

THE NEW “PUBLIC” CORPORATION

HILLARY A. SALE*

I

INTRODUCTION

This “review” of the Model Business Corporation Act (MBCA) comes at an important time, at least for the purposes of reflection.¹ The United States has experienced a financial crisis, a market crash, and a shift in the perception of America’s place in the global economy. By the time this issue goes to print, new financial reform legislation will increase the role of the government in the so-called private-law world of corporations. That legislation will press further on our conception of what the rights and responsibilities of “public corporations” actually are and will push us to reconceive the definitions of public corporations and corporate governance.

This article explores that issue—the definition of public corporation and its impact on corporate governance, using the MBCA’s definition as a starting point. Rather than accepting the definition of public corporations as those that are traded in markets, this article argues that, when viewed in light of the ways in which society’s views of corporations have changed, that definition is impoverished. Public corporations are not just creatures of Wall Street. They are creatures of Main Street, the media, bloggers, Congress, and the government. Indeed, the article argues, it is the failure of the fiduciaries of public corporations to understand their “publicness” that accounts for many of the recent scandals.

In 2005, the MBCA was amended to include changes responsive to the scandals involving Enron and other companies. One of the changes was to define the term public corporation and to set forth oversight responsibilities for directors of those corporations. Yet, the recent financial crisis makes clear that the directors and officers of public corporations have not internalized Enron’s lessons.² The failure of officers and directors to govern in a sufficiently public

Copyright © 2011 by Hillary A. Sale.

This article is also available at <http://www.law.duke.edu/journals/lcp>.

* Walter D. Coles Professor of Law and Professor of Management, Washington University School of Law. I would like to thank Jay Greathouse and Rebekah Raber for research assistance and Laura Rosenbury, Bob Thompson, Peter Wiedenbeck, and members of the Washington University School of Law for their workshop comments.

1. The MBCA is a “free-standing general corporation statute that can be enacted substantially in its entirety by a state legislature.” MODEL BUS. CORP. ACT, intro. at ix (2008).

2. The 2008 financial crisis also revealed that the officers and directors of the banks have much to learn about what it means to govern a public corporation. *See, e.g.*, Editorial, *What Is Goldman Hiding?*, N.Y. TIMES, June 8, 2010, at A26 (criticizing Goldman Sachs’s lack of cooperation with

manner has resulted not only in scandals, but also in more public scrutiny of their decisions, powers, and duties. To regain control, they need to understand that the definition of public, and the theory of corporate governance, have transformed. The space between the statutory definition of public corporation and the public's view of those corporations has grown. Corporate governance no longer simply delineates a relationship between officers, directors, and shareholders operating in the private-law sphere. Instead, this article posits that the government and the media have increasing influence over public corporations and their governance, and the private sphere is diminishing. The result is a theory of the corporation that operates in a public sphere—public in a different way—with changing obligations and an evolving, not a fixed, definition. The result is also a need for change in the way that officers and directors understand and do their jobs.

II

STATUTORY DEFINITION OF “PUBLIC CORPORATION”

Consider the statutory definition of public corporation. The MBCA defines the term to be “a corporation that has shares listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national securities association.”³ This definition ties public status to trading markets. The reference comes from the federal regulation of securities trading markets.⁴ Thus, the MBCA definition draws the line between public and private in accord with federal regulation and by reference to Wall Street.

The line is interesting. It tells us that public corporations are creatures of both federal and state regulation.⁵ The latter is important, but its governance influence is shrinking relative to the former. Federal regulation is growing substantially, and the line between the two is becoming blurred. Further, because federal laws and regulations are particularly influenced by politics, society, and media, the conception of the public corporation is changing. The result is that corporations operate in a public way, but in ways that have little to do with being traded on Wall Street.

Of course, acknowledging that federal regulation is growing begs the question: Why? There are multiple answers, some political, some legal. In part, the answer is that corporate officers and directors are not doing their jobs. They have failed to understand the force of public scrutiny and have, thereby, failed their corporations. They are not being good public company stewards.⁶ To get it

Congress and advocating increased punishment for noncompliance); Gretchen Morgenson & Louise Story, *Clients Worried About Goldman's Dueling Goals*, N.Y. TIMES, May 19, 2010, at A1 (detailing alleged conflicts of interests with customers).

