed to the stock market decline that started in 2000 – including the bursting of the "dot-com" bubble, a softer economy than many expected, September 11 and the ongoing terrorist threat, and the wars in Afghanistan and Iraq – one factor that weighed on stocks stands out for present purposes: corporate scandal. Beginning with Enron in the fall of 2001, a wave of corporate scandal crashed on the U.S. economy. In addition to Enron, the scandals involved companies such as WorldCom, Tyco, HealthSouth, Adelphia, and Global Crossing. They also ensnared mutual funds and leading financial institutions up and down Wall Street, along with major accounting firms, such as the collapsed Arthur Andersen. As if the *bona fide* scandals that made the headlines were not enough to drag the markets down, a record number of earnings restatements – increasing steadily from 116 restatements in 1997, to 158 in 1998, 234 in 1999, 258 in 2000, and 305 in 2001 when the scandals began to break[1] – fueled doubt about companies' governance, finances, and business plans. These doubts became particularly sharp as the overall market tumbled through 2008.

Broad and deep securities markets, where ownership and control are widely separated, depend on a healthy dose of investor confidence to convince

[1] Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Finance 624 (3d ed. 2003).

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investors to hand over trillions of dollars to directors and officers over whom they exercise relatively little influence.[2] Although the nature of business is that some enterprises will succeed and others will fail, shareholders need to trust that the management team holding the company's reins will run the business honestly, in good faith, competently, and loyally – in short, that the company will be run in the best interests of the shareholders as opposed to in the best interests of the directors and officers. The abuses at what amounted to a handful of companies, given that there are thousands of public companies in the United States, rocked investor confidence, resulting in a major sell-off of equities and deep concerns market-wide. Investors understandably became skittish and, unable to distinguish the "good" companies from the "bad" ones, dashed to the sidelines with cash in hand as events at Enron, WorldCom, and elsewhere unfolded. Although the scandals affected relatively few companies overall, the seeming perfect storm of corporate governance failures disillusioned many about the U.S. corporate governance system and the integrity of U.S. securities markets.

If the debacle at Enron had been an isolated incident that could have been written off as the work of a few rotten apples at the company, perhaps Congress and the President would have sat tight. But once WorldCom broke in mid-June of 2002, it seemed apparent that the U.S. corporate governance system was suffering from deep flaws that needed fixing. As political pressures mounted, and as stock prices continued to plummet, something was bound to be done. In late July, within weeks of the news of WorldCom's massive fraud, Congress almost unanimously approved the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act has proven to be the most important federal corporate governance and securities legislation since Congress adopted the original federal securities acts as part of President Franklin Roosevelt's New Deal. Once President George W. Bush signed the legislation into law on July 30, 2002, the markets were given additional assurance that fraud and corporate abuses would not be tolerated.[3] In addition to the legislative efforts of Congress and the President, a number of cops on the beat stepped up their efforts to detect and root out corporate wrongdoing: new listing standards were proposed for companies trading on the New York Stock Exchange or Nasdaq;

[2] For the classic treatment of the separation of ownership and control, see ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[3] For overviews of events leading to the adoption of the Sarbanes-Oxley Act, see LOUIS LOSS, JOEL SELIGMAN, & TROY PAREDES, 2 SECURITIES REGULATION 510–659 (4th ed. 2007); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449 (2002).

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the U.S. Securities and Exchange Commission (SEC) engaged in wide-scale rulemaking and intensified its enforcement efforts; the Department of Justice began to focus its attention on corporate fraud; and New York Attorney General Eliot Spitzer assumed an unprecedented role in going after corporate corruption.

There is no doubt that new legal mandates and credible threats of massive civil fines and prison time reshaped the corporate landscape. But in addition to all of this, shareholders, led by institutional investors and increasingly by hedge funds, have become much more active, recognizing that they have a role in protecting their own interests instead of simply relying on the government to protect them. Consider, for example, the outrage over executive pay; the spike in the number of shareholder proposals; and the growing push for majority voting for boards of directors. Such shareholder activism is assisted by a discerning financial and business media that has shined a bright light on corporate wrongdoing and mismanagement.

