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Dawn Following Darkness: An Outcome-Oriented Model for Corporate Governance

Martin B. Robins*

"The time has come,' the Walrus said, to talk of many things: of shoes—and ships—and sealing wax . . ." The Walrus and the Carpenter, Lewis Carroll, 1872

"The old ways that led to this crisis cannot stand. And to the extent that some have so readily returned to them underscores the need for change and change now. History can not be allowed to repeat itself." President Barack Obama, 2009

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I. INTRODUCTION

Both the President and the Walrus are correct in their own ways; in order to change the old ways which led to our current economic crisis, we must now talk of many things that for many years have seemed unthinkable. Among them are some long-standing principles of corporate law and governance. We must seek improvement in corporate governance so that large, systemically important firms do not become involved in the predicaments which precipitated the economic downturn and necessitated huge government bailouts to minimize the broader economic fallout.1

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This article advocates imposition of some explicit sanction on boards of directors of very large firms in certain circumstances where their firms have suffered seriously adverse financial outcomes, irrespective of whether "proper" process was followed.

President Obama correctly explains the need for societal concern when he states, "[T]here are some in the financial industry who are misreading this moment. Instead of learning the lessons of Lehman and the crisis from which we are still recovering, they are choosing to ignore them. They do so not just at their own peril, but at our nation's." 2 Corporate governance is relevant because there is general agreement that these recent debacles resulted from simple ineptitude or dishonesty—reckless or non-existent loan underwriting, irresponsible borrowing, overly complicated securitization or misleading accounting—and not from aggressive, innovative conduct of business. 3

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2. Crisis, supra note 1.

3. "[T]he financial crisis was caused by the meltdown of almost 25 million subprime and other nonprime mortgages—almost half of all U.S. mortgages . . . ." Peter J. Wallison, Barney Frank, Predatory Lender, WALL ST. J., October 16, 2009, at A19. In earlier cases which also illustrated the need for improved governance, several large companies, such as Enron, WorldCom, and Health South were brought down by outright fraud perpetrated by their managements. See MARK JICKLING, ACCOUNTING REFORM AFTER ENRON: ISSUES IN THE 108TH CONGRESS 1 (2003),
The objective of efforts to improve corporate governance must be the improvement of business decision-making in order to avoid the sort of catastrophic decisions that brought down and required bailouts of so many giant firms during 2008. By definition, this means that improvement of outcomes must be the ultimate objective of these efforts.

However, both present law and the most prominent of pending reform efforts have little to do with outcomes per se and much to do with processes which are deemed to impact outcomes. As will be discussed below, there is no legal accountability for anyone as a result of even disastrously poor corporate performance, so long as decision-makers utilized appropriate process and made appropriate disclosures. While there are numerous pending efforts to improve the situation, all of them are intended either to “deal with” public company executive pay practices which are quite confidently said by many knowledgeable observers, such as Federal Reserve Board Chairman Ben Bernanke and renowned Princeton professor of economics Alan Blinder, to cause the overly risky behavior which resulted in disaster, or to affect the composition of boards of directors of public companies in an effort to allow dissident shareholders to replace directors who have not performed effectively.

No less august a body than the G20 Finance Ministers and Central Bank Governors reflect this orientation on the part of policymakers. 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: “greater disclosure and transparency of the level and structure of remuneration for those whose actions have a material impact on risk taking”; “global standards on pay structure, including on deferral, effective clawback, the relationship between fixed and

4. See Alan Blinder, Crazy Compensation and the Crisis, Wall St. J., May 28, 2009, at A15. See also infra notes 12, 56. Even President Obama, in what appears to be a form letter sent to the author and others who have addressed this topic, speaks in the same sentence of “outrageous bonuses” and “risky transactions” but says little about the need for better decision-making on the merits of business issues. Letter from Barack Obama to Author (August 21, 2009) (on file with author). To this end through the Treasury Department, he is supporting legislation to give shareholders a “say on pay.” See infra notes 60-63 and accompanying text.

variable remuneration and guaranteed bonuses, to ensure compensation practices are aligned with long-term value creation and financial stability” and “corporate governance reforms to ensure appropriate board oversight of compensation and risk, including greater independence and accountability of board compensation committees.”

When commenting on the difficulty of finding a viable business model for fallen insurance giant AIG, one commentator critiqued these sentiments when he stated, “Deploring high CEO pay is so much more fun than grasping this difficult nettle. It’s also not a real solution.” An illustration of how rhetoric is being substituted for substantive improvement is found in the response of one renowned corporate governance expert to the decision by federal “pay czar” Kenneth Feinberg to cut cash compensation for executives of the firms, which required ongoing government bailouts:

This backward-looking strategy seems intuitive to any parent raising a child, or any pet owner trying to train a puppy. You wait until the child or puppy does something wrong (or right) and then respond with a punishment (or reward). The focus is on past behavior and leaves ample room for discretion.

With all due respect to Prof. Stout, this author favors ex ante direction and assignment of responsibility, aimed at avoidance of “bad behavior” over ex post sanctions once it occurs.

This author’s belief is that executive pay is irrelevant as a societal matter in itself and that the quality of executive decision-making is what must be addressed. Similarly, it is his belief that the composition of boards is equally irrelevant, but that their performance in vetting management decisions and integrity is very relevant. As a corollary to the preceding observations, the author believes that public policy should and must address corporate governance improvement only in those situations where its inadequacy can impact those outside the corporation. In such situations, it is preferable (and possible) to directly influence outcomes

9. In general, a puppy’s misbehavior will have less of a macroeconomic effect than a public company board’s misbehavior.
Instead of the processes which may impact them. This article is intended to explain why the emphasis on process is often misplaced, why the current legal environment is not conducive to the steps which he believes will bring about better outcomes, but tends to cause undue attention to process, and proposes certain changes which he anticipates will have this effect.

II. WHAT CAUSES BAD DECISIONS BY EXECUTIVES?

The current "conventional wisdom" is that compensation formulae directly encourage and are the principal contributor to overly risky behavior,\(^{10}\) and that boards of directors are so entrenched and insulated from risk of loss of their seats that they fail to properly monitor such behavior when it is occurring under their noses.\(^{11}\) Federal Reserve Chairman Bernanke states that "[c]ompensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability."\(^{12}\) Prof. Blinder declares:

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.\(^{13}\)

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11. Id. "Quite plainly, many [boards] were asleep at the switch, with disastrous consequences." Id. See also Ashby Jones, With Subpoenas, Cuomo Throws Himself in BacMer Imbroglio, WALL ST. J., Sept. 17, 2009, http://blogs.wsj.com/law/2009/09/17/with-subpoenas-cuomo-throws-himself-in-bacmer-imbroglio. New York Attorney General Andrew Cuomo when commenting on the Bank of America/Merrill Lynch transaction which led to much controversy about bonus payments as well as a large government bailout "said he wonders broadly where the boards were in 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?'" Id.
13. Blinder, supra note 4. See also Mark Whitehouse, Economists See Financial Crisis Response as Risky, WALL ST. J., January 7, 2010, atA2 (quoting Stanford University economist Robert Hall on the impact of skewed incentives: "The incentives are to take a very risky position. They get to pocket it if they win and it's the federal government's problem if they lose.").
However, this author's experience is that with all due respect to Chairman Bernanke and Prof. Blinder, the matter is not as simple as "duh" would suggest, in that poor business decision-making results from many factors besides pay, and that after the fact, ad hoc efforts to make executives financially accountable for bad outcomes are not likely to prevent such outcomes in the first place. In any event, it is far from clear that bad outcomes for one particular firm have the same societal impact as those for another. From a societal standpoint, it is essential that we properly identify situations where bad outcomes cannot be readily contained and develop mechanisms to prevent such bad outcomes instead of punishing after the fact those who cause them or imposing unneeded burdens on those who are not in a position to cause such damage.

