

ASPEN PUBLISHERS

ELECTIVE SERIES



Corporate Governance

PRINCIPLES AND PRACTICES

■ WALTER A. EFFROSS



Wolters Kluwer

Law & Business

ASPEN PUBLISHERS

**CORPORATE
GOVERNANCE:
PRINCIPLES AND
PRACTICES**

Walter A. Effross

Professor of Law

American University

Washington College of Law



Wolters Kluwer

Law & Business

AUSTIN BOSTON CHICAGO NEW YORK THE NETHERLANDS

© 2010 Aspen Publishers. All Rights Reserved.
<http://lawschool.aspenpublishers.com>

No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission in writing from the publisher. Requests for permission to make copies of any part of this publication should be mailed to:

Aspen Publishers
Attn: Permissions Department
76 Ninth Avenue, 7th Floor
New York, NY 10011-5201

To contact Customer Care, e-mail customer.care@aspenpublishers.com, call 1-800-234-1660, fax 1-800-901-9075, or mail correspondence to:

Aspen Publishers
Attn: Order Department
PO Box 990
Frederick, MD 21705

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

ISBN 978-0-7355-7731-2

Library of Congress Cataloging-in-Publication Data

Effross, Walter, 1963-

Corporate governance : principles and practices / Walter Effross.
p. cm.

Includes index.

ISBN 978-0-7355-7731-2 (perfectbound)

1. Corporate governance—Law and legislation—United States. I. Title.

KF1422.E38 2010

346.73'0664—dc22

2009049422

This book contains paper from well-managed forests to SFI standards.

About Wolters Kluwer Law & Business

Wolters Kluwer Law & Business is a leading provider of research information and workflow solutions in key specialty areas. The strengths of the individual brands of Aspen Publishers, CCH, Kluwer Law International and Loislaw are aligned within Wolters Kluwer Law & Business to provide comprehensive, in-depth solutions and expert-authored content for the legal, professional and education markets.

CCH was founded in 1913 and has served more than four generations of business professionals and their clients. The CCH products in the Wolters Kluwer Law & Business group are highly regarded electronic and print resources for legal, securities, antitrust and trade regulation, government contracting, banking, pension, payroll, employment and labor, and healthcare reimbursement and compliance professionals.

Aspen Publishers is a leading information provider for attorneys, business professionals and law students. Written by preeminent authorities, Aspen products offer analytical and practical information in a range of specialty practice areas from securities law and intellectual property to mergers and acquisitions and pension/benefits. Aspen's trusted legal education resources provide professors and students with high-quality, up-to-date and effective resources for successful instruction and study in all areas of the law.

Kluwer Law International supplies the global business community with comprehensive English-language international legal information. Legal practitioners, corporate counsel and business executives around the world rely on the Kluwer Law International journals, loose-leaves, books and electronic products for authoritative information in many areas of international legal practice.

Loislaw is a premier provider of digitized legal content to small law firm practitioners of various specializations. Loislaw provides attorneys with the ability to quickly and efficiently find the necessary legal information they need, when and where they need it, by facilitating access to primary law as well as state-specific law, records, forms and treatises.

Wolters Kluwer Law & Business, a unit of Wolters Kluwer, is headquartered in New York and Riverwoods, Illinois. Wolters Kluwer is a leading multinational publisher and information services company.

*To my parents,
Drs. Harris and Susi Effross*

PREFACE: PREPARATIONS AND PERSPECTIVES

As the first casebook devoted specifically to corporate governance, this book suggests responses to unresolved issues in addition to reviewing current law and practice.¹ Although their analyses are not intended or offered as legal advice, the chapters are designed for immediate practical consideration not only by law school² and business school³ classes, but also by boards of directors, individual directors and officers, shareholders, and their counsel.

In order, the chapters: introduce competing theories of corporate governance (Chapter 1); analyze the directors' and officers' fiduciary duties of care (2) and loyalty (3); examine the types of shareholders (4) and the shareholders' power to nominate and elect directors (5); review the corporation's methods and philosophies of determining executive compensation (6) and of engaging in corporate social responsibility initiatives (7); address the professional ethics responsibilities of counsel (8); identify issues in comparative (international) corporate governance (9); and, finally, inquire whether any governance mechanisms can be shown conclusively to enhance the financial performance of corporations (10).