As a result of all of this, it is fair to say that we have entered a new and especially controversial era in debates about corporate governance. The hallmark feature of this era is greater scrutiny of corporate actors by Congress, the SEC, state attorneys general, federal prosecutors, other corporate actors, judges, the public, and the media. Louis Brandeis said, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[4] Without question, closer tabs are being kept on corporate America now than ever before. But recognizing that more is not always better, this book's purpose is to consider what such close scrutiny has meant for corporate behavior so far and what it will mean for corporate behavior in the future.

This book begins in Part I with chapters by Lawrence Mitchell, Lawrence Cunningham, Scott Kieff, and Troy Paredes that study a fundamental relationship in the firm – that is, the relationship between the board of directors and the chief executive officer. Part II turns to executive pay, one of the most controversial issues in corporate governance. Chapters by Lucian Bebchuk and Jesse Fried, William Bratton, and Jeffrey Gordon address the structure of executive pay, the incentives executive pay creates for managers running the business, and opportunities for reform. The chapters in Part III cover various mechanisms for holding accountable managers and directors who loot the business, shirk, or "cook the books." Stephen Bainbridge considers shareholder activism. Merritt Fox considers the role of securities regulation. And Kathleen Brickey looks into the media's role. Part IV focuses on the source of regulation. In other words, should Congress or the states regulate corporate

[4] Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (1914).

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conduct? James Cox's chapter takes Delaware to task for its handling of corporate governance in the post-Enron era. Norman Veasey, a former Delaware Supreme Court Justice, along with co-authors Shawn Pompian and Christine Di Guglielmo, defend federalism and the role of the states in corporate governance regulation. Part V looks outward, considering corporate governance in foreign countries. Hideki Kanda's chapter looks at the differences between bank and capital market regulation with a special emphasis on Japan, while Rainer Kulms discusses ongoing developments in European corporate governance. While these chapters cover different countries, they both engage the broader debate of whether corporate governance around the globe is converging to the U.S. model. This book concludes with an epilogue by Joel Seligman. Seligman's contribution identifies three trends in corporate governance that have impacted corporate conduct so far and that are bound to impact corporate governance in the future.

Part I starts with Lawrence Mitchell's "The Trouble with Boards." Mitchell studies the history of the board of directors. Mitchell starts by recounting the board's evolution from its early beginning to the present-day monitoring model of the board. Mitchell argues that the board, as it functions today, was designed principally to protect its members from legal liability and to leave corporate power with management. Consider, for example, the deferential business judgment rule and the fact that directors can be exonerated from monetary liability for breaching the duty of care. Against the historical backdrop he paints, Mitchell asks a fundamental question: "Is the board of directors of the modern American public corporation a useful institution?" Put differently, Mitchell asks if we should even bother having boards. Shareholders are told that the board is the corporation's keeper and exists to represent the shareholders' interests. Yet, according to Mitchell, the board does not do this. Thus, the board's existence fosters a false sense of security for shareholders, as well as other corporate constituencies. Mitchell is down on the board, but he does note some possible remedies for what ails it. One option is simply to do away with the board entirely. A very different choice is for the board to step up and exercise real power. Another option is to have several boards at a company, each with a different function. For example, one board could be responsible for legal compliance, while a separate board takes charge of shaping corporate strategy. A particularly thought-provoking suggestion stems from Mitchell's claim that real power rests not with the board, but with the CEO. If real power resides with the CEO, then perhaps shareholders, and not the board, should get to elect the CEO, according to Mitchell. Such direct-shareholder election of the CEO would be a fundamental shift in corporate internal affairs. Mitchell stresses that the starting point for any meaningful reform is to reconceptualize

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the board's purpose, since in his view the predominant monitoring model has let us down.

The second chapter in Part I is "Rediscovering Board Expertise: Legal Implications of the Empirical Literature" by Lawrence Cunningham. Cunningham examines the balance between expertise and independence in the boardroom. Historically, independence has been favored over expertise, but Cunningham argues that theory, empirical evidence, and new legal pressures support placing a greater value on expertise. Accounting expertise, in particular, is called for among the members of board audit committees. Cunningham goes on to discuss the questions that arise naturally: what should be required of experts and in whose interest should they act? To the first question, he argues that accounting experts should take a broad role, monitoring both accounting earnings management and real earnings management. To the second, he proposes that the audit committee accounting experts themselves should determine the balance of their constituency among equity investors, debt investors, bonus-compensated employees, and society.