3. MODEL BUS. CORP. ACT § 1.40(18A) (2008).

4. *Id.* § 1.40 cmt. at 6.1.

5. They are also creatures of international law and markets, but that is a topic for another article.

6. Some blame the state laws and the courts interpreting them. For example, Delaware has long been thought to be the dominant state in corporate law. It has a specialized judiciary and bar, handling

right, directors and officers who govern public corporations must reconceptualize their role, with an eye to a definition of public corporation that is not based on Wall Street, but that is instead based on an understanding of the growing presence of Main Street.

III

GROWTH IN PUBLIC GOVERNANCE OF CORPORATIONS

The statutory definition of public corporation, then, is only a starting point. It begins with the growing realm of federal law and securities regulation, but requires attention to public scrutiny. Scrutiny is growing because industry failed to govern itself. Indeed, industry will not (and, it appears, cannot) govern itself. The result is growth in government governance, both in response to scandals and incrementally over time.⁷

Consider some examples of government governance: the forced merger between Bank of America and Merrill Lynch; the terms for the bailout of General Motors, requiring the ouster of its chief executive; the instructions to Chrysler to partner with Fiat; the caps on pay in banks receiving bailouts.⁸ These are examples of quid pro quo government governance that was responsive to public scrutiny and pressure.

How about British Petroleum (BP)? The oil gusher in the Gulf created an environmental and economic disaster. The result is a further reconception of

cases expeditiously. Randy J. Holland, *Delaware's Business Courts: Litigation Leadership*, 34 J. CORP. L. 771, 778 (2009) (noting the average time from submission to decision by the Delaware Supreme Court was 37.8 days in 2007); see DELAWARE SUPREME COURT INTERNAL OPERATING PROCEDURES ch. II, § (2) (2008) (cases must be decided within ninety days after oral arguments or submission of the briefs).

The Chamber of Commerce survey ranks the Delaware Courts as the best in the country from the perspective of business. Inst. for Legal Reform, *Lawsuit Climate 2008* (Apr. 23, 2008), at 15 (ranking Delaware as the best overall state liability system from 2003–2008); but see Theodore Eisenberg, *U.S. Chamber of Commerce Liability Survey: Inaccurate, Unfair, and Bad for Business*, 6 J. EMPIRICAL LEGAL STUD. 969 (2009) (arguing that the U.S. Chamber of Commerce Liability Surveys are substantially inaccurate and methodologically flawed).

Lately, however, more cases challenging Delaware corporations are being filed in states other than Delaware. See John Armour, Bernard S. Black & Brian R. Cheffins, *Is Delaware Losing Its Cases?* (European Corp. Governance Inst., Working Paper No. 151/2010, 2010), available at <http://ssrn.com/abstract=1578404> (indicating proportion of corporate suits involving Delaware public companies filed in Delaware has dropped markedly). Presumably, lawyers do not believe they can succeed in Delaware because the judiciary is too pro-business. Whether that is true is for another issue. What matters for the MBCA is that it not be perceived as drawing lines that make it too difficult for shareholders to appeal to the judiciary.

7. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 904 (2003) (noting that, as the federal disclosure obligations have increased, they resemble the duty-of-care obligations that were the province of state law); see also Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 635 (2003) (“[a]bsent a constitutional bar to federal involvement in corporate affairs, the federal government can determine, has determined, and will determine many critical elements of corporate governance” at the expense of historical state control).

8. Sheryl Gay Stolberg & Bill Vlasic, *U.S. Moving to Overhaul Ailing Auto Industry*, N.Y. TIMES, Mar. 30, 2009, at A1.

the terms public corporation and corporate governance. Despite BP's repeated assertions that it would compensate those harmed and clean up the Gulf, the public demanded government involvement. The result was two major "corporate" decisions. The first was the compensation fund: "\$20 billion . . . that [BP] will have no voice in allocating."⁹

The second, suspending dividend payments,¹⁰ is particularly interesting from the private–public corporate law perspective. Typically, corporate fiduciaries decide whether and when to pay dividends, with minimal scrutiny or intervention. Yet, in the case of BP, pressure from members of Congress, the media, and the government resulted in the suspension of the payments. BP is learning, painfully, what it means to govern subject to Main Street. When scrutiny develops, the government takes action to save corporations from the failures of their management.¹¹