The myriad rules of corporate governance are themselves constantly evolving. New federal and state statutes, regulations, and court decisions are issued, and prior ones amended; stock exchange listing requirements are updated; and industry groups, activist investors, and other commentators generate and revise lists of "best practices." Meanwhile, corporate scandals and financial crises focus public sentiment against, and legislators' attention on, new types of perceived abuses.

1. The discussions in the chapters reflect developments through July 31, 2009.

2. See Jenna L. LaRoche, *Corporate Governance Is "Hot Topic" for Law School Courses*, BNA Corp. Gov. Rpt., July 7, 2008, p. 80.

3. See Michael Jacobs, *How Business Schools Have Failed Business*, Wall St. J., April 27, 2009, p.A13 (noting, as a business school professor, that '[b]y failing to teach the principles of corporate governance, our business schools have failed our students.')

The resulting requirements, regulations, and recommendations sometimes overlap, often remain ambiguous, and regularly invite courts to assess the reasonableness and fairness of a director's or officer's conduct.

In helping clients safely navigate through these complexities and uncertainties, lawyers must continually anticipate problems that could arise, and determine how they might be prevented or resolved. Counsel for corporations, boards, directors, officers, or shareholders thus practice what Secret Service agents call, in a much different context, "situational awareness": that is, "thinking of the many things that could go wrong, and what you would do if one of those things happened."⁴

Beyond educating their clients about existing rules, lawyers can recommend everyday practices to forestall emergencies. For example, just as marathoners are advised to avoid dehydration by drinking frequently in the early miles of their races (even when they are not yet thirsty),⁵ so can a board of directors be urged to develop and regularly review policies concerning such areas as executive compensation and conflicts of interest.

Counsel can also, well in advance, prepare strategies and tactics to be deployed in crises, rather than conducting a frenzy of initial research in the midst of such a situation. As one chess columnist recently warned his readers, "[s]erious players must master basic endgames. . . . Figuring them out during a game is difficult, if not impossible."⁶

In suggesting forward-looking measures of both kinds, *Corporate Governance: Principles and Practices* combines the features and functions of a casebook, a sourcebook, and a workbook. The text explains the concepts and major elements of the relevant laws, often including excerpts from court decisions⁷ and references to recent news reports and elements of popular culture. The footnotes and appendices indicate resources for further research; and several chapters supply draft documents (such as board minutes, committee charters, or bylaw provisions) for consideration, adaptation, and revision.

However, some readers might find the book most useful for its questions, which generally identify practical operational concerns: for example, "[s]hould a corporation adopt a policy that no directors take their own personal notes at board and/or committee meetings—or that if they do take notes, those notes should be destroyed before the directors leave the meeting room?"⁸ These should be productive topics for a lawyer to discuss with clients,

4. Christopher Falkenberg, *Frequent Flier: Always Mindful of Finding the Nearest Exit*, N.Y. Times, Sept. 8, 2009, p. B6.

5. Gordon Block, *How to Train for and Run Your Best Marathon* 146-147 (1993) (recommending, "[d]o not wait until you are thirsty before you drink. By then it is too late, and you will have a tough time 'making up' the volume of water you have lost through perspiration.").

6. Dylan Loeb McClain, *They're No Fun to Learn, But Endgames Lead to Wins*, N.Y. Times, Sept. 13, 2009, p. 34 (adding, "Studying endgames are [sic] the chess equivalent of eating your vegetables. Part of what makes it a chore is there is no guarantee the knowledge will ever be useful.")

7. Excerpts from commentary and caselaw do not always indicate the removal of footnotes or citations.

8. Section 2.02(C)(2), Question 17.

especially since they are not usually addressed by standard corporate forms and “menus” of drafting options.⁹

Yet many of these questions, unlike their counterparts in mathematics and science textbooks, have no precise and definitive answer to be provided “in the back of the book.” Instead, whether, when, and how to address the issues they raise could vary in practice, according to the nature of the client and of its particular situation. Moreover, a client’s response might range from postponing consideration of an issue, to developing a checklist of substantive and procedural factors for creating a future policy, to quickly formulating and adopting specific corporate rules.