There is no "clearinghouse" compiling the reasons for bad business decisions. However both the author's direct experience and observations over several decades of practicing corporate law with clients of all sizes and in many industries in which he has observed the outcomes of many good and bad decisions, as well as writing about and teaching it, along with common sense, indicate that bad decisions result not only from skewed monetary incentives, but also from factors (alone or in combination) such as simple ineptitude, management ignorance of fact, law or market reality (sometimes willful, sometimes not), hubris, inertia, megalomania, excessive emphasis on speed of implementation, and "group-think," where faddish practices are slavishly adopted.

Additionally, there are situations—most notably Enron Corporation and Worldcom, Inc. in 2001 and 2002—where the key actors are flatly dishonest, as opposed to being honest but having their judgment colored by a compensation formula, and where we need to keep such persons out of power.

The sudden collapse of Enron Corporation in late 2001, amid revelations that its public accounting statements had been manipulated and falsified to conceal the company's true financial position, was the first in a series of major accounting scandals involving American corporations . . . . The watchdogs meant to protect public investors—-independent auditors, boards of directors, Wall Street analysts and regulators—were not an effective bar to corporate management bent on
artificial inflation of financial results. The costs of the accounting scandals have been high.\footnote{14}

The empirical analyses of the situation support this conclusion with respect to overly risky decision-making. “These studies suggest that bank executives were simply ignorant of the risks their institutions were taking—not that they were deliberately courting disaster because of their pay packages.”\footnote{15} Professor David Yermack of the NYU Stern School of Business concurs in saying, “[N]o evidence whatsoever indicates that errant executive compensation ‘caused’ the financial crisis of 2008.”\footnote{16}

To the extent such circumstances are applicable, the prospect of taking away someone’s pay after the fact is not likely to prevent a disaster in the first place. All that could prevent the disaster is to see to it that the decision-maker(s) who are unable or unwilling to make good decisions are kept or taken out of decision-making capacities before they can do damage. Put simply, an incompetent person will not become more competent as a result of the threat of recouping their pay.

The well chronicled Merrill Lynch episode is quite instructive. In 2006, the company did enact a pay plan for top management which embodied many, if not most, of the elements which are currently viewed as best practices, yet by its former CEO’s own admission, there was no genuine understanding of the risks that it was taking.

It sounds like something Washington’s pay czar might propose to rein in runaway bonuses on Wall Street. Tie executives’ compensation to their company’s stock price. Withhold big paydays for years. Claw back bonuses if things go wrong. And force risk-loving traders to gamble with their own money, not just their company’s. In fact those strictures were part of

\footnote{14} Jickling, \textit{supra} note 3.
\footnote{15} Jeffrey Friedman, \textit{Bank Pay and the Financial Crisis}, \textit{WALL ST. J.}, Sept. 28, 2009, at A21 (referring to very recent studies of the 2008 financial meltdown by Professors Rene Stulz, Rudiger Fahlenbrach, Viral Acharya, and Matthew Richardson). Board of director (BOD) ignorance of wrongdoing—as opposed to poor decision-making—is also emphasized in a letter to the SEC commenting on its proposed disclosure reforms submitted by The Ethisphere Institute through its Executive Director, Editor-in-Chief, and Managing Director: “The Board is typically unaware of most malfeasance that occurs within an organization. Our research indicates that commonly the board of directors is isolated from the actual workings of a corporation’s compliance and ethics function.” Letter from Alexander F. Brigham et al. to SEC (September 15, 2009), \textit{available at} \url{http://www.sec.gov/comments/s7-13-09/s71309-87.pdf}.
a compensation plan Merrill Lynch adopted voluntarily in 2006—two years before the company collapsed into the arms of Bank of America.17

John Thain, who was Merrill’s CEO at the time it was forced to combine with Bank of America, stated, “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.”18

This is an example of something other than pay driving poor decision-making and leading to a catastrophic outcome. If executives did not or could not understand the risks they were taking, it is a non-sequitur to contend that they knowingly assumed these risks as a result of skewed financial incentives and there is little reason to believe that changing their compensation formulae will lead to a different result.

III. THE CURRENT LEGAL FRAMEWORK IS NOT CONDUCIVE TO GOOD DECISION-MAKING

Current corporate and securities law does not provide proper incentives to avoid systemic disasters. In pertinent part, the model for corporate governance in all U.S. jurisdictions of significance has the following major components:19

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19. 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. See Delaware Division of Corporations, http://corp.delaware.gov (last visited Jan. 13, 2010). This article emphasizes Delaware authority in addition to the federal securities laws. The author is not aware of any authority to the contrary of the cited Delaware cases in any other commercially significant states.
A. Decision-making and oversight of management by a financially disinterested board of directors with "undivided loyalty" to the firm, that is, one lacking any direct pecuniary interest in the particular matter where the director is voting and which requires recusal in the particular case where this is not true\textsuperscript{20}

The author believes this point is self explanatory. However, the author would also like to note that the Sarbanes-Oxley Act of 2002\textsuperscript{21} augments this emphasis on independence with its requirements for detachment from management for the members of public company audit committees.\textsuperscript{22}

B. A fairly recent prescription by the Delaware Supreme Court in its decision in the case of Smith v. Van Gorkom\textsuperscript{23} of required processes for boards of directors (BOD) to utilize when considering major matters\textsuperscript{24} as part of their so-called "duty of care" which complements their duty of loyalty.

The Delaware court emphasized the need for directors to "inform themselves 'prior to making a business decision of all material information reasonably available to them'"\textsuperscript{25} in order to avoid a finding of a breach of their duty of care. In finding that these particular directors had not fulfilled their obligations, the court emphasized the minimal amount of time devoted to consideration of the matter in a non-emergency situation, the absence of reference by the directors to operative documentation pertaining to the transaction at issue, and the absence of input from legal or financial advisors.\textsuperscript{26}

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\textsuperscript{20} See DEL. CODE tit. 8, § 143 (West, Westlaw through 77 laws 2009); see also Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), cited approvingly in In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 750 (Del. Ch. 2005); cf. Meinhard v. Salmon, 249 N.Y. 458 (1928) (arguably originating this "duty of undivided loyalty" of corporate directors to their corporations).


\textsuperscript{22} See infra note 39 and accompanying text. See also Anup Agrawal & Sahiba Chadha, Corporate Governance and Accounting Scandals, 48 J. L. & Econ. 371 (2005).

\textsuperscript{23} 488 A.2d 858 (Del. Sup. 1985).