Other scandals have also prompted public scrutiny and government governance. Accountants, investment bankers, and lawyers were the gatekeepers who were supposed to prevent the Enron scandal, yet each group figured in it.¹² Legislation and regulation for those groups and others followed. Stock-options backdating is a governance scandal born of conflicts and greed. The result was scrutiny and government governance with actions by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). The 2008–2009 financial crisis is bringing another wave of federal law and regulation. The result is pressure on the line between the corporation as an entity in the private-law sphere, delineated by reference to markets, and the corporation as a public entity, defined by scrutiny and governed by government, Main Street, the media, and politicians.¹³ Changes in the law follow the scrutiny and, then, our understanding of corporate governance in public corporations begins to change.

This shift in the theory of corporate governance, however, is not just about the law. Law provides a definition—a delineation—between corporations traded in markets and those not so traded. But the law created the public–private distinction to begin with and, in so doing, gave weight to the private.¹⁴ The shift is occurring with scandals and scrutiny. It is occurring because the

9. *Id.*

10. Press Release, British Petroleum, BP Establishes \$20 Billion Claims Fund for Deepwater Horizon Spill and Outlines Dividend Decisions (June 16, 2010), *available at* <http://www.bp.com/genericarticle.do?categoryId=2012968&contentID=7062966>.

11. David E. Sanger, *Strong Steps or Oversteps?*, N.Y. TIMES, June 18, 2010, at A1. (“[T]he only way to save [GM] from its own worst instincts was to become its temporary owner and bring new blood into the boardroom.”).

12. Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 144–45 (2004); *see also* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 403–11 (2004) (discussing gate-keeping failures in the Enron context).

13. *See* Thompson & Sale, *supra* note 7.

14. *See* JEAN L. COHEN & ANDREW ARATO, CIVIL SOCIETY AND POLITICAL THEORY 352 (1992) (“[T]he private . . . ‘spheres’ have always been constituted and regulated by law, even if what is constituted includes a domain of autonomous judgment that can come into conflict with law.”).

public and shareholders have pushed for it. Why? Because corporate fiduciaries failed to understand their publicness. The result is pressure on the conception of the terms, public corporation and corporate governance. The traditional view of corporate governance as solely about the relationship between directors, officers, and shareholders—establishing the balance of power between the groups that owned and ran corporations—is giving way to a more textured, substantive, and public view of governance, a form of “publicness,” defined by scrutiny and government.¹⁵

IV

IMPLICATIONS OF THE NEW “PUBLICNESS”

The evolution is dramatic in times of scandal and incremental over time. Consider the smaller form of a corporation, a close corporation. In a close corporation, shareholder, officer, and director groups converge. Family members own, manage, and direct their own entities. As corporations grow, the groups grow and so do their responsibilities. When they choose to become public corporations, they become subject to multiple regimes. Then, when scandals occur, public focus on what they are doing and the corporate governance system grows.

The result is public pressure and, then, government in governance. Theoretically, state law, which is very hands-off and delegates to the private actors, is the domain of corporate governance; federal law regulates only how the internal corporate actors communicate with the shareholders.¹⁶ This line has always been only a construct.¹⁷ Deference to the private was a choice, but the choices are changing. The theoretical and actual balances of power have shifted. The federal government, through the SEC and, indirectly, the DOJ, occupies more of the governance space.¹⁸ That space is becoming increasingly susceptible to public pressure. In short, once a company is legally public, its publicness makes a difference first, in how it is regulated, and second, in what is expected from it.

15. Thompson & Sale, *supra* note 7, at 864.

16. *See supra* note 7 and accompanying text.

17. *Cf.* MARTHA MINOW, MAKING ALL THE DIFFERENCE: INCLUSION, EXCLUSION, AND AMERICAN LAW 277 (1990) (“Tracing the presence of state power in the family sphere, historically described as removed from the state, suggests something powerful about boundaries: both sides of a boundary are regulated, even if the line was supposed to distinguish the regulated from the unregulated.”).