Among the perspectives¹⁰ from which practitioners and executives might approach the chapters’ questions are the following:

- (1) Historical: how has this issue generally been addressed?
- (2) Positive/Descriptive: how are corporations currently resolving the issue posed? What factors do they take into account in choosing procedures and/or rules to follow?
- (3) International/Comparative: how are corporations in other countries dealing with the issue?
- (4) Empirical: what percentages of which types of corporations have resolved the issue by each of the methods so far adopted? How, if at all, can such resolutions be correlated with a change in the market value of a corporation’s stock, and/or with other objective indicators of the firm’s performance?
- (5) Normative/Prescriptive: how *should* the issue be resolved, and what social and legal policies justify that resolution?
- (6) Document Drafting: what language could be added to (or revised in) an existing corporate document to resolve the issue? If a new corporate document should be created to address the matter, what type of document should it be, and what should it provide?
- (7) Legislative/Regulatory Drafting: should this issue be addressed by legislation—and if so, by state rather than federal legislation? How should any such legislation be worded? Should it be enabling (that is, allowing corporations the option of adopting a certain practice), or mandatory (requiring that practice)?
- (8) Judicial/Litigation Drafting: have courts deciding this issue agreed with each other? Have their opinions left practical elements of the issue vague or unresolved? In litigation of this issue, what language should counsel urge courts to adopt in their decisions?
- (9) To what degree should the law and culture of corporate governance extend beyond discouraging directors and officers from abusive practices (by exposing them to personal civil and/or criminal liability) to

9. Cf. Stacy Conradt, *10 Secret Menu Items at Fast Food Restaurants*, Sept. 28, 2009, available at cnn.com/2009/LIVING/wayoflife/09/28/mf.10.secret.menu.items/index.html?iref=newssearch (identifying such unadvertised items as the “short” size of Starbucks coffee and unpublicized policies as Chipotle’s, which “says that if they have the [test] item available, they will make it for you.”)

10. See also Appendix A (suggesting approaches for identifying, and preparing seminar papers or law review articles analyzing, topics in corporate governance).

encourage them to engage in “best practices”? For instance, one leading corporate court has stated that “Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices.”¹¹ Where are the lines between abusive, appropriate, and aspirational practices for directors and officers, and how clearly should they be drawn? When, why, and how should a lawyer recommend that a client pursue “best practices” rather than those that are legal but merely average or acceptable?

- (10) Ethical- what concerns of professional responsibility and malpractice does the resolution of the issue raise for the lawyer?

Almost half a century ago, a leading commentator reviewed the extraordinary degree of flexibility permitted management by corporate statutes, and mourned that

corporation law, as a field of intellectual effort, is dead in the United States. When American law ceased to take the “corporation” seriously, the entire body of law that had been built upon that intellectual construct slowly perforated and rotted away. We have nothing left but our great empty corporation statutes—towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.¹²

Many provisions of modern corporate statutes remain flexible, enabling, and permissive rather than rigid, mandatory, and restrictive. Yet for the reasons discussed in the following chapters, today’s corporate law professors and practitioners find significant areas of the legal architecture being redeveloped and refurbished, and less wind-swept than ever.

This book attempts to provide some maps and tools for creating secure spaces within these construction zones, and for maximizing corporations’ and their participants’ potentials, plans, and progress.

11. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 697-98 (Del.Ch. 2005).

12. Bayless Manning, *The Shareholder’s Appraisal Right: An Essay for Frank Coker*, 72 Yale L.J. 223, 245 n.37 (1962).

ACKNOWLEDGMENTS

I thank Dean Claudio Grossman of the American University Washington College of Law for his continuous support, for summer research grants, and for funding of research assistance. This book also benefited from my conversations with, and the advice and insights of, my colleague Egon Guttman.