\textsuperscript{24} Smith v. Van Gorkom has been read by the Disney Court and others as providing guidance as to when "expert" advice—such as legal or investment banking—is required prior to certain BOD decisions, especially those involving corporate combinations, and strongly discouraged hasty decision-making involving major corporate transactions. Disney, 907 A.2d at 769.

\textsuperscript{25} Smith, 488 A.2d at 872.

\textsuperscript{26} Id. at 876.
Compounding the impact of this decision is the response of the Delaware Legislature, which promptly enacted title 8, section 102(b)(7) of the Delaware Code to allow corporations to include in their certificates of incorporation language “eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty [other than duty of loyalty or intentional misconduct/bad faith] as a director.”

Delaware’s Vice Chancellor has stated that “[o]ne of the primary purposes of 102(b)(7) is to encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith.” While there is little reason for disagreement with the Smith court’s holding, its prescription should be viewed as necessary, but not sufficient. The time has come to reconsider this policy of simply absolving directors who properly inform themselves of relevant information of any responsibility for the ultimate use of such information.

In practice, one manifestation of this process orientation has been an almost blind deference to the judgment of ratings agencies with respect to mortgage-backed securities, notwithstanding the common knowledge that lending standards had been so drastically reduced.

C. Very strong deference by reviewing courts to the “business judgments” of genuinely disinterested BODs based upon proper process, notwithstanding adverse or disastrous results.

In a very recent case involving one of the firms at the epicenter of the 2008 problems, Citigroup, the Delaware Court of Chancery made extremely clear that pursuant to Smith, this is a cornerstone of present law:

27. DEL CODE tit. 8, § 102(b)(7) (West, Westlaw through 77 laws 2009).

28. Disney, 907 A.2d at 752 (quoting 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 In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009) and elsewhere, this encouragement was wildly successful.

29. Wallison, supra note 3 and infra note 76 (describing the prevailing, explicit public policy for many years to encourage homeownership by reducing lending standards, especially for Fannie Mae and Freddie Mac). Despite this being the case, rating agencies did not adjust their ratings to reflect the additional credit risk.

30. “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .” DEL. CODE tit. 8, § 141(a). This statute also applied in the Disney and Citigroup cases. See Disney, 907 A.2d at 746; Citigroup, 964 A.2d at 120.
[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.\(^3\)

There is no doubt that this is a correct statement of present law, but the $45 billion of government funds injected into Citigroup as part of the 2008 TARP bailout as a result of what the court found to be “staggering losses”\(^3\)\(^2\) indicates the dire need for change.

D. **Emphasis in the federal securities laws, including the proxy rules governing director elections,\(^3\)\(^3\) as well as securities issuance and secondary market trading on risk disclosure instead of substantive regulation.\(^3\)\(^4\)**

The major securities laws are the Securities Act of 1933,\(^3\)\(^5\) which regulates initial issuance of securities to the public or in “private placement” transactions, the Securities Exchange Act of 1934,\(^3\)\(^6\)

\(^{31}\) Citigroup, 964 A.2d at 122 (quoting from In re Caremark Int’l. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (emphasis added)).

\(^{32}\) See supra note 1 and accompanying text; Citigroup, 964 A.2d at 139.

\(^{33}\) See infra note 40.

\(^{34}\) The federal securities laws have been described as “rotten egg” statutes, meaning that one can sell all of the rotten securities they want, so long as they clearly disclose how rotten they are. “[The Securities Act of 1933] has sometimes been called ‘the rotten egg’ statute because its theory is that it is perfectly alright to sell rotten eggs to the public as long as you say clearly that they are rotten—and perhaps tell why and how they became rotten . . . .” A.A. Sommer, Jr., SEC Commissioner reprinted in SEC Annual Rpt. 1973 at 1-2 available at http://c04O3731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1970/1973_1024_Somm erAnnualReports.pdf. The forms for companies to use for securities offerings and periodic disclosures expressly require and cause extensive discussion of “risk factors” pertaining to their businesses. 17 C.F.R. § 229.503(c) (2009). Item 503 of Regulation S-K, which is incorporated into many of the forms used in connection with securities offerings under the Securities Act of 1933, requires disclosure and discussion of the “most significant factors that make the offering speculative or risky” including “Your lack of an operating history” and “Your lack of profitable operations in recent periods.” Id.


which in pertinent part regulates trading in already-issued securities and the obligations of public companies with respect to periodic financial reporting and shareholder votes, and the Sarbanes-Oxley Act of 2002, which sought to respond to the fraudulent public company behavior which became evident in 2000 and 2001 by imposing additional responsibility on officers and directors and essentially remaking the public accounting profession.\textsuperscript{37}

The SEC's official website describes the purposes of the major Acts as follows:

Often referred to as the 'truth in securities' law, the Securities Act of 1933 has two basic objectives:

- require that investors receive financial and other significant information concerning securities being offered for public sale; and

- prohibit deceit, misrepresentations and other fraud in the sale of securities ....

The [Securities Exchange Act of 1934] empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

....

The [Act] also governs the disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action ....\textsuperscript{38}

The Sarbanes-Oxley Act of 2002, which was characterized by former President Bush as "the most far reaching reform of American business practices since the time of Franklin Delano Roosevelt," is described by the SEC only as "[m]andat[ing] a number of reforms to enhance corporate responsibility, enhance financial

\textsuperscript{37} The Sarbanes-Oxley Act of 2002, Pub. L. No 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, & 29 U.S.C.). Other federal statutes govern various securities related matters, such as mutual fund and investment advisor operation, but are not germane to general corporate governance issues.

disclosures and combat corporate and accounting fraud and create[ing] the Public Company Accounting Oversight Board.\textsuperscript{39}

The principal regulation governing proxy disclosure with respect to director elections, Exchange Act Schedule 14A,\textsuperscript{40} provides for disclosure of intricate detail as to officer and director compensation (base and incentive), security holdings (direct, option and restricted), retirement benefits (qualified and non-qualified), perquisites such as company-provided home security, financial planning, club memberships, vehicles and aircraft use and some comparison of company performance to those in its industry "peer group." However, it is far from clear that any of this provides any substantial insight into the nature or quality of anyone's business decision-making.

E. \textit{Emphasis by reviewing courts and commentators on director conduct regarding merger and acquisition and other major corporate transactions, instead of operating decisions in the "ordinary course of business"}\textsuperscript{41}