Cunningham also considers whether independence and expertise are necessarily mutually exclusive. Although expertise derived from inside knowledge of the corporation is often opposed to independence, expertise derived from substantive knowledge in a discipline (e.g., accounting) is not. Cunningham argues that it is in fact this latter variety of expertise that is especially valuable when combined with independence. Promoting this combination requires realigning legal doctrine with the empirical evidence favoring expertise.

"The CEO and the Board: On CEO Overconfidence and Institutionalizing Dissent in Firms" by Scott Kieff and Troy Paredes concludes Part I. A great deal of attention has been aimed at going after corporate malfeasance in the post-Enron era. Fraud and looting are problems. But in trying to craft a corporate governance regime that remedies such agency costs, a different problem often is overlooked. That is, a great deal of firm value is destroyed when companies are run poorly. Even when directors and officers are acting loyally and are properly incentivized to maximize profits, the company can struggle, and possibly go under, if corporate strategy is not properly tended to and if particular business opportunities are not properly evaluated. Bad business decisions, or even good business decisions that are then implemented poorly, are a very real concern. Kieff and Paredes encourage more attention to be paid to improving the strategic decision making of corporate actors who are well-intentioned and hard-working and who are acting in good faith. They stress that it is important for management and its advisers to have good information and to deliberate earnestly to ensure there is a full airing of issues. The hallmark of good decision making is a balanced assessment of risks and

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rewards. Kieff and Paredes worry that boards and subordinate officers are too deferential to the CEO in how the enterprise is run, such that one view, the CEO's, too frequently dominates corporate decision making. So they explore a particular fix – namely, institutionalizing dissent in firms by appointing a formal devil's advocate on the board. The express job of the devil's advocate would be to challenge assumptions, identify risks, offer competing options, and press counterarguments.

"Pay Without Performance: Overview of the Issues" by Lucian Bebchuk and Jesse Fried starts off Part II of this book. What accounts for the structure of executive pay? Why are CEOs paid as much as they are? What does it mean for CEO pay to be "excessive"? To what extent do CEOs set their own pay? Bebchuk and Fried have developed one of the most influential theories of executive compensation – the so-called "managerial power" theory. Bebchuk and Fried contend that too often there is no meaningful arm's-length negotiation between managers and boards when boards fix managerial pay, and their chapter details the various ways in which managers influence their pay, even as boards have become more independent. Hence, it should come as no great surprise that executive compensation has skyrocketed. The managerial power theory highlights a cognate feature of executive compensation arrangements – that is, the need to avoid public outrage over outsized pay packages. Bebchuk and Fried claim that managers often structure their pay to "camouflage" their compensation to avoid public outrage. Instead of taking an especially large salary, senior executives may obscure their pay through pension plans, deferred compensation arrangements, and retirement perks. Managers and directors may also try to legitimize executive compensation with the stamp of approval from a supposedly independent outside compensation consultant. Having problematized executive compensation, Bebchuk and Fried offer a number of reforms. Among other things, they argue for improving transparency by having companies reduce all forms of compensation to a single dollar value. They also suggest having companies disclose the extent to which an executive's pay is attributable to general market and industry developments and not the executive's own efforts. The SEC has recently followed a similar reform agenda in revamping the agency's executive compensation disclosure requirements for public companies. Bebchuk and Fried do not stop with urging better disclosure, however. They also recommend several separate substantive provisions for compensation arrangements. These terms are designed to link pay to performance. Their most provocative suggestion strikes at the heart of the firm. Bebchuk and Fried argue that shareholders should be given more direct authority over the enterprise and greater freedom to remove directors and to put forth their own nominees.