No document request was too small, too large, or too obscure for the Pence Law Library's Associate Dean Billie Jo Kaufman and Inter-library Loan Manager Y. Renee Talley-Cutbert, and especially for Deputy Director Adeen Postar.

For their gracious, prompt, and painstaking administrative assistance I could always rely on Rosalena Thompson and support services manager Elma Gates.

From the inception of this project I appreciated the encouragement of Nancy Rapoport of the William S. Boyd School of Law.

John Devins, my editor at Aspen, was consistently helpful throughout.

I am grateful to William G. Bowen for permission to reprint passages from *The Board Book* (2008).

At Harvard Law School, Dean Robert Clark, Lucian Bebchuk, and Reinier Kraakman introduced me to many of the dimensions and attractions of studying, writing about, and practicing corporate law. I hope that I have similarly inspired students in my own classes in Business Associations and in Advanced Corporate Law: Corporate Governance.

For their valuable research assistance, I thank Colleen Bailey O'Boyle, Thomas Berger, Clelia Castro-Malaspina, Alexander Coleman, Bethany Dickman, Shaunte Hurley, Deanna Remmes, Peter Salzler, and David Santoro.

Any errors, of course, remain my own.

SUMMARY OF CONTENTS

<i>Contents</i>	<i>xi</i>
<i>Preface: Preparations and Perspectives</i>	<i>xxiii</i>
<i>Acknowledgments</i>	<i>xxvii</i>
1 THE DEFINING DYNAMICS OF CORPORATE GOVERNANCE: PURPOSES AND PRIORITIES	1
2 THE BOARD'S POWERS AND PROCESSES (I): DUTY OF DUE CARE – PREPARATIONS AND PRECAUTIONS	27
3 THE BOARD'S POWERS AND PROCESSES (II): DUTY OF LOYALTY – PREDISPOSITIONS AND PRECLUSIONS	87
4 THE ROLE OF SHAREHOLDERS: PROXIES AND PROPOSALS	161
5 NOMINATING, ELECTING, AND REMOVING DIRECTORS: PREREQUISITES AND PERFORMANCES	275
6 COMPENSATING DIRECTORS AND OFFICERS APPROPRIATELY: PAYMENTS AND PERQUISITES	329
7 CORPORATE SOCIAL RESPONSIBILITY: PROFIT-MAXIMIZING VS. PHILANTHROPY	397

8	SPECIAL CONSIDERATIONS OF LEGAL ETHICS: PROFESSIONALISM AND PRIVILEGE	435
9	COMPARATIVE CORPORATE GOVERNANCE: PATHWAYS AND POSSIBILITIES	477
10	DOES GOOD CORPORATE GOVERNANCE PAY?: PREDICTIONS AND PROOFS	495
APPENDICES		
A	SUGGESTED APPROACHES AND THEMES FOR PAPERS ON CORPORATE GOVERNANCE	501
B	A SHAREHOLDER'S MENU OF CORPORATE GOVERNANCE PROPOSALS/PREFERENCES	507
C	RECOMMENDED RESOURCES FOR CORPORATE GOVERNANCE RESEARCH	513
	<i>Table of Cases</i>	519
	<i>Index</i>	525

CONTENTS

<i>Preface: Preparations and Perspectives</i>	<i>xxiii</i>
<i>Acknowledgments</i>	<i>xxvii</i>
1 THE DEFINING DYNAMICS OF CORPORATE GOVERNANCE: PURPOSES AND PRIORITIES	1
1.01 INTRODUCTION	1
1.02 SIX TRIADS	4
1.03 THE SEPARATION OF OWNERSHIP FROM CONTROL	6
1.04 THE NEXUS OF CONTRACTS MODEL	8
1.05 THE DIRECTOR PRIMACY MODEL	10
1.06 TRADITIONAL VS. MODERN ROLES OF DIRECTORS	12
1.07 WHOSE INTERESTS SHOULD DIRECTORS SERVE?	14
1.07(A) The Berle-Dodd Debate	14
1.07(B) The Shareholder Primacy Model	16
1.07(C) The Communitarian Model	19
1.07(D) The Team Production Model	19
1.08 THE GENESIS AND INTERACTION OF PRACTICES, RULES, STATUTES, AND REGULATIONS	22