18. Most recently, the SEC proposed changes to Rule 14a-11 (describing a proxy access proposal), Rule 14a-8 (allowing shareholder amendment of bylaws to adopt election procedures), Item 401 of Reg. S-K (requiring additional background disclosure about directors and nominated directors), Item 407 of Reg. S-K (requiring descriptions of a company’s leadership structure), and Item 402 of Reg. S-K (requiring enhanced compensation disclosures).

This topic—the space and governance of public companies—is increasingly important.¹⁹ The recent financial crisis has brought the publicness and impact of corporations to the forefront of people’s minds. The loss of jobs, the credit crunch, and the fear of a bank run all were brought on, in part, by public corporations. They were failures of regulators and the regulated: a failure of the government to regulate and a failure of industry to self-regulate.²⁰ It is a failure of both the private and the public sector to understand publicness and the existence of a public governance space.

Industry admits its failure. John Mack, the chief executive officer (CEO) of Morgan Stanley, told Congress, “We can’t control ourselves.”²¹ Mack did not say, however, that the banks pressured the SEC to let them self-regulate their capital ratios.²² Nor did he admit that they did not do so. Instead, risk-taking spiraled out of control in search of profits and compensation. The result was leverage at shocking levels—a significant factor in the crisis.²³ Now there is increased pressure for the government to occupy the governance space.²⁴ This pressure for government in governance is due to the corporations’ failure to recognize their own publicness. Their failure prompts scrutiny and pressure from Main Street, on politicians and the government. The response is increased publicness and government in governance.

19. The significance of greater scrutiny for public companies was addressed in 1932. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 7 (rev. ed. 1991) (“New responsibilities toward the owners, the workers, the consumers and the State thus rest upon the shoulders of those in control.”); see Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 *LAW & CONTEMP. PROBS.* 109, 129 (Autumn 2004) (tracing the increase in federal regulation designed to shape the “corporate manager’s decision matrix”).

20. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 *VA. L. REV.* 707, 711 (2009) (noting that deregulation and overconfidence in the self-correcting market may have fueled the growth of risky behavior).

21. *Morgan Stanley’s Mack: “We Cannot Control Ourselves,”* N.Y. TIMES ONLINE (Nov. 19, 2009), <http://dealbook.blogs.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves/> (quoting John J. Mack as stating “[r]egulators have to be much more involved”).

22. Coffee & Sale, *supra* note 20, at 737–38 (stating that the five main investment banks, including J.P. Morgan and Goldman Sachs, led the charge to exempt brokerage units from capital-ratio limitations).

23. In conjunction with high concentrations of assets in subprime mortgages and real estate assets, firms were left “exposed and vulnerable.” *Id.* at 737.

24. Paul Volcker, the former Federal Reserve chairman, advocated bank regulation as a key part of financial reform. See, e.g., Paul Krugman, *Financial Reform 101*, N.Y. TIMES, Apr. 2, 2010, at A23 (arguing the merits of Volcker’s argument for breaking “too big to fail” financial institutions); Sewell Chan, *Congress Is Pressed To Complete Reform Bill*, N.Y. TIMES, June 7, 2010, at A1 (noting the banks’ lobbying efforts to avoid legislation that would impose bans on proprietary trading and on their ability to make market bets with their own money).

The pressure for government intervention is not new.²⁵ Nor is the banks' failure to recognize their publicness.²⁶ Consider the realm of disclosure regulation, an early form of government governance. Public corporations are subject to significant amounts of federal disclosure regulation, a system with roots in the market crash and Great Depression.²⁷ Back then, the private banks were also subject to public scrutiny. The Pecora Commission put considerable pressure on banking leaders.²⁸ The banks made the mistake of assuming that their private books were outside the public purview of the politicians. They argued that Congress lacked jurisdiction over them because they were private companies.²⁹ Congress rejected their claim, and the Senate passed a resolution requiring the Morgan bank to make its private books public, and left its leader “terrified.”³⁰

Today, the SEC requires disclosure of considerable information about policies, choices, and processes.³¹ The regulations have been growing steadily and are not solely about disclosure. Instead, the regulations are about the power of disclosure to force substance.³² The theory of this information-forcing-substance regime is that companies will create systems and policies in order to fill in all of the regulatory disclosure blanks and answer the questions posed.³³ In short, officers and directors do not want to report that they do not have a system in place if the SEC has deemed reporting on that system to be important.