There is extensive jurisprudence around the duties of boards when their firm is "in play." In the wake of \textit{Smith}, the Delaware courts developed intricate rules governing what their duty of care dictates directors may, must and must not do to avoid a hostile takeover,\textsuperscript{42} when some change of control is inevitable,\textsuperscript{43} maximize

\begin{itemize}
  \item \textsuperscript{39}Id. The Sarbanes-Oxley Act was enacted in 2002 in response to major corporate scandals early in the last decade—such as Enron, WorldCom and Adelphia—indicating major weaknesses in governance allowing the existence of outright fraud in financial reporting, has a decided emphasis on compensation, disclosure, and procedure with its major provisions requiring additional officer and director signatures on securities law filings, 15 U.S.C. § 7241, documentation of internal controls, 15 U.S.C. § 7262, additional regulation of the public accounting profession and separation of accounting firm auditing and consulting activities, 15 U.S.C. §§ 7212, 7231, allowing recapture of executive pay in the event of certain earnings restatements, 15 U.S.C. § 7242, and prohibitions on corporate loans to their own executives, 15 U.S.C. § 78m. While all of this may be desirable in its own right, it does not attempt to directly influence decision-making, and clearly has not lead to a vast improvement in outcomes. The U.S. Supreme Court granted certiorari to a case addressing the constitutionality of the Public Company Accounting Oversight Board. Free Enterprise Fund v. Public Company Accounting Oversight Board, 537 F.3d 667 (D.C. Cir. 2008), \textit{cert. granted}, 129 S. Ct. 2378 (2009) (No. 08-861).
  \item \textsuperscript{40} 17 C.F.R. § 240.14a-101 (2009). As this article goes to press in February 2010, new SEC rules intended to enhance the value of existing disclosure of management compensation by elaborating on the value of stock option grants were taking effect. Floyd Norris, \textit{A Window Opens on Pay for Bosses}, N.Y. TIMES, January 15, 2010, at B1. These changes are also discussed in the Release, infra note 69.
  \item \textsuperscript{41}Stephen J. Lubben & Alana J. Darnell, \textit{Delaware's Duty of Care}, 31 DEL. J. CORP. L. 589 (2006).
  \item \textsuperscript{42} See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
  \item \textsuperscript{43} See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
\end{itemize}
the price to shareholders,44 and structure a change of control agreement to permit the making of higher bids.45 Additionally, there is a separate federal statute known as the Williams Act46 which also addresses proper conduct by issuers and security holders in connection with public offers to purchase securities, usually in efforts to take over or take private companies, known as "tender offers." While all of these obligations make sense in the merger and acquisitions (M&A) context, they appear to take the focus of boards off of operational matters and cause heightened scrutiny of management primarily with respect to changes of control, when, as we have recently seen, non-M&A matters such as credit underwriting and security investment policy standards can have much greater implications. We need to develop a comparable jurisprudence governing oversight of operational matters.

Complicating the process of applying these rules to facilitate proper governance is the assignment to the plaintiff in cases of this nature of the burden of proof. That is, if one wishes to pursue a private claim against corporate officers or directors for breach of an applicable standard, they must produce some sort of meaningful evidence affirmatively indicating that the breach has occurred before the defendant must produce its own evidence to rebut the claim. As the court in Citigroup noted:

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 the plaintiffs, the party challenging the directors' decision, to rebut this presumption.47

By definition, requiring a party to satisfy a burden of proof tilts the process against them by providing for their adversary to win if neither party is able to present a persuasive case for relief. It is especially significant here where evidence as to the nature of the board's discussions is not publicly available at the inception of a lawsuit, usually not available without costly, time-consuming dis-

44. See Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).
45. See Omnicare v. NCS Healthcare, 818 A.2d 914 (Del. 2003).
47. Citigroup, 964 A.2d at 124 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
covery, and perhaps totally unavailable as a result of attorney-client privilege.48

While all of these standards are useful in the appropriate context,49 the author argues that they are seriously incomplete in our current environment because they do not make anyone directly responsible for an adverse outcome in any context—even one where there are major societal consequences—so long as they “jump through the right hoops” of risk disclosure, impartiality and decisional process. They also have little relevance for “day-to-day” decisions which, while nominally not having the same implications as contemplated securities offerings, divestitures, mergers or acquisitions, can have a comparable financial impact. Witness the decisions by many financial companies to lower their credit underwriting standards, which had such a major role in our economic boom and bust. Such decisions do not fit neatly (or at all) into the major corporate transaction category and may not have even been considered by relevant BODs, and probably were not undertaken at any given time for any one organization. However, the catastrophic impact of these ill-conceived actions is obvious.

The need for improved governance has recently been acknowledged by a blue-ribbon forum of regulators and market participants convened by the Wall Street Journal to consider the “Future of Finance.” The panel includes a task 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.50

IV. WHY DOES THE CURRENT LEGAL REGIMEN NOT ADDRESS OUTCOMES?

A major reason which has been articulated is that it is essential to economic development that we encourage risk-taking and innovation by not imposing liability upon anyone when business risks


49. See infra notes 85-90 and accompanying text; Disney, 907 A.2d at 716.

50. Ken Brown, Too Big to Fail, WALL ST. J., December 14, 2009 at R5 (statement of Ken Costa, Chairman of Lazard International). 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.” Id.
or innovations have adverse results. The concern is that if decision-makers can be embroiled in litigation or suffer personal loss because a business decision turns out poorly in financial terms, they will make or authorize only conservative choices that perpetuate the status quo but do not advance anything for the company or society.

The Delaware Court of Chancery resoundingly affirmed that this is the case in its decision in Citigroup:

The Delaware Supreme Court made clear in Stone that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however this obligation does not eviscerate the core protections of the business judgment rule—protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one...

Other related reasons for this deference to the decisions of management and BODs include a desire to avoid discouraging qualified persons from serving in these capacities and a lack of judicial expertise for the intelligent consideration, let alone second guessing, of such matters.

A separate set of considerations, applicable mainly at the federal level, is a long-standing philosophical choice favoring individual, especially investor, freedom, so long as the individuals are properly informed, over governmental dictates as to what is “appropriate” for anyone. Hence, the disclosure-oriented approach of the federal securities laws.

51. Citigroup, 964 A.2d at 125.
52. Disney, 907 A.2d at 750.
53. Citigroup, 964 A.2d at 126 n.58.
54. Richard Jennings and Harold Marsh stated:
The only standard which must be met in the registration of securities is an adequate and accurate disclosure of the material facts concerning the company and the securities it proposes to sell... Assuming proper disclosure, the Commission cannot deny registration or otherwise bar the securities from public sale whether or not the price or other terms of the securities are fair or the issuing company offers reasonable prospects of success. These are factors which the investor must assess for himself in the light of the disclosures provided; and if the facts have been fully and correctly stated, the investor assumes whatever risks may be involved in the purchase of the securities.
V. PENDING REFORM PROPOSALS DO NOT ADDRESS THE UNDERLYING PROBLEM

While there is no shortage of efforts to ultimately obtain better decisions from systemically important players, none of them directly address the matter. For example, the Federal Reserve has sought to address compensation policies for bank employees of every stripe, which it believes encourages excessive risk taking.

Under the proposal, the Fed could reject any compensation policies it believes encourage bank employees—from chief executives, to traders, to loan officers—to take too much risk. Bureaucrats wouldn’t set the pay of individuals, but would review and, if necessary, amend each bank’s salary and bonus policies to make sure they don’t create harmful incentives . . .

Pay is now seen as a factor that could make a firm, and more broadly the financial system as a whole vulnerable to collapse.
New York Attorney General Cuomo shares the belief that regulators can somehow align compensation with the "correct" level of risk: "Cuomo said he wants to ensure that banks are compensating employees in a way that doesn’t encourage excessive risk-taking or endanger taxpayers. ‘Any attempts to better tie compensation to long-term sustainable growth is a good thing in our opinion, as opposed to incentives that promote short-term profits.’"  

