Corporate Governance

Corporate Governance
Cases and Materials

SECOND EDITION

J. Robert Brown, Jr.
Lisa L. Casey

Carolina Academic Press
Durham, North Carolina

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ISBN 978-1-5221-0097-3
E-Book ISBN 978-1-5221-0099-7
LCCN 2016944757

Carolina Academic Press, LLC
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
www.cap-press.com

Printed in the United States of America

To the Brown and Lee children and grandchildren,
Tessa, Beth, Ryan, Josh, Zoey, and Emerson,
all unique and astounding in their own right.
JRB

To Mom and Dad, my first and most important teachers:
you formed both my heart and my mind;
To Sean, Caitlin, Jillian and Kristen: you bring me such joy; and
To Brian: there simply are no words adequate to express my love and appreciation.
LLC

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Preface

A textbook on corporate governance is a particularly daunting thing to write. Like all textbooks, it must provide an overview of an area of law in a manner that is sufficiently accessible to the faculty member teaching the class and to the students who are trying to understand the area. Corporate governance, however, is a particularly challenging topic to develop in a casebook for two reasons.

First, the area involves a complicated regulatory construct, a byproduct not of reason but path dependency. Governance practices may emanate from the federal government, particularly the Securities and Exchange Commission, state government, with Delaware the predominate player, and the stock exchanges, self-regulatory organizations that are for-profit companies with regulatory responsibilities. Each regulator has a different philosophical approach and works to promote its own policy objectives. Moreover, enforcement mechanisms vary. For example, private enforcement is a significant enforcement tool under the federal securities laws but not under the rules of the stock exchanges.

At the same time, the regulatory construct has been in a state of considerable flux. Historically, matters were neatly divided between the SEC and the states. With its creation in 1934, the SEC was assigned the task of regulating corporate disclosure, particularly financial disclosure, while states continued to regulate the substantive standards of corporate governance. But in response to various corporate scandals and crises—most significantly, after the collapse of Enron and WorldCom in 2001 and 2002—the post-Depression division of authority shifted.

In passing the Sarbanes-Oxley Act in 2002, Congress gave the SEC more extensive authority over the substance of corporate governance, particularly with respect to board structure. Congress continued this trend toward federalization by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. Dodd-Frank, among other things, clarified the SEC's authority to allow shareholders to include their nominees for the board in the company's proxy statement and gave to the agency greater authority to define director independence.

Second, corporate governance law has become extraordinarily dynamic. For a time, the area was somewhat sleepy. Public companies were run by their executive officers with occasional intervention by boards of directors. Boards consisted mostly of company employees or other persons with financial connections to the company. Shareholders were mostly passive. To the extent investors became unhappy with man-

agement, their only real option was to exercise their rights under the Wall Street Rule; they sold their shares and exited from the company.

Much, however, has changed. Institutional investors now own about two-thirds of the outstanding shares in U.S. public companies. With the increased domination of institutional shareholders, and increased concentration of public company stock in the portfolios of the largest institutions, has come increased shareholder involvement. Shareholders have sought a greater role in corporate governance. Among other things, Congress and the SEC provided shareholders with more say in the election of directors and an advisory vote on executive compensation. At the same time, shareholders have resorted to private action for other reforms including majority vote requirements for directors and greater access to the company's proxy statement for their nominees.

Likewise, corporate boards have undergone significant structural changes. Director independence has emerged as the accepted method of reducing agency costs by management. As a result, insiders (with the exception of the CEO) have been all but eliminated from public company boards. The role of outside directors as monitors of management has been strengthened. For example, federal law requires that independent directors on the audit committee of public companies, rather than the CEO, have the authority to hire and fire the corporation's independent accountants.

The other development has been the growing involvement of public interest in the evolution of the governance process. At one time, governance was largely a matter between owners and managers. That is no longer the case. The public has taken an interest in the rulemaking efforts of the SEC. When the SEC proposed a rule seeking to require companies to disclose the ratio between the compensation paid to the median employee and the CEO, over 280,000 comment letters were received. Likewise a petition for rulemaking that sought the mandatory disclosure of political contributions garnered over a million comments. Likewise, Congress has begun to impose disclosure requirements that are aimed at the public rather than shareholders.

In Dodd-Frank, for example, Congress mandated rules that required companies to disclose their use of "conflict minerals," a requirement that had little to do with profit maximization and everything to do with publicizing corporate acquisition of minerals used to facilitate violence in parts of Africa. The mere fact that Congress has, in Sarbanes-Oxley and Dodd-Frank, chosen to intervene into the governance process suggests that reforms will increasingly be determined more by the interests of voters rather than the interests of owners and managers. This promises to add significant uncertainty to the evolutionary process.

This textbook attempts to illuminate and accommodate both the complicated regulatory framework and the dynamic nature of corporate governance law. Chapters typically cover all three areas of regulation—federal, state, and SRO. We examine corporate governance as positive law, but we also include normative and even empirical perspectives on the doctrine. We have incorporated discussions on new developments and evolving practices, often in the comments and questions following each section.

Nonetheless, this area of law, by definition, represents a complex balance that we, as authors, have attempted to depict, and that you, the faculty and students using the textbook, will discover during the pedagogical process.

Because we have written this book as a teaching tool, we have edited the cases and other materials heavily to aid in the text's readability. Citations and footnotes usually have been omitted, mostly without indication. Although this second edition does not include a separate statutory supplement, we have included, in the text, excerpts of the key statutes and regulations, and, of course, complete copies of the relevant laws and rules are readily accessible on the internet.

We would be remiss not to mention a number of people who have helped us with this textbook. Steven E. Baum did a yeoman's job in acquiring the copyright approvals, of which there were many. Sana Hamelin, JP Thibeault, Susan Beblavi, and Samual Hagreen had the unenviable task of reading chapters and eliminating the errors that can creep into a manuscript this size. They performed at the highest level. Robert Hutchison, Andrew Smith, Catherine Zung, and librarian Warren Rees contributed their excellent research skills to this project over many months, and Robert, Catherine, and Andrew also assisted with the often tedious task of editing cases and the like. Suzie Vervynckt graciously helped with formatting the text. We are grateful for all of their contributions … and their good humor!

We look forward to your comments and suggestions.

J. Robert Brown, Jr.
Lisa L. Casey
June 15, 2016