1.09	BEYOND RULES: ASSIMILATING AND INTERNALIZING CORPORATE GOVERNANCE VALUES	24
2	<i>THE BOARD'S POWERS AND PROCESSES (I): DUTY OF DUE CARE – PREPARATIONS AND PRECAUTIONS</i>	27
2.01	THE RATIONALITY REQUIREMENT	32
2.02	THE REQUIREMENT OF BEING APPROPRIATELY INFORMED	33
2.02(A)	The Duty to Attend Meetings	33
2.02(B)	The Duty to Know Basic Background Information About the Corporation and About Directors' Responsibilities	37
2.02(C)	The Duty to Inquire	38
2.02(C)(1)	The <i>Van Gorkom</i> Decision	39
2.02(C)(2)	The Delaware Supreme Court's <i>Disney</i> Decision	45
2.02(C)(3)	(Re) Drafting Exercise: Minutes of Directors' Meeting	57
2.02(D)	The Duty to Monitor the Corporation's Activities and Performance	58
2.02(D)(1)	The <i>Caremark</i> Decision	58
2.02(D)(2)	The <i>McCall</i> and <i>Abbott Laboratories</i> Decisions	61
2.02(D)(3)	The Delaware Supreme Court's <i>Disney</i> Decision	63
2.02(D)(4)	The <i>Stone</i> Decision	65
2.02(D)(5)	Other Requirements of, and for, Compliance Programs	83
2.02(D)(5)(a)	The Sarbanes- Oxley Act	83
2.02(D)(5)(b)	The Federal Sentencing Guidelines	84
3	<i>THE BOARD'S POWERS AND PROCESSES (II): DUTY OF LOYALTY – PREDISPOSITIONS AND PRECLUSIONS</i>	87
3.01	DISTINGUISHING NON-INTERESTED FROM INDEPENDENT	89
3.02	IDENTIFYING AND RESOLVING CONFLICTS OF INTEREST: STATE CORPORATE LAW	91

3.02(A)	Interested Director (or Officer) Transactions	91
3.02(B)	Board Responses to Potential Changes of Control	93
3.02(B)(1)	Conflict of Interest and the Duty of Loyalty	93
3.02(B)(2)	Good Faith Component of the Duty of Loyalty	95
3.03	RELATED PARTY TRANSACTIONS: SEC REGULATION S-K	97
3.04	IDENTIFYING INDEPENDENT DIRECTORS: THE EXCHANGES' LISTING REQUIREMENTS	99
3.05	MEETING IN EXECUTIVE SESSION; "LEAD DIRECTORS" OR "PRESIDING DIRECTORS"	105
3.06	COMPROMISED INDEPENDENCE, AND THE SPECIAL PROBLEM OF "STRUCTURAL BIAS"	109
3.07	ELEMENTS OF THE DUTY OF LOYALTY: DISCRETION IN WORD — AND IN DEED?	118
3.07(A)	Leakers: The Duty Not to Reveal Details of Board Deliberations	118
3.07(B)	Muddiers: The Duty Not to Dissent Publicly from the Board's Position	120
3.07(B)(1)	The ACLU Situation (2006)	121
3.07(B)(2)	The Dartmouth Situation (2007)	122
3.07(C)	Stainers: A Duty Not to Embarrass the Corporation?	125
3.07(C)(1)	The "One-Name" Situation	128
3.07(C)(2)	The "Imus" Situation.	128
3.08	COMMITTEES OF THE BOARD	132
3.08(A)	The Audit Committee	132
3.08(A)(1)	Composition	134
3.08(A)(2)	Operation	138
3.08(A)(3)	Sample Document: Audit Committee Charter	141
3.08(B)	The Executive Committee	146
3.08(B)(1)	Sample Document: Executive Committee Charter	146
3.09	FIDUCIARY DUTIES OF CARE AND LOYALTY IN INSOLVENCY OR NEAR-INSOLVENCY SITUATIONS	150
3.09(A)	"Zone of Insolvency"	150
3.09(B)	"Deepening Insolvency"	154