The SEC, backed by President Obama, has joined the fray by “proposing amendments to the proxy rules under the Securities Exchange Act of 1934” with respect to reporting companies who “have received financial assistance under the Troubled Asset Relief Program (TARP) to permit a separate shareholder advisory vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the Commission” in the manner contemplated by the TARP legislation. This is an effort to “enhance the compensation and corporate governance disclosures registrants are required to make about their overall compensation policies and their impact on risk taking.”

A U.S. Treasury Fact Sheet entitled, “Ensuring Investors Have a ‘Say on Pay,”’ “in support of a requirement—that there be a non-binding shareholder vote on executive pay for all public companies and not just financial firms, confidently proclaims, “Say on pay will improve directors’ accountability to the owners of the company . . . .” However, studies indicate that there is no empirical evidence to support this statement but that ignorance of pertinent facts pertaining to the particular company or the marketplace is much more of a factor than pay formulae. An illustration of the confusion around the

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61. See supra note 15 and accompanying text; Yermack, supra note 16.
dichotomy between pay and risk is the comment of House Financial Service Committee Chairman Barney Frank on a House bill to facilitate shareholder “say on pay” requirements: “Under this bill, the question of compensation amounts will now be in the hands of shareholders and the question of systemic risk will be in the hands of the government.” If compensation amounts do not influence risk taking, there is no public benefit in regulating such compensation amounts. If they do have such an influence, then both matters should be regulated by the same agency.

A critique of the recent efforts to regulate or determine pay summarizes the fallacy in their rationale:

Q: But what about the argument that systemically important firms shouldn’t be in risky businesses?

A: Instead of saying that a bank should get out of this or that business because one individual has a contract that entitles him to a lot of money, someone should ask whether this business was too risky or not? Is this business the business we really want the bank in? Best I can tell, in most instances, no one in Washington at least asked these questions.

Even better than these questions being asked in Washington, would be for them to be asked in appropriate boardrooms.

Separately, the SEC purports to address BOD accountability by “revisit[ing] whether and how the federal proxy rules may be impeding the ability of shareholders to exercise the fundamental right under state law to nominate and elect members to company boards of directors.” As a result of its concern, shared with others, of “whether boards of directors are truly being held accountable


for the decisions that they make,”64 SEC Chairman Mary Schapiro “has championed the proxy-access proposal in response to the financial crisis, in which critics say corporate boards failed to check out of control risk taking.”65

The SEC’s solution is that “[u]nder the proposed rule [Exchange Act Rule14a-11], certain shareholders would be able to include their nominees for director in the company’s proxy materials unless the shareholders are otherwise prohibited—either by applicable state law or a company’s charter/bylaws—from nominating a candidate for election as a director.”66 In a sharp break with practice, the company would be forced to pay for the inclusion of the dissident slate on the company’s proxy materials, thus encouraging the running of dissident slates.67

This has been described as “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.”68

65. See Lynch, supra note 5.
66. Id.
67. “What’s magical about this is that it costs [the shareholder] no money, you can simply nominate someone on a proxy statement and get the shareholders to vote.” Creating a Bigger Mess? Battle Lines Are Drawn on the Proxy Access Rule (Sept. 2, 2009), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2331 (quoting Wharton School Professor of Legal Studies and Business Ethics Professor William C. Tyson). The same source indicates the minimum holding periods and dollar values which would have to be satisfied for shareholders to include their own slates on company proxy ballots. Id.
68. Jeffrey McCracken & Kara Scannell, Fight Brews as Proxy Access Nears, WALL ST. J., Aug. 26, 2009, at C1 (quoting John Finley, Esq., partner at Simpson, Thatcher and Bartlett). Assuming arguendo that Mr. Finley is correct, this says more about the significance of prior SEC rules to corporate governance than it does about the impact of this change. The same sentiments are expressed in a less elegant manner by Nell Minow, a well-known critic of current corporate governance. Speaking about pay reform she stated: “The only way you’re going to change things is to throw the bums out [referring to corporate directors].” Joe Nocera, Pay Cuts but Little Headway in what Matters Most, N.Y. TIMES, Oct. 23, 2009, http://www.nytimes.com/2009/10/23/business/23nocera.html?_r=1&dbk. The author believes that the preceding headline embodies better analysis than Ms. Minow’s comments. Pay practice is not what matters most; competent performance is. And after the fact removal from office does little to enhance performance in office.

The Citigroup situation is instructive. As noted in the text, the Delaware courts have strongly reiterated the absence of legal accountability for the decisions or inaction that led to its massive losses and government bailout. See supra pp. 42-43. Yet, as this article goes to press, an effort is being made by two labor unions to remove from Citigroup’s board a director who headed its audit and risk management committees at the relevant times. “We’re focused on holding a director accountable whose failure to oversee and manage risk cost taxpayers hundreds of billions of dollars and brought his firm to the brink of collapse” said Daniel Pedrotty the director of the AFL-CIO’s office of investment.” David Enrich, Two Unions Push for Resignation of Armstrong from Citi’s Board, WALL ST. J.,
This is a non sequitur. The ultimate vehicle for enforcing director accountability for bad decisions is to increase their personal exposure as a result of such decision. Removing them from a board while leaving it to shareholders, government, and their successors to deal with the consequences of such bad decision is, at most, embarrassing, and does not align risks and rewards.69

Directors often are compensated with company stock as well as fixed amounts of cash. To the extent that stock is a significant component of their remuneration, all other things being equal, they have every incentive to take risks to maximize the value of their stock. Simply increasing the risk of their being removed from office—in many cases after realizing large financial rewards from their service from stock sales or otherwise—does not eliminate this skewed profile.70

Whatever embarrassment may occur from an after-the-fact removal, the director suffers no financial consequences and there is no direct benefit to shareholders or counterparties from such removal. If the director was too lazy or stupid to recognize the likelihood of impending disaster, it seems doubtful that the threat of

January 19, 2010, at C7. The author simply disagrees that removal at this time constitutes any sort of bona fide accountability when the courts are not permitted to impose any liability.

In any event, as permitted by a recently enacted Delaware law, Del. Gen. Corp.L. § 112, several companies have voluntarily adopted by-laws that provide for such shareholder reimbursement in whole or part. Joann S. Lublin, Fair Fight? Assistance is Offered in Proxies, WALL ST. J., Oct. 26, 2009, at B1.

69. The SEC diluted its message regarding proxy access by adopting in December 2009 “Proxy Disclosure and Solicitation Enhancements” which are intended to enhance the disclosure of the effect on a company’s risk taking of its compensation policy (at all levels):

We are proposing to amend our [compensation discussion and analysis] requirements to broaden their scope to include a new section that will provide information about how the company’s overall compensation policies for employees create incentives that can affect the company’s risk and management of that risk . . . . The proposed amendments would require a company to discuss and analyze its broader compensation policies for employees generally, including non-executive officers, if risks arising from those compensation policies or practices may have a material effect on the company.