25. After the 1929 market crash and Great Depression, Congress initiated hearings before the Senate Committee on Banking and Currency (the Pecora Commission) to investigate the banking industry. FERDINAND PECORA, *WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS* 89 (1968) (“A bank was supposed to occupy a fiduciary relationship and to protect its clients, not to lead them into dubious ventures; to offer sound, conservative financial advice, not a salesman’s puffing patter. But the introduction and growth of the investment affiliate had corrupted the very heart of these old-fashioned banking ethics.”); see also Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1175–76 (2004) (stating that these hearings revealed financial institution abuses, early corporate governance scandals (for example, executive compensation and dividend declarations), and shareholder abuses—setting the stage for unprecedented financial reform).

26. Senators accused the banks of taking large bonuses during profitable years and denying responsibility during losses. Bank, *supra* note 25, at 1175; see Pecora, *supra* note 25, at 130 (“[H]ad there been full disclosure of what was being done in furtherance of these schemes, they could not have long survived the fierce light of publicity and criticism. Legal chicanery and beneficent darkness were the banker’s stoutest allies.”).

27. Bank, *supra* note 25.

28. *When Washington Took On Wall Street*, VANITY FAIR, June 2010, at 156 (stating that J.P. Morgan, Jr. “was terrified” about having to testify before the Pecora Commission).

29. *Id.* at 158.

30. *Id.* at 156–58.

31. See, e.g., ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* 12 (AEI Press 2002) (describing the classic justifications for securities disclosure—that firms bearing the cost of disclosing the information cannot appropriate all the benefits, and that the capital markets fail to protect investors from fraud).

32. Thompson & Sale, *supra* note 7, at 872–74 (describing information-forcing-substance nature of federal disclosure requirements).

33. Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1376 (2006).

This information-forcing-substance tool ties to the difference in the conception of corporate governance in today's world. Governance is not just about relationships between officers, directors, and shareholders. Public companies operate in a public sphere, making public disclosures on a regular basis. The SEC dictates what, when, why, and how much they must say. Corporations are also subject to media and blogging. So is the SEC. These factors combine to increase expectations about the SEC's role and pressure for the SEC to do something when things go wrong. That pressure shifts to corporations, their public disclosures, and their governance choices.

The expectations grow over time and change our understanding about public companies and their governance. For example, as reporting requirements grow and technology increases, information becomes more accessible, digestible, and analyzable. Media, employees, politicians, and everyday people demand more. In turn, corporate publicness grows. Then, our understanding of their governance shifts. Rather than being about the relationship, governance is now about substance. It is about compensation, risk, and choices.³⁴ It is about shareholders demanding a different say in how corporations are run,³⁵ but it is also about what the public, the politicians, and the media think.

For the directors and officers who govern public corporations, this concept of publicness provides powerful lessons. As an initial matter, they must learn to govern publicly. They must internalize what it means to be public in the broader sense this article develops. Take executive compensation as an example. It is an area traditionally occupied by state law and subject to minimal scrutiny. Compensation, however, is now a focus of attention.³⁶ Congress has been examining it and the ways in which it might have played a role in the meltdown. The public is also paying attention. Why?

Set wisely, compensation can encourage healthy risk-taking and help facilitate growth.³⁷ Improperly calibrated compensation, however, can lead to

34. Thompson & Sale, *supra* note 7, at 874–75; Sale, *supra* note 33.

35. LUCIAN ARYE BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* ix–x (2006) (arguing current executive compensation agreements are flawed due to influence of executives over boards and urging shareholder approval of executive compensation). *See also* Julie Creswell, *Does Icahn Still Make Them Tremble?*, N.Y. TIMES, Mar. 21, 2010, at BU1 (indicating shareholders “terroriz[e] corporate chiefs and battl[e] entrenched boards” to get on a board and then push for quick change).

