SIDLEY AUSTIN BROWN & WOOD LLP
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# THE CONTINUING EVOLUTION OF CORPORATE GOVERNANCE IN THE UNITED STATES

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# "CORPORATE GOVERNANCE" DEFINED

The basic framework for (i) how decisions are made by or within a corporation and (ii) how non-owner decision-makers are selected and held accountable.

# IDEAS, FORCES AND EVENTS THAT HAVE SHAPED U.S. CORPORATE GOVERNANCE

- Multiple Components of a Complex System
- Basic Thesis
  - U.S. corporate governance has been shaped over time by many ideas, forces and events. U.S. corporate governance is a continuous work-in-process.
- Corollary
  - Not all incremental changes are ultimately appropriate or fit well within the existing framework.

# IDEAS, FORCES AND EVENTS THAT HAVE SHAPED U.S. CORPORATE GOVERNANCE (CONT'D.)

- Five Items of Special Potency in Shaping U.S. Corporate Governance
  - Resolution of Question "For Whose Benefit is a Corporation Operated?"
  - Prevalence of the Widely-Held, U.S. Corporation
  - Rise of the Institutional Investor
  - Merger and Takeover Case Law of 1980s
  - Cycle of Scandal and Reform

# RESOLUTION OF QUESTION "FOR WHOSE BENEFIT IS A CORPORATION OPERATED?"

- Long-Standing Debate
- Alternative Views
  - Broader Societal
  - Narrower Capitalistic
- Importance of the Answer
  - Form follows function.
- Resolution
  - The Narrower Capitalistic view has prevailed.
  - "Other constituencies" statutes.
  - There are many, many rules specifically directed at the protection of other constituencies

# PREVALENCE OF THE WIDELY-HELD, U.S. CORPORATION

- Populism
- Liquidity v. Control
- Supply and Demand
- Results
  - Separation of ownership and control
  - Ubiquity of equity ownership makes corporate governance a political issue

# RISE OF INSTITUTIONAL INVESTORS

- Increase in Gross Investment
- Increase in Activism
  - Department of Labor
  - Institutional Shareholder Services (ISS)
  - Index funds
  - Political agenda
- Tools of Activism
  - Public relations
  - Withheld votes and shareholders proposals
  - Proxy contests
  - Litigation

# MERGER AND TAKEOVER CASE LAW BEGINNING IN THE 1980S

- Pivotal issue of corporate governance: Who gets to decide on a sale of the corporation?
- Summary of the law:
  - Directors Responsibility.
  - Director Authority.
  - Shareholder Recourse.
- Broader implications of these cases:
  - Clearly Established Boards as the Dominant Decision-Making Body.
  - Application to Non-M&A Decisions.
  - Director Protections.
  - Institutional Shareholder Reaction to Director Authority.

# CYCLE OF SCANDAL AND REFORM

- Prominent past examples
  - “Crash” of 1929 —1933 and 1934 Securities Laws
  - Bad corporate citizenship in 1970s —Environmental Protection Act; Foreign Corrupt Practices Act; ERISA
  - Concerns about Executive Compensation in 1990s — Increased use of stock options

# CYCLE OF SCANDAL AND REFORM (CONT'D.)

- Recent past/current events — reactions to accounting scandals (Enron, etc.)
    - Sarbanes-Oxley Act of 2002
        - Response to failures of all of the ”watch-dogs”
        - Essentially emergency legislation
        - Principal provisions
        - Did not address stock options
        - Federalization of corporate law
    - Stock exchange rule changes
    - Energized and further empowered prosecutors
    - Judicial revisiting of director protections
- Privately-held corporations and not-for-profit corporations

# PROMINENT FEATURES OF U.S. CORPORATE GOVERNANCE TODAY

- A Board of Directors that is —
  - Independent
  - Non-executive chairman or a “lead director”
  - Executive session
  - Erosions of legal protections
  - Working harder than ever before
- A Chief Executive Officer who is —
  - Less powerful
  - Anxious

# PROMINENT FEATURES OF U.S. CORPORATE GOVERNANCE TODAY (CONT'D.)

- Institutional shareholders that are —
  - Pretty satisfied
  - Still pressing
- Smaller U.S. companies that —
  - Wonder whether the benefits of being public outweigh the costs
- Non-U.S. companies that —
  - Wonder why they should list in the U.S.

# FLAWS IN THE SYSTEM

- Excessively complex due to multiple sources of rules
- Occasional failures of institutional investors to wield their power responsibly
- Risk of “checklist governance”
- Temptation to allow high performing companies to be less rigorous about good governance
- Fallacy of expecting good governance to yield good business performance
- Very significant costs associated with new compliance regime
- Potential that obsession with compliance and fear of liability will impede appropriate risk-taking and innovation