70. The risk of removal from their primary position—as opposed to a secondary position as a director—which befell many executives of troubled financial firms such as Bank of America, Washington Mutual, Citigroup, Wachovia, and Merrill Lynch did not seem to dissuade officers from excessive risk taking.
removal once disaster strikes will somehow rectify the laziness or stupidity in time. It also seems to call upon attenuated logic to believe that shareholders will recognize poor performance by directors early enough to prompt them to exercise authority to cause their removal and timely installation of a new board which will insist upon a reversal of the ill-founded management policies before they do serious damage. There is no evidence that the threat of after-the-fact removal causes sufficient oversight to prevent disaster. The limited empirical evidence on the point indicates that there appears to be little connection between audit committee independence prompted by the Sarbanes-Oxley law and avoidance of earnings restatements.71

Whatever one thinks about the merits of the pending proposals for change, they are, at best, an inefficient approach and, at worst, irrelevant. Regulating pay does not address outcomes; at most, it addresses one factor in them, and seems based on the simplistic premise that pay is the only factor prompting risky behavior when there are many such factors.72 Prompting additional disclosure of pay practices and/or nonbinding shareholder votes on them is but one step further removed from addressing outcomes. Making it easier to remove poorly performing directors is only an after-the-fact alternative.

VI. WHY AND WHERE DO WE NEED A CHANGE IN PHILOSOPHY?

For the most part, this author agrees with the rationales for present law and its preservation. Without a doubt we must encourage innovation and individual choice in investments and other matters. We must also encourage qualified people to serve as corporate officers and directors and to take calculated business risks. Any new legal regimen must maintain these incentives to the extent and in the places that they serve their stated purposes.73

71. Anup Agrawal & Sahiba Chadha, Corporate Governance and Accounting Scandals, 48 J.L. & ECON. 371, 375 (2005). While far from conclusive, the studies cited would suggest that even facilitating the election of totally independent directors through shareholder proxy access may not improve outcomes in other contexts.

72. See supra note 15 and accompanying text.

73. It is time to recognize that a "one-size-fits-all" business judgment rule is no longer appropriate. Federal Reserve Chairman Bernanke acknowledged the need for tailoring compensation policy to fit individual circumstances: "For most banking organizations, the use of a single formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to provide at least some employees with incentives to take excessive risks." Solomon, supra note 56. Whatever may be the case for customizing pay plans, there is at least as strong a case for similar action with respect to legal frameworks.
However, the economic meltdown resulted from decisions by a relative handful of firms, which had little or nothing to do with innovation or any other behavior which we wish to encourage, such as technological progress. The author believes that it is time for a judicious change in the rule reiterated in the Citigroup case with respect to entities which are in a position to cause damage to the broader economy as a result of their own missteps.

Immunizing business decisions from after the fact review by courts makes perfect sense when we are talking about new products, increased research and development expenditures to bring them about, refinements of existing products, expansion into new markets, promotional strategies, and the like. We must protect business people in all capacities when they consider and decide upon such matters if the consequences of an ill-founded decision can be expected to be contained within one entity.

This does not require us to protect the sort of reckless (frequently fraudulent) lending and borrowing, incomprehensible securitization, and aggressive, often fraudulent, accounting by very large firms that led to so many corporate implosions and collateral damage during this decade. These practices have nothing to do with encouraging innovation benefiting consumers or anyone else in society, service by qualified people or anything else worth encouraging.

In far too many cases, it appears that all of this went on either without the knowledge of BODs or with their tacit encouragement. For example, with the approval of its BOD, Bank of America in 2007 and 2008 purchased both Countrywide Financial, a leading originator of low quality loans, and Merrill Lynch, a leading purchaser of securities comprised of such loans, long after the dire situations of Countrywide and Merrill had become public.

74. These practices occurred both at the corporate level as balance sheets were loaded with far too much debt, and the individual level as homeowners and buyers obtained sub-prime and Alt-A mortgages based upon no evidence or fraudulent evidence of income, assets or collateral, often in collusion with lenders and brokers.

WaMu and Wachovia, now part of Wells Fargo helped stoke the housing bubble by issuing tens of billions of dollars of so-called option adjustable rate mortgages. Option ARMs, as they are known, were typically made with little or no documentation and allowed borrowers to underpay in early years—at the expense of much higher monthly payments later . . . . When the market turned, these loans began defaulting at a rapid clip, leaving the lender with huge losses.

knowledge. Similarly, with the encouragement of key members of Congress, Fannie Mae and Freddie Mac stepped up their purchases of low quality loans long after their already precarious financial condition had been well documented. At best, actors relied upon the ill-supported judgment of rating agencies, but did not exercise meaningful judgment of their own. We need a standard that encourages critical thinking instead of herd behavior.

What cries out for legal changes to try to prevent such catastrophic outcomes for private firms is the interconnected nature of today's financial world, both within the U.S. and around the world. That is, as we saw all too well during 2008 and early 2009, we can no longer confine the damage from a failed large entity to its own investors, employees, customers, etc. A failure by a "too big to fail" entity reverberates around the world economy through contractual counterparties who may themselves be dragged down if their trading partner defaults and impairs investor and lender confidence, which fouls the gears of commerce and brings to a halt economic activity involving "innocent bystanders." Of course, this requires inordinately costly bailouts and fiscal and monetary stimuli of the sort which were adopted by Congress, the Federal Reserve, and the Bush and Obama administrations in efforts to restart the engines of commerce and prevent total economic collapse and social unrest.

It is simply not possible to confine the effects of poor decision-making within many large firms to those firms and their direct constituencies. We must consider external measures to prevent these problems. Prof. Blinder aptly describes this interconnection, albeit as part of his contention that compensation practice is to blame:

75. See Jones, supra note 11; Wallison, supra note 3.
76. See Blinder, supra note 4. The existence of explicit federal policy encouraging reduction in lending standards by agencies such as Fannie and Freddie to promote homeownership is well documented by Wallison, supra note 3, and subsequently at Peter J. Wallison, The Price for Fannie and Freddie Keeps Going Up, WALL ST. J., December 30, 2009, at A17. "The GSE's had begun buying risky loans in 1993 to meet the 'affordable housing' requirements established under congressional direction by the Department of Housing and Urban Development." Id.
77. "For instance traders who were discouraged from taking big chances with bank capital instead moved into AAA-rated mortgage bonds that turned out to be more dangerous than the ratings implied." Jon Hilsenrath, Plan Aims to Curb Dangerous Risks, WALL ST. J., Oct. 23, 2009, at A4.
78. Costly in terms of both direct costs, interest on debt incurred to finance them, potential inflation, and contractionary effects of higher taxes to finance them.
If the costs of foolish compensation schemes remained bottled up inside firms, they would not be a cause of public policy concern, although shareholders should still worry. But that is plainly not the case. Most of the world’s financial system collapsed after an orgy of irresponsible risk-taking, and the consequences for the real economy have been devastating.\textsuperscript{79}

In doing so, we must be cognizant of the need to distinguish bona fide innovation and business risk-taking, which should still be protected by current standards, from simple reckless or fraudulent behavior, and give the benefit of the doubt to decision-makers when there is genuine room for disagreement as to which is which.

Professor Hal Scott of the Harvard Law School argues persuasively that the extent of interconnectedness is not well known and probably less than commonly believed, but likely to exist outside the traditional financial sector where government’s “regulation” is impossible:

If large losses by institutional investors and other stakeholders are the real reason why we are concerned with interconnectedness and “system 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.\textsuperscript{80}

Since it is BODs which have ultimate responsibility for selecting, overseeing, compensating, and dismissing management, we must assure that there is meaningful oversight by BODs of corporate management of the most interconnected firms at a time when debacles can be averted. The objective of encouraging risk-taking has worked too well in too many very large, interconnected firms.