36. *See* Erin White, *Theory & Practice: Investors Start to Make Their Voices Heard on Pay*, WALL ST. J., May 10, 2010, available at <http://online.wsj.com/article/SB10001424052748704173804575232702668870386.html?KEYWORDS=Investors+Start+to+Make+Their+Voices+Heard+on+Pay> (pointing to investor responses to “say on pay” practices at Motorola Inc. and Occidental Petroleum Corp. as a recent shift in focus on compensation); David Segal, *Wall St., a Financial Epithet, Stirs Outrage and Punch Lines*, N.Y. TIMES, Feb. 3, 2009, at A1 (noting public outcries against investment bankers’ compensation and bonuses). Some corporations have adopted proposals to allow shareholders to vote on executive pay as a means of “foster[ing] investor trust.” *See, e.g., Microsoft to Let Investors Give Input on Pay*, WASH. POST, Sept. 19, 2009, at A11.

37. *See, e.g.,* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures*, 3 J. FIN. ECON. 3 (1976) (arguing that compensation can reduce agency costs that arise from the modern corporation’s separation of ownership and control).

inappropriate risk-taking. Indeed, it contributed to the 2008 financial crisis.³⁸ Compensation has played a role in multiple scandals. For example, Enron sorted investment banks into tiers based on their willingness to do deals.³⁹ Highly ranked banks got the lucrative business. To get the ranking, however, they had to do lesser deals—some of which had little business purpose other than moving money around. Why did the banks agree? Compensation.⁴⁰ What was the result? Deals with little substance and excessive risk.⁴¹

Stock-options backdating was all about compensation.⁴² Options were backdated to ensure profitability. Yet, the purported reason for the options was to provide an incentive for officers and directors to take calculated risks. Options that start and remain in the money provide no such incentive. Instead, options backdating provided no incentives or, worse, the wrong ones.⁴³ In some cases, the directors and officers approving it presumably breached their fiduciary duties.⁴⁴

Compensation used to be the domain of directors, officers, and state law, not the federal government and Main Street. Directors and officers were presumed able to make the decisions in accord with their fiduciary duties. When the state-law fiduciaries (and courts) failed to manage compensation, the federal government intervened. For example, the “clawback” provision in the Sarbanes-Oxley Act forces CEOs and chief financial officers to repay incentive-based compensation in light of a later financial restatement tied to misconduct.⁴⁵ Directors had the power to demand this disgorgement, but the federal government stepped in. Sarbanes-Oxley also precludes loans to officers in corporations in which loans are not a regular part of business.⁴⁶ Such loans used to be subject to conflicting-interest approval.⁴⁷ Government now occupies that

38. Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, 22 J. APPLIED CORP. FIN. 60 (2010) (positing that earnings management and officer interaction with analysts is partly responsible for current accounting manipulation crisis); see also Sale, *supra* note 12, at 152 (noting compensation and stock price as motivating factors for future cash flow manipulation).

39. Sale, *supra* note 12, at 144–45.

40. *Id.*

41. *Id.*; see also Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1131–32 (2003) (arguing that inadequate compensation disclosure of Enron managers hampered the market).

42. *Ryan v. Gifford*, 918 A.2d 341, 354–55 (Del. Ch. 2007) (finding that backdating creates a windfall for officers and directors).

43. Fuller & Jensen, *supra* note 38.

44. See, e.g., *Ryan*, 918 A.2d at 356 (finding allegations “so egregious” that business judgment rule did not apply and a “substantial likelihood” of director liability existed).

45. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745, 778 (codified at 15 U.S.C. § 7243) (Supp. III 2003) [hereinafter Sarbanes-Oxley Act]; see also *SEC v. Jenkins*, No. CV 09-1510-PHX-GMS, 2010 WL 2347020 (D. Ariz. June 9, 2010) (finding issuer misconduct, as opposed to individual misconduct, suffices to trigger clawback).

46. Sarbanes-Oxley Act § 402, amending Section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(k) (2002).

47. MODEL BUS. CORP. ACT ANN. § 8.01 cmt. at 8-14 (2008) (defining a “conflicting interest transaction” as a “transaction effected or proposed to be effected by the corporation . . . respecting

space. The lesson is that, in a world of public corporations, it is unrealistic for boards and officers to think that they can set compensation without something more than a nod to the public.⁴⁸ Compensation is subject to public scrutiny and provides a salient example of the growing area of public governance.