3.10	EMERGING CONCERNS ABOUT “HONEST SERVICES” LIABILITY OF DIRECTORS AND OFFICERS	156
3.11	QUESTIONS ON CONTRACTUALLY SPECIFYING FIDUCIARY DUTIES OF CARE AND LOYALTY	158
4	<i>THE ROLE OF SHAREHOLDERS: PROXIES AND PROPOSALS</i>	161
4.01	CORPORATIONS AS DEMOCRACIES?	163
4.02	TYPES OF SHAREHOLDERS	165
4.02(A)	Different Dividend/Liquidation Rights: Preferred Shareholders	165
4.02(A)(1)	Venture Capitalists as Preferred Shareholders	169
4.02(B)	Different Voting Rights: Common Stock	172
4.02(B)(1)	“Supervoting” Common Stock	173
4.02(B)(2)	Common Stock With Restricted Voting Rights	174
4.02(B)(3)	Regulatory, Judicial, and Exchange Responses	175
4.02(C)	Controlling Shareholders Holding Common Stock	176
4.02(D)	Institutional Investors Holding Common Stock	178
4.02(D)(1)	Pension Funds	179
4.02(D)(1)(a)	Relational Investing	187
4.02(D)(2)	Mutual Funds	190
4.02(D)(3)	Hedge Funds	193
4.02(D)(4)	Private Equity Funds	197
4.02(D)(5)	Sovereign Wealth Funds	198
4.02(D)(6)	Banks as Shareholders	201
4.02(D)(7)	Influences on Institutional Shareholders: Proxy Advisory Firms and Governance Ratings Agencies	201
4.02(D)(8)	Shareholder Advisory Committees	203
4.02(D)(9)	The Private Securities Litigation Reform Act of 1995 (PSL RA)	207
4.02(D)(10)	The Federal Government as Shareholder (2008-)	211
4.02(E)	Divorcing Voting from Ownership of Shares	213

	4.02(E)(1)	Vote-Buying Agreements	213
	4.02(E)(2)	“Empty Voting” Arrangements	219
4.03	THE INTERESTS OF (NON-SHAREHOLDER) CREDITORS: LENDERS AND BONDHOLDERS		222
	4.03(A)	Credit Rating Agencies and Corporate Governance	226
	4.03(B)	“Vulture Investors”/“Distressed Debt Investors”	227
4.04	SHAREHOLDER ACCESS TO DOCUMENTS AND EXECUTIVES		228
	4.04(A)	Access to Books and Records	228
	4.04(B)	Access to Directors	232
4.05	SHAREHOLDER MEETINGS AND FORUMS		235
	4.05(A)	Meetings of Shareholders	235
	4.05(A)(1)	Annual Meetings of Shareholders	235
	4.05(A)(2)	Special Meetings of the Shareholders	241
	4.05(A)(3)	Shareholder Meetings in Chapter 11 Reorganizations	242
	4.05(B)	Virtual Meetings of Shareholders	245
	4.05(C)	Electronic Shareholder Forums	246
4.06	PROXIES		248
4.07	SHAREHOLDER PROPOSALS		252
	4.07(A)	Methods of Disseminating Proposals	252
	4.07(A)(1)	Management’s Proxy Statement, or Proponent’s Own Mailing	252
	4.07(A)(2)	Direct Announcement by Proponent at Annual Meeting	253
	4.07(B)	Submitting Proposals; Grounds for Exclusion	256
	4.07(B)(1)	Improper Under State Law	258
	4.07(B)(2)	Violation of State Law	259
	4.07(B)(3)	Violation of Proxy Rules	259
	4.07(B)(4)	Personal Grievance; Special Interest	259
	4.07(B)(5)	Relevance	260
	4.07(B)(6)	Absence of Power or Authority	261
	4.07(B)(7)	Management Functions	262
	4.07(B)(7)(a)	The <i>Roosevelt</i> Decision	263
	4.07(B)(7)(b)	The <i>Cracker Barrel</i> Saga	264