\textsuperscript{79} Blinder, \textit{supra} note 4.

For firms having the economic significance of Citigroup, the objective of encouraging risk-taking is no longer entirely appropriate and must be tempered by an objective of maintaining stability.

We need a legal regimen which forces directors at systemically important firms to familiarize themselves with what management is doing, and ask the tough questions of management before policies are implemented, to see if the downside risk of those policies is understood (or has been considered at all) and to change course when even an originally well conceived strategy is no longer suitable. Ultimately, we need to force directors to consider on an ongoing basis whether their firms' managements should be in their positions at all, in order to screen out dishonest, reckless or incompetent persons.

VII. PROPOSED LEGAL CHANGES

Despite the notable failures which have caused so much recent dislocation, the existing legal regimen has worked well in most cases, especially outside the financial sector, and been a major factor in America's economic growth over many years since World War II. This author would leave it in place in its entirety for firms which do not have the potential to cause systemic harm as a result of their missteps. The changes contemplated in this article should apply only to the largest firms and those in industries—directly or through affiliates—where their interconnections are greatest.

These changes should be made at state levels, through legislation amending the sections of the corporation codes governing director liability, starting with Delaware and other states of greatest commercial significance, such as New York, California, and Illinois. The implementing legislation should make clear that changes in certificates of incorporation and by-laws may not supersede the statutory changes by providing company exculpation or indemnification for judgments against directors. In the interest of fairness to directors, the changes should apply only to the consideration of actions occurring after the effective date of the legislation.

It must be emphasized that these changes are only a starting point for an essential discussion. Specific transactions, time

81. See discussion infra of Disney where the author argues that cases similar to a controversial case involving adjudicated poor performance by directors should continue to be governed by the current standard and not give rise to BOD liability.
frames, and amounts should be the subject of extensive commentary from all interested parties, so that their impact on genuine entrepreneurial activity is kept to a minimum. The important thing is to begin development of a regimen where there is meaningful accountability at the BOD level for seriously bad decisions in an environment and of a magnitude which are likely to significantly impact the broad economy. The mechanics are much less important than the principle.

VIII. TRIGGERING EVENTS

In particular, the proposed change in standards would apply to any company, public or private, which:

- is subject to operational regulation by an federal agency with jurisdiction over major financial companies (not only banks) such as the FDIC, U.S. Treasury, Federal Reserve or Comptroller of the Currency; or

- has since June 30, 2008, directly, or through an affiliate, received any assistance, whether or not repaid, from any program administered by any agencies, such as TARP or Term Asset Lending Facility; or

- is not regulated as provided above but has had total assets exceeding $50 billion at any time during the preceding eighteen months prior to the date of determination by a court in the action against the BOD, and outstanding “obligations,” broadly defined to include not only direct obligations but also those arising through vehicles such as credit default swaps, other derivative contracts (measured at notional value), special purpose vehicles, or similar arrangements, exceeding $100 billion at any time during the preceding 18 months prior to the date of determination by a court.

As more fully explained below, where an entity meets the preceding criteria, the Citigroup standard will not apply to actions alleging breach of a duty of care by BODs. That is, its officers and

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82. The author concedes that using the date of determination by a court would lead to a flexible standard, where a company would be covered by different sets of rules at different times, but argues that in borderline cases, directors should behave more conservatively.

83. If the special commission suggested by Prof. Scott, see supra page 57, is actually constituted, its findings should also enter into this analysis.
directors would not be entitled to the presumption of the business judgment rule or any similar standard(s) governing review of their decisions on their merits, and compliance with the pronouncements in *Smith v. VanGorkom* would not suffice in any civil action alleging a breach of any duty of care if any of the following events have occurred during the eighteen months preceding the determination date by the court:

- Un-dismissed criminal proceedings have been brought against the entity, any of its affiliates, or its or their executive officers materially involving anything to do with the entity's business;

- Un-dismissed civil legal proceedings involving in excess of $50 million have been brought against the entity, any of its affiliates, or its or their executive officers, if such proceedings involve an element of willfulness, as opposed to "mere" negligence;

- The entity or any of its affiliates has filed bankruptcy or insolvency, or been seized by any regulatory body;

- The entity or any of its affiliates has received any extraordinary governmental assistance because of its financial condition;

- The entity or any of its affiliates has, during the preceding thirty-six months, cumulatively written down their assets, taken charges, or established reserves, or been subject to transactions reflected on their audited financial statements having a similar effect, in an amount exceeding the greater of $5 billion or 2% of its total assets;

- The entity or any of its affiliates has been subject to charges reflected on their audited financial statements reflecting acquisition-related goodwill impairment in an

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84. Only an adjudicated dismissal on the merits would count for this purpose; a stipulated dismissal pursuant to a settlement would not be considered a dismissal.

85. FDIC insurance and Federal Reserve discount window borrowing and open market transactions would be disregarded for this purpose.

86. Write-downs of the sort taken by Washington Mutual, Wachovia, Countrywide and National City following their acquisitions—$29 billion, $56 billion, $40 billion and $9 billion, respectively—are indicative of the situations this subsection is intended to cover. Peter Eavis, *Silent Treatment on Bank Write-downs*, WALL ST. J., Sept. 21, 2009, at C10.
amount exceeding the greater of $5 billion or 2% of its total assets.87

In order to mitigate the impact upon directors of potentially "stale" claims based upon old events where access to potentially exculpatory evidence may be difficult, claims under this new standard would be subject to a short statute of limitations, such as eighteen months after a claim arises.

IX. LEGAL IMPACT

Where the foregoing criteria are met, the burden of proof in any action against directors based upon a breach of their duty of care88 would shift to the directors who would be required to respond to any well pleaded complaint, prior to the presentation of any evidence by the plaintiff, with credible affirmative evidence allowing the court89 to determine that a reasonable trier of fact would be more likely than not to find that they have met their relevant obligations.90

If the court does not make such a determination, a verdict would be directed for plaintiffs, with a damages phase to proceed in accordance with current practice, but subject to a cap of $5-10 million per individual defendant. If the court does make such determination, then the burden of proof would shift back to the plaintiff with further proceedings in accordance with present practice, and the plaintiff would be responsible for all of defendants' legal and other fees in connection with the initial phase of the litigation.

87. One could credibly argue that large operating losses should be added to this list as it is a board's job to supervise management such that "good" performance is delivered. However, the author rejects this view on the basis that operating performance—at least in the short term—is a function of so many variables that are beyond the reasonable control of boards (e.g. world and national economic circumstances), that it would be unfair to hold boards directly responsible. Similarly, legitimate entrepreneurial activity by definition may give rise to large losses, but as noted, supra, we should not seek to deter such activity. This would mean, inter alia, that write-downs or write-offs of research and development costs, or the taking of reserves or provisions in the ordinary course of business (up to some dollar or percentage threshold), would not trigger any of the special rules described herein.

88. No change is proposed in any action alleging a breach of a duty of loyalty, or with respect to the standards governing advance of litigation expenses.