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The next chapter is William Bratton's "Supersize Pay, Incentive Compatibility, and the Volatile Shareholder Interest." Commentators and policy makers generally agree that executive compensation should be structured not only to compensate senior managers for their efforts, but to incentivize them to run the business in the shareholders' best interests. Put differently, the CEO and other top executives should be financially motivated to enhance shareholder value. But as Bratton highlights, this overlooks a key concern. It typically is assumed that all shareholders are the same, in which case they all have the same interests – say, a higher stock price today. Bratton explains that this view of shareholders is too simplistic. Shareholders are not monolithic. Bratton catalogues the different types of shareholders as follows: long-term investors, speculators, noise traders, fundamental value investors, long-term holders, "dumb money," and "smart money." Once the shareholder class is unpacked this way, what maximizing shareholder value means in practice is unclear, as Bratton illustrates. For example, a manager may make an imprudent investment in some fashionable new venture, such as an on-line business strategy, if that is what the market will reward in the short term. This may get today's stock price up, which is good for a speculator, but it may mean a lower stock price in the future, at the expense of long-term investors. Similarly, a manager who makes capital budgeting decisions with an eye toward hitting this quarter's earnings target may sacrifice future firm value by delaying or foregoing important investments. Further, executives may feel pressured to manage earnings or, worse yet, engage in actual fraud to meet earnings targets. Bratton says that compensation arrangements often align managers' interests with those of short-term speculators and that managers instead should be motivated to maximize the long-term fundamental value of the firm. How can this be done? One strategy that Bratton stresses is to turn managers into long-term investors by restraining the alienability of their equity grants.

The third chapter in Part II is "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Muddling Through" by Jeffrey Gordon. Gordon describes two strands in the executive compensation debate: pay for performance and social responsibility. Although both have focused on giving the board and possibly shareholders more power to evaluate and constrain executive compensation, Gordon argues that pay for performance is likely to dominate the decision making of boards and shareholders, leaving social responsibility concerns to the political process.

Unfortunately, pay for performance does not produce an easy answer in all situations, and Gordon suggests that it is best understood as a goal rather than a simple, measurable output variable. With that in mind, Gordon turns to current reform efforts, particularly shareholder involvement in compensation

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setting. After describing a theoretical framework for understanding various approaches to the issue, Gordon analyzes the U.K. approach to "say on pay" and finds it lacking. Instead of a one-size-fits-all solution from the legislature, he suggests "muddling through" with a refined version of the existing US combination of firm-by-firm consideration of "say on pay" and shareholder threats to remove compensation committee members. Although such an approach may lead to socially unacceptably high levels of compensation, Gordon argues that such considerations are best addressed through tax policy rather than corporate governance reform.

Stephen Bainbridge opens Part III with his chapter, "Shareholder Activism in the Obama Era." Investors have long subscribed to the "Wall Street Rule" – if the company you invest in is underperforming, sell. Today, shareholders are much more active than in the past. Most notably, institutional investors have been exercising their voice in an effort to influence management and the board. Shareholder proposals are on the rise, for example, and shareholders have resorted to "just vote no" campaigns, withholding their votes for disfavored board nominees. As Bainbridge explains, there has been support for giving shareholders even more influence by facilitating the exercise of their franchise. Among other developments, the SEC proposed new rules that would have given shareholders access to the corporate ballot to nominate directors to compete with the company's slate. So-called "majority voting" for director elections has also gained steam. Bainbridge defends the separation of ownership and control and argues against shareholder activism in general and against extending the shareholder franchise in particular.

In key respects, Bainbridge's argument centers on his claim that the most active investors are union and public pension plans, which are often motivated by political considerations or the interests of non-shareholder constituencies, such as union or government employees. He makes three primary arguments. First, Bainbridge reasons that activist shareholders often pursue objectives that are not shared by passive investors and that often cut against the interests of passive investors. Second, he explains that shareholder activism undercuts board authority over the enterprise. Third, Bainbridge argues that greater investor activism simply relocates agency problems. For example, as institutional investors become more active, we have a new worry about whether pension fund managers are acting in the best interests of fund beneficiaries, in addition to traditional concerns over whether directors and officers are managing the business in the shareholders' best interests. In sum, Bainbridge argues against empowering shareholders to hold directors and managers more accountable.