The recent crisis reinforces this lesson. The crisis was, in part, brought about by a public governance failure. Bad compensation practices are symptoms of bad governance.⁴⁹ Compensation is tied to risk and can result in bad decisions, bad strategy, and fraud.⁵⁰ Boards that are not paying attention to compensation are weak boards and will be scrutinized publicly. Kenneth Feinberg is doing just that. He is reviewing compensation for “bailed out” banks and has completed a study of compensation paid to the twenty-five highest earners at each such company.⁵¹ Early discussion of the findings reveals at least two problems. First, the pay structures are rarely tied to risk-taking.⁵² Second, the pay structures have not yet changed—despite considerable public attention and pressure.⁵³ The result is more government in the governance space.⁵⁴

Compensation also provides a lens through which to view the incremental growth of regulation and publicness. For many years, the SEC has been active in this area, creating additional information-forcing-substance regulation in the area of executive compensation. Recent changes require public companies to disclose more detail about compensation and its role in decision-making.⁵⁵ They

which, at the relevant time, the director knew that a related person was a party or had a material financial interest”).

48. See, e.g., Editorial, *Taming the Fat Cats*, N.Y. TIMES, Dec. 20, 2009, at WK6 (advocating taxes to punish bankers that rushed to repay federal bailout money in order to avoid compensation constraints).

49. Coffee & Sale, *supra* note 20, at 746–48 (showing that compensation and risk reappeared in the latest financial crisis).

50. Sale, *supra* note 12, at 144–45.

51. Eric Dash, *Fed Finding Status Quo in Bank Pay*, N.Y. TIMES, June 9, 2010, at B1; Paritosh Bansai & Megan Davies, *Pay Czar Sees Signs Wall Street Changing Pay Habit*, REUTERS, Apr. 26, 2010 (quoting Kenneth Feinberg as saying it is “too early to tell” if banks have changed compensation practices, but also referring to banks as “tone deaf” on executive pay); *Geithner Critiques Wall St. Pay*, N.Y. TIMES, Dec. 5, 2009, at B2 (calling for all banks, even those that repaid TARP (Troubled Asset Relief Program), to reduce compensation and tie it to long-term goals).

52. See Eric Dash, *supra* note 51 (citing a Federal Reserve report that the banking industry has not adjusted compensation to reduce risk-taking).

53. *Id.*

54. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951–953, 124 Stat. 1376, 1899–1904 (2010) [hereinafter Dodd-Frank Act] (requiring shareholder vote on executive compensation and “golden parachutes”; prescribing composition of compensation committees; and requiring additional disclosures relating to executive compensation); Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 75 Fed. Reg. 66,590-01 (proposed Oct. 28, 2010) (to be codified at 17 C.F.R. pts. 229, 240, & 249) (regulations pursuant to Dodd-Frank Act relating to shareholder approval compensation and golden parachutes).

55. 17 C.F.R. § 229.402 (2009). First enacted in 2006, the 2009 revisions to the Compensation Discussion and Analysis section included added disclosure for the following: qualifications and experience, multiple directorships, legal proceedings, diversity considerations, leadership structure and rationale, risk-oversight role, results of votes, compensation policies and practices in risk-management context, equity awards and compensation, consultant fees, and conflicts.

must disclose why they chose compensation structures, strategies, and plans—not just amounts.⁵⁶ They must also disclose the risks presented by their compensation formulations.⁵⁷ These are information-forcing-substance regulations. The purpose is to force information and action on the part of boards.⁵⁸

These regulatory changes add to earlier reforms. Those reforms added to others. Over time, the combined regulatory actions produce increased transparency about compensation choices and strategies.⁵⁹ If the information-forcing-substance nature of the regulation works, the fiduciaries are pressed to adhere to their duties when setting compensation. Indeed, if the regulations really work, they give backbone to directors who want to push back on compensation systems.⁶⁰ Either way, each layer of additional regulation pushes on the private–public governance line.

The result is another layer of government governance and publicness. This layer will be different from the earliest disclosure-based ones. Public governance is becoming more textured. The government governance role is becoming increasingly substantive, and it will continue to grow. Once involved in compensation, the government becomes “responsible” for it. Scrutiny and more publicness follows. The cycle builds, and the result is a different system from the deferential, state-law-based one that left compensation largely in the private realm.