89. Perhaps, after expedited discovery.

90. Goldman Sachs has recently added such a standard to its stock-based pay plan for senior directors with management responsibility: "[T]he [stock] holding period includes a stronger provisions to allow Goldman to take back the shares in cases where the employee failed to properly account for risk." Joe Bel Bruno, Goldman Sachs Top Execs Get No 2009 Cash Bonus, WALL ST. J., Dec. 10, 2009), http://online.wsj.com/article/BT-CO-20091210-713039.html.
In order to maximize directors’ oversight efforts where they are needed, claims under this new standard could not be waived in a firm’s certificate of incorporation under provisions such as Section 102(b)(7) of the Delaware General Corporation Law. However, they could be covered by officer/director insurance policies procured by the firm, so long as such policies have a high deductible payable by the covered individuals (such as $1 million), one half of the premiums are paid by the directors, and procurement of such insurance is approved in advance by shareholders holding at least 60% of the firm’s voting equity.

It must be noted that this standard does not make directors strictly liable for adverse outcomes under any circumstances. No matter how dire the result, they may still escape liability by affirmatively demonstrating that they have properly overseen management. Without a doubt, this change would cause additional recovery from directors of affected firms, at least for a time, until the additional exposure caused an increase in vigilance and a reduction in risk taking. The use of the damage cap, short statute of limitations, liability of unsuccessful plaintiffs for defendants’ legal fees, and the limited authorization of director and officer insurance coverage are efforts to mitigate any excessive risk aversion which may result from this new standard and thereby avoid a lending contraction.

In considering whether this is socially desirable, it is essential to understand where it would not apply. It would not apply to firms which, although large in absolute terms, do not present high levels of systemic exposure. The fairly recent Disney case is a good illustration of where this author believes that present law need not be changed. This case involved a claim by Disney shareholders against former officers and directors alleging that the directors’ actions of entering into and performing an employment agreement and severance contract with a senior executive, Michael Ovitz, constituted, inter alia, a breach of their duty of care.

Making such a claim superficially appealing is the fact that Mr. Ovitz 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 his tenure. The court found in favor of the defendants with respect to all claims, especially the ones involving the duty of care, despite its disdain for the manner in which the

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91. *Disney*, 907 A.2d at 716.
situation was handled. The court applied the business judgment rule, with its strong presumption in favor of director action\textsuperscript{92} to make clear that so long as directors are properly informed and act in good faith, the “content of the board decision” is not subject to review, even if it is deemed to be “stupid,” “egregious,” or “irrational.”\textsuperscript{93} This led the court to determine that while the conduct of the directors in the consideration of these matters fell far short of “best practices,” it did not breach the duty of care.\textsuperscript{94}

In distinguishing this case from \textit{Smith v. Van Gorkom}, the court emphasized that the one involved a sale of the entire company, while the other did not,\textsuperscript{95} bolstering the concern that current corporate law to the extent it requires director oversight at all, is addressed much more to M&A situations than to “day to day” matters which can have even greater implications.

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 to Mr. Ovitz 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 fall-out of the sort we saw in 2008. Disney did not have the kinds of financial connections to other entities through derivative securities and the like that magnified the effect of the poor management in the financial sector and related firms. Indeed, when news of the Ovitz fiasco became public in 1997, there were no macroeconomic ramifications. Even for Disney, while a nine figure amount is certainly material, the financial effect was fleeting and did not bring down the company or give rise to any possibility or speculation that this could happen. Contrast this with the massive economic dislocation brought about by the consequences of the bad risks taken by Citigroup and others like it who are governed by the same business judgment rule. The rule that makes good sense in the \textit{Disney} context is not appropriate in the \textit{Citigroup} context. It is time to recognize that our complex, interdependent economy requires a greater tailoring of legal rules to reflect unique industry circumstances than the economy of ten or twenty years ago.

\textsuperscript{92} Id. at 746-47.
\textsuperscript{93} Id. at 750.
\textsuperscript{94} Id. at 697. “[M]any aspects of defendants’ conduct . . . fell significantly short of the best practices of ideal corporate governance.” Id.
\textsuperscript{95} Id. at 767.
This suggests that for most firms, even very large firms, the traditional business judgment rule, which has clearly contributed to much desirable entrepreneurial activity, is still justified. This is especially the case today, where job creation is a key social priority, such that we want to encourage business risk-taking where the consequences of such risks can be confined to the firm taking them. As the Disney court noted:

The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based upon the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value.96

While this approach of disregarding outcomes for all firms made perfect sense in 2005 and for the most part still makes sense today, what we have learned about the interconnections of some firms requires some modification. We simply cannot allow every firm to engage in unrestrained risk-taking, with only the marketplace to sit in judgment, when bad outcomes of such risk-taking have such widespread collateral damage to persons who were in no position to evaluate (let alone mitigate) the significance to them of such risk-taking as is the case with persons investing directly in a firm pursuing aggressive practices.

A good deal of deliberation is required before any change of this magnitude is implemented anywhere, in order to minimize any unwarranted contraction of financing or other business activity. There is no doubt that the initial reaction in many corporate boardrooms will be an emphasis on conservatism in lending, investing and hiring decisions. Former Federal Reserve Board Chairman and current Obama Administration advisor Paul Volcker advocates a significant reduction in the risks assumed by commercial banks in order to maintain the stability of the financial system: “Extensive participation in the impersonal, transaction oriented capital market does not seem to me an intrinsic part of commercial banking.”97 The comments reflect Mr. Volcker’s long held view that banks should act more in line with their tradi-

96. Disney, 907 A.2d at 698.
tional role and not take extremely risky gambles, which could threaten the viability of commercial banks and expose the Federal Reserve and taxpayers to large risks. It may be politically impossible and perhaps economically premature to implement these sorts of draconian restraints suggested by Mr. Volcker on the activities of banks or other large firms. Even if this is true, it still militates in favor of much greater oversight of the trading activity which does occur.

One would expect any tendency toward excessive risk aversion to be fairly promptly mitigated as a result of natural competition for profitable business opportunities and the realization that the changes are applicable to only a relatively small portion of firms. Furthermore, one would also expect the legal changes to prompt an increased emphasis on diversification of risks to reduce the likelihood of problems from one “bad bet.”

Given the author’s belief that any unintended risk aversion would be temporary, he believes that it is well worth it in order to substantially reduce the likelihood of a handful of firms bringing us to (or beyond) the brink of ruin as a result of their unbridled risk taking. We have reached a point in our economic development where we need to revisit our premise that risk is always desirable in itself, and strive for standards which directly encourage private entities, especially those with the highest level of interconnection to the rest of the economy, to properly evaluate risks. Rather than dance around the issue with mechanisms which at best indirectly affect the appetite for risk such as regulating compensation or identity of directors, it is more logical to address directly risk-taking by imposing some consequences when such risks turn out to be ill-founded. While the specific parameters of those consequences should be the subject of much discussion among the bench, bar, and commentators before any change is made, it is clear that we must have a fundamental re-examination of the business judgment rule in order to shield our economy from what it has wrought when indiscriminately applied.

While the action proposed in this article may seem drastic, so too are the economic circumstances which prompted its consideration. As Lewis Carroll’s Walrus has said, the time has come to talk of many things—even those which seemed unspeakable in another era.

98. Id.