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Merritt Fox's "After *Dura*: Causation in Fraud-on-the-Market Actions" is next. At the core of the federal securities laws is a mandatory disclosure regime. The federal regime is designed to remedy the informational asymmetries that exist between companies and investors. The logic is that by arming investors with information, mandatory disclosure promotes informed investor decision making, capital market integrity, and capital market efficiency. Once they are empowered with information, investors can protect themselves against corporate abuses and mismanagement, and there is no need for the government to engage in more substantive securities regulation. All of this presumes that the information disclosed is complete and accurate. In reality, disclosures are not always truthful. Fox's chapter addresses the legal regime that empowers private litigants to enforce the federal securities laws to ensure the accuracy of corporate disclosures. Fox's chapter examines the civil liability system under the federal securities laws. Fox focuses his attention on an important Supreme Court decision handed down in 2005, *Dura Pharmaceuticals, Inc. v. Broudo*. *Dura* defines the loss causation element under the general federal antifraud provisions, section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. In finding that plaintiff-shareholders cannot show loss causation by pleading that an alleged misstatement led to an inflated stock price, the case has made it more difficult for shareholders to bring actions alleging fraud. Fox gives a detailed account of *Dura*, loss causation, and fraud-on-the-market actions generally. More pointedly, he argues that the loss causation requirement is nonsensical in fraud-on-the-market cases. Fox concludes that the Supreme Court has left several key issues unanswered, and he offers a number of important suggestions for lower courts to follow as they flesh out *Dura* in the years ahead. Depending on how the lower courts apply *Dura*, private litigation for fraud will be more or less impactful in holding parties to account under the federal securities laws and thus shaping corporate behavior.

In Part III's third chapter, "From Boardroom to Courtroom to Newsroom: The Media and the Corporate Governance Scandals," Kathleen Brickey studies the media. To the extent that sunlight is a disinfectant – and the mandatory disclosure regime of the federal securities laws is premised on the view that it is – the media play an important role shaping corporate conduct by shining light on wrongdoing and mismanagement. The media also influences lawmakers by stirring up opposition to certain corporate practices. Reports in the *New York Times* and the *Wall Street Journal* and on television often prod public outrage and capture the attention of lawmakers, thus influencing the agenda of legislators and regulators. Further, investors can use the media to

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wage a public campaign against particular senior officers and board members, and lawmakers can exhort particular reforms by taking to the airwaves and the op-ed pages. That said, as Brickey describes, the media sometimes gets it wrong and can be used as a tool to thwart corporate accountability. Through the lens of high-profile cases involving individuals such as Martha Stewart, Dennis Kozlowski, and Richard Scrushy, Brickey tackles a number of fundamental concerns. Has the media's rush to provide instantaneous coverage compromised journalistic integrity? Has reporting by the press risked causing mistrials? Is the media manipulated by corporate actors or their opponents? Is the media being used to influence juries? The media plays a more complex role in securities markets than simply disseminating information to investors and other stakeholders.

Part IV begins with "How Delaware Law Can Support Better Corporate Governance" by James Cox. Delaware is the most important source of corporate law in the United States. Cox takes Delaware to task for falling short in regulating corporate behavior. He censures Delaware for not more actively cultivating best practices for corporate actors and for too readily deferring to management and the board. Cox goes so far as to describe the law of fiduciary duty in Delaware as "vacuous" and says that "there is no there there." Cox spares almost no important corporate law doctrine, criticizing Delaware's duty of care, its lack of a meaningful duty of good faith, the demand requirement in derivative litigation, the law governing the usurpation of a corporate opportunity, and Delaware's takeover law. In so doing, Cox analyzes numerous leading Delaware cases, including *Disney*, *Aronson*, *Van Gorkom*, *Caremark*, *Broz*, *Unocal*, *Moran*, and *Blasius*. Cox concludes that the Delaware courts must see themselves as being in the "norms business" and must announce judicial expectations for directors and officers more sharply and sternly. He also argues that the Delaware courts should defer less to management and the board and should not be beholden to the standard claim that the Delaware courts must tread lightly to avoid discouraging risk taking. Cox thus calls into question longstanding judicial practice under the business judgment rule. Why have the Delaware courts gone easy on directors and officers, if indeed they have as Cox suggests? Cox notes one explanation – namely, that in order to ensure that Delaware remains the jurisdiction of choice for incorporation, the Delaware courts have decided to be friendly to management and boards.

Norman Veasey is much more sanguine about Delaware's success crafting corporate law. He is a unique authority on the topic, having served as the Chief Justice of the Delaware Supreme Court. In his chapter in Part IV, "Federalism versus Federalization: Preserving the Division of Responsibility in

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