In short, compensation decisions are public and politicized. Compensation prompts intense scrutiny because compensation and conflicts are often at the root of governance scandals and risky decision-making. Thus, when the public company fiduciaries fail to manage it—to govern with an awareness of publicness—government occupies the space. Once the government steps in, the scrutiny grows and builds on itself. The shift should not be surprising. Public

56. The SEC Staff at the Division of Corporate Finance reminded companies that the Compensation Discussion and Analysis should focus on the *how* and *why* of compensation decisions. Div. of Corporate Fin., *Staff Observations in the Review of Executive Compensation Disclosure*, SEC. AND EXCH. COMM’N (Oct. 9, 2007), <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>.

57. Proxy Disclosure Enhancements, Securities Act Release No. 9089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092 (Dec. 16, 2009) (providing new disclosure requirements for companies filing proxy or information statements requiring details of material risk in compensation policies and practices).

58. See Mary Hughes, *Heightened SEC Expectations for Disclosure May Require Amended Filings*, *Official Says*, CORPORATE LAW DAILY (BNA), June 3, 2010 (stating that staff was asking companies to confirm that they “went through an analysis” and “were paying attention” to compensation and its impact on risk).

59. See generally Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449 (2001) (analyzing the SEC’s role in disclosure violations, the pursuit of transparency, and the link to corporate fiduciary duties).

60. See, e.g., *New Pressures Forge Stronger Board, CEO Ties*, 1 AGENDA 1 (Jan. 23, 2006) (noting that boards are being pressured “to rigorously challenge management,” and that the result has been improved communications, content at meetings, information, generally better relationships between board and CEO, and increased focus on strategy and decision-making for shareholders).

companies govern subject to public scrutiny in a public governance space. The scrutiny comes from more than just shareholders—the traditional governance partners. It comes from the media and Main Street. Publicness results.

Compensation, then, also provides lessons for public company directors and officers. First, they must accept their publicness. They must understand the importance of being public and their place in this public governance space. They must make their strategic decisions in that context. It does not mean that they cannot make good business decisions, it means that they must. As we have seen, the shareholders, the public, and the government will hold them accountable. The result is the erosion of so-called private-law governance principles and an increase in government governance.

Second, corporate officers and directors need to understand that publicness is here to stay. The Business Roundtable and other industry groups pressed hard for the rollback of provisions in the Sarbanes-Oxley Act, arguing it was bad for business and the capital markets.⁶¹ The Bush Administration also pushed for changes in the form of the Treasury Blueprint.⁶² Scandals and crises followed these efforts, making a decrease in public scrutiny less likely. The message out of these cycles is clear: Public companies will be regulated. They cannot (and will not) do it themselves, and it is not going away.

V

CONCLUSION

Public company fiduciaries must address the expectations of shareholders *and* Main Street about what the company can and will do. They must operate with a sense of their publicness. They must learn to comply with rules and regulations in a public manner. The failure to do so is bad for business.⁶³ Publicness is not just about market status. It is about the media, bloggers, commentators, shareholders, and politicians. It is about Main Street, not about Wall Street. And Main Street is watching.

61. See COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 2–6 (2006) (positing that stringent regulatory policies caused the United States to lose capital market competitiveness); see also Coffee & Sale, *supra* note 20, at 711 n.10 (noting U.S. policymakers have been bombarded with advice and predictions that stricter regulation would cause regulated entities to relocate to less demanding markets).

62. Dep't of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (2008); see also Coffee & Sale, *supra* note 20, at 716 (noting that the “common underlying theme unit[ing] the Blueprint’s separate strands” was decreasing the U.S.’s traditionally aggressive enforcement policies to maintain U.S. capital market competitiveness); Barbara Black, *New Models of Regulating the Financial Markets: The SEC at 75*, 78 U. CIN. L. REV. 445, 449 (2009) (stating that the Blueprint was the product of the “prevailing deregulatory philosophy”).

63. See, e.g., Joe Bel Bruno, *Goldman Hires Public Relations Executive from J.P. Morgan*, DOW JONES NEWSWIRES, June 8, 2010 (reporting that Goldman was facing “populist backlash” and its reputation had taken a beating).